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"The U.S. Economy: An Optimistic Outlook, But With Some Important Risks"

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Greater Boston Chamber of Commerce
Economic Outlook Breakfast 2018

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Good morning. It's a pleasure to be back with the Greater Boston Chamber of Commerce to share my economic outlook.

Before I begin my remarks, let me note as I always do that the views I express are my own, not necessarily those of my colleagues on the Federal Reserve Board of Governors or the Federal Open Market Committee (FOMC or Committee).

Last Friday the Bureau of Labor Statistics released the monthly employment report. While only 103,000 new jobs were created in March, the first quarter as a whole held quite strong job growth. Over the first three months of 2018, the U.S. economy added an average of

202,000 jobs per month – which, over the longer run, is roughly twice as many as would be required to keep the unemployment rate stable at current levels of employment, given the growth in the labor force.

This strong first-quarter job growth occurred even though the labor market is already tight, as indicated by an unemployment rate at 4.1 percent, a rate that most economists consider to be below the sustainable rate of unemployment. Consistent with tight labor markets, wages have been rising, albeit gradually – average hourly earnings rose 2.7 percent over the past year, about three-quarters of a percentage point faster growth than in 2013 and 2014.

The tight national labor market is also reflected in New England. When I talk to employers around the Federal Reserve's First District, which includes the six New England states, I increasingly hear of the difficulty in attracting employees – and more and more business leaders mention the additional tactics their organizations must use to attract the talent necessary to move their businesses forward.

The relative strength of the first-quarter employment growth is consistent with the strong economic forecast provided by monetary policymakers after the Federal Reserve's FOMC meeting in March. The median forecast of Fed policymakers was for the economy to grow somewhat faster in 2018 than earlier in the recovery – specifically, 2.7 percent in 2018 (versus 2.2 percent on average since the recovery began in the second quarter of 2009).[1]

With this growth projected to be fairly strong, the unemployment rate is expected to fall below 4 percent, with inflation rising close to the Federal Reserve's 2 percent target by the end of 2018. These forecasts, it should be noted, also incorporate the assumption of two additional

25-basis-point rate increases in the short-term interest rate during the balance of 2018, beyond the one that occurred at the FOMC's March meeting.

My own views are that labor markets may tighten more than the median SEP forecast suggests, and that inflation is likely to increase a bit more than the current median forecast by FOMC participants. Therefore, I expect somewhat more tightening may end up being needed than is currently reflected in the projected median for the federal funds rate.

Of course, I am talking here about forecasts, not outcomes. Economic forecasts often prove imperfect, with actual results varying from the forecast in part because economists need to make assumptions about variables that are quite hard to predict. Simply put, many important economic decisions are not straightforward. For example, what will happen with tariffs around the world over the course of this year? Will the Organization of the Petroleum Exporting Countries (OPEC) significantly alter its production of oil? And how will foreign economies' monetary policy change? Many of these questions require the forecasting of political outcomes rather than underlying economic relationships – and this is not an area of comparative advantage for economists.

Given this reality, I will spend more time this morning discussing the *risks* around forecasts than I will the forecasts themselves. In particular, I will highlight two important risks to the economy in the short run (trade and overheating) and two potential risks in the long run (reduced capacity of both fiscal and monetary policy to act against downturns).

Let me be clear that I am identifying risks, not making a prediction that they will happen. I think it is important to identify risks worth thinking about and watching for, and underline why policymakers need to continuously monitor incoming economic data and make adjustments should the data come in other than expected.

Exploring the Forecasts from the Summary of Economic Projections (SEP)

Figure 1 provides the actual inflation rate for the core personal consumption expenditures or PCE (the solid line), and the median PCE inflation *forecast* from FOMC participants at the March meeting (the dashed line). As is clear from the chart, we have been undershooting the Federal Reserve's 2 percent inflation target. This undershooting has been largely due to the decline in the relative price of imports from 2014 to 2016, and the decline in telecommunications prices in early 2017. But that shortfall is forecasted to end soon – and it is notable that Committee members expect an overshoot of the Fed's inflation target in the medium term.

Figure 2 shows that the unemployment rate has been declining relatively quickly since the first quarter of 2015, and that Committee members expect the path to level off in the medium term at well below 4 percent. Notably, the median expectation for the longer-run rate of unemployment – usually taken to be policymakers' estimate of the sustainable rate – is 4.5 percent in the March SEP (the horizontal line). Clearly, policymakers expect very tight labor markets in the short and medium term relative to what we expect to prevail in the longer term.

Figure 3 shows the actual path of the federal funds rate from the first quarter of 2015 to the first quarter of 2018, and the median of SEP projections of the federal funds rate's path through the fourth quarter of 2020. The median forecast is for three 25-basis-point increases in 2018 (including the increase which followed the March FOMC meeting) and another three in

2019. So again, it is worth noting that the gradual rise of inflation toward – and then above – its target, and the projection for a falling unemployment rate that dips well below its estimated long-run sustainable level, occur despite the gradual tightening of monetary policy assumed in FOMC participants' forecasts. Importantly, some of the underlying economic strength in these forecasts comes from the projected effects of substantial fiscal stimulus, generated both by tax cuts and by the higher government spending incorporated in the recent federal budget.

In summary, the Committee's median outlook is fairly optimistic. My own forecast calls for an even more pronounced decline in the unemployment rate, given my expectation that cyclical strength in labor force participation will provide only a partial offset to solid gains in payrolls. Despite this positive outlook, I think it is important to consider the risks around this forecast. So now I will touch on what I see as some short-run risks, and then some longer-run risks.

Short-run Risks

The first risk I want to discuss today is one that has been on the front pages of newspapers and has also been reflected in the increased volatility of financial markets recently: the outlook for international trade. **Figure 4** shows exports of goods and services relative to GDP from the first quarter of 2015 through the fourth quarter of 2017. While the United States is less dependent on exports for growth than are many of our major trading partners, exports are still a relatively large component of total goods and services produced in the U.S. economy. At roughly 12 percent of total goods and services, exports play a much smaller role in the overall economy than consumption, which is roughly two-thirds of the U.S. economy. But exports play a larger role than, for example, housing, which accounts for roughly 4 percent of the overall economy. Of course, here I am taking a macroeconomic view of the economy; I recognize that some industries and firms will feel more acutely any changes in the export and trade environment.

Some context is important. It would take a significantly broader set of trade actions than those reported to date to materially reduce the roughly $2.4 trillion in annual U.S. exports. Still, spillover effects are possible, beyond just the industries where exports could be affected by possible trade barriers. There could also be indirect economic effects from trade disputes with important, but difficult to measure, impacts. For example, concerns about possible supply disruptions might cause firms to source supplies from other countries – and the new capacity in these other countries could potentially mean less U.S. investment and employment.

A second possible impact is on prices. As **Figure 5** shows, prices of imported goods grew at a slower pace than overall inflation, thus holding down overall inflation over the last several years. Indeed, imported goods prices fell until about the beginning of 2017, in part because of a strong dollar, although that trend appears to be changing more recently. Of course the imposition of tariffs also pushes up prices that consumers pay for goods impacted by the tariff. In addition, actions to avoid possible tariffs can cause precautionary stockpiling, which can disrupt the flow of orders and cause production bottlenecks. Concerns about these possible disruptions likely explain some of the heightened volatility in stock prices of late.

Beyond trade issues, there is a second short-run risk to the outlook, and it moves in the opposite direction. While I expect the unemployment rate to drop to 3.7 percent by the end of this year, it is possible that unemployment will fall even more rapidly in the short-term. An undesirable "boom-bust" scenario may become more likely if unemployment moves far below where we expect labor markets to settle in the long-run. **Figure 6** shows the difference between the actual unemployment rate and the Congressional Budget Office's (CBO) estimate of the natural rate of unemployment from 1970 to the first quarter of 2018, with recessions shaded. Today, unemployment is already below the CBO estimate of the natural rate. As the graph shows, periods in which unemployment dipped significantly and persistently below the estimated natural rate historically have tended to generate conditions that resulted in a recession.

While labor markets provide important indicators of potential unsustainability, it is important to be alert to *financial* stability issues as well. As **Figure 7** shows, the spreads between corporate bonds and 10-Year U.S. Treasuries have fallen to relatively low levels, and several academic studies have highlighted that the investor confidence that generates low credit spreads often precedes subsequent economic reversals.[2]

Let me reiterate that I am not forecasting significant trade disruptions or substantial boom-bust problems. But the risk that they could develop means we must be very carefully monitoring incoming data to see if they indicate an increased probability that these risk scenarios could occur.

Long-run Risks

There are also longer-run risks that should be considered at this juncture in the economy. With monetary policy still relatively accommodative, and fiscal policy quite accommodative, it seems unlikely that the economy would perform poorly in the near term. However, it is important to consider whether some of that accommodation may potentially generate risks that play out over the longer term.

One of the risks is illustrated by the CBO projection of public debt levels that was recently released. Gross federal debt as a percentage of GDP, shown in **Figure 8,** has been rising over the past decade. The dotted line shows the current projection through 2028. This debt-to-GDP ratio will rise to levels not seen since just after World War II. My concern is this: by using up so much fiscal capacity now – by which I mean the ability to lower tax rates or boost federal spending to offset economic weakness – the country risks not having sufficient fiscal capacity in the future when it might be needed. And this lack of *fiscal* capacity would be particularly troubling if *monetary* policy could not aggressively offset adverse shocks.[3]

Figure 9 shows that there is also some reason to be concerned about how aggressively monetary policy can respond to a large adverse shock. At the onset of most previous economic recessions, short-term interest rates were quite high. This provided plenty of room to reduce interest rates as the economy went into recession. The one time that short-term interest rates reached zero in recent history was in the aftermath of the Great Recession. Once the FOMC cut the short-term policy rate to its effective lower bound, reaching the limit of stimulus from that tool, the Federal Reserve employed its balance sheet to purchase longer-term assets, thus lowering longer-term interest rates and providing further monetary accommodation and stimulus. These actions, which I fully supported, were nonetheless politically controversial and the subject of some debate among economists.[4]

So how much room do we expect to have to lower interest rates in response to future recessions? The Federal Reserve's SEP includes a forecast of where short-term interest rates will settle in the long run. The most recent median forecast for the longer-run federal funds rate is 2.9 percent, which is quite low by historical standards. The underlying reason for this is that most Committee members expect real interest rates to be quite low, due to a demographically driven slowing in labor force growth coupled with slow growth in productivity. Combined with a 2 percent inflation goal, this implies low long-run, short-term policy rates, implying that on average we could lower rates by less than 3 percentage points in response to a recession. Since in many recessions we lower rates by as much as 5 percentage points, it is quite likely that interest rates would reach zero again in a downturn.

Certainly expanding the Federal Reserve's balance sheet, and perhaps using other less-conventional monetary policy interventions, can help support the economy, should it be needed.[5] However, several questions and concerns exist. How effective will these unconventional tools be in offsetting adverse shocks? Is there significant opposition among the public and Congress to the Fed using nontraditional tools? How limited will fiscal policy be in buffering an adverse shock or downturn? These questions, while a bit sobering, highlight the need to increase the potential of policy buffers to respond to possible future problems.

Concluding Observations

The outlook for the economy projected by participants in the March FOMC meeting is quite positive. My own forecast is somewhat stronger in terms of unemployment rates and inflation outcomes than the SEP forecast, which is why I am in favor of somewhat more tightening than the median FOMC member. However, a forecast of the most likely outcome is not a promise, and there are important potential risks to that forecast. Disruptive international trade actions or increasing the risk of a boom-bust economy by overextending could, in my view, prove problematic for the economy. And the status of fiscal and monetary "buffers" call into question their ability to work against a shock or downturn.

I am hopeful that the risks I have discussed can be avoided. Assuming these near term risks are avoided, my own forecast is somewhat stronger than the SEP forecast. Of course, I would support a somewhat faster increase in the federal funds rates if that stronger growth does indeed occur.

In sum, the economic outlook is good, but we must all be attuned to what could go wrong in the short term and in the long term, and what that implies for appropriate monetary policy.

Thank you.

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[1] Measured as the percent change in real GDP from the fourth quarter of 2017 to the fourth quarter of 2018.

[2] See for example, López-Salido, David, Jeremy C. Stein, and Egon Zakrajšek. 2017. "**Credit-Market Sentiment and the Business Cycle**." Quarterly Journal of Economics 132 (3): 1373-1426; Gilchrist, Simon, Vladimir Yankov, and Egon Zakrajˇsek, "Credit Market Shocks and Economic Fluctuations: Evidence From Corporate Bond and Stock Markets," *Journal of Monetary Economics*, 56 (2009), 471–493. Gilchrist, Simon, and Egon Zakrajˇsek, "Credit Spreads and Business Cycle Fluctuations," *American Economic Review*, 102 (2012), 1692–1720.

[3] For additional perspective, see remarks by Eric S. Rosengren: "Monetary, Fiscal, and Financial Stability Policy Tools: Are We Equipped for the Next Recession?" delivered on March 23, 2018, in Washington D.C. It also highlights the importance of macroprudential tools such as the countercyclical capital buffer.

[4] That debate included disagreement over the efficacy of such actions, as well as concerns about whether the Federal Reserve was engaging in credit allocation by purchasing mortgage-related securities. In my view, there is room for debate over the former, especially as the Fed embarked on more and more rounds of asset purchases; I am less concerned that the Fed has any intention of allocating credit to particular sectors in this way. I for one am a proponent of such actions when necessary.

[5] For additional perspective, see remarks by Eric S. Rosengren: "Considering Alternative Frameworks: an Inflation Range with an Adjustable Inflation Target," delivered on Jan. 12, 2018 in San Diego, California.