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"The Economic Outlook – and Two Risks to the Forecast that are Worth Watching"

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The views expressed today are my own, not necessarily those of my colleagues on the Federal Reserve Board of Governors or the Federal Open Market Committee.

Good morning, it is a pleasure to be with you today. Participating in the CBIA's outlook event is always a great way to start the new year.

We end 2019 and begin 2020 with an economy that is doing quite well. The labor market is strong, with the national unemployment rate at 50-year lows. Inflation is somewhat below 2 percent, the Federal Reserve's target, but is projected to gradually return to 2 percent.

In addition, most professional forecasters are expecting the good news to continue in 2020. The consensus forecast has real GDP growing roughly at potential; the unemployment rate remaining near its historically low range of last year; and inflation approaching the Fed's 2 percent target. Financial markets, too, appear optimistic about the economy's prospects, with stock market indices ending the year close to all-time highs.

These elements of the forecast for 2020 have not changed much over the past year. Yet the current outlook for 2020 is conditioned on a much more accommodative stance for monetary policy. At this time last year, the members of the Fed's monetary policy committee – the Federal Open Market Committee, or FOMC – were anticipating interest rate *increases*, given the tight labor markets and the expectation that inflationary pressures would build as a result. With the outbreak of trade-related concerns and worries over a potential global slowdown, the FOMC voted to reduce the federal funds rate three times during 2019 to insure against the risk of an economic downturn. As we closed out the year, it was clear that labor markets remained strong and the economy continued to grow faster than its estimated potential.

In the December Summary of Economic Projections (SEP), FOMC members provided their outlooks for economic conditions in 2020, the consensus of which was quite similar to that of private forecasters. The SEP forecast also includes a projection of expected monetary policy rates, the so-called dot plot, which shows the path for monetary policy consistent with FOMC members' forecasts. The December dot plot showed no change in the median interest rate from 2019 to 2020, but has rates rising very gradually next year and beyond. Such a forecast reflects what the FOMC policymakers think is the most likely outcome, but it goes without saying that the economy rarely evolves exactly as expected.

Today, I will focus on the economic outlook for 2020 – and two potential risks to the outlook that could arise, should the economy grow faster than expected due to the accommodative stance of monetary policy.

The first potential risk I will discuss has to do with the acceleration of inflation, in that there is the possibility that labor markets could tighten to unsustainable levels, causing inflationary pressures to build faster than the very gradual pace that is currently expected. The second potential risk I will discuss has to do with financial stability, in that persistently low interest rates could lead consumers and firms to take on riskier financial investments in search of better returns, increasing asset prices to unsustainable levels. There are also, of course, risks that the economy could underperform, and these derive primarily from geopolitical and trade risks. I have focused some on these risks in previous talks.[1] But to preview my conclusion: If these risks remain contained, my view is we will likely have another year of good economic outcomes.

Overview of the Economic Outlook

Over the most recent two quarters, real GDP has grown close to 2 percent, somewhat above what economists believe is the economy's potential growth rate. My own estimate of that rate is about 1.75 percent. By that calculus, the economy has recently been growing somewhat faster than its potential rate, and correspondingly unemployment declined a bit, over 2019.

Figure 1 shows actual GDP growth as a solid line, and then provides the forecast of FOMC participants (the median of their projections in the SEP) through 2022, shown as squares. It shows that the median forecast of Fed policymakers is for future real GDP growth to be 2 percent in 2020, then 1.9 percent in 2021, and then 1.8 percent in 2022.[2] The SEP also includes the median of estimates for growth in the longer run (potential growth), which is 1.9 percent – slightly higher than my own estimate. But in sum, the median of these forecasts anticipates annual GDP growth to be around the level we have seen recently, and close to Committee members' estimates of potential.

Turning from growth to labor markets, over the past nine months the unemployment rate has remained in a relatively tight band, ranging from 3.5 to 3.7 percent. As is consistent with a growth estimate close to the economy's potential, the median forecast of Fed policymakers is for the unemployment rate to remain in this narrow band, as **Figure 2** shows.

FOMC members' current median estimate of the unemployment rate in the longer run is 4.1 percent. This estimate has declined noticeably over the past two years, as the actual unemployment rate fell below 4 percent and even so, inflation remained somewhat below the Fed's 2 percent target. My own estimates are for the unemployment rate to be somewhat below the SEP median projections for 2020 through 2022, and for longer-run unemployment to be somewhat higher than the Committee's median projection of 4.1 percent.

Turning to prices, the inflation rate has continued to be somewhat lower than the Fed's 2 percent inflation target. The SEP median forecast has core inflation ending 2020 at 1.9 percent and hitting the 2 percent target in the following two years, as shown in **Figure 3**. By the way, it is worth noting that while the current core inflation rate is only 1.6 percent, there were very low readings last spring which will fall out of the annual average this spring. And more recent annualized quarterly readings have been much closer to 2 percent. So while there remains uncertainty about the trajectory for inflation, I personally do expect readings at or around the 2 percent target in the future.

In addition, the current federal funds rate is well below the 2.5 percent rate the Committee expects in the longer run, so monetary policy is currently accommodative. Given the stability of the forecasts for GDP growth, unemployment and inflation, it is not surprising that the median forecast for interest rates (shown in **Figure 4**) is for no change this year and gradual increases over the next two years. Certainly, the lack of inflationary pressure to date has provided one justification for accommodative monetary policy despite the duration of the recovery and a current historically low unemployment rate. However, maintaining interest rates below the consensus longer-run "equilibrium" interest rate is predicated on both inflationary pressures not building up and financial stability concerns being contained.

Overall, the SEP medians project a very benign outlook, with what can be considered an almost ideal economic outcome: Inflation returning to target, labor markets remaining quite strong, and economic growth close to potential. However, as I mentioned in my introduction, the world rarely unfolds exactly as forecast. So it is important to consider some of the risks that could cause significant deviations from this rather positive forecast.

Risks to the Forecast: Acceleration of Inflation

Since the financial crisis of 2008, the inflation rate has fairly persistently undershot the Fed's target of 2 percent, which we use in pursuing our assigned mandate of price stability. Undershooting the target for most of the period since the crisis was not especially surprising, given the slack in resource utilization caused by the severe recession. However, the more recent absence of significant inflationary pressures – despite very low unemployment rates – has been more surprising. In fact, given historically low unemployment rates, most forecasters have systematically expected more inflation than has actually occurred.

The inverse relationship between the unemployment rate and the inflation rate – high unemployment is associated with lower inflation, other things equal, and *vice versa* – is often referred to as the "Phillips Curve," named after New Zealand economist A.W. Phillips, who first observed the regularity of the pattern. This relationship was more apparent up until the mid-1990s, but it has become noticeably weaker over the past 25 years. There are many potential explanations for the smaller effect of unemployment on inflation, including the somewhat diminished size and influence of labor unions and more effective inflation targeting by central banks. Whatever the reasons, the relationship has undeniably weakened, with inflation remaining below 2 percent despite the unemployment rate reaching 50-year lows.

One implication of low inflation and low nominal interest rates is that there is very little room for monetary policy to react to an economic downturn by reducing rates. Currently, with nominal interest rates and inflation below two percent, Fed policymakers have much less room to reduce short-term interest rates before hitting the effective lower bound than they did in recent recessions. In addition, prevailing *long*-term rates are lower, because of lower expected inflation and lower inflation risk premia. This leaves policymakers with less room to use large-scale asset purchases to push down long-term rates, should they hit the effective lower bound with the short-term rates they influence.[3]

While private forecasts and the Fed's SEP expect low inflation and low interest rates, I would note that this is predicated on inflation continuing to be tame. However, we should acknowledge that there are relatively few cases where the unemployment rate and the Fed's policy interest rate both remained well below their estimated long-run values for an extended time.

As a result, one risk that could alter the outlook is if inflationary pressures build up more quickly than currently expected. Admittedly, with little room currently to lower rates in a downturn, inflation somewhat exceeding projections could be a good thing. But economists do not have a very precise understanding of how inflation expectations form, and of course an economy eventually running too hot could increase inflationary pressures.

Figure 5 shows that average hourly earnings have been trending up over the past five years, although in the most recent report released last Friday, the preliminary figures indicate a pause, which will be followed closely in terms of the trend. While some of this increase is consistent with wages that reflect inflation a bit below 2 percent, and productivity growth of about 1 percent, we see some evidence that a strong labor market is placing additional upward pressure on wages, as the wages of nonsupervisory workers have risen more quickly. Let me be clear – sustainable wage growth is a good thing. But with higher minimum wages, and more wage pressures for low-wage workers, wage inflation that noticeably exceeds the sum of productivity growth and inflation may result in price pressures, particularly in sectors that do not face import competition, such as services.

Again, to some degree, wage increases need not be inflationary if they are offset by increased productivity. However, the growth in productivity has been modest in recent years, as shown in **Figure 6.**

Also, real wage gains in excess of productivity growth tend to be reflected in a weakening of corporate profits relative to GDP. As shown in **Figure 7,** corporate profits relative to GDP have been tailing off in recent years. While lower corporate profit margins are one way to absorb wage pressures without raising prices, relatively lower corporate earnings of late may make absorbing increased wage costs less likely.

To the extent that firms are unable or unwilling to absorb the rising costs as wages respond to low unemployment, we may observe the associated inflation risk materializing. Admittedly, most forecasters do not expect this in their modal (most likely outcome) forecast. But more rapid than expected inflation remains a risk of running the economy with accommodative monetary policy *and* tight labor markets.

Risks to the Forecast: Financial Stability

As a practical matter, central bankers do not have much historical experience with extended periods where interest rates are running below the estimated equilibrium level while unemployment rates are, simultaneously, historically low. So we want to be alert to any potential risks emerging. In my view, another potential risk is that low interest rates and a booming economy will encourage investors to increasingly "reach for yield" – that is, they will take on more risk in order to raise the nominal returns they are receiving (since the associated risk premiums embedded in the returns to riskier assets compensate for that added risk).[4]

Real estate is an area of the economy that is historically susceptible to this risk-taking. Both residential and commercial real estate are sensitive to the level of interest rates, and are widely held as collateral by leveraged financial institutions.[5] Some of the more severe recessions, both in the U.S. and abroad, have occurred when real estate prices collapsed and the financial positions of highly leveraged institutions and households became precarious. That is, the debt they held came to greatly exceed the value of the assets they had borrowed against.

Figure 8 shows the change in house prices relative to per capita personal income since 2015, for the United States and several European nations. An increase in the index indicates purchasing a home is less affordable, as income is not increasing as rapidly as house prices. The index has risen almost 10 percent in the U.S. since 2015, as housing prices have been rising faster than per capita personal income. In some countries – like Portugal, the Netherlands, and Germany, the index and house prices have risen much more sharply since 2015. Low interest rates – in some cases negative – may be spurring house price increases.

Similarly, there continue to be decreases in the capitalization rates of commercial real estate properties. A low capitalization rate – the ratio of net operating income to the price of the property, at the time of the transaction, shown in **Figure 9** – implies relatively high valuations compared to the income the property is expected to generate, which is a sign of inflated asset prices. Fortunately, some sectors have seen capitalization rates decreasing less rapidly of late.

In sum, it is important to see and understand the risk that sustained low interest rates could place more pressure on real estate asset prices through reach-for-yield behavior – a scenario that preceded the 1990 and 2007 recessions. In certain scenarios, financial stability risks could potentially emerge as a problem for the otherwise benign outlook.

Concluding Observations

To summarize and conclude, private forecasters and FOMC participants anticipate a good outcome for the economy in 2020 and beyond, with low inflation and strong labor markets. However, as with any forecast, there are risk scenarios that are not captured in the most likely outcome for the economy. I have highlighted two potential risks that I will be monitoring this year – inflation picking up more than currently expected; and asset prices, particularly real estate prices, showing evidence of more acute financial stability risks. To be fair, there are also downside risks to the economic outlook, as well – primarily centered on the potential for trade disruptions and slowing growth among our trading partners. But I see the potential risks to inflation and financial stability as somewhat more concerning, overall.

Thank you again for inviting me to participate in today's forum. Best wishes to *all* in Connecticut, New England, and the nation for a positive and prosperous 2020.

[1] For example, see additional discussion in my talk, "Exploring Economic Conditions and the Implications for Monetary Policy," Oct. 11, 2019.

[2] Measured on a fourth quarter to fourth quarter basis.

[3] Currently, with nominal interest rates below 2 percent, Fed policymakers have less than 2 percentage points to lower rates in the event of a downturn – less than one-half the amount by which they typically lowered rates to fight past recessions. In addition, prevailing *long*-term rates are lower now than in the past because of lower expected inflation, lower inflation risk premia, and the lower term premia that our large-scale asset purchases engendered. This leaves policymakers with correspondingly less room to lower long-term rates through such purchases, a policy that proved effective in spurring the economy following the last recession once the Fed had pushed short-term interest rates to their effective lower bound. The lack of room to cut rates if needed certainly amplifies any downside risk to the forecast.

[4] See, for example, Lina Lu, Matthew Pritsker, Andrei Zlate, Kenechukwu Anadu, and Jim Bohn, "Reach for Yield by U.S. Public Pension Funds," Federal Reserve Bank of Boston, Supervisory Research and Analysis Working Papers 2019, Series 19-2. Other papers have found reach-for-yield behavior in other investor types, including insurance companies.

[5] For more discussion, see my talk, "Financial Stability and Regulatory Policy in a Low Interest Rate Environment," Nov. 11, 2019.