FEDERAL RESERVE BANK of ST. LOUIS

Remarks on the 2018 U.S. Macroeconomic Outlook

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29th Annual Economic Outlook Conference
Gatton College of Business and Economics
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Feb. 6, 2018
Lexington, Ky.

Any opinions expressed here are my own and do not necessarily reflect those of the Federal Open Market Committee.

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Introduction

Key themes in this talk

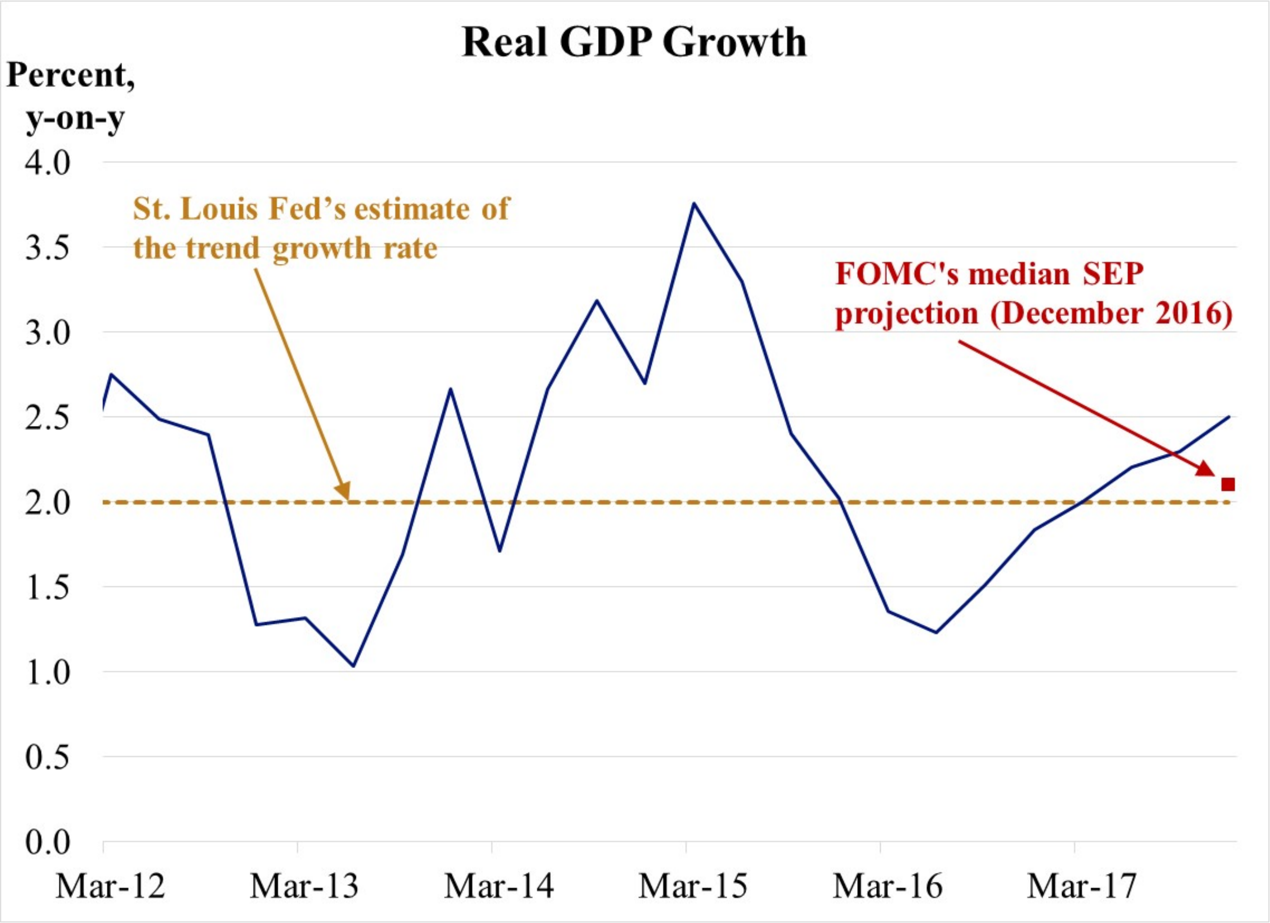
- U.S. real GDP growth surprised to the upside during 2017. The natural prediction from here would be that growth will now slow toward trend during 2018 and 2019.
- The possibility of a tax-driven investment boom in the U.S. leans against this type of forecast.
- Inflation remains low. Continued strong labor market performance is unlikely to translate into meaningfully higher inflation because Phillips curve effects are weak.
- Inflation expectations have moved more in line with the 2 percent inflation target of the Federal Open Market Committee (FOMC).
- Monetary policy is closer to neutral today.

The 2017 Economic Growth Surprise

Real GDP growth surprised to the upside

- The U.S. real GDP growth rate in the fourth quarter was 2.5 percent, measured from one year earlier, against a trend growth rate that we at the St. Louis Fed think is about 2.0 percent.
- As of December 2016, the FOMC median projection for 2017 growth was 2.1 percent, so the upside surprise in 2017 was arguably modest.
- The U.S. was joined by other large economies in achieving better-than-expected growth. This fed into the profits of U.S. multinationals, which helped U.S. equity prices rally in 2017.
- The natural forecast to make at this point would be that growth will slow toward the trend pace during 2018 and 2019.

The 2017 U.S. economic growth surprise



Sources: Bureau of Economic Analysis and Federal Reserve Board. Last observation: 2017-Q4.

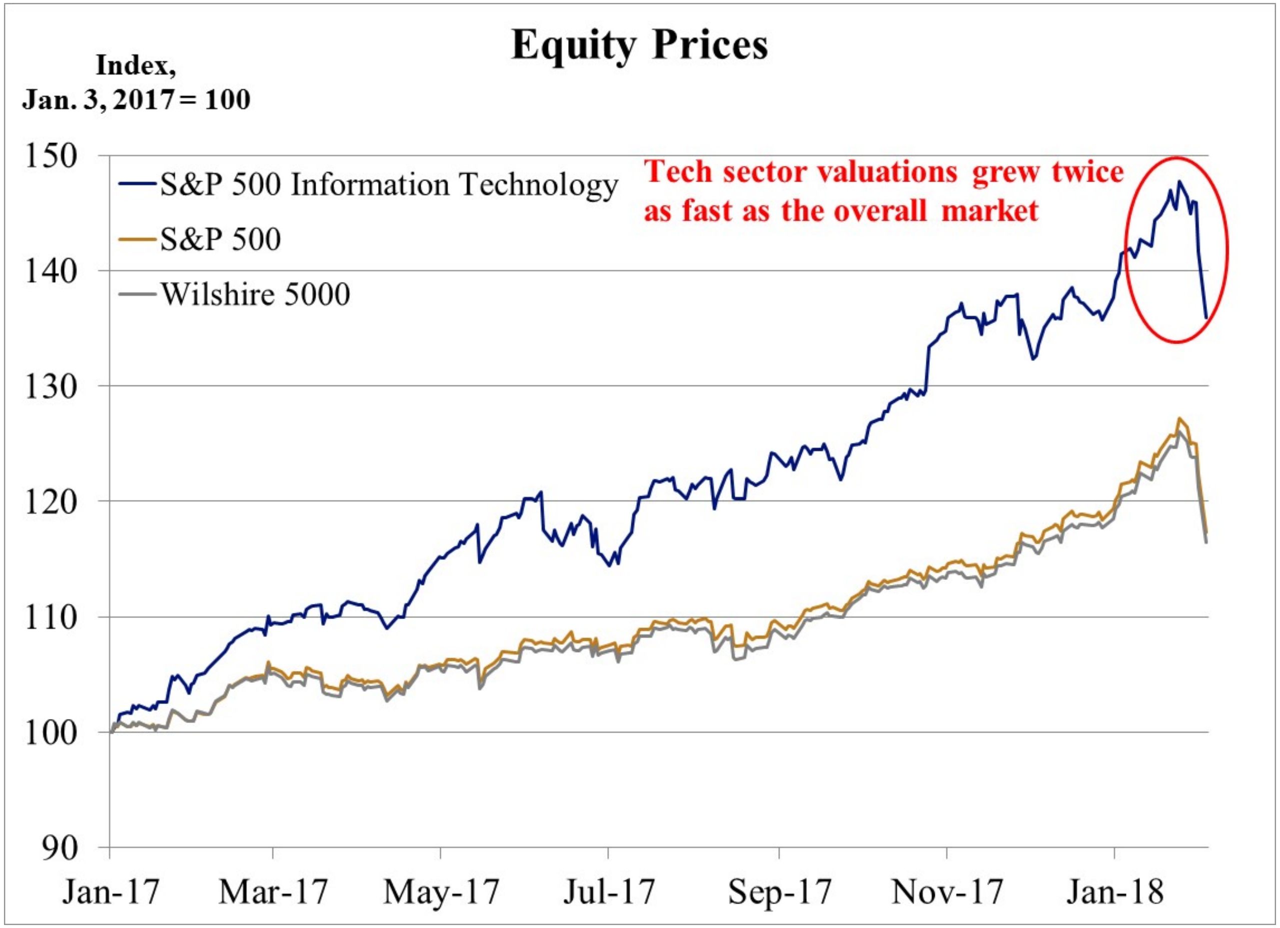
The 2017 global growth surprise

Country	IMF Projection for 2017 as of October 2016	2017 Q4-on-Q4	Growth surprise (percentage points)
United States	2.2%	2.5%	+0.3
Euro area	1.5%	2.7%	+1.2
United Kingdom	1.1%	1.5%	+0.4
Japan	0.6%	2.1%*	+1.5
China	6.2%	6.9%	+0.7

** 2017 Q3-on-Q3.*

Sources: International Monetary Fund World Economic Outlook, October 2016*; Bureau of Economic Analysis; Eurostat; Economic and Social Research Institute (Government of Japan); National Bureau of Statistics of China and author's calculations.*

Equity valuations rally on global growth



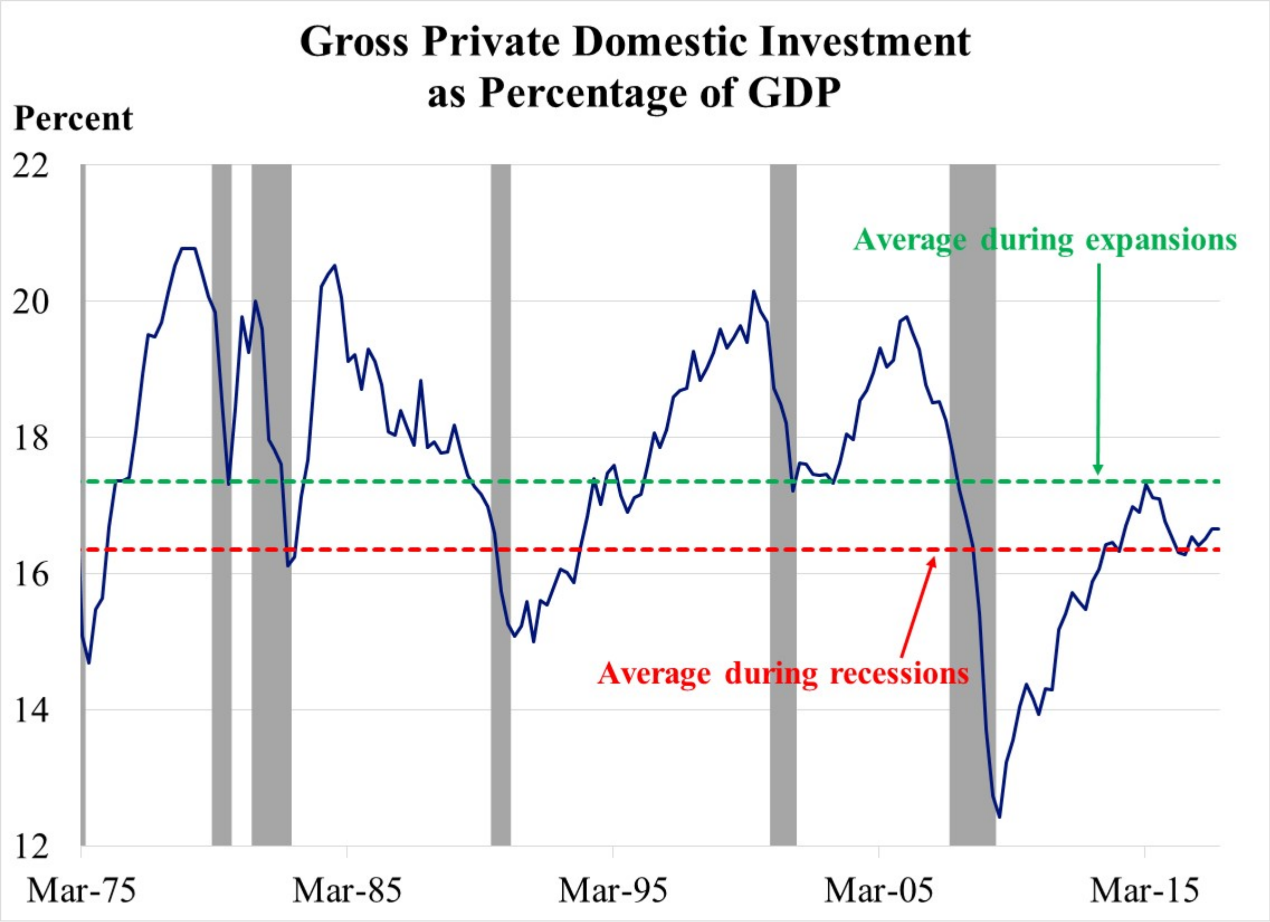
Sources: Bloomberg and author's calculations. Last observation: Feb. 5, 2018.

An Investment Boom in 2018?

Will tax reform fuel an investment boom?

- The recent reform of the U.S. tax code lowered the corporate tax rate and made other changes designed to spur investment.
- Investment has been relatively low during the last 8 years.
- If investment returns to its average from past expansions, growth in the U.S. will improve.
- Most forecasters seem to be hedging their bets on whether or not an investment boom will materialize.
- An investment boom is not my baseline case, but I am keeping a close watch on this issue.

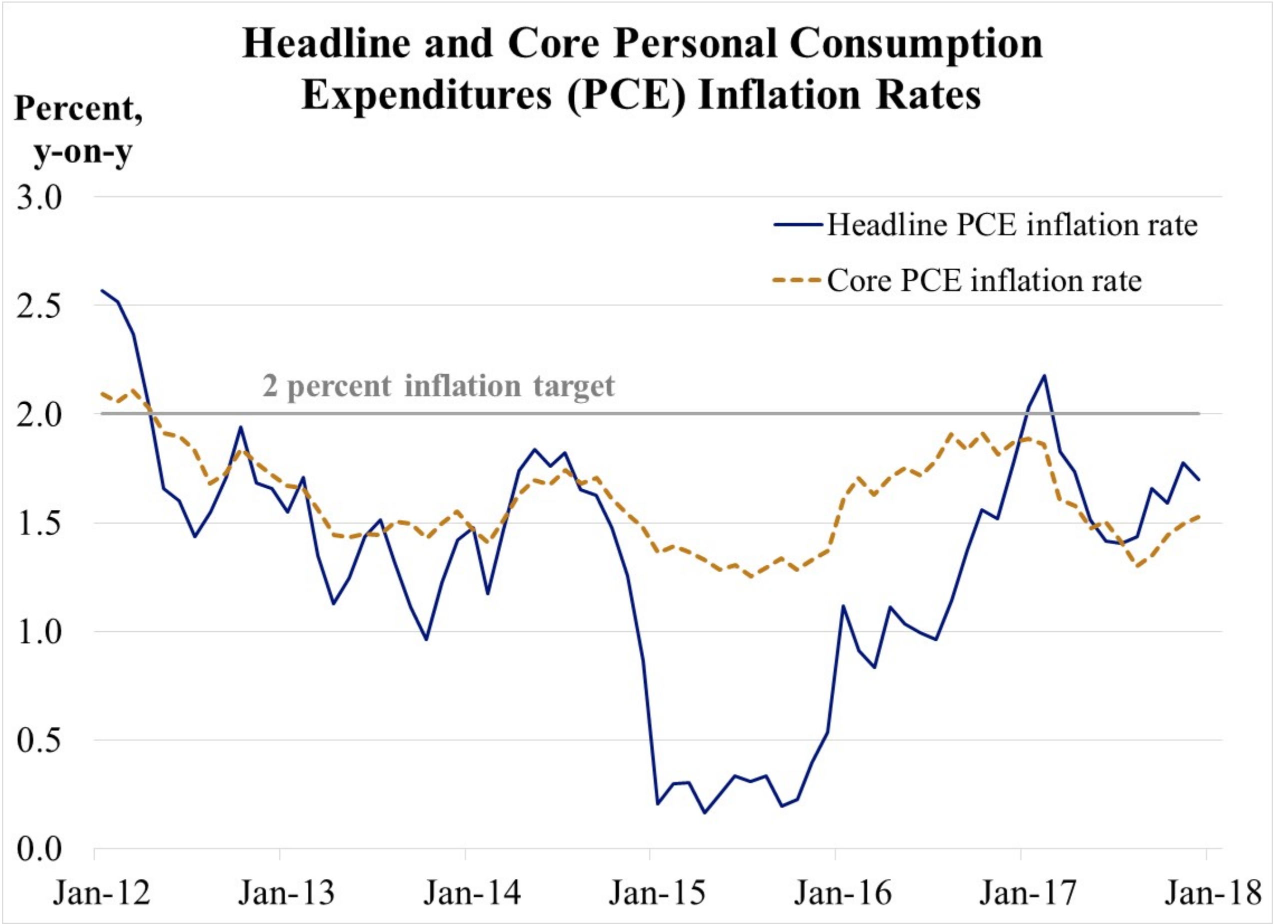
Investment has been low



Sources: Bureau of Economic Analysis and author's calculations. Last observation: 2017-Q4. The shaded areas indicate NBER recessions.

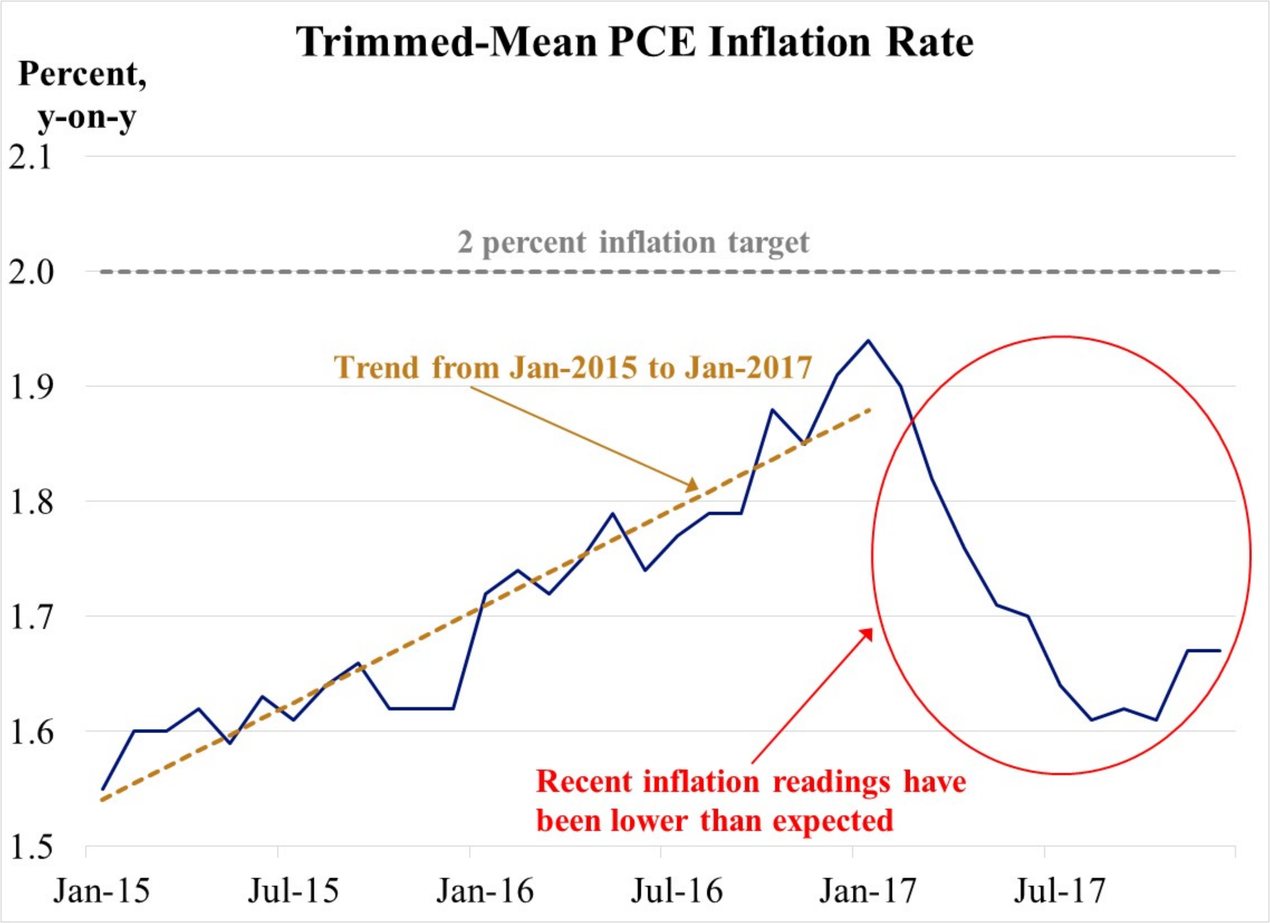
Inflation Remains Low

U.S. inflation has been mostly below target since 2012



Source: Bureau of Economic Analysis. Last observation: December 2017.

Trimmed-mean PCE inflation lower than expected in 2017

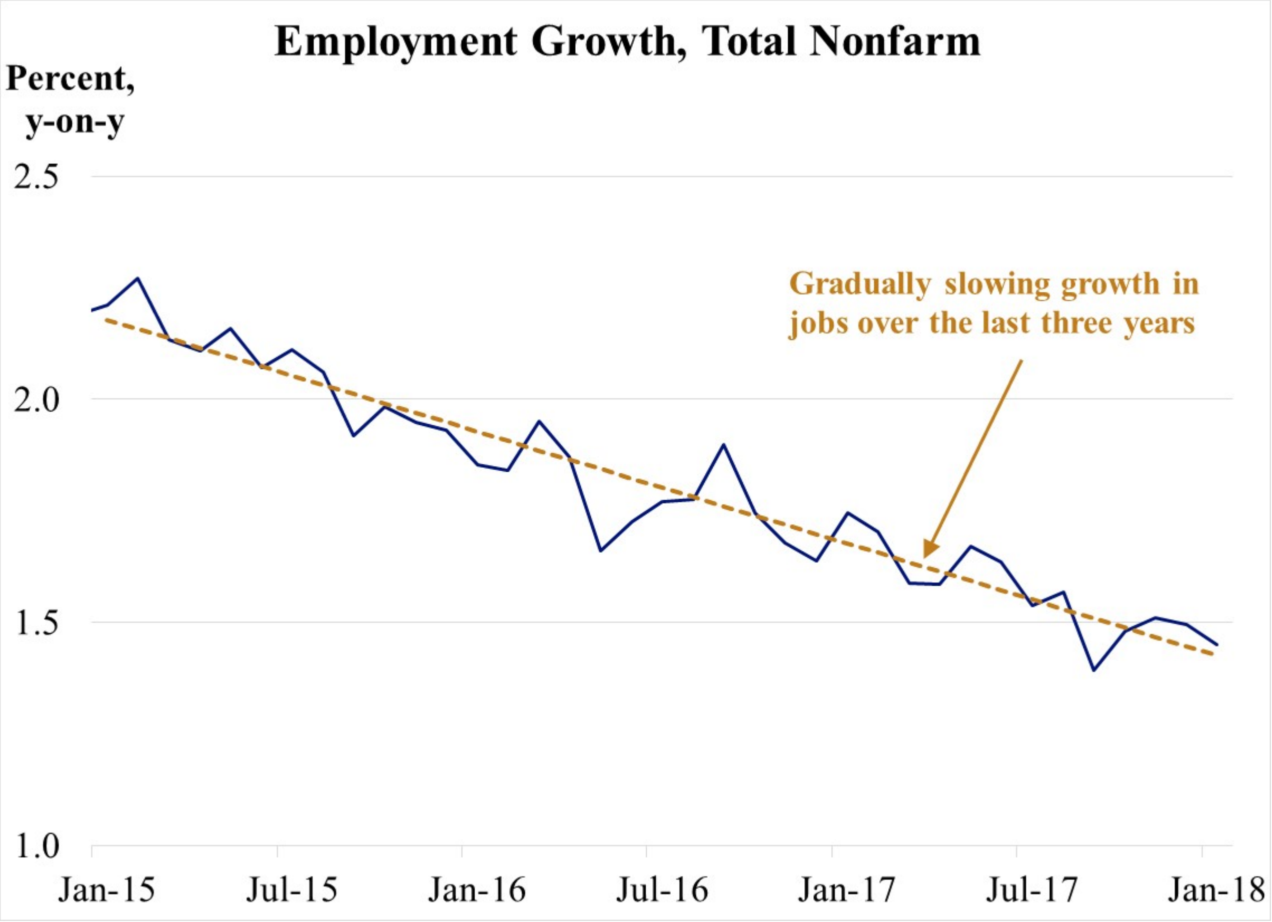


Sources: FRB of Dallas and author's calculations. Last observation: December 2017.

The outlook for inflation

- The low readings on inflation during 2017 occurred against a backdrop of relatively good labor market performance and a still historically low policy rate.
- The recent report on jobs was good, with the BLS reporting 200,000 jobs created and the unemployment rate holding steady at 4.1 percent in January.
- I caution against interpreting good news from labor markets as translating directly into higher inflation.
- The empirical relationship between these variables has broken down in recent years and may be close to zero.

Jobs growth slowing but still robust

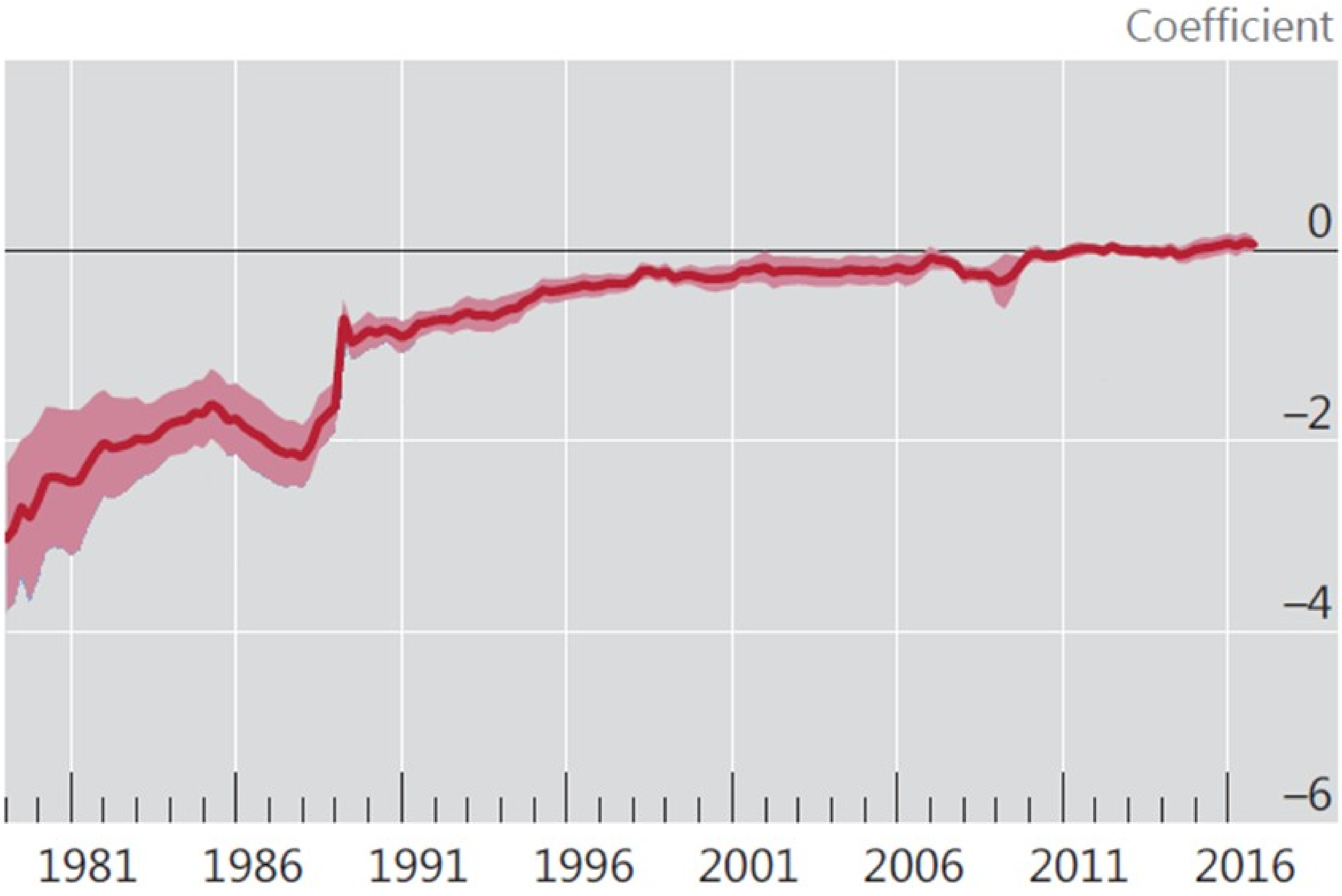


Sources: Bureau of Labor Statistics and author's calculations. Last observation: January 2018.

Some recent estimates of the key Phillips curve parameter

- The latest annual report of the Bank for International Settlements has published some statistical estimates of the relationship between inflation and measures of resource utilization, like unemployment.
- They used rolling 15-year samples of data from G-7 economies and averaged across the results.
- The relationship used to be reliably negative: Lower unemployment led to higher inflation.
- But in recent years, the relationship has not been significantly different from zero.

The disappearing Phillips curve

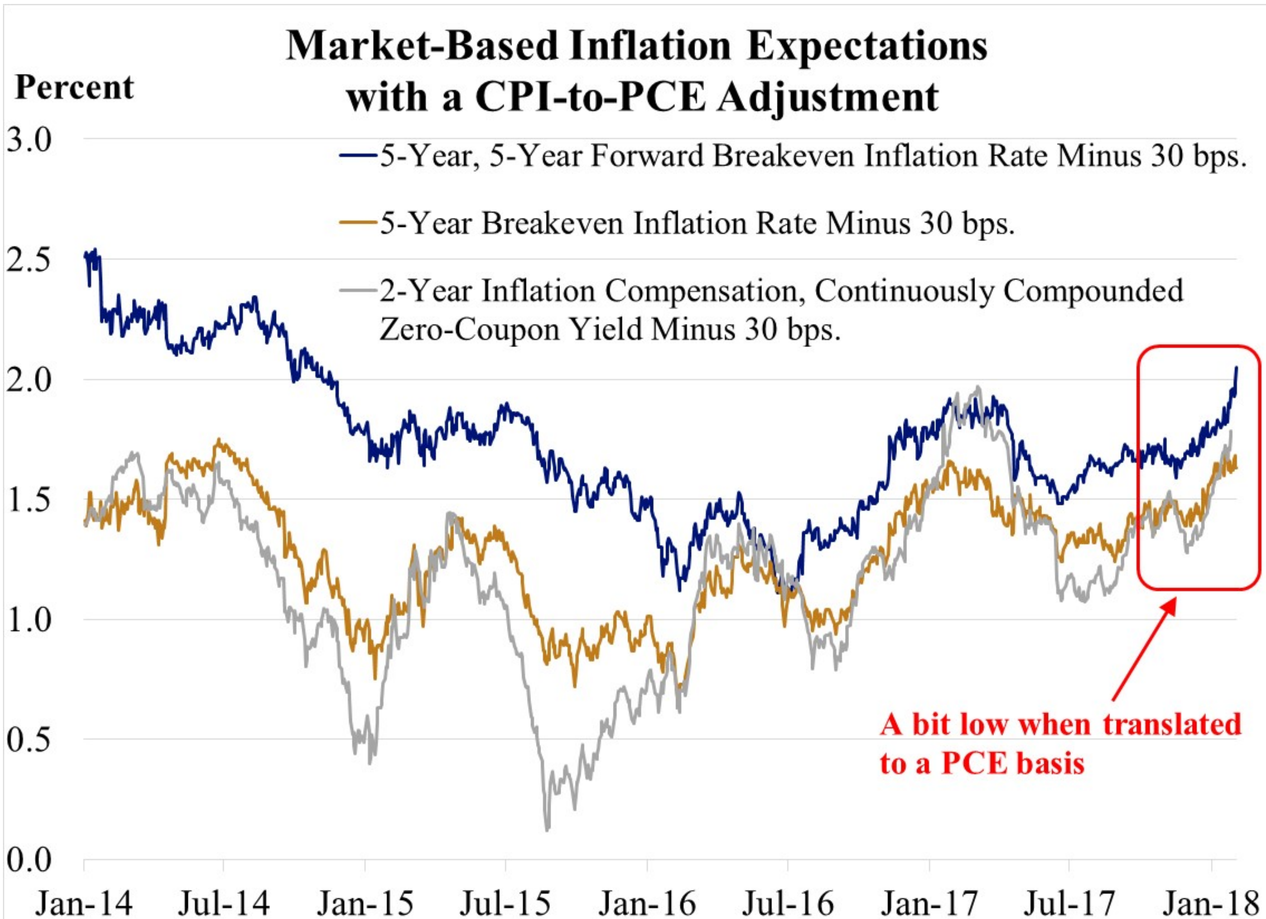


Note: Rolling 15-year window estimates and confidence bands from a panel of G-7 economies.
Source: Bank for International Settlements (2017).

Inflation expectations have increased but remain a bit low

- According to modern theory, a variable that may give a signal of future inflation is inflation expectations.
- Market-based measures of inflation compensation have moved higher recently.
- The measures today are closer to being in line with the FOMC's 2 percent inflation target, but remain a bit low.
- The market-based measures are for consumer price index (CPI) inflation, and so we adjust them downward somewhat to roughly translate into PCE inflation.
    - Historically, PCE inflation has run somewhat lower than CPI inflation.

Inflation expectations remain a bit low



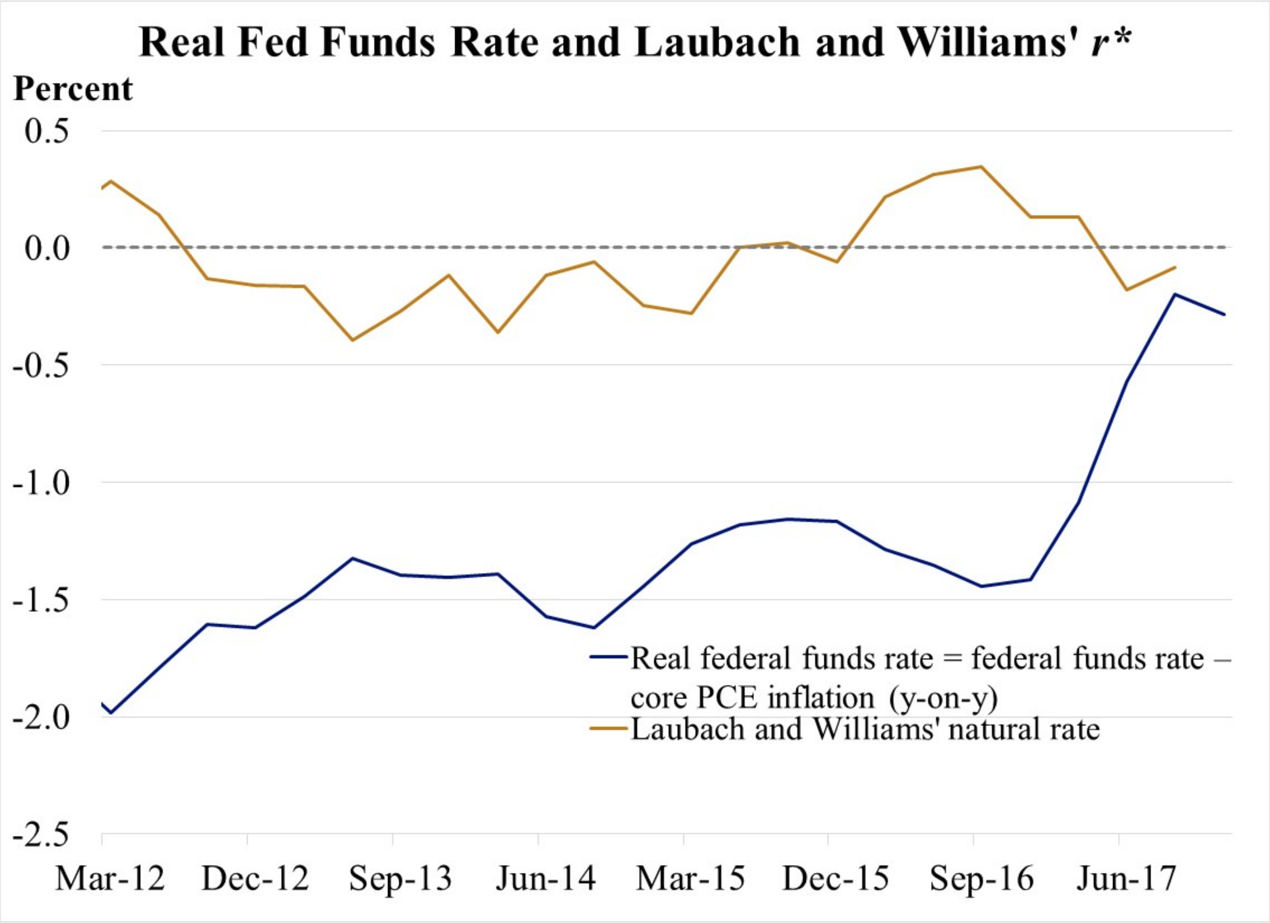
Source: Federal Reserve Board. Last observations: Feb. 2 (breakeven inflation rates) and Jan. 26, 2018.

Monetary Policy

The monetary policy stance

- The FOMC has begun to reduce the size of its balance sheet, gradually reversing the quantitative easing programs that characterized U.S. monetary policy while the policy rate was near zero.
- The policy rate range has been increased gradually and now stands at 1.25 – 1.50 percent.
- Current estimates of the neutral real rate, commonly called r^*, are near zero.
- With core PCE inflation at 1.5 percent, the current policy rate setting minus PCE inflation is near r^*, suggesting the current policy setting is closer to neutral than in previous years.

Monetary policy closer to neutral



Sources: Federal Reserve Board, Bureau of Economic Analysis, FRB of San Francisco and author's calculations. Last observations: 2017-Q4 and 2017-Q3.

Conclusion

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- The natural prediction from here would be that U.S. real GDP growth will now slow toward trend during 2018 and 2019.
- The possibility of a tax-driven investment boom in the U.S. leans against this type of forecast.
- Inflation remains low. Continued strong labor market performance may not reliably translate into meaningfully higher inflation.
- Inflation expectations have moved more in line with the 2 percent inflation target.
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