FEDERAL RESERVE BANK *of* ST. LOUIS

Some Consequences of the U.S. Growth Surprise

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Introduction

Main ideas

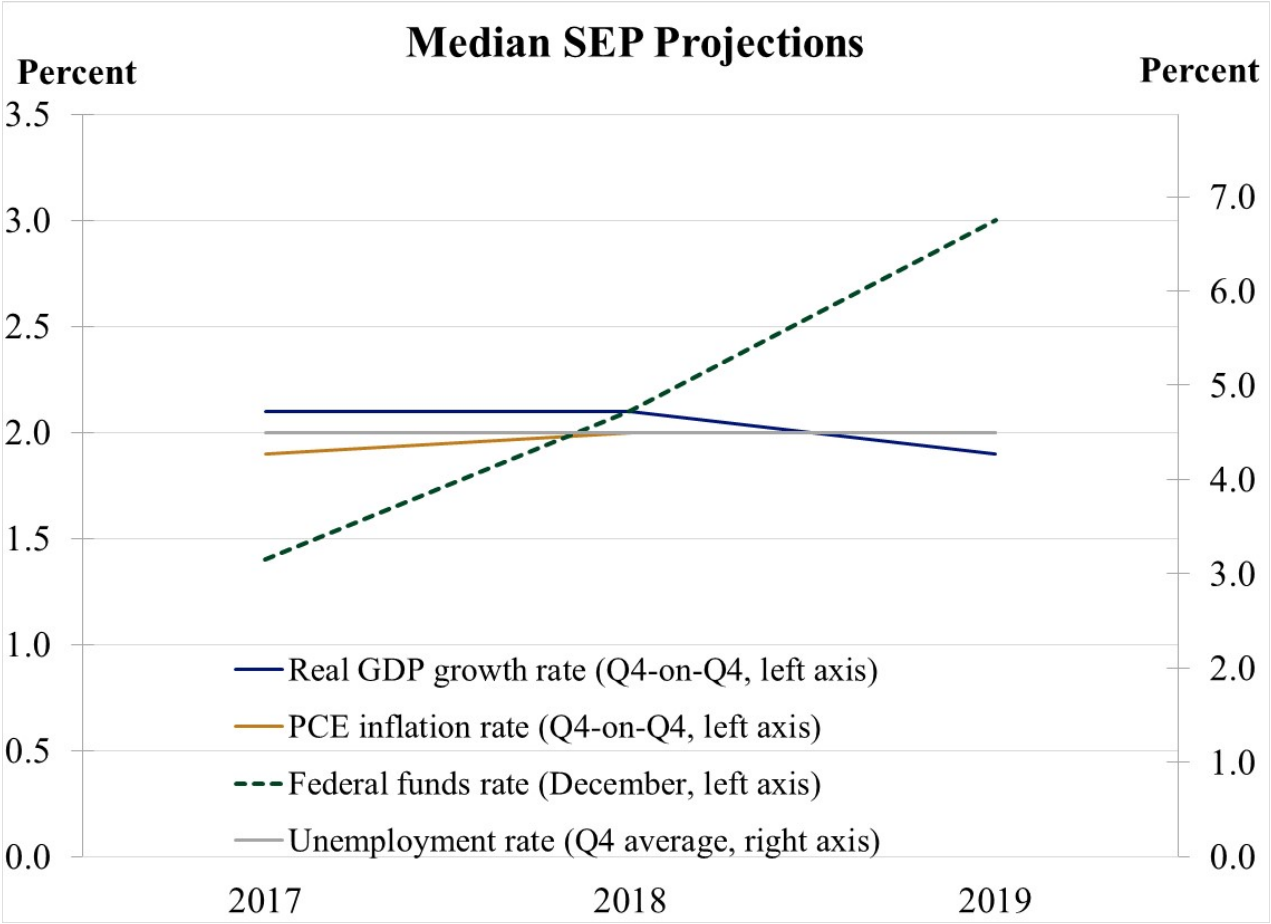
- As of March 2017, U.S. real GDP growth was projected to be close to 2 percent for 2017, 2018 and 2019.
- It now appears growth will exceed that forecast for all three years.
- A key consequence of this growth surprise is that it has allowed the Federal Open Market Committee (FOMC) to normalize along its projected path, with attendant consequences for global financial markets.
- Continuation of the U.S. growth surprise likely requires faster U.S. productivity growth.

The U.S. Forecast as of March 2017

The March 2017 projection

- The FOMC releases a Summary of Economic Projections (SEP) each quarter.
- In March 2017, the median projection was for stable and subdued economic growth in 2017, 2018 and 2019.
    - Relatedly, unemployment and personal consumption expenditures (PCE) inflation were projected to remain about constant over these three years.
- Nevertheless, the median projection among FOMC participants was that the policy rate would rise over this period.
- The next chart summarizes the March 2017 median SEP.

The March 2017 projection



Source: Federal Reserve Board, March 2017 SEP.

Summary of the March 2017 view

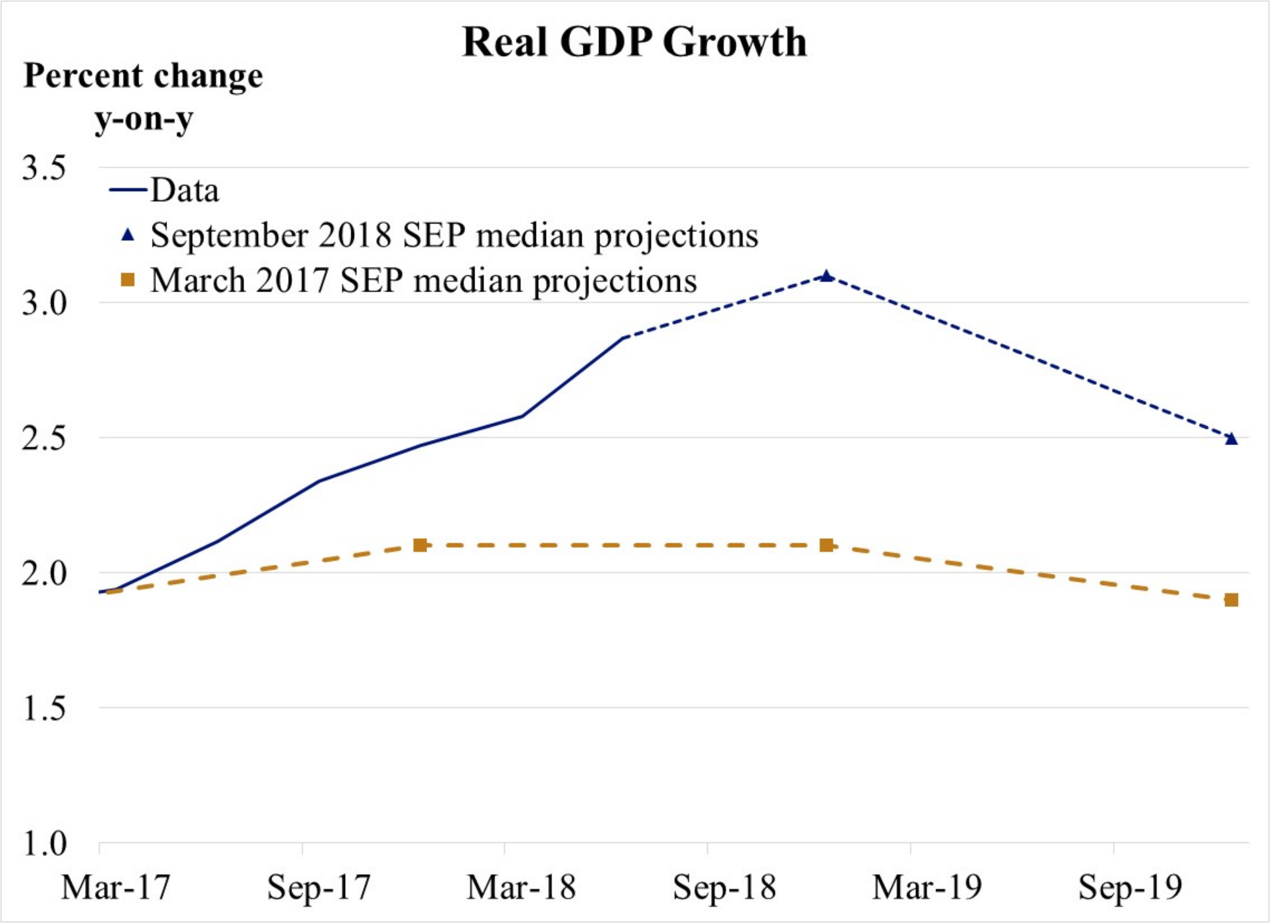
- Broadly speaking, in March 2017 the FOMC expected very little movement in U.S. real GDP growth, unemployment and inflation over a three-year horizon.
- This is reflected in the three essentially flat lines in the previous chart.
- The FOMC projected that this outcome would be consistent with a rising U.S. policy rate.

Key Macroeconomic Variables: Projections vs. Realizations

A projection puzzle

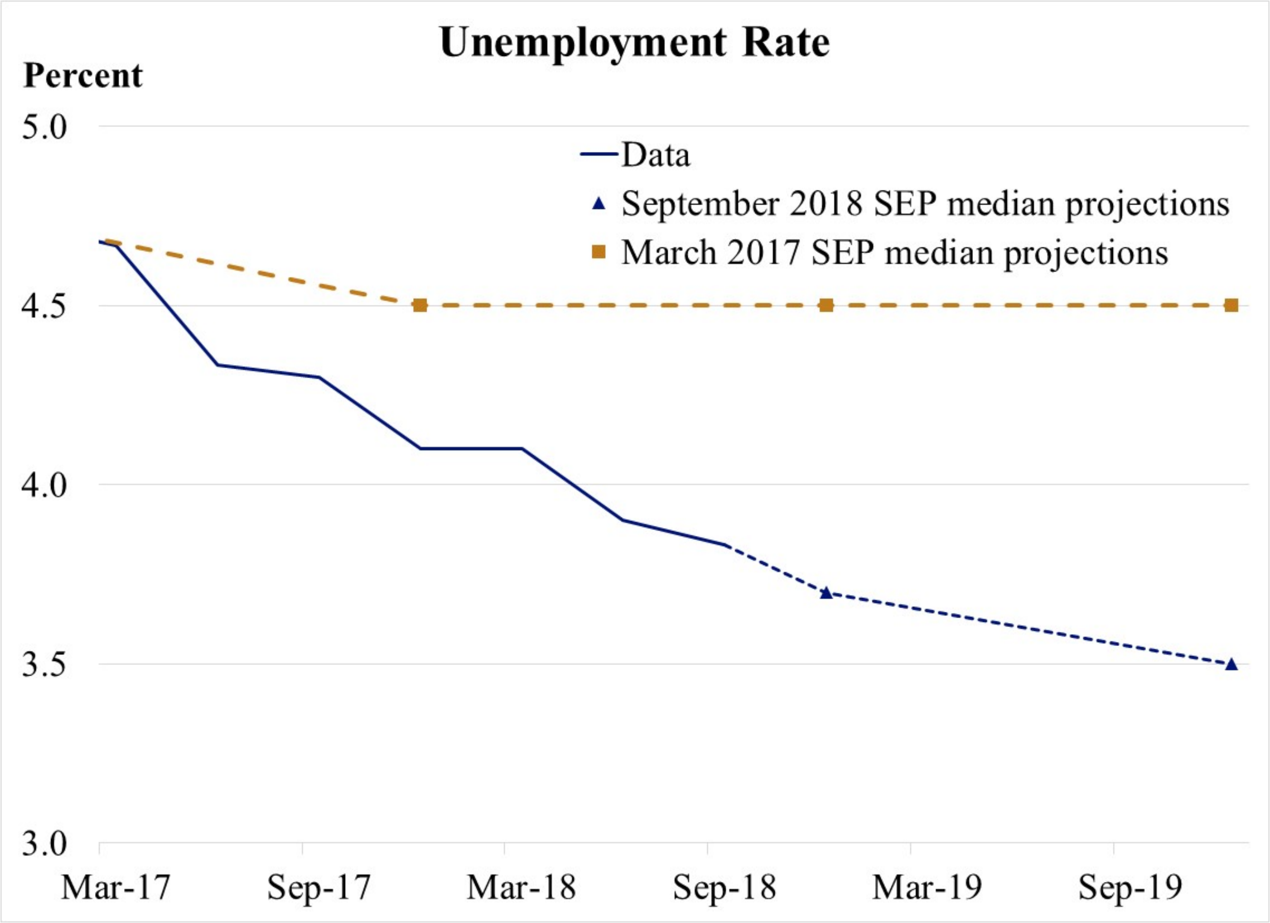
- As with many macroeconomic forecasts, the March 2017 SEP projection has turned out to be inaccurate in important respects.
- In particular, actual real GDP growth has been stronger than expected, actual unemployment has trended lower than expected, and actual inflation has been somewhat lower than expected.
- At the same time, the actual policy rate path so far has been about what was projected in March 2017.
- How could the actual rate path be as projected when other variables deviated from expectations?

The U.S. growth surprise



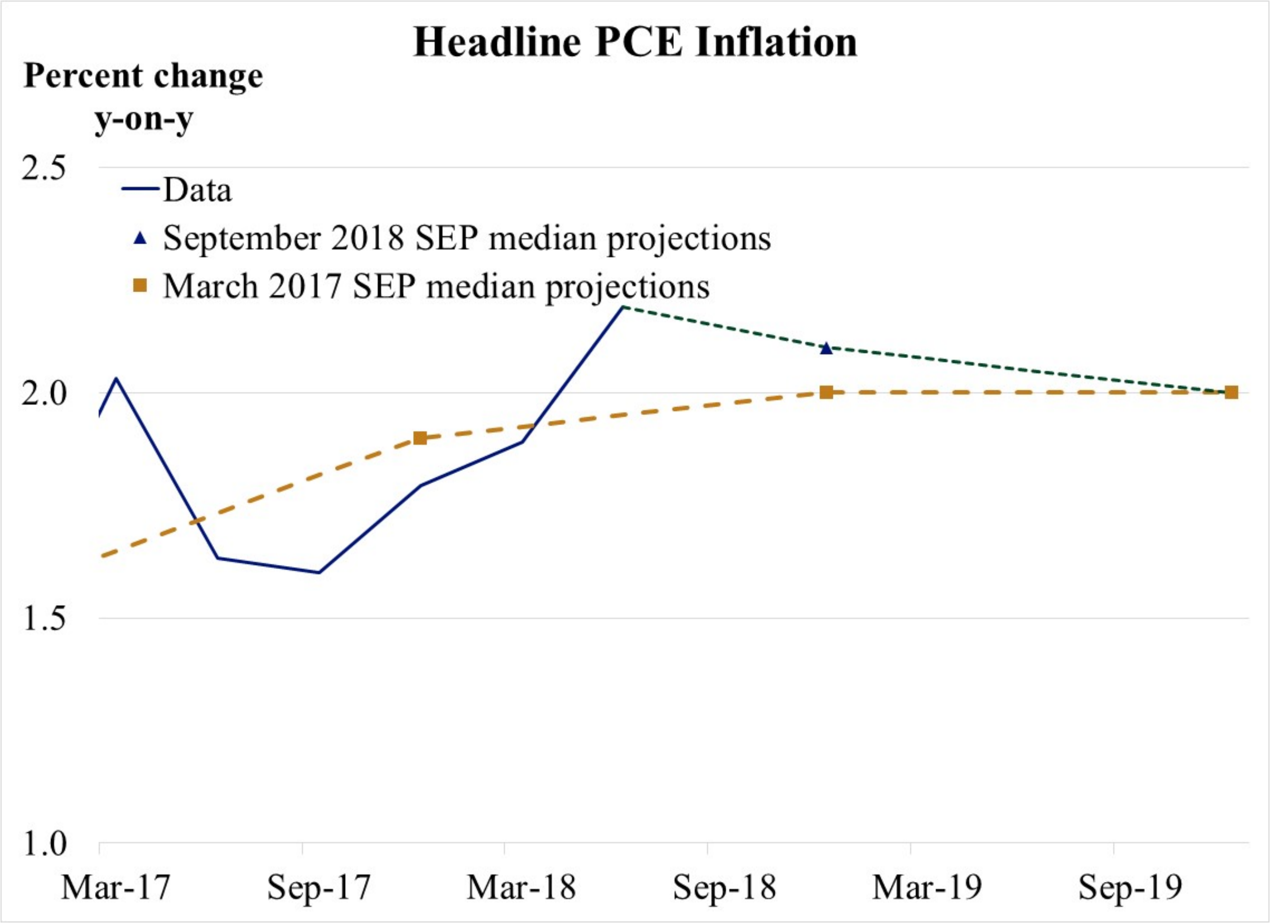
Sources: Bureau of Economic Analysis and Federal Reserve Board. Last observation: 2018-Q2.

The U.S. unemployment surprise



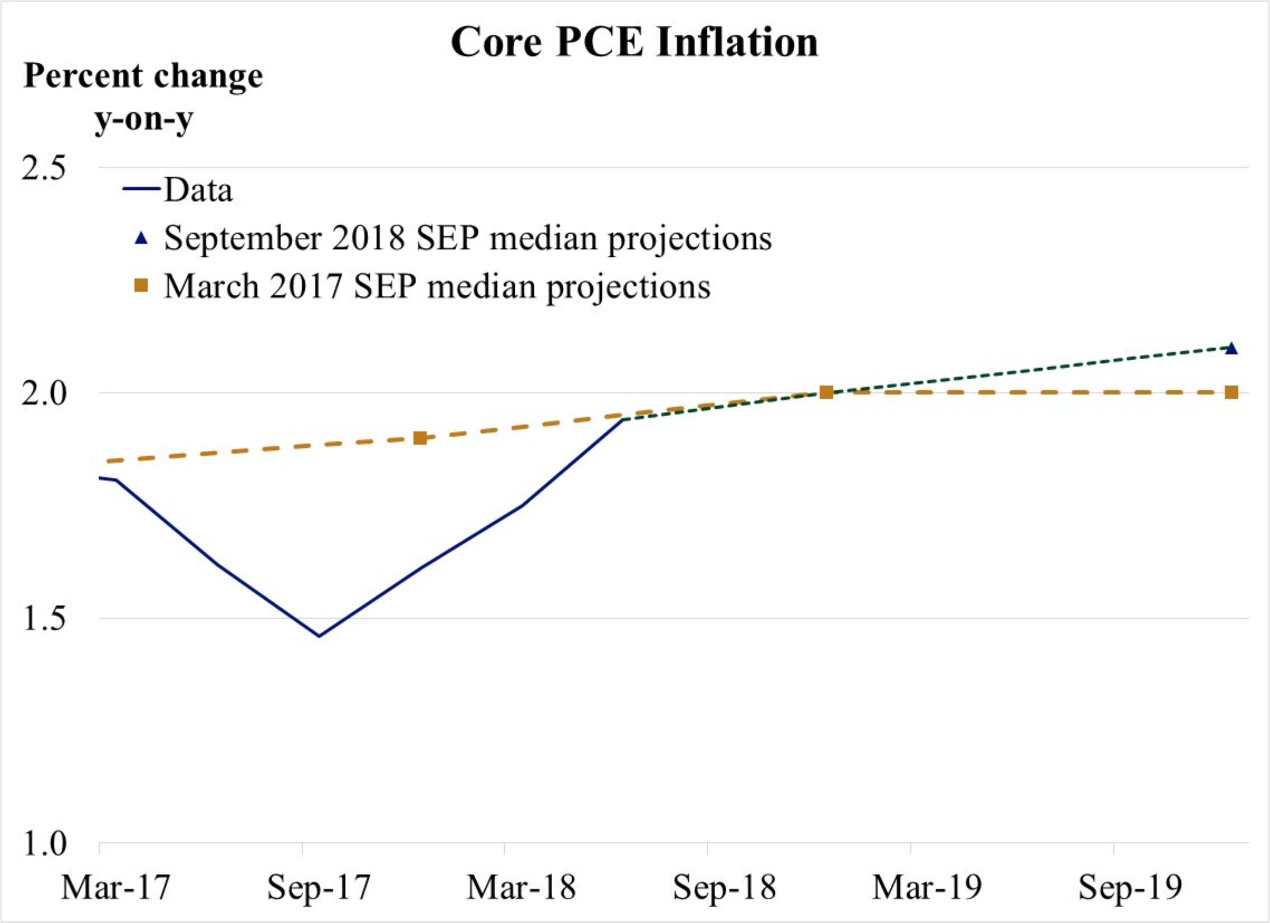
Sources: Bureau of Labor Statistics and Federal Reserve Board. Last observation: 2018-Q3.

The U.S. headline inflation path



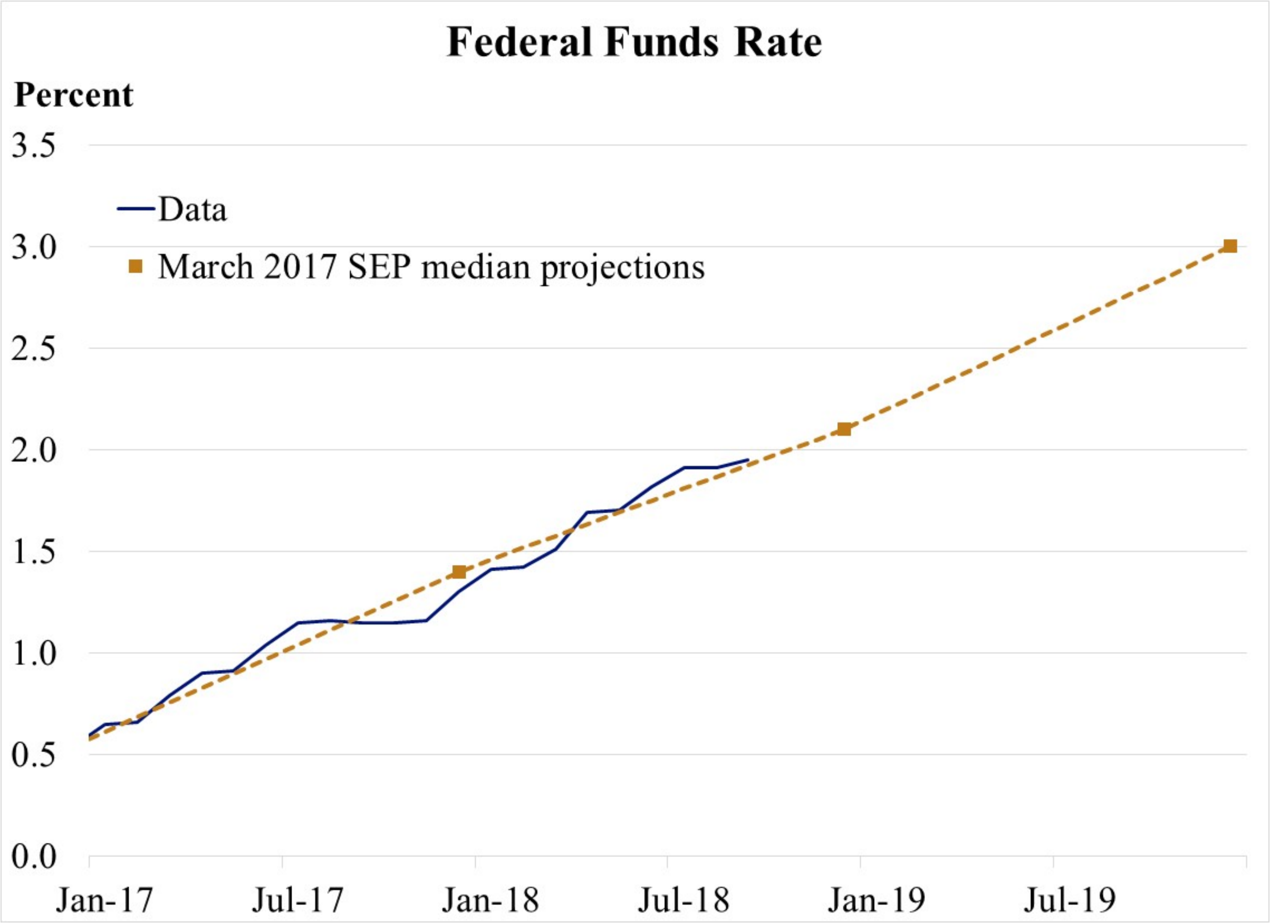
Sources: Bureau of Economic Analysis and Federal Reserve Board. Last observation: 2018-Q2.

The U.S. core inflation surprise



Sources: Bureau of Economic Analysis and Federal Reserve Board. Last observation: 2018-Q2.

The U.S. policy rate: No surprise



Source: Federal Reserve Board. Last observation: September 2018.

The Global Context

The global growth surprise

- In the fall of 2016, the International Monetary Fund produced a forecast of real GDP growth for the U.S. and other economies worldwide.
- All major economies surprised to the upside in 2017 relative to that forecast. Relatively speaking, the growth surprise was larger outside the U.S.
- In 2018, the growth surprise is on track to be positive in the U.S. while other major economies are projected to not do as well as they did in 2017.
- This helps explain some of the major macroeconomic events of the last two years.
- The following table illustrates these outcomes.

The growth surprise outside the U.S.

	2017 projected [1]	2017 actual [2]	Difference 2017a−2017p	2018 projected [2]	Difference 2018p−2017a
U.S.	2.2%	2.3%	0.1	2.9%	0.6
Euro area	1.5%	2.4%	0.9	2.2%	−0.2
U.K.	1.1%	1.7%	0.6	1.4%	−0.3
Japan	0.6%	1.7%	1.1	1.0%	−0.7
China	6.2%	6.9%	0.7	6.6%	−0.3

Growth rates are year-over-year; differences are expressed in percentage points.

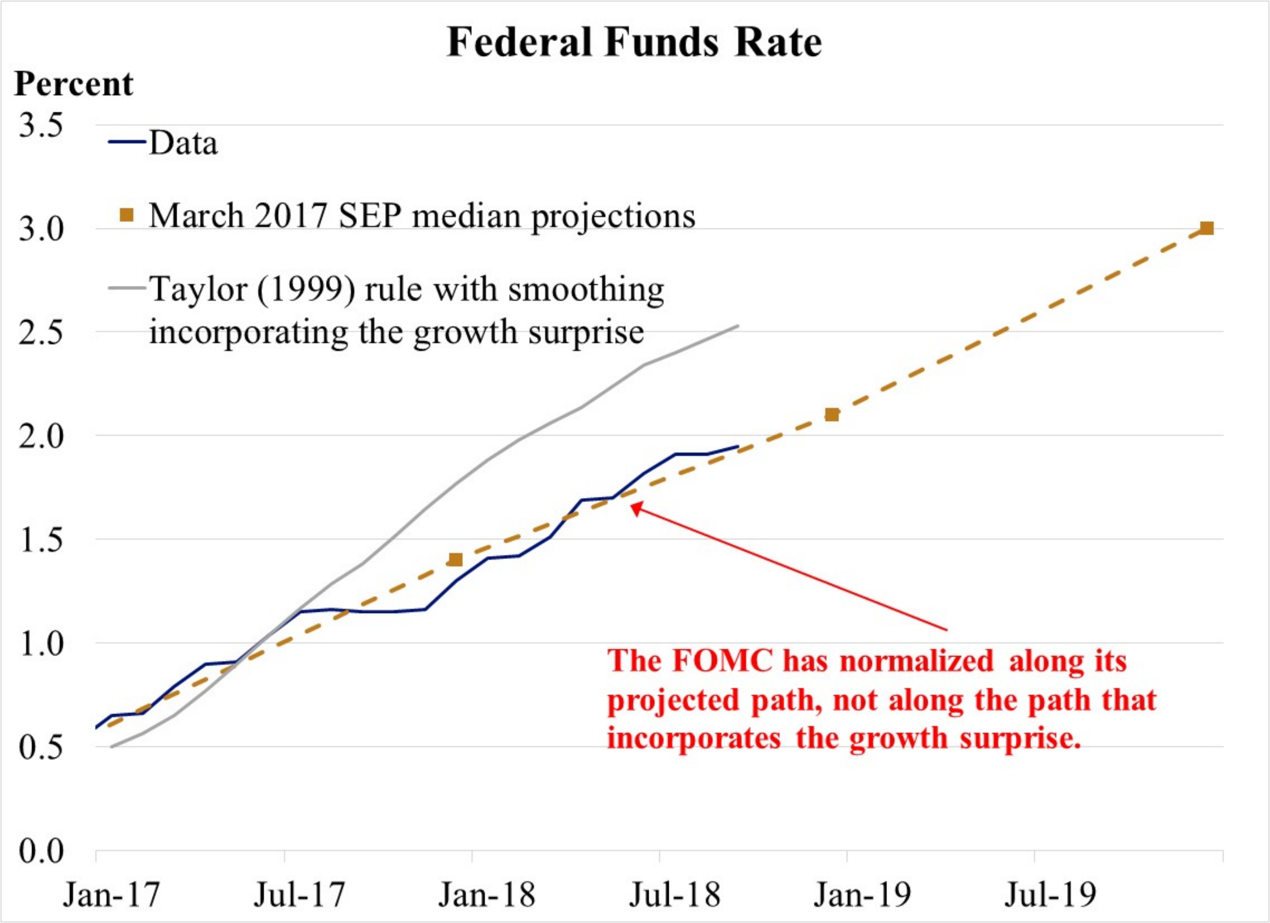
Sources: *(1) International Monetary Fund*, World Economic Outlook, *October 2016;*
(2) International Monetary Fund, World Economic Outlook Update, *July 2018.*

Some Consequences of the U.S. Growth Surprise

A few consequences

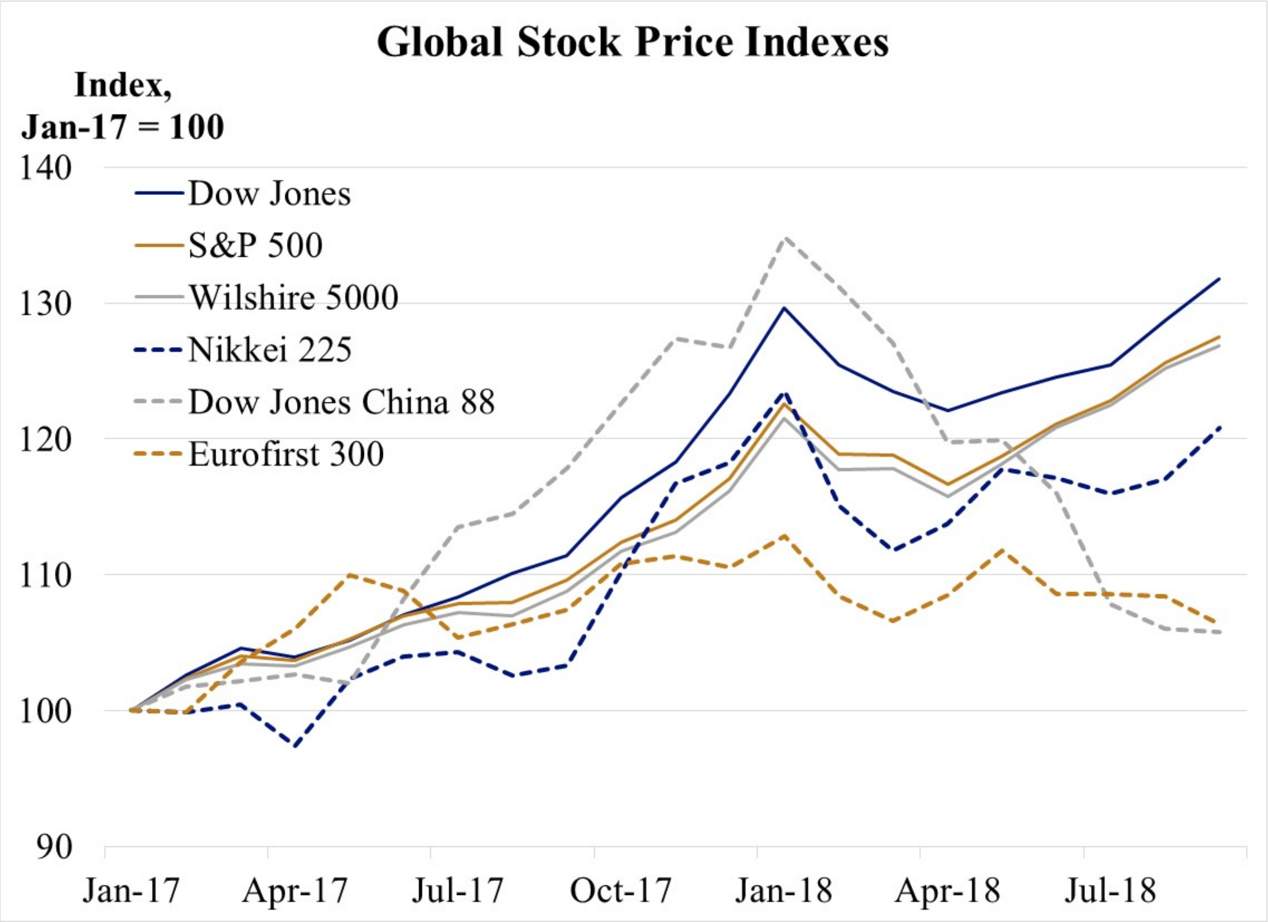
- I will discuss a few consequences of these events:
  - First, faster-than-expected U.S. real GDP growth and lower-than-expected U.S. unemployment have allowed the FOMC to normalize along its projected path.
  - Second, the faster-than-expected global real GDP growth has helped the profitability of U.S. firms, helping to drive U.S. equity markets higher.
  - Third, the dollar naturally weakened in 2017 (due in part to the larger growth surprise abroad) and has naturally strengthened in 2018 (due in part to the larger growth surprise domestically).

Normalization along the projected path



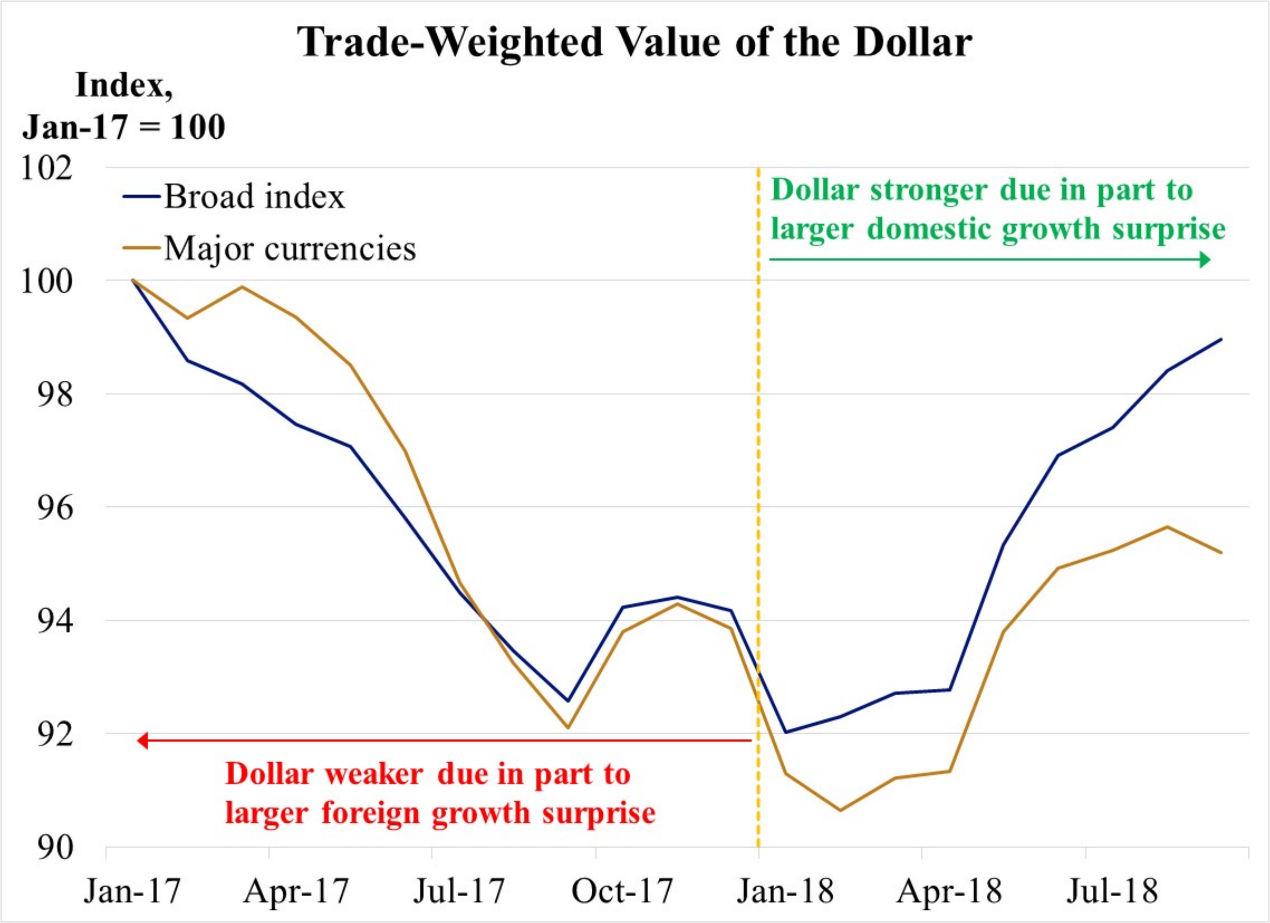
Sources: Bureau of Economic Analysis, Bureau of Labor Statistics, Federal Reserve Board and author's calculations. Last observation: September 2018.

Equity valuations increase



Sources: Wall Street Journal, Standard & Poor's, Dow Jones, Financial Times and STOXX Limited. Last observation: September 2018.

Stronger dollar in 2018



Source: Federal Reserve Board. Last observation: September 2018.

Can the Growth Surprise Continue?

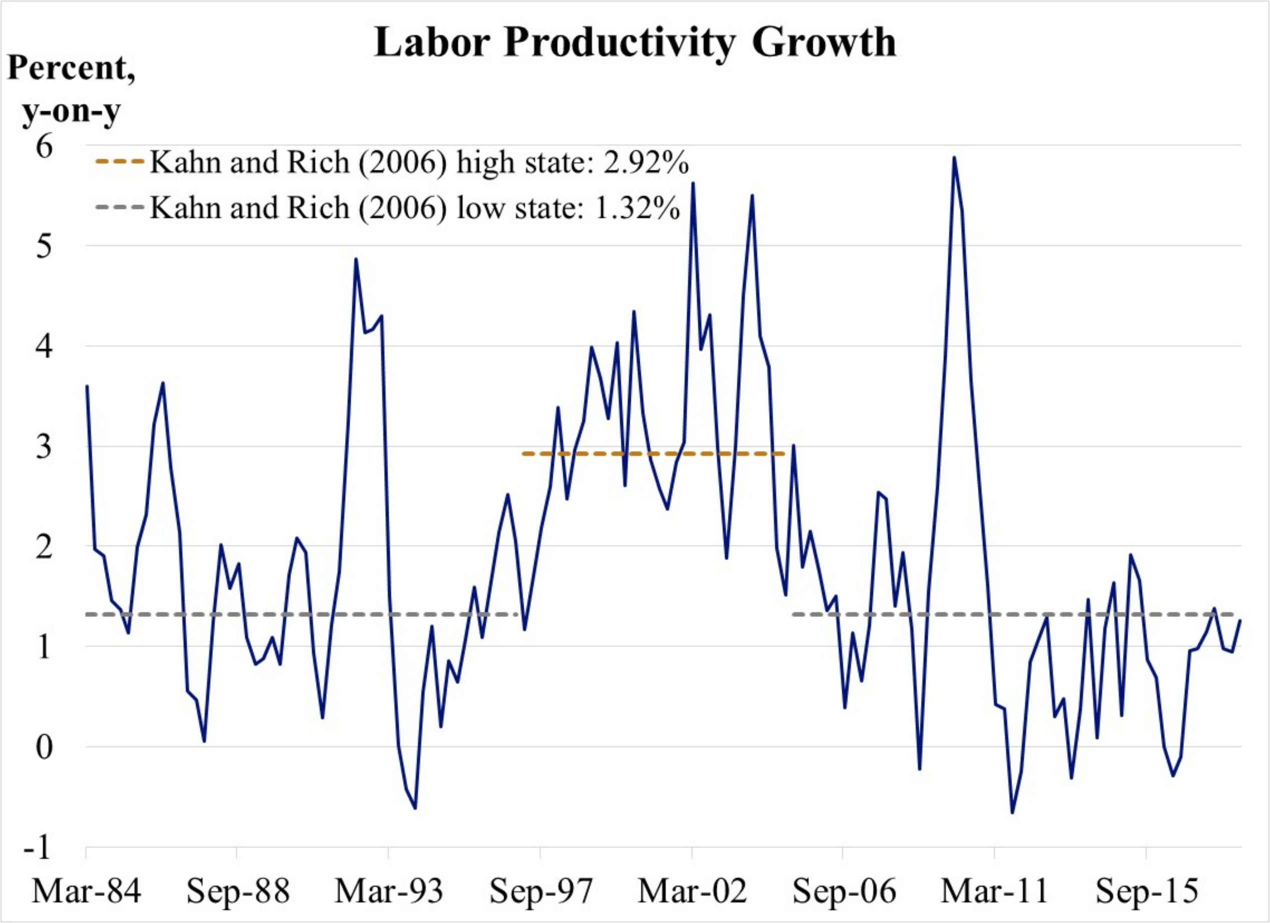
Can U.S. growth continue apace?

- The U.S. potential growth rate is widely thought to be relatively low, in part due to demographics.
  - Labor force growth has been slower in the U.S. since 2008 due to demographic factors.
- Accordingly, the U.S. will likely need faster productivity growth in order to maintain current real GDP growth rates.
- This is a possibility if U.S. investment improves and technological diffusion begins to improve business processes at a faster pace.

U.S. labor force growth has been low

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

U.S. productivity growth has been low



Sources: Kahn and Rich (2006, 2007) and FRB of New York. Last observation: 2018-Q2.

Bottom line on U.S. potential growth

- The U.S. labor force growth rate remains close to the 0.5 percent average since 2008.
- The U.S. labor productivity growth rate does not appear at this point to be meaningfully different from the Kahn-Rich low-state value of 1.3 percent.
- Adding these together suggests a potential growth rate for the U.S. of 1.8 percent, about the same as many private-sector forecasts.
- A switch to the high state for labor productivity growth (2.9 percent in the previous chart) would raise the U.S. potential growth rate to a stunning 3.4 percent. This switch is a possibility, but it has not materialized so far.

Conclusion

Conclusions

- Economists' views of U.S. economic growth are in flux due to the surprisingly strong performance of the U.S. economy relative to projections made in the first half of 2017.
- The U.S. growth surprise has been a factor in allowing the FOMC to normalize its policy rate along a projected path, with attendant consequences for global financial markets.
- Continuation of the U.S. growth surprise likely requires faster U.S. productivity growth.

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