The U.S. Macroeconomic Outlook

James Bullard
President and CEO, FRB-St. Louis

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Any opinions expressed here are my own and do not necessarily reflect those of the Federal Open Market Committee.
Introduction
Key themes in this talk

- The U.S. economy has arguably converged to a low-growth, low-safe-real-interest-rate regime, a situation that is unlikely to change dramatically during 2017.

- The Fed can take a wait-and-see posture regarding possible changes to U.S. fiscal and regulatory policies.

- The U.S. policy rate can remain relatively low and still keep inflation and unemployment near targets.

- Now may be a good time for the FOMC to consider allowing the balance sheet to normalize by ending reinvestment.
The Low-Growth Regime
Real GDP growth around 2 percent

- Real GDP growth measured from one year earlier has averaged just 2.1 percent over the last seven years.
- The last two years have shown very little change in year-over-year real GDP growth.
  - 2015-Q4: 1.9 percent, 2016-Q4: 2 percent.
- A natural conclusion is that the economy has converged upon a growth rate of about 2 percent.
Real GDP growth in 2017

- These considerations make it seem unwise to forecast more rapid growth in 2017.
- In addition, some indications for growth in the first quarter of 2017 are below 2 percent.
- If the tracking estimates turn out to be correct, the economy will have to grow that much more rapidly during the last three quarters of 2017 to surpass 2 percent for the year as a whole.
## Tracking estimates for 2017-Q1 real GDP growth

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<td>Blue Chip Consensus</td>
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<td>FRBNY Staff Nowcast</td>
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<td>St. Louis Fed Economic News Index</td>
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<td>Atlanta Fed GDPNow</td>
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<td>Macroeconomic Advisers</td>
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* percent change from the previous quarter, annualized
Residual seasonality?

- In recent years, first-quarter real GDP growth in the U.S. has generally been lower than in other quarters, despite the de-seasonalization process used to assemble the data.
- The magnitude of this effect is debatable.
- On balance, weather effects in the first quarter of 2017 have not been particularly pronounced.
- It may be better to use real GDP growth measured from one year earlier to gauge performance.
Q1 vs. Q2 real GDP growth

Labor Market Improvement Slowing
Labor market improvement has slowed over the last 18 months. The unemployment rate has declined only a few tenths of a percent over the last 18 months. Nonfarm payroll employment growth measured from one year earlier was 2.3 percent in February 2015 and has slowed to 1.5 percent today. Private hours growth measured from one year earlier was 3.4 percent in February 2015 and has slowed to just 1.4 percent today. Bottom line: Labor market improvement has been slowing.
The decline in the unemployment rate has slowed.
Employment growth has slowed

Hours growth has slowed

Divergent trends in retail sector employment growth

**Employment in the Retail Sector**

- **Non-Store Retailers**
- **Internet-Sensitive Stores** *

* Electronic & appliance stores; clothing & clothing accessories stores; sporting goods, hobby, book & music stores; general merchandise stores.

The Low-Productivity-Growth Regime
U.S. labor productivity growth has been low

- U.S. growth over the medium and longer term is thought to be driven by labor force trends and productivity trends.
- U.S. labor productivity has been growing at an average rate of 0.4 percent since early 2013, whereas it grew at a rate of 2.3 percent per year from 1995 to 2005.
- A statistical model that estimates the probability that the U.S. economy is in a low-productivity-growth regime puts nearly all the probability on the low-growth regime.*
- Bottom line: Faster productivity growth is the surest path to more rapid real GDP growth in the U.S.

The high- and low-productivity-growth regimes

Last observation: 2016-Q4.
Low-productivity-growth regime probability

Inflation Close to 2 Percent
U.S. inflation as measured by the Dallas Fed trimmed-mean inflation rate measured from one year earlier has barely increased in the last several years (1.9 percent in February).
- This measure controls for some of the effects of energy prices.

Headline inflation measured from one year earlier has also returned to the 2 percent target (2.1 percent in February).

Most other measures of inflation are also near 2 percent.

Inflation expectations have been rising but are still somewhat low.

Bottom line: Inflation has essentially returned to 2 percent and is expected to remain there.
Inflation essentially at 2 percent

Inflation expectations remain somewhat low

The Low-Safe-Real-Real-Rate Regime
The low-safe-real-rate regime is a global phenomenon.

The low-safe-real-rate regime has been many years in the making.

These considerations suggest that the regime will not go away quickly, and so it may be unwise to forecast that the safe rate will rise.

The Fed’s policy rate setting uses the safe rate as a benchmark.

I conclude that a relatively low policy rate is likely to remain appropriate going forward.

The low-safe-real-rate regime: Unlikely to change soon
The low- and high-real-rate regimes in the U.S.

One-year ex-post real yields are low globally

Low safe real rates have been developing over decades

Bottom line on the low-safe-rate regime

- Real rates of return on government paper are exceptionally low in the current global macroeconomic environment.

- It seems unwise to rely on mean reversion to predict that the forces driving safe real rates to such low levels are likely to reverse anytime soon.

- This then feeds through to the policy rate, which is also likely to remain low.
Current U.S. Monetary Policy
Policy rate projections: Differences in views

- What is the difference between the St. Louis Fed’s view and the view underlying the median dots in the FOMC’s Summary of Economic Projections (SEP)?

  Answer: We do not assume mean reversion in the rate of productivity growth or in the real rate of return on short-term government paper.

- The median dots suggest that the real rate of return, in particular, will return to its 2001-2007 U.S. average, while the St. Louis Fed does not predict this.

- This leads to a St. Louis Fed forecast of a relatively flat policy rate over the next two to three years, with some upside risk.
The FOMC policy rate projections vs. reality

The policy rate path dichotomy

Impact of New Fiscal and Regulatory Policies
Impact of the new fiscal and regulatory policies

Will the new fiscal and regulatory policies move the U.S. into a higher growth regime? The Fed can wait and see.

Here are two considerations:

- The economy is not in recession today, so fiscal policies should not be viewed as countercyclical measures.
- U.S. productivity growth is low and could be improved considerably.
  - Deregulation could improve productivity growth.
  - Infrastructure spending could improve productivity growth.
  - Tax reform could improve productivity growth.
The Fed’s Balance Sheet Policy
The Fed’s balance sheet has been an important monetary policy tool during the period of near-zero policy rates.

The FOMC has not set a timetable for ending the current reinvestment policy.

Now that the policy rate has been increased, the FOMC may be in a better position to allow reinvestment to end or to otherwise reduce the size of the balance sheet.

Adjustments to balance sheet policy might be viewed as a way to normalize Fed policy without relying exclusively on a higher policy rate path.
The Fed’s balance sheet assets

Current policy is distorting the yield curve

- The current FOMC policy is putting some upward pressure on the short end of the yield curve through actual and projected movements in the policy rate.
- At the same time, current policy is putting downward pressure on other portions of the yield curve by maintaining a $4.47 trillion balance sheet.
- This type of “twist operation” does not appear to have a theoretical basis.
- A more natural normalization process would allow the entire yield curve to adjust appropriately as normalization proceeds.
Some have argued that the size of the balance sheet should not be reduced until the policy rate is high enough that it can be reduced appropriately should a recession develop.

This is sometimes called “policy space.”

The same “policy space” argument can be made for the size of the balance sheet.

We should be allowing the balance sheet to normalize naturally now, during relatively good times, in case we are forced to resort to balance sheet policy in a future downturn.
Conclusion
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- The U.S. economy has arguably converged to a low-real-GDP-growth, low-safe-real-interest-rate regime.
- Because of this, the Fed’s policy rate can remain relatively low while still keeping inflation and unemployment near goal values.
- The new fiscal and regulatory policies could impact productivity growth and therefore improve the pace of real GDP growth.
  - The Fed can wait to see how these new policies evolve.
- Ending balance sheet reinvestment may allow for a more natural adjustment of rates across the yield curve as normalization proceeds.