Remarks on the 2018 U.S. Macroeconomic Outlook

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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

• 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

The 2017 global growth surprise

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

*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


Tech sector valuations grew twice as fast as the overall market
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

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

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

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

Real Fed Funds Rate and Laubach and Williams' $r^*$

Percent

0.5
0.0
-0.5
-1.0
-1.5
-2.0
-2.5

Mar-12 Dec-12 Sep-13 Jun-14 Mar-15 Dec-15 Sep-16 Jun-17

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

• 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.
• Monetary policy is closer to neutral today.
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