Ukrainian Financial Forum

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The Outlook for US Monetary Policy

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What We'll Cover Today

- Current **state** of the US economy
- Baseline **outlook** for the US economy and monetary policy
- **Risks** to the outlook.
- **Policy mitigants** for the risks.

State of US Economy

The Fed’s Dual Mandate

- Congress has assigned the Fed two monetary policy goals:

- Promote **price stability** and **maximum employment.**

- So: How is the Fed doing?

The Fed View

“The main takeaway is that the economy is doing very well.

Most people who want to find jobs are finding them, and **unemployment** and **inflation** are **low**.“

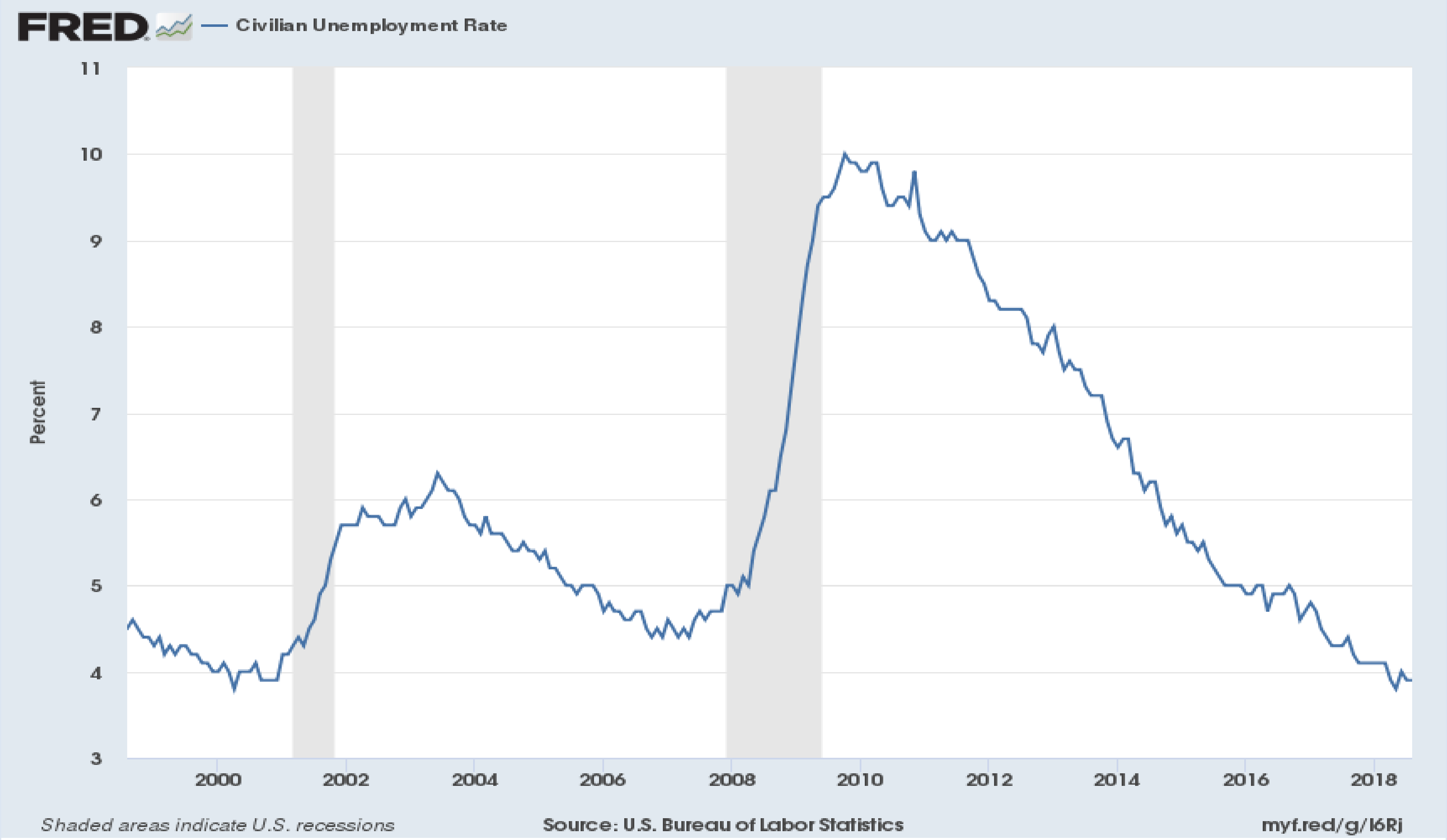
J. Powell opening statement, June 2018 FOMC press conference

Questions …

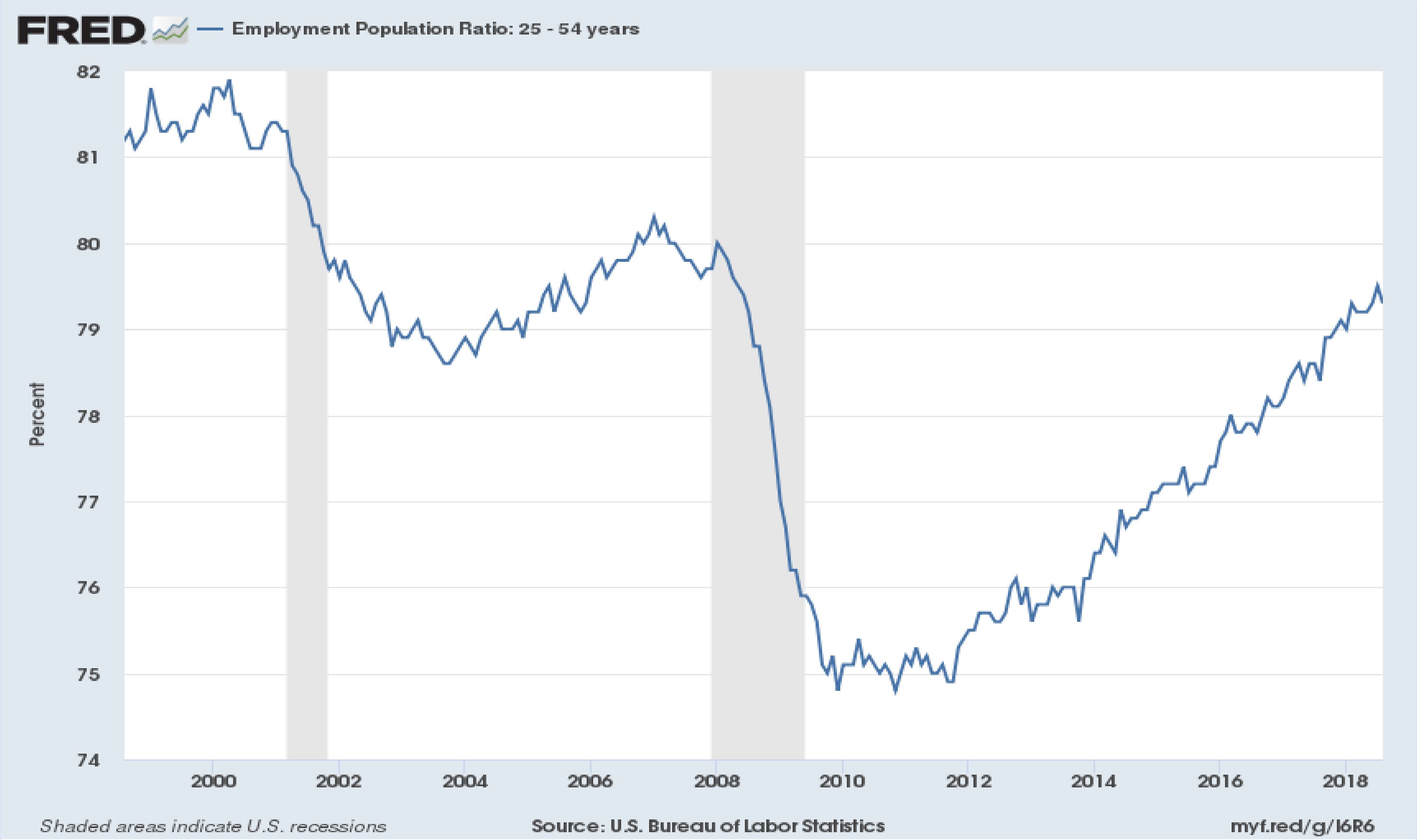
- Is the US at ”maximum employment”?
- Are prices “stable”?
- Why might some Americans feel the economy isn’t “doing very well”?

Maximum Employment?

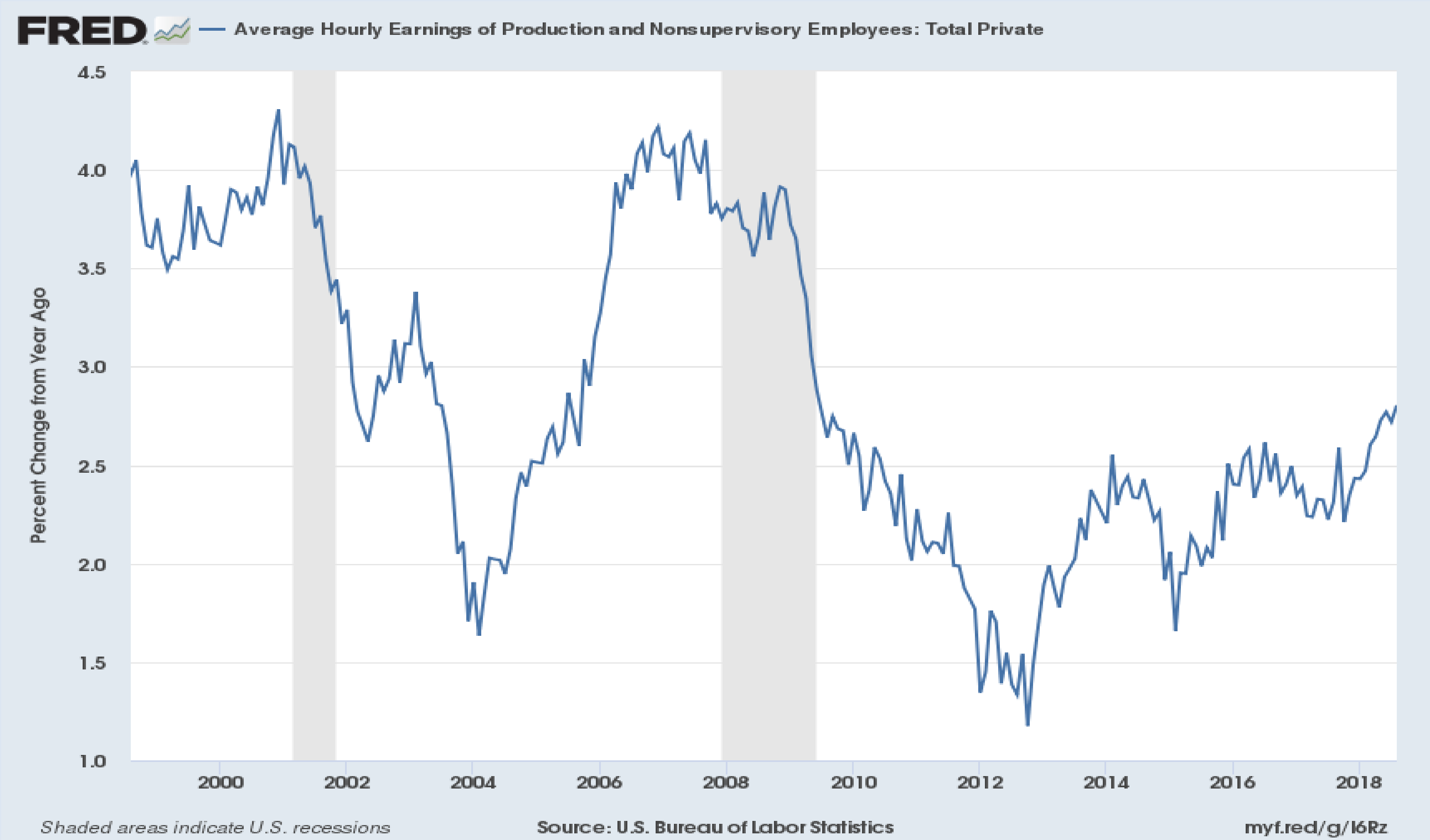
Unemployment Rate (past 20 years)



Employment-Population Ratio for Ages 25-54 (past 20 years)

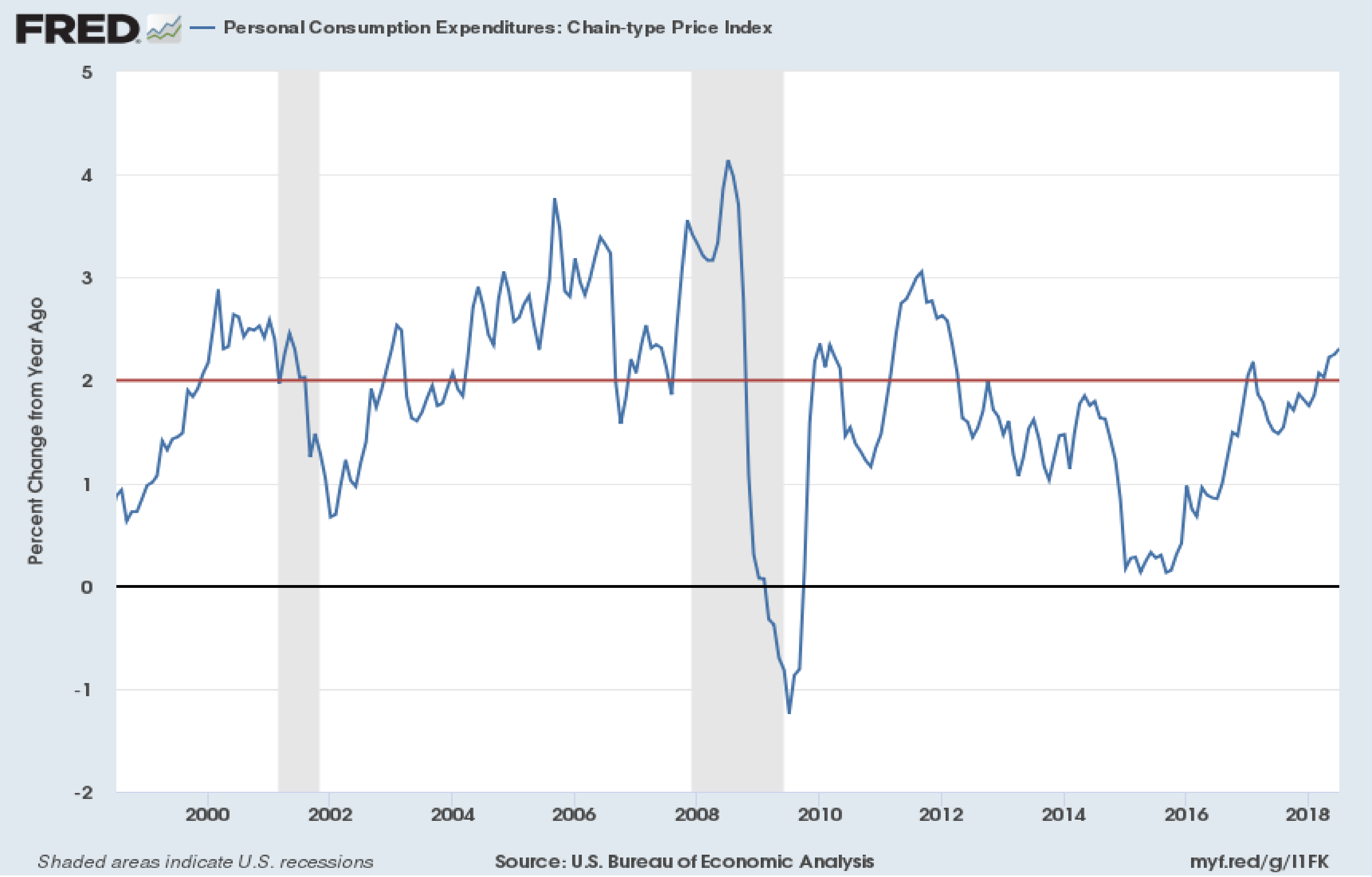


Annual (Nominal) Wage Growth (past 20 years)



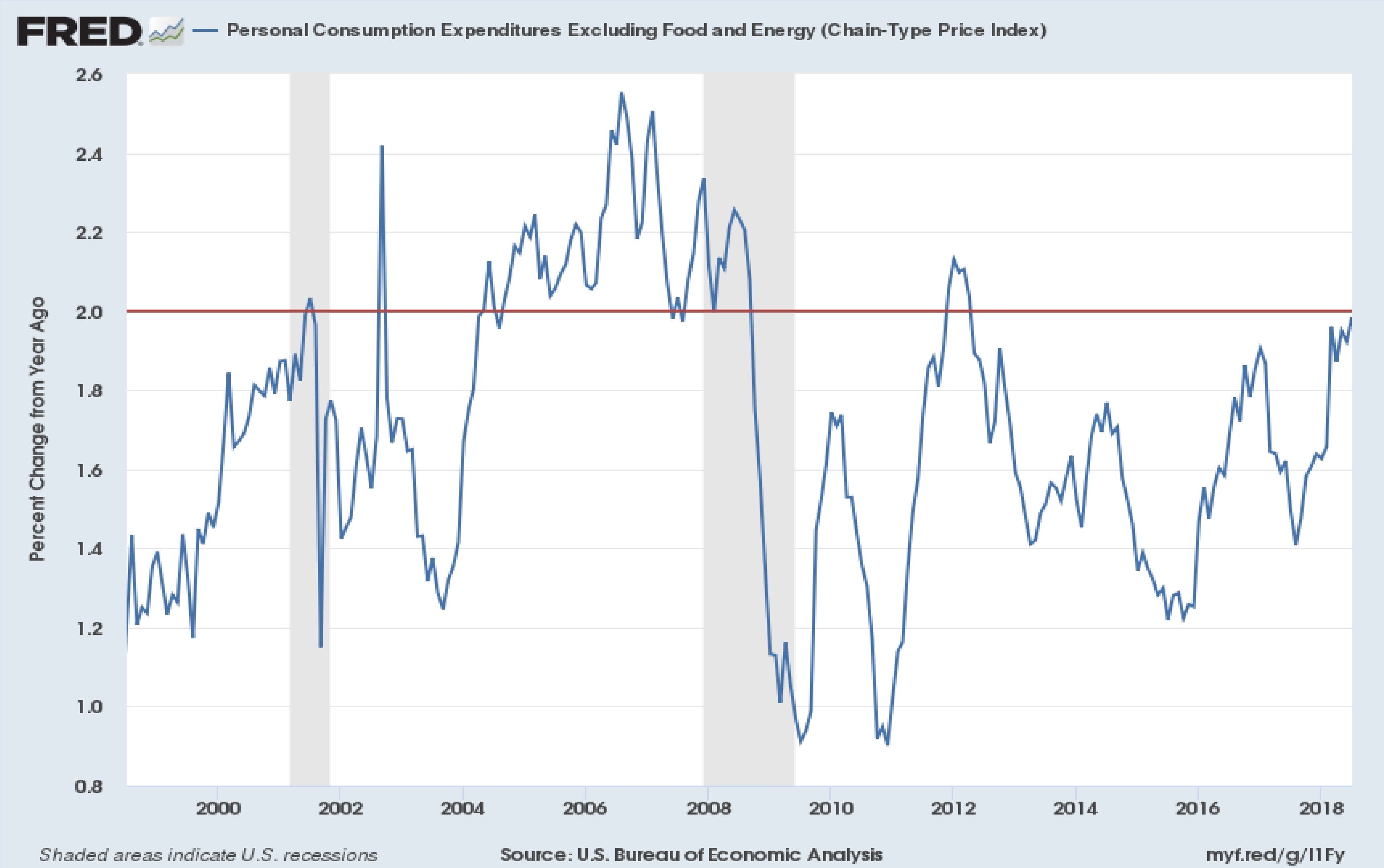
Price Stability?

Headline PCE Inflation (past 20 years)



Unit = Percent change from one year ago.
Source: Federal Reserve Bank of St. Louis

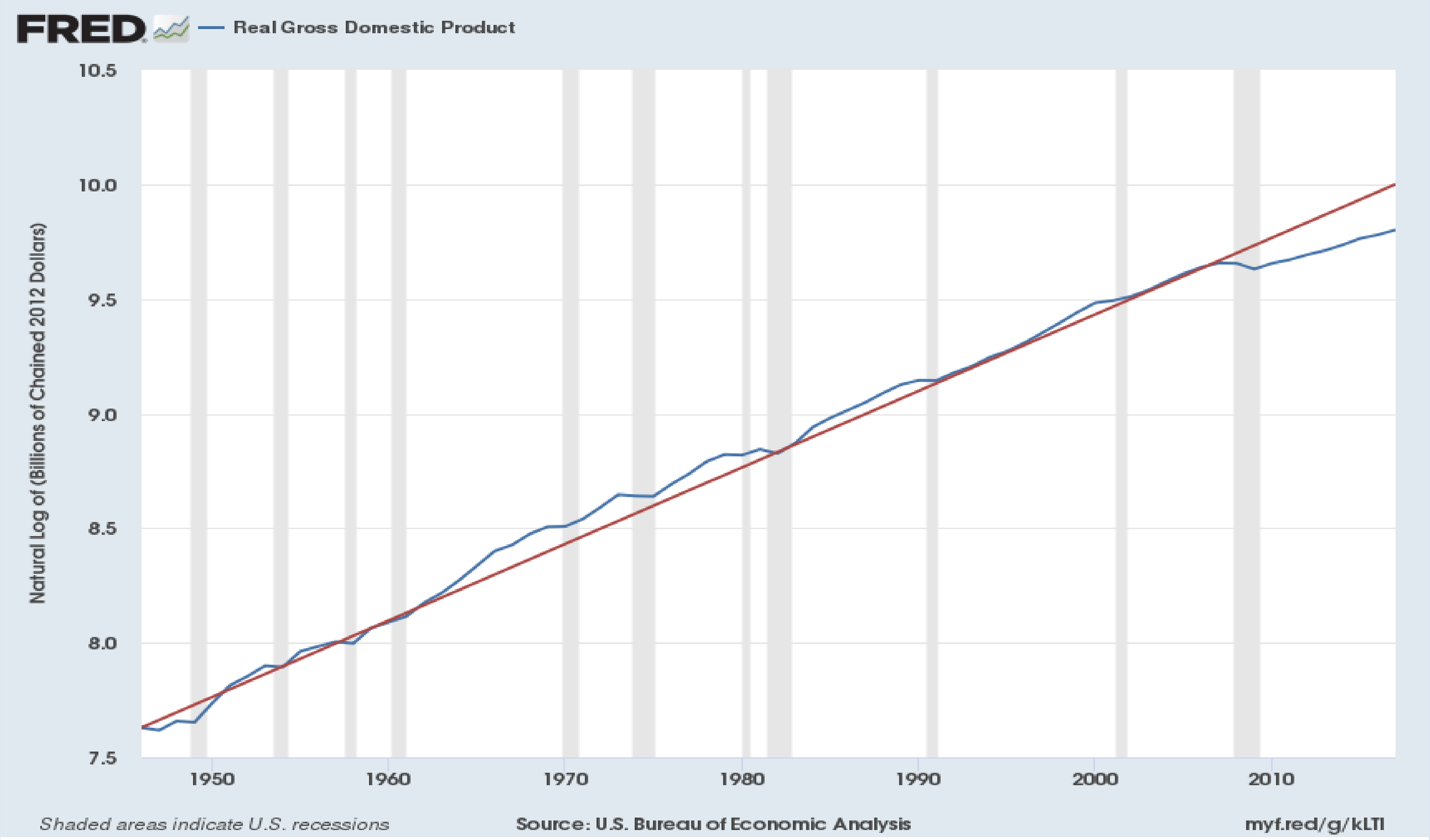
Core PCE Inflation (past 20 years)



Unit = Percent change from one year ago.
Source: Federal Reserve Bank of St. Louis

The Gap

Real GDP (past 71 years)



Sources of the Gap?

- The gap is about **20 percentage points.**

- About 1/3: **demographic (baby boom retirement)**.

- What about the other 2/3?

Sources of the Gap?

- The gap is about **20 percentage points.**
- About 1/3: **demographic (baby boom retirement)**.
- What about the other 2/3? **Conventional wisdom: not the fault of policymakers.**

My Summary

- US is close to full employment … but I would say it is still a year (or maybe even two) away.

- Underlying inflation is below (but VERY close to) Fed's target of 2%.

- Important Q: Can policy choices ameliorate the large gap (relative to pre-2007 trend)?

US Economic Outlook

The Fed Outlook (as of June)

	2019 (4th Quarter)	2020 (4^{th} Quarter)	Long Run
Unemployment Rate	**3.5%**	**3.5%**	**4.5%**
PCE Inflation	2.1%	2.1%	2.0%
Fed Funds Rate	3.1%	3.4%	2.9%

Comments

- The Fed is aiming for the unemployment rate to rise from 3.5% (in 2020) to 4.5% (in long run).

- This will require below-potential growth for a (long?) period of time.

- Can the Fed do this without causing a recession?

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Comments

- The Fed is willing to (temporarily) aim for inflation slightly above its long-run target of 2%.

- This is a significant – and welcome – change from past practice.

- It will give Fed more room for stimulus during future recessions.

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FWIW: My Own Take

- Underlying inflation is likely to remain slightly below 2% through 2020.
- Long-run unemployment rate might well be less than 4%.
- Fed should raise fed funds rate very slowly from current level (of ~1.9%).

Risks to the Outlook

Risk Assessment

- Inflation: repeat of 1966?
- Recession: repeat of 2001 (or 2008)?
- Other risks?

Risk 1: The 1966 Scenario

- In 1965-67, US federal government expanded:
  - Military operations in Vietnam
  - Social safety net: ”War on Poverty”

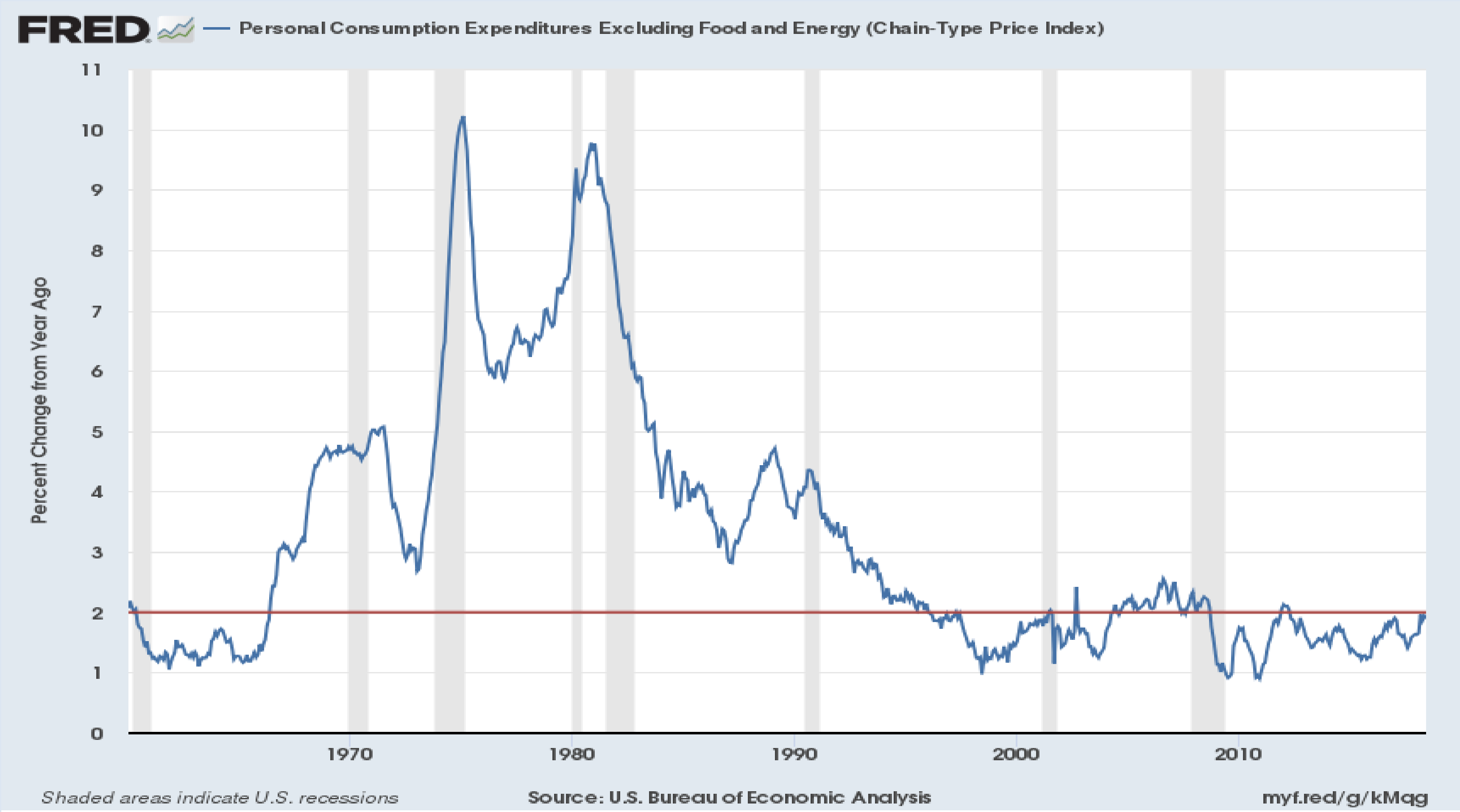
- This was a large fiscal stimulus when the unemployment rate was near historical lows.

Parallels with 2018

- In 2017-20:
  - Large tax cut
  - Large increase in government spending

- This was a large fiscal stimulus when the unemployment rate was near historical lows.

What Happened to Inflation in 1966?



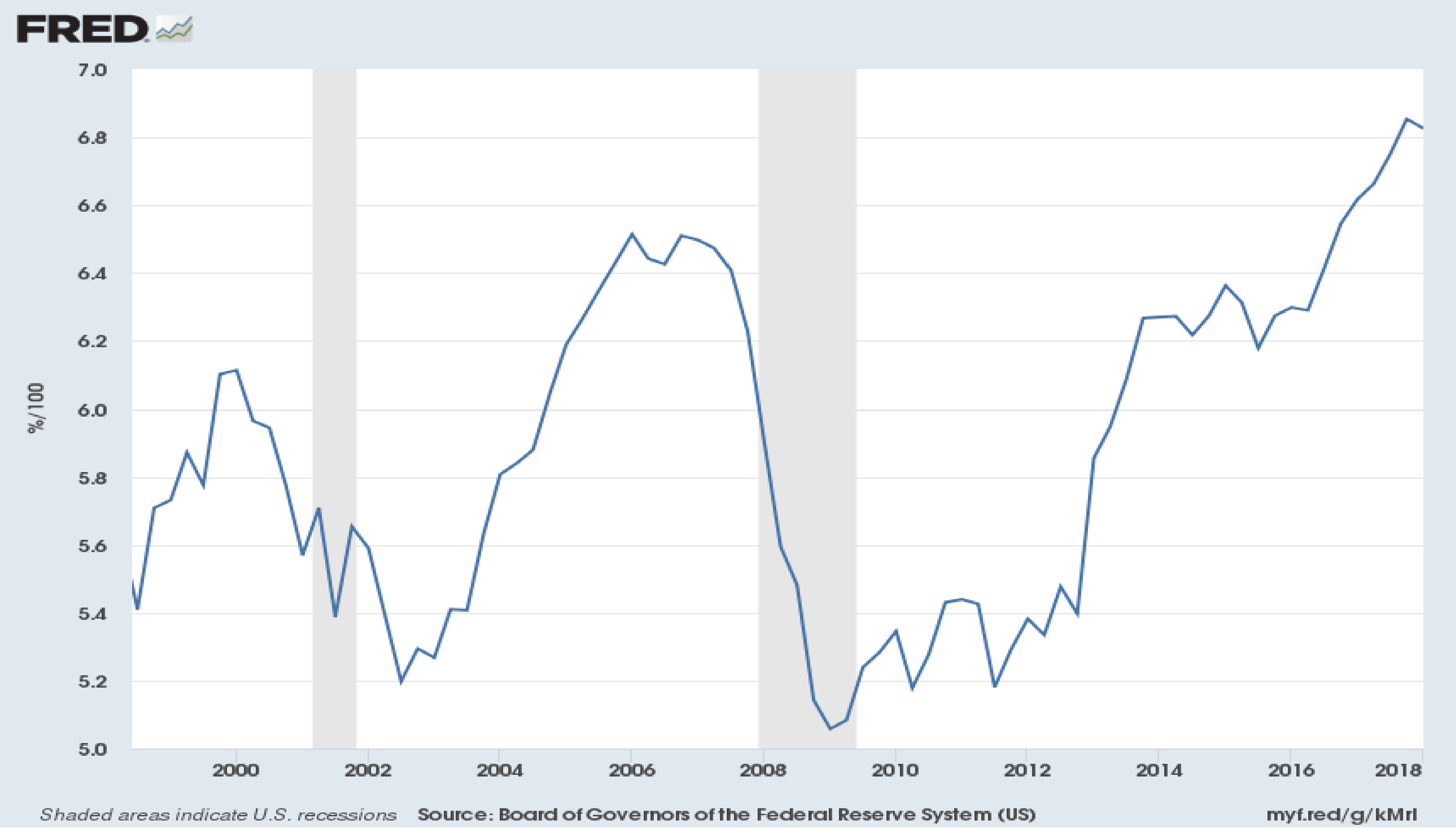
Risk 2: A Net Worth Fall

- Net worth was very elevated in early 2000 and mid-2006.

- It fell sharply thereafter – and the shock to aggregate demand triggered.

- And now net worth is even higher than in 2006 …

Net Worth/Disposable Personal Income (past 20 years)



Other Risks

- Simultaneous tightening of fiscal and monetary policy in 2020.
- Trumpian uncertainties (tariffs, etc.).
- Inverted yield curve.

A Good “Risk”

- Several improved investment incentives:
  - Regulatory changes
  - Tax changes
  - Prospects of higher aggregate demand.

- These may generate material growth **without** inflationary pressures.

Policy Mitigants for the Risks

Mitigating Inflation Risk

- Suppose undue inflationary pressures develop.
- The Fed can respond by raising interest rates (much?) more rapidly.
- Downsides: lower growth and political heat.

Mitigating Net Worth Risk

- Suppose net worth falls, leading to lower aggregate demand.
- As in 2001 and 2008, the Fed can respond by lowering interest rates.
- But there's a problem …

A Shortage of Tools?

- In 2001: The Fed successfully offset the net worth shock – but it had to lower the fed funds rate by about **5 percentage points**.

- This suggests that that Fed could not offset a similarly sized shock in the next year or two.
  - Note that the effectiveness of QE or forward guidance remains in dispute.

Summary

The Good News Is Very Good

- The outlook for the US economy is remarkably benign.

- The US is looking forward to:
  - Low unemployment
  - Close to 2% inflation
  - Low interest rates

But (As Always) There Are Risks

- Fiscal stimulus might generate undue inflation.
- A net worth crash could shrink aggregate demand.

Asymmetry in Risk Migitation

- The Fed can readily offset undue inflationary pressures by raising interest rates (by a lot?).

- But the Fed may not be able to lower interest rates by enough to offset net worth shock.

- This asymmetry argues in favor of continued caution in raising interest rates.