William C Dudley: The outlook for the US economy in 2018 and beyond

Remarks by Mr William C Dudley, President and Chief Executive Officer of the Federal Reserve Bank of New York, at the Securities Industry and Financial Markets Association, New York City, 11 January 2018.

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Good afternoon. It is a pleasure to have the opportunity to speak with you at this event. Today, I will focus on the economic outlook for 2018 and beyond. As always, what I have to say reflects my own views and not necessarily those of the Federal Open Market Committee (FOMC) or the Federal Reserve System.[1]

Broadly speaking, the prospects for continued economic expansion in 2018 look reasonably bright. The economy is likely to continue to grow at an above-trend pace, which should lead to a tighter labor market and faster wage growth. Under such conditions, I would expect the inflation rate to drift higher toward the FOMC's 2 percent long-run objective.

Over the longer term, however, I am considerably more cautious about the economic outlook. Keeping the economy on a sustainable path may become more challenging. While the recently passed Tax Cuts and Jobs Act of 2017 likely will provide additional support to growth over the near term, it will come at a cost. After all, there is no such thing as a free lunch. The legislation will increase the nation's longer-term fiscal burden, which is already facing other pressures, such as higher debt service costs and entitlement spending as the baby-boom generation retires. While this does not seem to be a great concern to market participants today, the current fiscal path is unsustainable. In the long run, ignoring the budget math risks driving up longer-term interest rates, crowding out private sector investment and diminishing the country's creditworthiness. These dynamics could counteract any favorable direct effects the tax package might have on capital spending and potential output.

Favorable near-term outlook

Turning to the near-term outlook, the prospects appear favorable for another year of above-trend growth. Consumer spending should continue to grow at a moderate pace, supported by solid fundamentals. Household income is being bolstered by faster compensation growth and continued healthy employment gains. Moreover, the aggregate household balance sheet remains in good shape, due in part to rising home prices, a strong stock market, and only moderate growth in household debt. Over the past year, home prices have risen by about 7 percent on a national basis, and the S&P 500 equity index has risen by nearly 20 percent. In contrast, household debt has risen about 4 percent over the past year, only slightly higher than the growth in personal income. Further, the household debt service burden is low, reflecting the extended period of low interest rates.

Of course, the aggregate figures mask some underlying problems. Two issues worth highlighting are the persistent growth in income and wealth inequality and the burden of rising student loan debt.[2] Many people of more modest means don't directly benefit from rising home and stock prices. And, increasing student debt burdens have made it more difficult for many young adults to become homeowners.[3] This is significant because homeownership is a major avenue for wealth accumulation for many households. Nevertheless, the tightening labor market should provide greater opportunities for workers to obtain employment, build human capital, and gain greater opportunities to improve their financial circumstances.

On the business side of the ledger, investment spending should remain solid. Business cash flows are strong, and the corporate sector is set to receive a meaningful lift from the recently

enacted tax legislation. The large reduction in the statutory corporate income tax rate from 35 percent to 21 percent and the 100 percent expensing provision for investment should drive down the effective cost of capital for business.

In addition, the U.S. economy should be well supported by the recent improvement in the global economic outlook. More synchronized cyclical recoveries in Europe and Japan—and a revival of growth in many emerging market economies—should ensure that demand for U.S. goods and services remains strong.

Putting it all together, I have raised my real GDP forecast for 2018 by about half a percentage point to three quarters of a percentage point to a 2½ percent to 2¾ percent range. About one-third of this upward revision reflects the firmer momentum of the economy going into 2018 and about two-thirds the stimulative impact of the tax legislation.

While this legislation will reduce federal revenues by about 1 percent of GDP in both 2018 and 2019, I anticipate the boost to economic growth will be less than that. Most importantly, most of the tax cuts accrue to the corporate sector and to higher-income households that have a relatively low marginal propensity to consume. This suggests that a significant portion of the tax cuts will be saved, not spent.

On the business side, the boost to investment from the lower corporate tax rate and full expensing is likely to be relatively modest. In the past, aggregate investment spending has not been very sensitive to the cost of capital, which is only one of many factors that influence investment spending.[4] Moreover, the reduction in the effective tax rate for corporations—or what they typically pay in practice—is only about 3 to 4 percentage points, far smaller than the reduction in the statutory rate. On the household side, the impact is likely to be attenuated by the temporary nature of many important provisions. Households may not spend much of the additional after-tax income if they perceive the gains as likely to be transitory.

Finally, the legislation is likely to generate some frictional costs that will mitigate its effects on growth. In particular, it likely will have disparate impacts regionally and across economic sectors. For example, the $10,000 cap on the amount of state and local income and property taxes that can be deducted will raise the effective cost of owning higher-end residential property in high-tax states. This could adversely affect prices and construction activity of high-end housing in such states.

If the economy continues to grow at an above-trend pace in 2018, the labor market should tighten further. In fact, I anticipate that the civilian unemployment rate will fall below 4 percent this year and reach the lowest level since at least 2000. If this scenario proves accurate, this should lead to further firming of wage growth.

On this point, some wonder whether the relationship between tight labor markets and higher inflation has broken down. I have not lost faith in this relationship. As the labor market has tightened over the past few years, we have seen a discernible firming in the wage inflation trend from 2 percent to around 2½ percent.[5] Also, data at the state level indicate that states with lower unemployment rates tend to have firmer wage trends. This supports the case that tighter labor markets tend to be associated with higher wage growth.

As the labor market tightens and wage growth firms further, I would expect these conditions to push up price inflation, particularly for services. Research by the New York Fed has found that prices of manufactured goods do not appear to be sensitive to labor market tightness.[6] In contrast, tighter labor markets tend to be associated with higher price inflation for services. This difference presumably reflects several factors. First, prices of manufactured goods are determined in global markets, whereas prices for most services are determined locally. Second, there remains significant excess capacity in manufacturing across much of the world. In the

United States, for example, the manufacturing capacity utilization rate was only 76.4 percent in November, about 2 percentage points below its average since 1972. Third, for manufactured goods, there may be more scope for substituting capital for labor, and/or lowering labor costs by importing labor-intensive intermediate goods. To the extent that this margin of adjustment is available, it would tend to dampen the impact of higher wage costs on prices of manufactured goods. Finally, the so-called "Amazon" effect, which results in greater price transparency for buyers, may weigh disproportionately on goods prices.

Although inflation remains somewhat below the FOMC's 2 percent objective on a year-over-year basis, I still anticipate that it will stabilize around that level over the medium term. As I noted earlier, above-trend growth should tighten the labor market further, pushing up wage inflation and eventually services prices. In fact, we have already seen some increase in inflation in recent months. Over the three months ending with November, core personal consumption expenditure prices rose at a 1.8 percent annual rate, up from a corresponding rate of just 0.4 percent last May. The pronounced slowing of core inflation during the first half of 2017 was due, in part, to transitory factors, such as a sharp fall in prices for cellular phone services. Those influences have been temporarily depressing the year-over-year figures.

When these transitory influences drop out of the year-over-year numbers this spring, the inflation rate is likely to move higher. Importantly, even as inflation undershot the FOMC's objective over the past year, inflation expectations have been broadly stable. I would be much more concerned if low inflation outcomes were contributing to a decline in inflation expectations. That would make it more difficult to push inflation back toward our 2 percent objective and would increase the risk of getting stuck at the effective lower bound for interest rates following the next economic downturn, which inevitably will come.

Even if inflation were to remain somewhat below 2 percent over the near future, that might not be a serious problem, if the economy were to continue to perform well in other respects. To me, it would imply that the unemployment rate associated with "maximum employment" is lower than current estimates and that we could let the labor market tighten a bit further. This would be a positive outcome because the productive capacity of the U.S. economy would be enhanced and more people would be able to find jobs, develop their job skills, and build their human capital.

In short, 2018 looks like it will be a good year for the economy. I anticipate that the Federal Reserve will make further progress in achieving its dual mandate objectives of maximum sustainable employment and price stability. If circumstances evolve close to what I have outlined today, I will continue to advocate for gradually removing monetary policy accommodation. As I see it, the case for doing so remains strong. While the fact that inflation is below the FOMC's 2 percent objective argues for patience, I think that is more than offset by an outlook of above-trend growth, driven by accommodative monetary policy and financial conditions as well as an increasingly expansionary fiscal policy.

Moreover, if the labor market were to tighten much further, there would be a greater risk that inflation could rise substantially above our objective. But, let me be clear: A small and transitory overshoot of 2 percent inflation would not be a problem. Were it to occur, it would demonstrate that our inflation target is symmetric, and it would help keep inflation expectations well-anchored around our longer-run objective. In contrast, if inflation were to shoot appreciably above 2 percent for a considerable time, the FOMC would have to adopt a markedly tighter policy stance that would put the economic expansion at risk. In such circumstances, it is unlikely that we would be able to sustain a low level of unemployment and also achieve our inflation objective.

Potential concerns for the longer-term outlook

So, if 2018 looks good, what about the longer term? Let me start by discussing what I'm not worried about, before turning to those areas where I have greater concerns. For one, I do not think the economic expansion—now in its ninth year—is vulnerable just because it is "old." As

we like to say, expansions don't die of old age—they die either because monetary policy needs to be tightened appreciably to combat rising inflation, or because the economy gets hit with a large shock that overwhelms the ability of the Federal Reserve and other policymakers to stabilize it successfully. In general, with inflation below the FOMC's long-run objective we can be cautious in how we adjust monetary policy.

Similarly, I am not concerned about the recent flattening of the Treasury yield curve even though some commentators believe that such a flattening foreshadows a recession. At the end of 2017, the spread between the 10-year Treasury bond and 2-year Treasury note had narrowed to 52 basis points, from 125 basis points at the start of the year. As I see it, some flattening in the yield curve should be expected as we gradually remove monetary policy accommodation. If the yield curve were not flattening, it would suggest that we were behind the curve in removing accommodation. Moreover, this recent flattening is not particularly pronounced. For example, the 10-year/2-year spread of 52 basis points is only 46 basis points narrower than the average since 1978.

In addition, all else equal, we should expect the yield curve to be flatter than normal in the current environment. Not only are bond term premia depressed due to quantitative easing both here and abroad, but the low inflation environment is also likely a contributing factor. If investors perceive that the risk of significantly higher inflation has fallen over time as inflation has persistently undershot 2 percent, they should demand lower bond term premia as compensation for inflation risk. Finally, while inverted yield curves have typically preceded recessions, I am unaware of any causal element in that relationship. For example, I don't believe that banks become unwilling to lend when the yield curve inverts and that this tightening of credit availability "causes" a recession. I think it is noteworthy that in the current environment, higher short-term interest rates tend to raise—not lower—the banking industry's profitability. This is demonstrated, in part, by the strong performance of bank stocks in 2017 as the Federal Reserve raised short-term interest rates.

As I see it, the Treasury yield curve becomes inverted when investors believe that short-term real interest rates are high and monetary policy is tight. Investors anticipate that such a regime will slow the economy and be followed by a reduction in short-term rates. Because these expectations turn out to be validated eventually, we observe that inverted yield curves precede and signal recessions. But, we are not in this situation currently. Investors expect short-term interest rates to rise, not drop, and to remain higher in the future than they are now. Despite the flatter yield curve, the consensus view continues to be that monetary policy is not yet tight.

One area I might be slightly—but not particularly—worried about is financial market asset valuations, which I would characterize as elevated. While valuations are noteworthy, I am less concerned than I might be otherwise because the economy's performance and outlook seem consistent with what we see in financial markets. Volatility in the real economy has been low, and this has been matched by low volatility in financial markets, which has helped support high valuations. I am also less worried because the financial system today is much more resilient and robust than it was a decade ago. Thus, even if financial asset prices were to decline significantly—which presumably would occur if the economic outlook were to deteriorate—I don't think such declines would have the destructive impact we saw a decade ago. Higher capital and liquidity requirements for major banks have made the banking system more resilient and better able to absorb market shocks without this impairing its ability to intermediate credit flows between borrowers and savers. It was the collapse of confidence in the financial system in 2008 that caused credit availability to dry up, contributing greatly to the severity of the Great Recession.[7]

So, what am I worried about? Two macroeconomic concerns warrant mention. The first is the risk of economic overheating. Now, this seems like an odd issue to focus on when inflation is low, but it strikes me that this is a real risk over the next few years. Not only do we have an

economy that is growing at an above-trend pace—at a time when the labor market is already quite tight—but the economy will be getting an extra boost in 2018 and 2019 from the recently enacted tax legislation. Moreover, even though the FOMC has raised its target range for the federal funds rate by 125 basis points over the past two years, financial conditions today are easier than when we started to remove monetary policy accommodation.

This suggests that the Federal Reserve may have to press harder on the brakes at some point over the next few years. If that happens, the risk of a hard landing will increase. Historically, the Federal Reserve has found it difficult to achieve a soft landing—especially when the unemployment rate has fallen below the rate consistent with stable inflation. In those circumstances, the Federal Reserve has been unable to both push up the unemployment rate slightly to a level that is consistent with stable inflation and avoid recession.[8] Now, I don't want to imply that a recession is inevitable once the FOMC finds it necessary to nudge up the unemployment rate to a sustainable level. The starting point in terms of the inflation rate is also important because it will influence how far the FOMC is likely to go in terms of making monetary policy tight. Nevertheless, I think it is fair to say that the track record on this score is not encouraging.

The second risk is the long-term fiscal position of the United States. Recognizing that fiscal policy is the domain of the executive and legislative branches rather than the Federal Reserve, I would emphasize several points. For one, the current U.S. fiscal position is far worse than it was at the end of the last business cycle. For example, in fiscal year 2007, the budget deficit was 1.1 percent of GDP; in fiscal 2017, it was 3.5 percent of GDP. Similarly, federal debt held by the public was 35 percent of GDP in fiscal 2007, and 77 percent in fiscal 2017. Additionally, three factors will undoubtedly cause these budgetary pressures to intensify over time: the tax legislation will push up the federal deficit and federal debt burden; debt service costs will rise as interest rates normalize; and entitlement outlays will increase as the baby boom generation retires. Let me discuss each of these in turn.

With respect to the tax legislation, the Joint Committee on Taxation estimates the cost at around $1.1 trillion over the next 10 years.[9] This estimate takes into consideration the likelihood that the legislation will boost the productive capacity of the U.S. economy somewhat—raising the economy's potential growth rate—and that this incremental growth will generate additional tax revenues. To me, this seems like a reasonable estimate, recognizing that with any complex tax legislation, there is a high level of uncertainty about its impact on longer-term growth and revenues. It is possible that the boost to the nation's productive capacity from higher capital spending and greater labor supply will be higher than anticipated, leading to faster growth and greater revenue. But, on the other side, the revenue projections might also turn out to be overly optimistic as households and businesses react to changes in the tax code by adjusting how they conduct their activities in a way to minimize their tax liabilities. This might especially be true as people look to take advantage of the lower top marginal pass-through rate that is available on sole proprietorships, partnerships, LLCs and S corporations compared to wage income.

Debt service costs will undoubtedly be boosted by higher levels of federal debt and higher interest rates. In fiscal year 2007, federal debt service costs totaled $237 billion on $5 trillion of federal debt held by the public. By fiscal year 2017, although federal debt held by the public had nearly tripled to almost $15 trillion, debt service costs were $263 billion, only modestly above where they were 10 years earlier. Over the past decade, the sharp decline in short- and long-term interest rates has kept a lid on debt service costs—that lid is now being lifted.

Although the future path of interest rates is highly uncertain, the most recent 10-year projections of the Congressional Budget Office (CBO) illustrate where debt service costs are heading. For example, the CBO projects that debt service costs in 2027 will be more than $800 billion—nearly 3 percent of GDP, more than double their current share.[10]

Finally, the retirement of the baby boom generation over the next decade will put considerable pressure on outlays. The CBO projects that, by 2027, outlays on Social Security and Medicare will rise to 6 percent and 5 percent of GDP, respectively—each more than a percentage point higher than in 2017.

As the economist Herbert Stein once remarked, trends that are unsustainable must end. How, precisely, the United States chooses to address its fiscal challenges will have important consequences for the economy, monetary policy, and financial markets in the years ahead.

To sum up, I am optimistic about the near-term economic outlook and the likelihood that the FOMC will be able to make progress this year in pushing inflation up toward its 2 percent objective. The economy has considerable forward momentum, monetary policy is still accommodative, financial conditions are easy, and fiscal policy is set to provide a boost. But, there are some significant storm clouds over the longer term. If the labor market tightens much further, it will be harder to slow the economy to a sustainable pace, avoiding overheating and an eventual economic downturn. Another important issue is the need to get the country's fiscal house in order for the long run. The longer that task is deferred, the greater the risk for financial markets and the economy, and the harder it will be for the Federal Reserve to keep the economy on an even keel.

Thank you for your kind attention. I would be happy to take a few questions.

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[1] Gerard Dages, Saraphin Dhanani, Beverly Hirtle, Jonathan McCarthy, Richard Peach, and Paolo Pesenti assisted in the preparation of these remarks.

[2] See William C. Dudley, Remarks at the Economic Press Briefing on the Regional Economy, August 10, 2017 and 2017 Economic Press Briefing: Wage Inequality in the Region. See also William C. Dudley, The Monetary Policy Outlook and the Importance of Higher Education for Economic Mobility, October 6, 2017.

[3] See the New York Fed's Economic Press Briefing on Household Borrowing, Student Debt Trends and Homeownership, April 3, 2017. See also Bleemer, Brown, Lee, Strair, and van der Klaauw, 2017. Echoes of Rising Tuition in Students' Borrowing, Educational Attainment, and Homeownership in Post-Recession America. Federal Reserve Bank of New York Staff Reports, no. 820 (July).

[4] For example, business investment in new equipment has historically been highly correlated with the capacity utilization rate, which remains relatively low.

[5] As measured by average hourly earnings or the Employment Cost Index.

[6] Peach, Richard, Robert Rich, and M. Henry Linder. 2013. The Parts Are More Than the Whole: Separating Goods and Services to Predict Core Inflation. Federal Reserve Bank of New York, *Current Issues in Economics and Finance*, Vol. 19, No. 7.

[7] See William C. Dudley, Lessons from the Financial Crisis.

[8] Since the late 1940s, any time the three-month moving average of the unemployment rate increased by 0.3 percentage points or more, it was a sign that the economy was either already in or about to enter recession. The cumulative rise in the monthly unemployment rate from its low prior to the official start of the recession to its peak has been at least 2 percentage points.

[9] See Joint Committee on Taxation, Macroeconomic Analysis of the Conference Agreement for H.R. 1, the 'Tax Cuts and Jobs Act', December 22, 2017.

[10] Congress of the United States, Congressional Budget Office, An Update to the Budget and Economic Outlook: 2017 to 2027, June 2017.