John C Williams: The economic outlook - the “new normal” is now

Remarks by Mr John C Williams, President and Chief Executive Officer of the Federal Reserve Bank of New York, at The Economic Club of New York, New York City, 6 March 2019.

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As prepared for delivery

Thank you for the kind introduction. It’s a great pleasure to be here today and a huge honor to be joining the board of the Economic Club of New York. This institution has been an essential forum for debate for many decades, and I sincerely hope today will be no exception.

I’m going to start with a spoiler: At a certain point during this speech I will talk about interest rates. I imagine that if I don’t, you’ll feel you’ve been shortchanged. So before I get going, I’ll give the usual Fed disclaimer that the views I express are mine alone and do not necessarily reflect those of the Federal Open Market Committee or anyone else in the Federal Reserve System.

R-star

Now that’s out of the way, I want to take you back a long time ago, to a galaxy far, far away. It’s 2001: Destiny’s Child is topping the charts, you were marveling over your Motorola flip phone, and I was a young economist at the Board of Governors in Washington, D.C. At the time, I was burning the midnight oil, along with a fellow economist, Thomas Laubach, trying to understand what the burst of productivity growth generated by the tech boom meant for interest rates, both in the short term and in the long run. This led us to develop a model for measuring r-star.

I know what’s going through your mind: *“What is this r-star that you speak of?”* R-star is how economists describe the neutral or natural rate of interest. It’s the rate that we expect to prevail in the long run when interest rates are neither providing a boost to the economy nor trying to cool things down. It’s neither accommodative, nor contractionary. In other words, it’s the “normal” interest rate we expect in “normal” economic times.

G-star

One of the major factors determining r-star is… you guessed it, g-star! G-star is what economists mean when they describe trend growth, sustainable growth, or potential growth of the economy. The two main drivers of g-star are labor force growth and productivity growth.

We started trying to understand where r-star was when productivity growth was very high. During the boom GDP growth averaged over 4 percent per year. Our estimate of r-star for that time was above 3 percent, a full percentage point higher than before the tech boom started.

Given that this research was originally focused on the reasons r-star had risen, it’s ironic that I and others have ultimately dedicated much more of our careers to understanding why it’s dropped. In recent years, r-star has been averaging well below 1 percent. And it’s actually now lower than at any time before the Great Recession.

One of the reasons for this dramatic decline in r-star lies in changes to the major factors determining potential growth: labor force growth and productivity growth.

Baby boomers are retiring and fertility rates have come down. Both of these demographic shifts have significantly slowed labor force growth relative to past decades.

Productivity growth has also fallen considerably from the boom years of the late 1990s and early 2000s. All the rapid changes in technology that we see around us every day may make this seem counterintuitive. But for the moment, being able to order a Nintendo Switch and have it arrive the same day is, *shockingly*, not increasing productivity in a meaningful way. I could go on for quite some time on this topic, but will leave it to another day!

I should note that these demographic and productivity trends are not unique to the United States. In fact, we've seen similar slowdowns in growth and sharp declines in r-star in other advanced economies.[1]

So why did I take you back to simple days of the millennium bug, when you were playing Snake on your phone and ordering takeout from a paper menu?

The Economic Outlook

Understanding the fundamentals driving g-star and r-star provides a helpful backdrop for what's going on in the economy today, and an indication of what we should expect in the future.

What is the current economic outlook?

The potential growth rate, or g-star, currently appears to be about 2 percent. That may sound low to many of you, but remember that labor force and productivity trends have slowed considerably relative to the past, and that's unlikely to change anytime soon.

By comparison, actual GDP growth for 2018 came in at just above 3 percent. A number of positive tailwinds gave the economy this extra boost. Strong global growth, fiscal stimulus, and accommodative financial conditions all helped drive strong headline GDP growth and a tight labor market.

These tailwinds have calmed, and in fact reversed in some cases, and I expect growth to slow considerably relative to last year, to around 2 percent. Three developments contribute to this view: a downturn in global growth, heightened geopolitical uncertainty, and the effects of tighter financial conditions.

Starting with global growth, the outlook in both Europe and China has become less bright, with the downgrade to the outlook in Europe notable. This means less demand for our exports.

In addition, there's geopolitical risk on the horizon that's creating angst. I know we're all on tenterhooks waiting to see what will happen at the end of this month to our good friends across the pond. And concerns around trade negotiations continue to loom large. These geopolitical risks leave an imprint on the economy as businesses put off hiring and investment decisions until the air has cleared.

Moving away from the global context, back to the United States, the tightening of financial conditions that occurred late last year will likely restrain consumer and business spending this year. In fact, we have already seen a sustained slowing in housing construction, in part reflecting less favorable financing costs.

Now, I know this talk of slowing growth is causing uncertainty, some hand-wringing, and even fear of recession. But slower growth shouldn't necessarily come as a surprise. For quite some time, the economic fundamentals have pointed to GDP growth much lower than what we saw in the 1990s, for example.

In fact, my 2 percent growth forecast is right in line with g-star. That means slower growth isn't necessarily cause for alarm. Instead, it's the "new normal" we should expect. And, it's important to remember that this is happening at a time when the labor market is very strong.

From the perspective of monetary policy, the overall picture of the economy is about as good as it gets: very low unemployment, sustainable growth, and inflation just about at our 2 percent goal.

Given this favorable situation, when you look at monetary policy, things are looking pretty normal as well. My current estimate for r-star is 0.5 percent, so when you adjust for inflation that's near 2 percent, the current federal funds rate of 2.4 percent puts us right at neutral.

What Does the Future Hold?

So what does the future hold?

With a strong labor market, moderate growth, and no sign of any significant inflationary pressures, the baseline outlook is quite favorable, as I've said.

Of course, there are a number of different scenarios that could play out over the year ahead. Geopolitical uncertainty and other factors holding back growth may recede, and the U.S. economy could resume the robust trajectory of last year. Or GDP growth could continue closer to trend, which is my own forecast. Finally, there's always a chance that downside risks could knock GDP growth off course.

What will the response of the Fed be? My short answer: It depends!

I promised talk of interest rates, and here it is. I've said it before, and no doubt, I'll say it as long as I work for a central bank. But in the current conditions the phrase takes on even more importance. Our response will always be "data dependent."

When growth is well above trend, raising interest rates to keep the economy on a sustainable path is the right decision. Equally, when faced with a crisis like the Great Recession, it's incumbent upon policy makers to use every tool at their disposal to get the economy back on course.

The base case outlook is looking good, but various uncertainties continue to loom large. Therefore, we can afford to be flexible and wait for the data to guide our approach. In that context, the FOMC decided to keep interest rates where they were at the most recent meeting, and noted the importance of patience in determining future policy actions.

To use a nautical metaphor, guiding the U.S. economy is like steering a large ship. Monetary policy decisions can leave a wake several miles long, with implications that reach far into the future. We'll consider the full range of data, the headline statistics, the market indicators, and we'll listen to our business contacts on the ground, as we aim to keep the economy on its current course of a strong labor market, sustainable growth, and 2 percent inflation.

Conclusion

R-star provides a helpful framework, not just for thinking about monetary policy, but also for understanding the current progress of GDP growth and its likely trajectory over the coming years.

Moderate growth, both in the U.S. and the global economy, is far less alarming when you know what the underlying factors might be. And all the signs have been pointing to a slower growth trend. You may have had Destiny's Child—Beyoncé—turned up too loud to spot the signs, but they have certainly been there.

Slow trend growth and low r-star in the current global context presents certain challenges to monetary policy, another topic for a future day. In everything that we do, we need to consider all the information, and exercise data dependence and flexibility, as we navigate the course ahead.

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[1] See John C. Williams, Interest Rates and the 'New Normal', Remarks to the Community Banking in the 21st Century Research and Policy Conference, St. Louis, Missouri (October 5, 2017), and Kathryn Holston, Thomas Laubach, and John C. Williams, Measuring the Natural Rate of Interest: International Trends and Determinants,

Journal of International Economics, Volume 108, Supplement 1, pp. S59–S75 (May 2017).