Views on the Economic and Policy Outlook

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- Atlanta Fed president and CEO Raphael Bostic presents his view of the current economy, the national outlook, and the Fed's policy path as part of the University of Georgia's Georgia Economic Outlook series.

- Bostic says there is a lot to like about the current U.S. economy. If estimates hold, growth of gross domestic product for the year will have topped 3 percent for the first time since 2005.

- Bostic believes that partly due to the trajectory of capital expenditures, real GDP growth will slow over the next few years as the effects of tax reform and fiscal stimulus begin to wane.

- Bostic notes that most respondents to an Atlanta Fed survey measuring firms' year-ahead expectations and uncertainties said tax reform will not affect their capital expenditures at all. The survey also found that, despite uncertainty regarding tariffs and changes in trade policy, most firms are still generally quite optimistic about their outlook over the year ahead.

- He believes that given the current strong growth, very low unemployment rates, and inflation close to 2 percent, monetary policy ought to be taking a more neutral position.

- Bostic: "We're within shouting distance of neutral." He does not see clear signs of overheating nor of a material weakening in the macroeconomic data. Should the data deliver clearer signs of either, he would be fully prepared to support policy actions to mitigate the risks in either direction.

Good afternoon, and thank you for that kind introduction. It's a pleasure to be here today.

We are less than two weeks away from the December meeting of the Federal Open Market Committee (or FOMC). I won't predict the outcome—I'll leave that to you. Between now and the meeting, I will continue to process the incoming data to inform my assessment of the health and momentum of the economy and balance the risks to the outlook.

Today, I will offer a few thoughts on how I see the current position of the economy, the national economic outlook, and some particulars on the labor market, inflation, and risk management as I consider the monetary policy path.

As always, these will be my personal views and may not reflect those of my colleagues here or other colleagues on the FOMC or in the Federal Reserve System.

Current economic conditions

There is a lot to like about the current snapshot of the U.S. economy. Output has continued to grow at an above-trend clip, the unemployment rate is very low on a historical basis, and inflation has held near the FOMC's 2 percent target recently.

Real, inflation-adjusted gross domestic product (GDP) has been on something of a tear recently. Over the first three quarters of 2018, real GDP has increased by 3.3 percent. And according to GDPNow, the Atlanta Fed's in-house tracking model, GDP is expected to increase by a little more than 2 ½ percent in the fourth quarter.

To be sure, this early in the fourth quarter, there is a lot of uncertainty about the estimate. But if it holds, growth for the year will have topped 3 percent for the first time since 2005. And it will have come in about a half-percentage point higher than I expected even just six months ago.

Alongside the robust pace of economic growth we have enjoyed this year, job gains have averaged roughly 200,000 a month and the unemployment rate has fallen to 3.7 percent, a level that has not been sustained for at least a half-century.

We will, of course, get an important update on labor market conditions in tomorrow's labor report. I think we are very close to meeting the first half of the FOMC's dual mandate—promoting maximum sustainable employment growth. And it's possible that we have gone some measure beyond. I will say a bit more on this later.

The other half of the FOMC's mandate is to deliver price stability, which has been defined as 2 percent inflation over the longer run. As of October, the year-over-year percent change in the Personal Consumption Expenditures (PCE) price index was at 2 percent. Excluding food and energy prices, the core PCE price index was just a notch below that on a year-over-year basis. Transparency requires that I note that its performance over the past three months has been modestly weaker. Still, if you paint with a broad enough brush, inflation is either at or very close to our target.

It's possible that some of the unexpectedly strong growth we've seen this year can be tied to a more robust response by households to income tax cuts along with a faster ramp-up in federal spending than I anticipated.

Consumer spending has accelerated this year, and especially over the past two quarters. Interestingly, the acceleration seems to be concentrated in two arguably discretionary spending categories—apparel and food services. In fact, the pickup in household spending at restaurants has led to its highest two-quarter growth rate since the early 1990s, more than tripling its typical contribution to overall output growth.

Going forward, my baseline view is that consumer spending will revert to a less torrid but still solid pace. I hold this view, in part, because the latest monthly data on apparel and food services have softened. This may also suggest that some of the impacts from tax reform on household spending growth are waning.

The pace of federal government spending has also quickened over the second half of the year, turning from a headwind to a tailwind for growth, and is now adding about a fourth of a percentage point to growth, on average, over the past four quarters.

Perhaps surprisingly, business investment has remained relatively tepid. Nonresidential fixed investment has slowed in each of the first three quarters of 2018. After factoring in a small rebound we expect to see in the fourth quarter, the year-over-year growth rate in business fixed investment will likely still be slightly below its average growth rate during the past two expansions.

Economic outlook

Now to my outlook. Like many other forecasters, I see real GDP growth slowing over the next few years as the effects of tax reform and fiscal stimulus begin to wane. By the end of 2020, my projection has real GDP keeping pace with the underlying potential growth rate of the economy, which I estimate to be modestly below 2 percent.

One reason I'm a bit skeptical that the current pace of growth can be sustained into the next year is the trajectory of capital expenditures. That view is primarily informed by two unique research initiatives undertaken by my bank's research department.

The first is an extensive network of business contacts, community groups, and nonprofit organizations that we affectionately call REIN—or the Regional Economic Information Network. Insights from this REIN network help me paint a broader picture of the health of the economy than I could capture with economic models alone.

The other initiative is an exciting new national survey of firms. In partnership with Steven Davis of the University of Chicago Booth School of Business and Nicholas Bloom of Stanford University, the Atlanta Fed has created the Survey of Business Uncertainty (or SBU). This innovative panel survey measures the one-year-ahead expectations and uncertainties that firms have about their own costs, employment, capital investment, and sales. The sample covers a broad range of firm sizes and all regions of the U.S. economy, and every industry sector except agriculture and government.

Last November, after the original House bill on tax reform had passed, the SBU had a survey in the field asking firms how tax reform would affect their capital expenditure plans for 2018. Roughly two-thirds of respondents said the reform wouldn't affect their capital expenditures at all. Just 15 percent said they would increase capital spending by 10 percent or more, and those responses came mostly from smaller firms.

These results held in a follow-up survey in February. The survey asked the same question on capital expenditures for 2018 and extended it to include plans for 2019 as well. The results were not meaningfully different than before for 2018. Roughly three-quarters of firms did not plan to change their capital expenditure plans in 2019 as a result of the tax reform.

And, arguably, this has been borne out in the middling trajectory for business investment we have seen so far.

Now, before you think I'm keeping these great insights from the Survey of Business Uncertainty to myself, I'll invite you to visit our website. Last Wednesday, the Atlanta Fed began publishing some of these data. The hope is that policymakers and researchers can use the SBU to help forecast economic activity and better understand how business expectations and uncertainty affect economic outcomes.

I see both upside and downside risks to my growth projection. On the upside, businesses may interpret the recent strength of consumer spending as a signal of stronger future demand and may ramp up expansionary capital investment to meet it.

On the other hand, the U.S. economy has been beset by increasing uncertainties that may slow its growth, such as international trade tensions, the potential slowing of the global economy, and a recent bout of financial volatility. Indeed, our SBU survey data suggest that business uncertainty has increased since the beginning of the year.

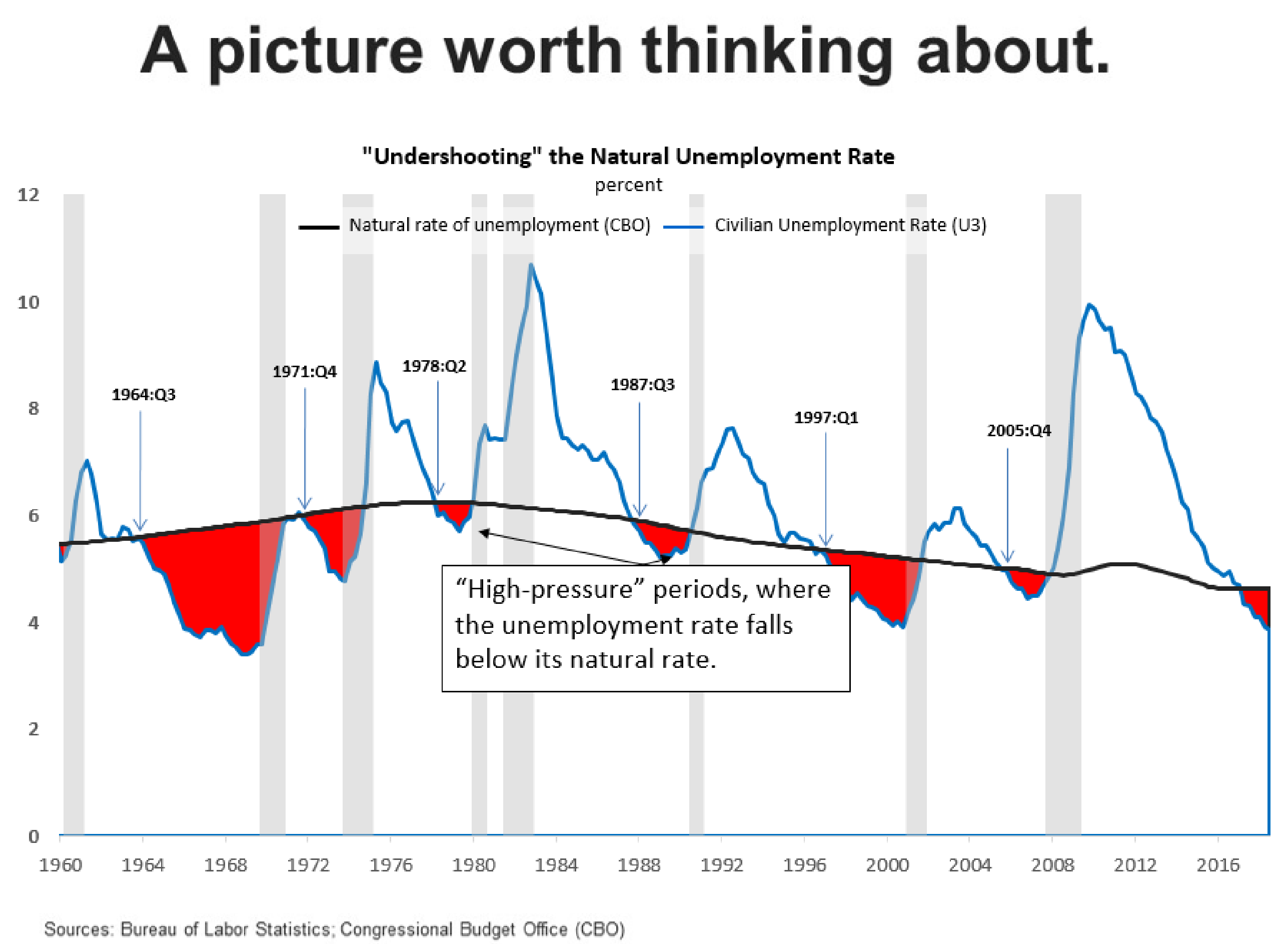
To be clear, while uncertainty regarding tariffs and changes in trade policy remains a feature of the economic backdrop, most firms appear to have taken this in stride. According to our survey data, businesses are still generally quite optimistic about their outlook over the year ahead.

Thoughts on the policy path

Given the current constellation of strong growth, very low unemployment rates, and inflation close to 2 percent, I think that monetary policy ought to be taking a more neutral position—one that neither provides policy accommodation nor hinders growth.

While that sounds easy enough, this neutral rate is not something we observe directly, and as such, we can only infer its position. So in attempting to achieve a neutral stance of policy, I have adopted a risk management approach, attempting to balance both the upside and downside risks to a further removal of accommodation.

Those risks are, one, staying too accommodative on rates and risking an overheated and unstable economic and financial environment. And, two, pushing rates up too far, too fast and potentially short-circuiting an otherwise sustainable expansion. And it just so happens I have a picture that helps highlight those risks.



This slide shows periods of time when the actual unemployment rate fell below what the U.S. Congressional Budget Office now estimates as the so-called natural rate of unemployment. I refer to these episodes as “high-pressure” periods.

Here is the punchline. Dating back to 1960, every high-pressure period ended in a recession. And all but one recession was preceded by a high-pressure period.

There are many possible interpretations for the leading relationship between high-pressure periods and economic downturns. One is that the relationship is entirely spurious. But I’m not convinced that such a benign interpretation is consistent with good risk management practice.

I think a risk management approach requires that we at least consider the possibility that unemployment rates that are lower than normal for an extended period are symptoms of an overheated economy.

One potential consequence of overheating is that inflationary pressures inevitably build up, leading the central bank to take a much more “muscular” stance of policy at the end of these high-pressure periods to combat rising nominal pressures. Economic weakness follows.

You might argue that the simple answer is to not respond so aggressively to building signs of inflation, but that would entail risks that few responsible central bankers would accept.

It is true that the Fed and most other advanced-economy central banks have the luxury of solid credibility for achieving and maintaining their price stability goals. But we shouldn’t forget that such credibility was hard won.

Inflation expectations are reasonably stable for now, but we know little about how far the scales can tip before it is no longer so.

On the other hand, there are decided risks to raising rates too soon and too aggressively.

The crux of the issue, as I see it, is that it is very difficult in real time to determine when the economy is actually overheating. That is especially true at the moment, when the signaling from the nominal side of the economy is, if anything, still a bit subdued.

While nominal wage growth has picked up since the beginning of the year, it is still trending in line with productivity growth and inflation. Inflation itself has, if anything, softened slightly over the past three months.

I know that on this picture the “normal” or natural rate of unemployment is drawn with a sharp black line, but in reality it’s best to think about that line as more of a blurred zone or range. My definition of normal is a sustainable level that avoids overheating the economy. I would have pegged an unemployment rate around 5 percent as normal when the Committee started down the path of normalization in 2015. Fast forward to September of this year, and the Committee’s longer-run consensus projection for the unemployment rate had fallen by almost half a percentage point, to 4.5 percent. And, I’m on record suggesting it may even be lower than that. So the red zone could be smaller than what you see here.

Estimating the capacity of the economy—of which the unemployment rate is just one measure—is extremely difficult, not least because it can be a moving target. One example is the behavior of the U.S. labor force participation rate.

The labor force participation rate of prime-age U.S. workers, especially women, has actually been rising. We have no solid explanation for this trend. But it is reasonable to suspect that larger flows of workers into the labor market, smaller flows of unemployed workers out of the labor market, and still relatively modest wage pressures are signs that there may be more slack in labor markets than implied if we just focused on the unemployment rate. Some might argue that this is further evidence that we are right at or close to full employment rather than measurably beyond it.

Conclusion

So, in an environment where even defining the concept of overheating is a challenge, how can we balance the risks of being too timid with the risk of being too muscular? For me, the answer is to proceed cautiously, with a keen eye on the data. This will particularly be the case over the next six to 12 months, as I look for signals in the data that might confirm or refute my current position.

I currently think we're within shouting distance of neutral, and I do think neutral is where we want to be. I'm not seeing clear signs of overheating, nor am I seeing any indications of a material weakening in the macroeconomic data at the moment.

That said, should the data deliver clearer signals of either, I would be fully prepared to support policy actions to mitigate the risks in either direction.