

**The U. S. Economic Outlook:
Upside and Risks**

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My Policy Package: “Be Like Canada”

- **Immigration**
- **Medical Care**
- **University Tuition and Debt**
- **Parental Leave and Support – Labor Force Participation of Prime-age Females**
- **My Moment in Seattle**

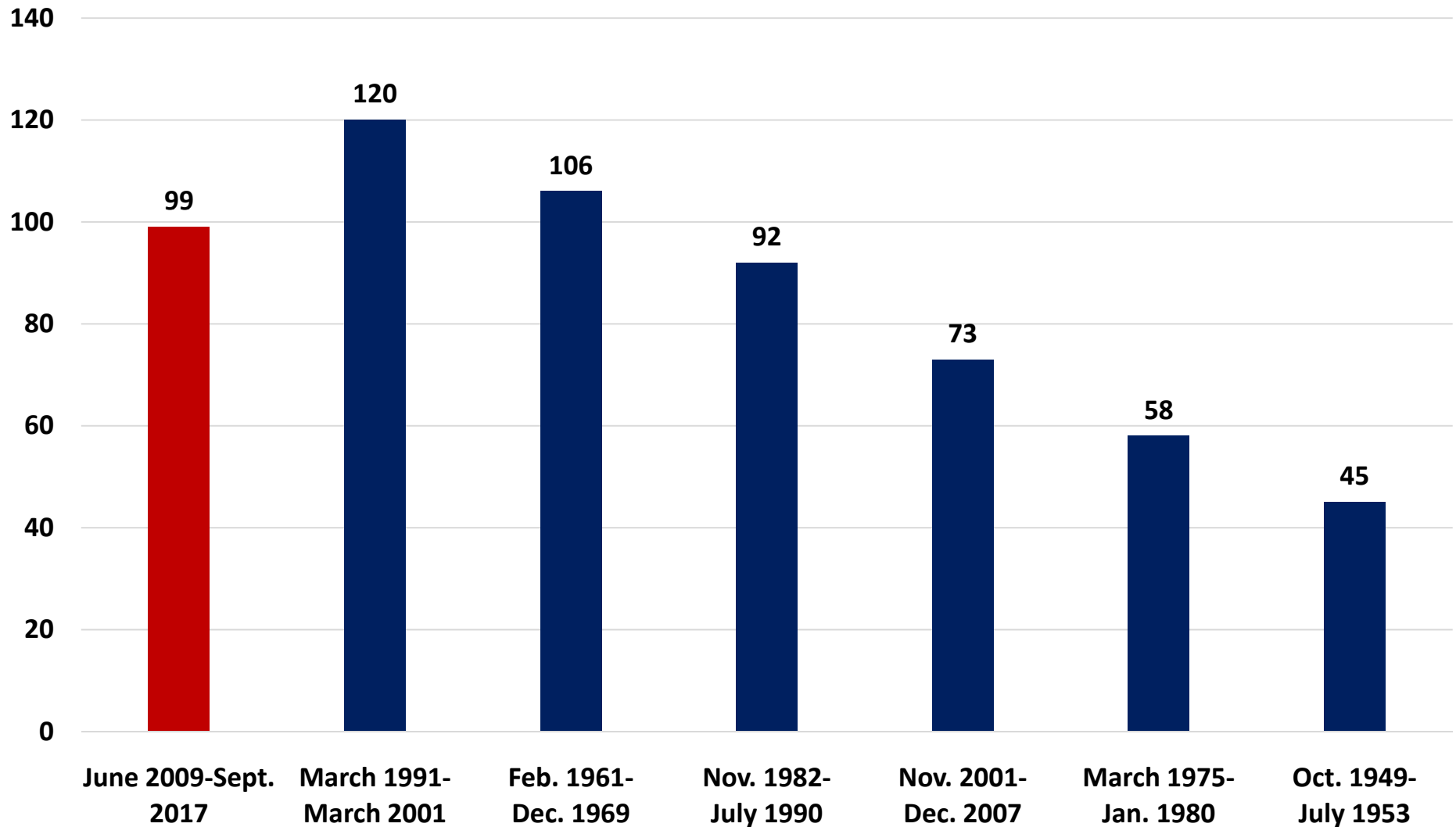
The U. S. Economic Outlook: A Preview

- **Economic Expansion Has Reached 99 Months**
 - Record is 120 months, March 1991 to March 2001
- **Current Situation: Unemployment and Inflation**
- **Perspective: What Has Killed Previous Expansions?**
- **The Demand Side: Obstacles Ahead?**

Preview: Policy and the Supply Side

- **Monetary Policy: How Restrictive?**
- **Tax Cuts and Reform: How Likely? How Stimulative?**
- **Can the Supply Side Support the Demand Expansion?**
- **Will Growth Fall Below 2%? Productivity and the Available Supply of Labor**

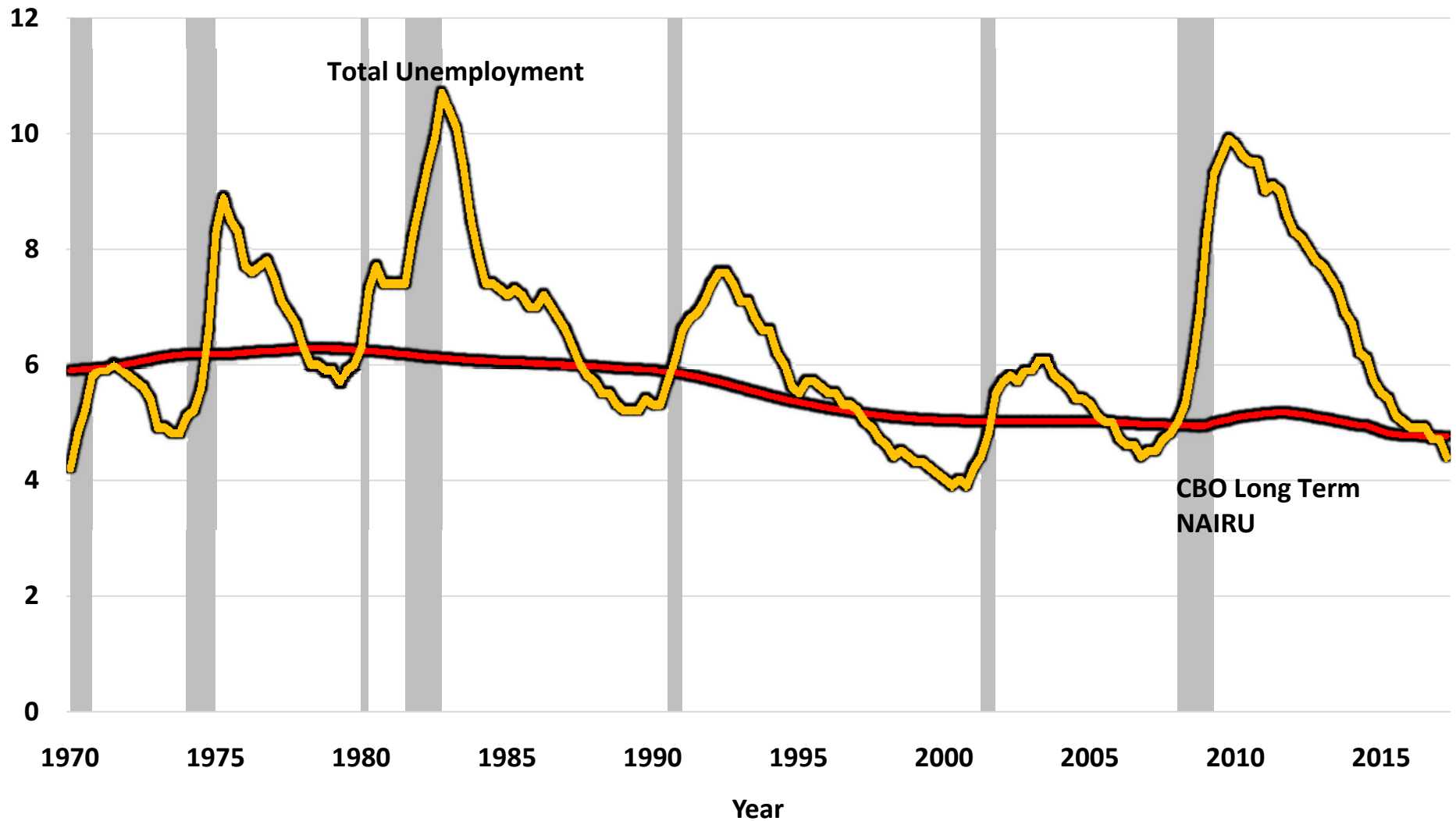
Length of Expansions: Current vs. Previous Five Longest



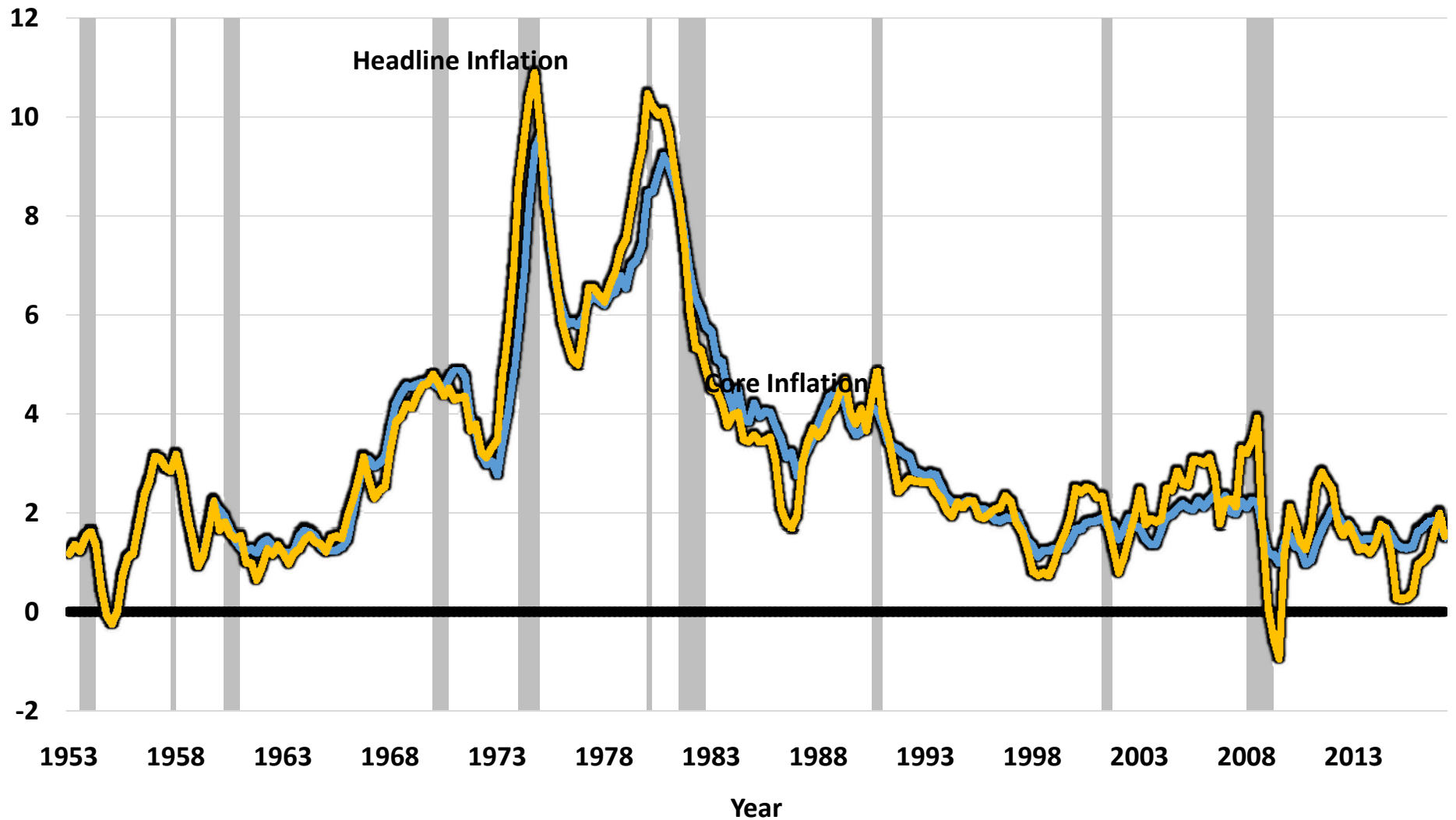
The Current Economy: A Golden Moment

- **“Golden” except for Harvey and Irma. Estimated hit to 2017:Q3 Growth: 3.0 to 2.3.**
- **Unemployment rate has fallen from 10 percent in October 2009 to 4.4 percent in August 2017**
- **Below Most Estimates of the NAIRU**
- **But Inflation is Not Accelerating as in Past Expansions**
- **How Low Can Unemployment Go?**
 - **3.8% April 2000, 3.4% Fall-Winter 1968-69**

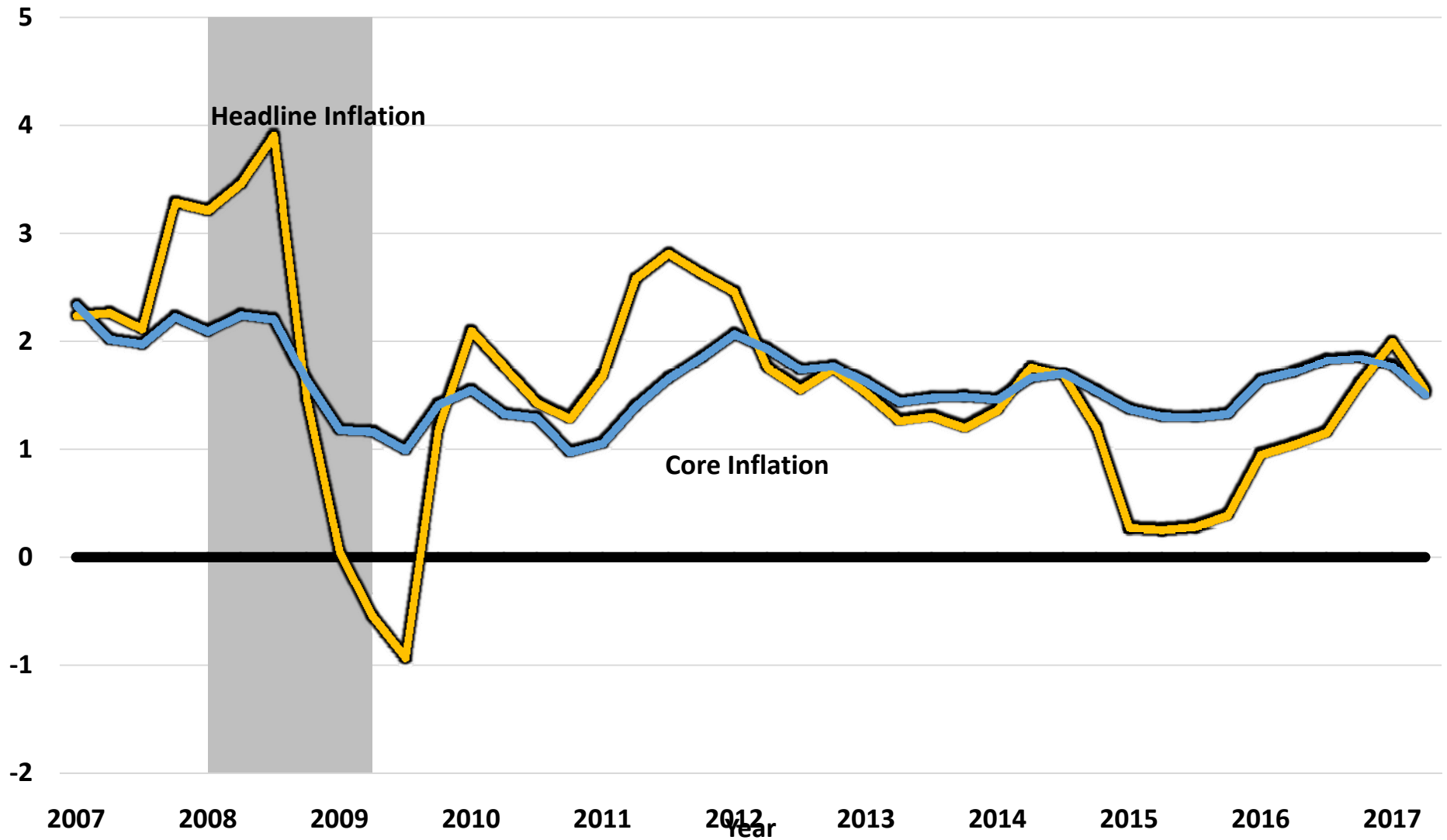
The Unemployment Rate and the NAIRU, 1970-2017



Headline and Core Inflation, 1970-2017



A Close-Up Look at Inflation, 2007-2017



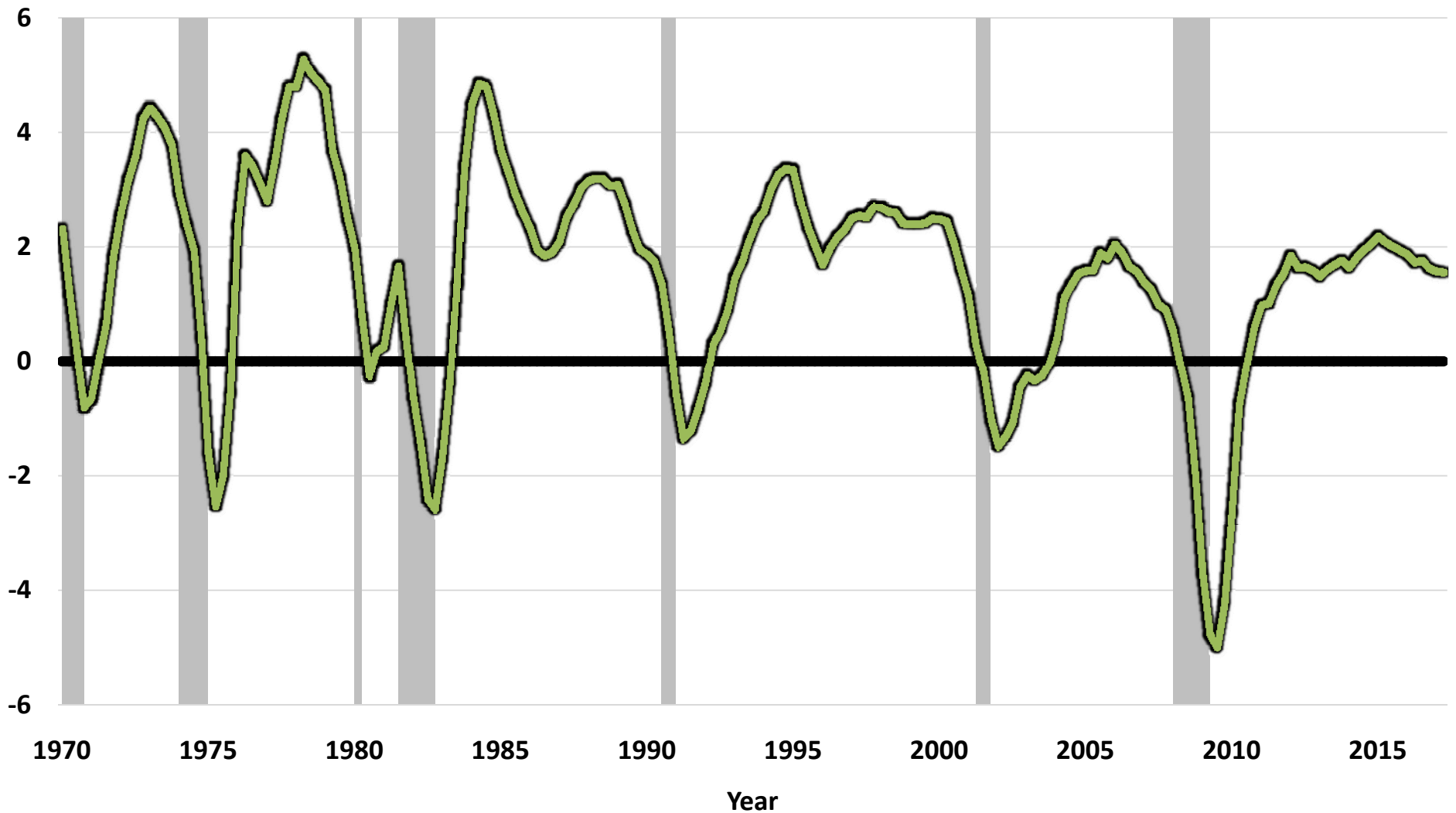
What Killed Previous Expansions?

- **Most common, high interest rates as Fed responded to rising inflation**
 - Late 1950s, late 1960s, late 1980s
- **Special category – oil shock inflation**
 - In 1974 caused a recession as higher prices took away spending power
 - In 1980 the Fed boosted rates to double digits
- **Other special categories:**
 - collapse of dot.com investment boom of late 1990s, together with stock market crash
 - Collapse of housing and excess leverage that led up to 2008-09 financial crisis.

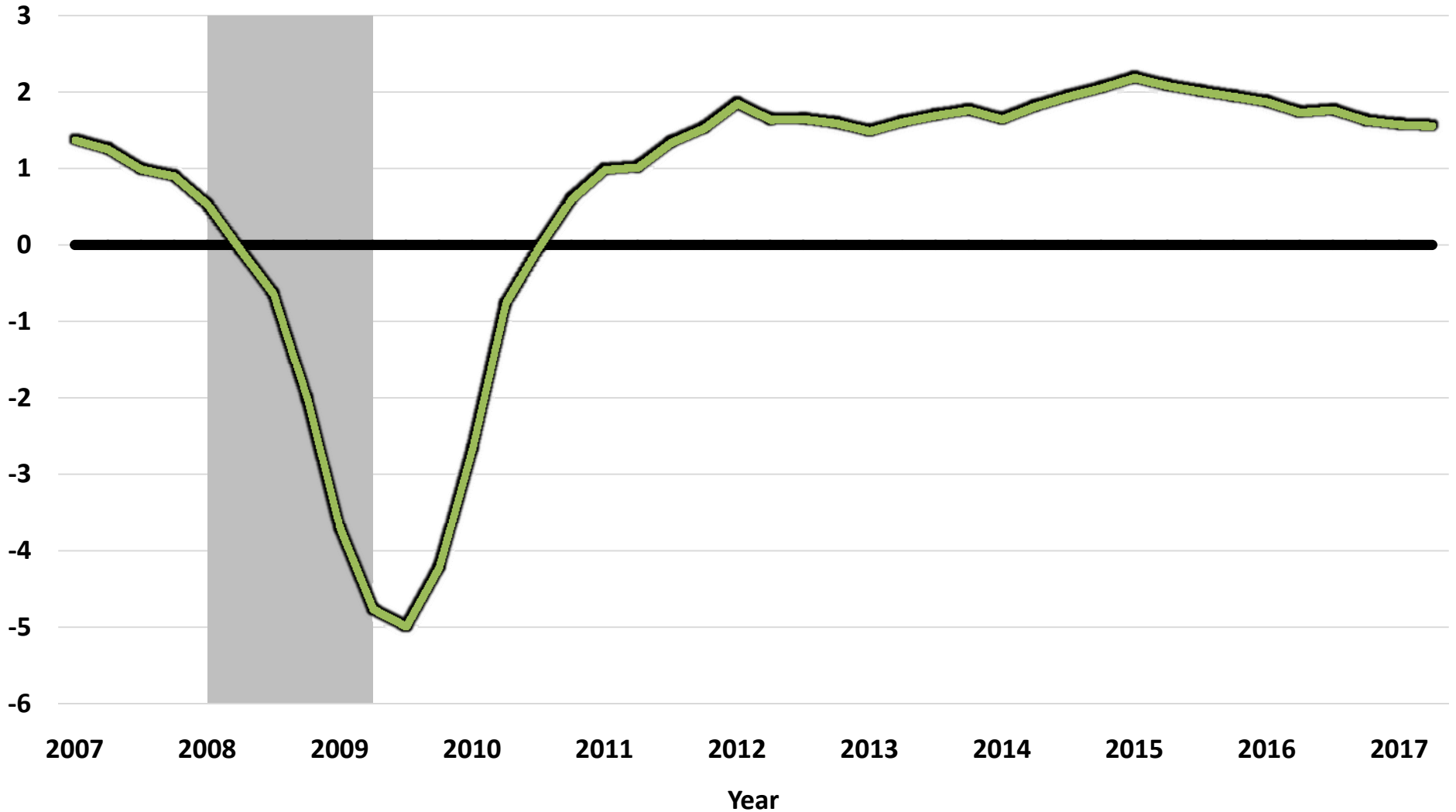
Without a Negative Shock, Expansion is a Virtuous Circle

- **Employment growth causes income to grow**
- **Income growth causes consumption spending to grow**
- **Higher consumption spending creates more jobs, more growth of employment**
- **Consumers don't suddenly save most of their income, they spend it**

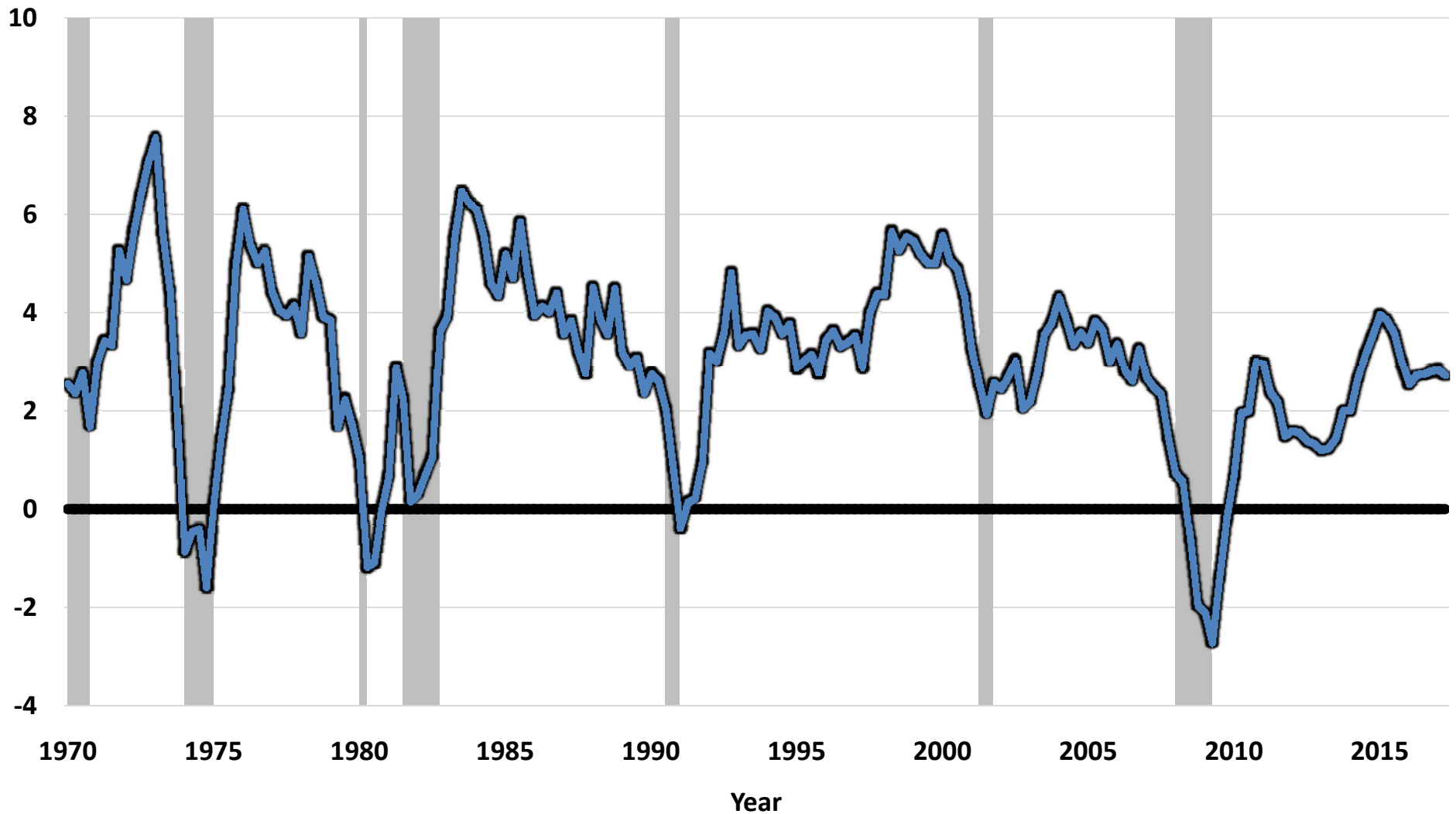
Half of Virtuous Circle, Employment Growth 1970-2017



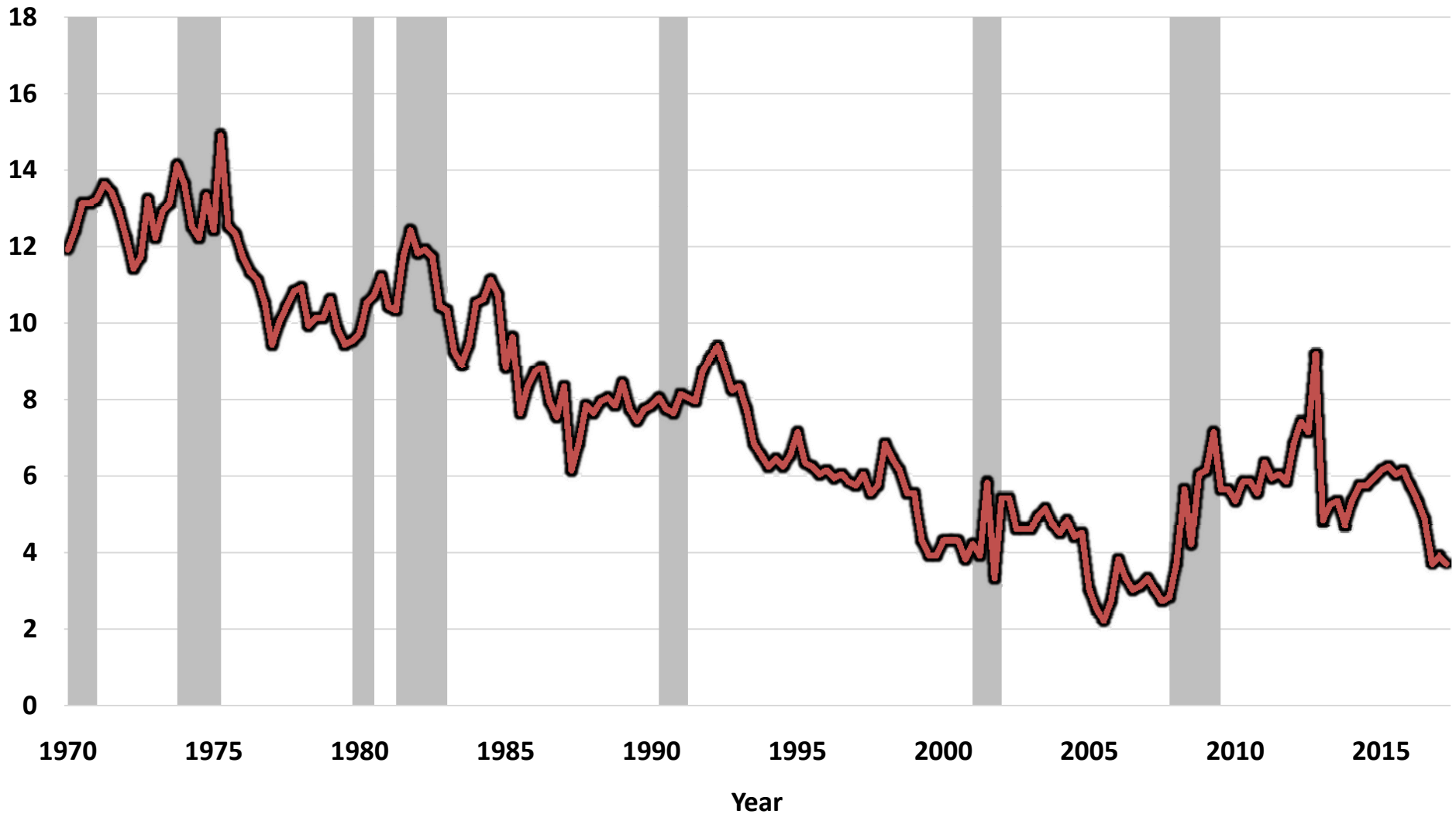
A Closeup of Employment Growth, 2007-2017



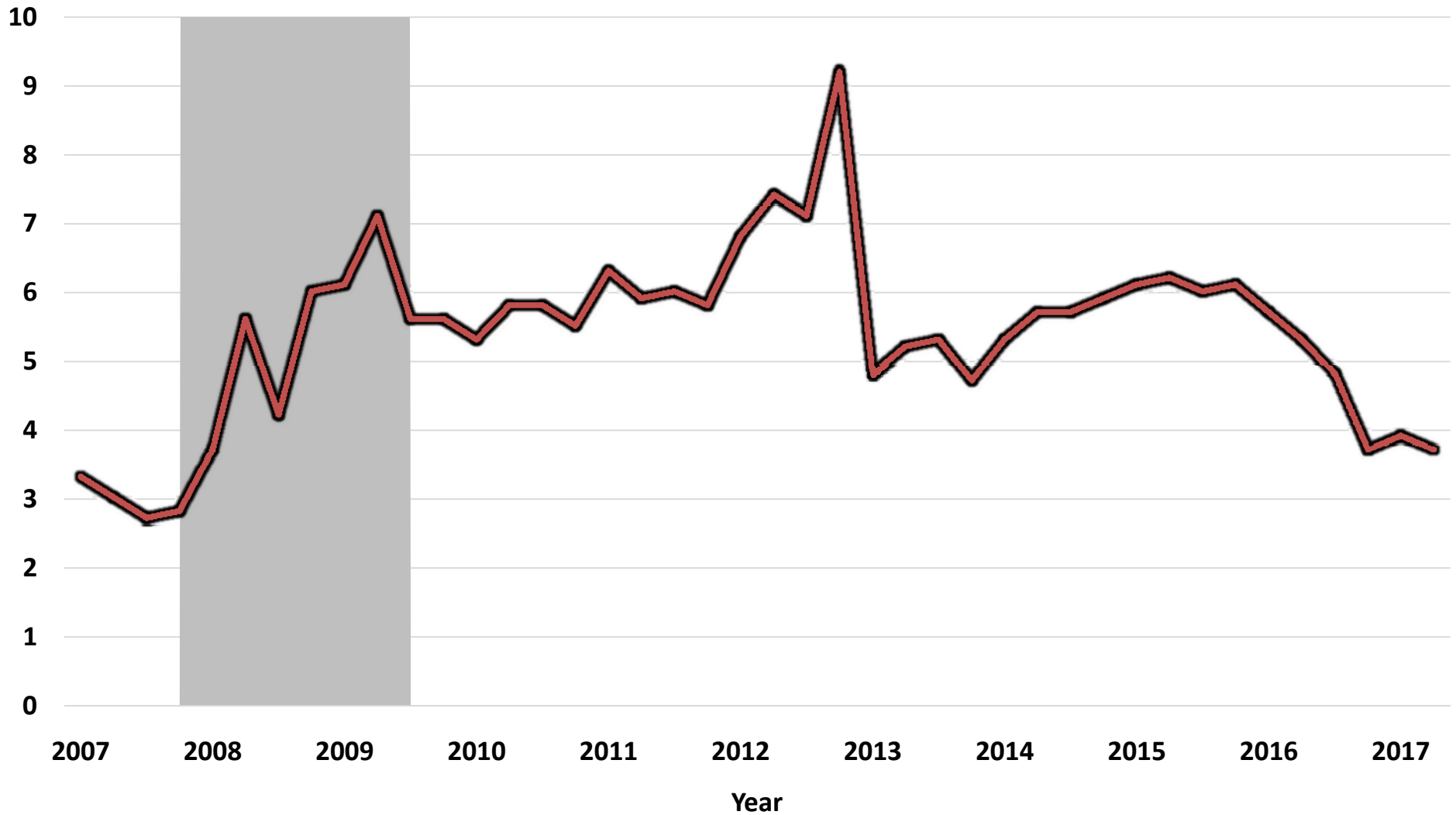
Other Half of Virtuous Circle, Consumption Spending Growth 1970-2017



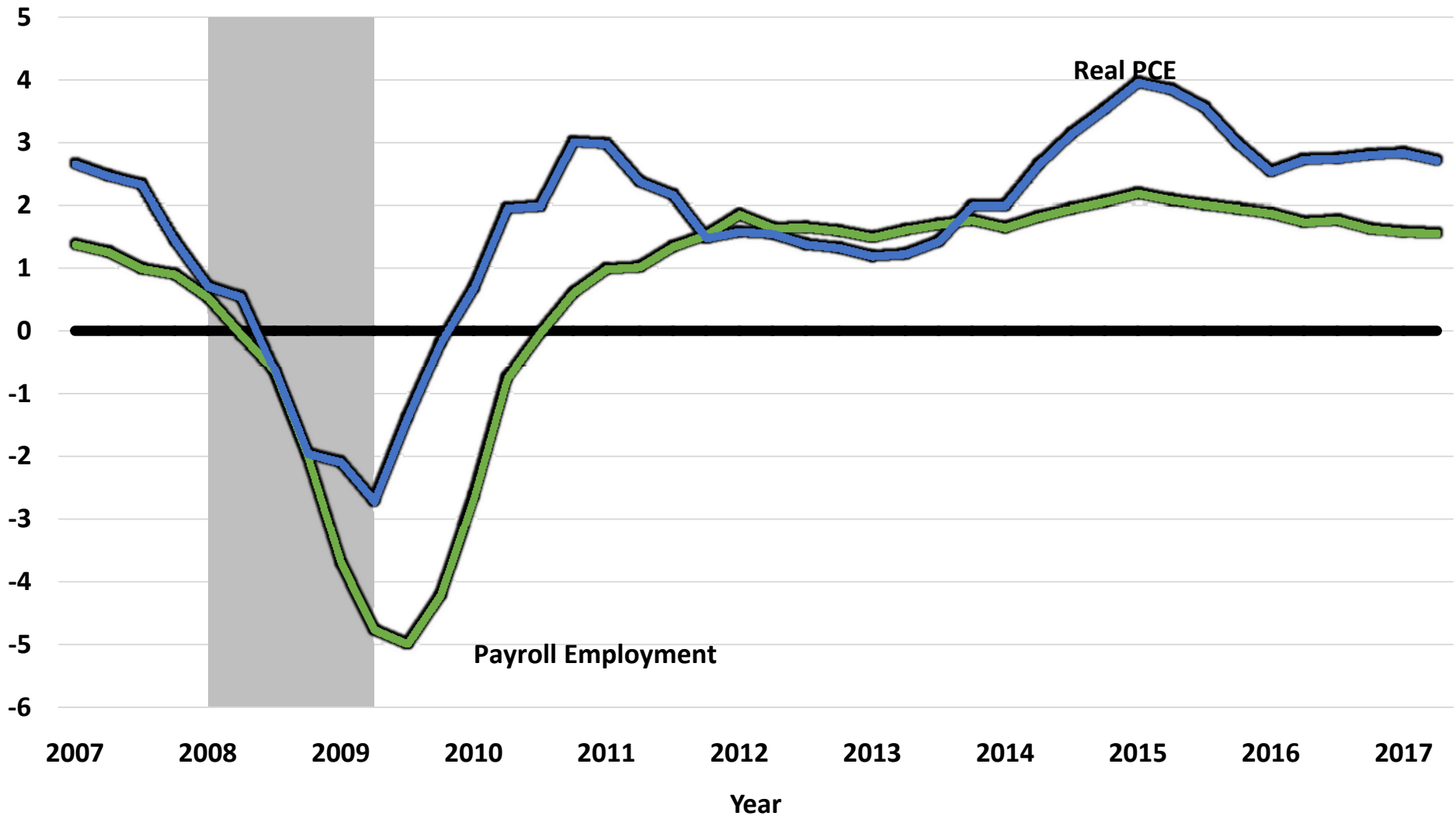
Personal Saving Rate, 1970-2017



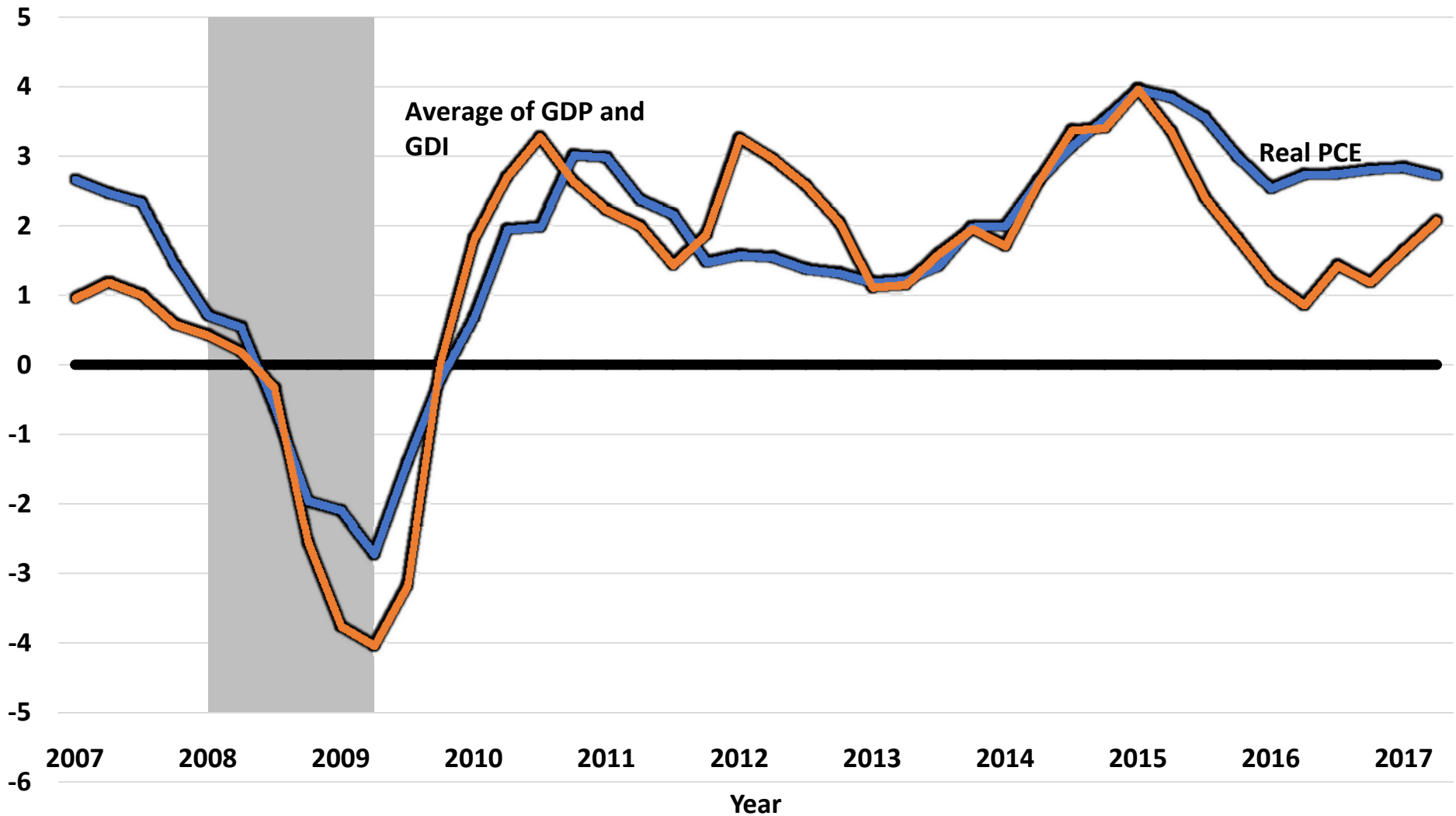
Closeup of Personal Saving Rate, 2007-2017



Closeup of Consumption and Employment Growth Feeding Each Other



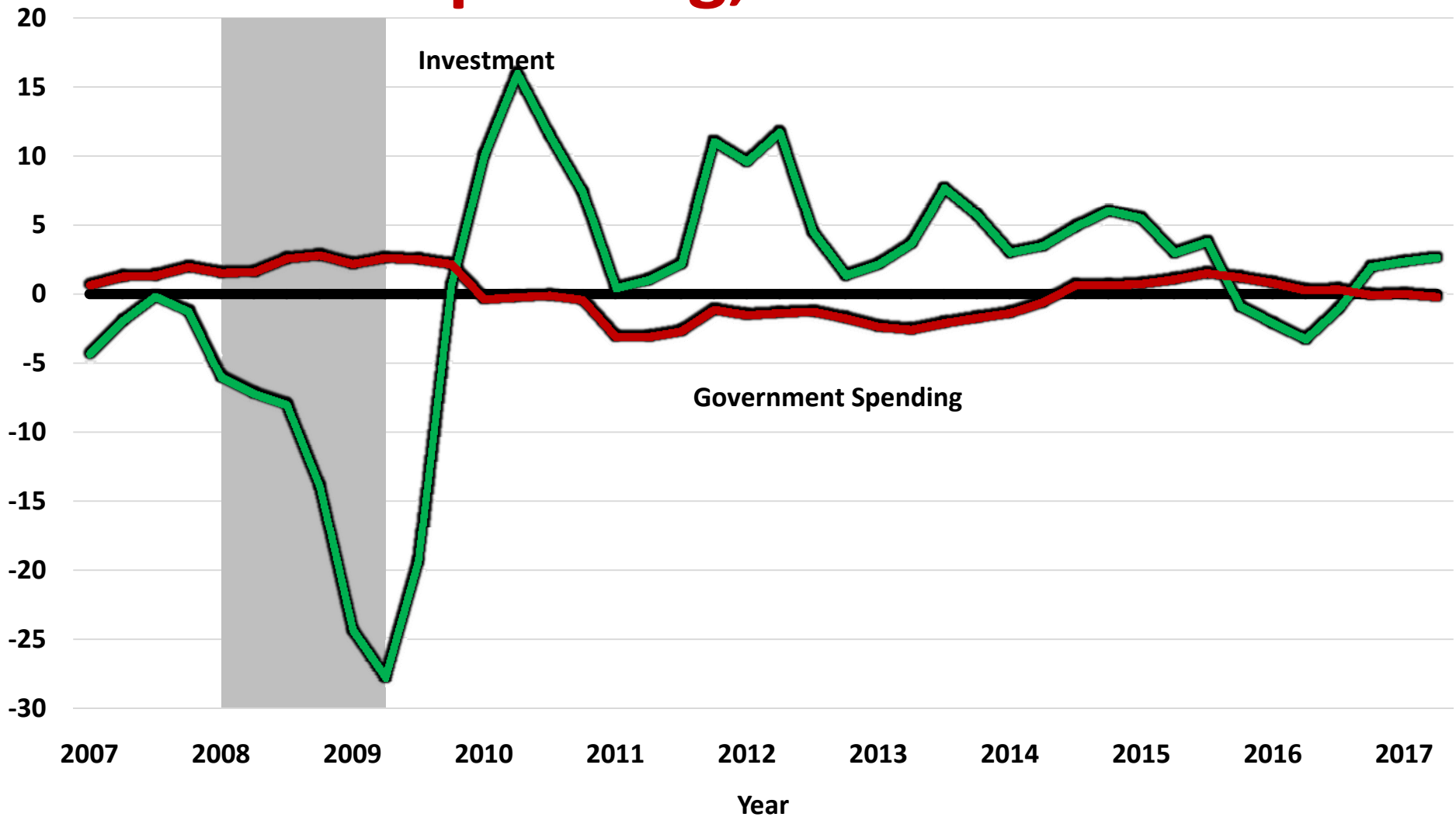
Comparison of Consumption Growth and GDP Growth, 2007-17



Consumption Growth 3% Since 2014, Why GDP Growth Only 2%?

- **GDP = C + I + G + NX**
- **The sum of I + G + NX has been growing slower than GDP**
- **Investment weakness, corporations sitting on record-breaking profits (as share of GDP)**
 - **Dividends, share buy-backs**
- **Government spending weakness**
 - **Republican Congress forced spending cuts in 2012-13**
 - **State and local cutbacks after recession**

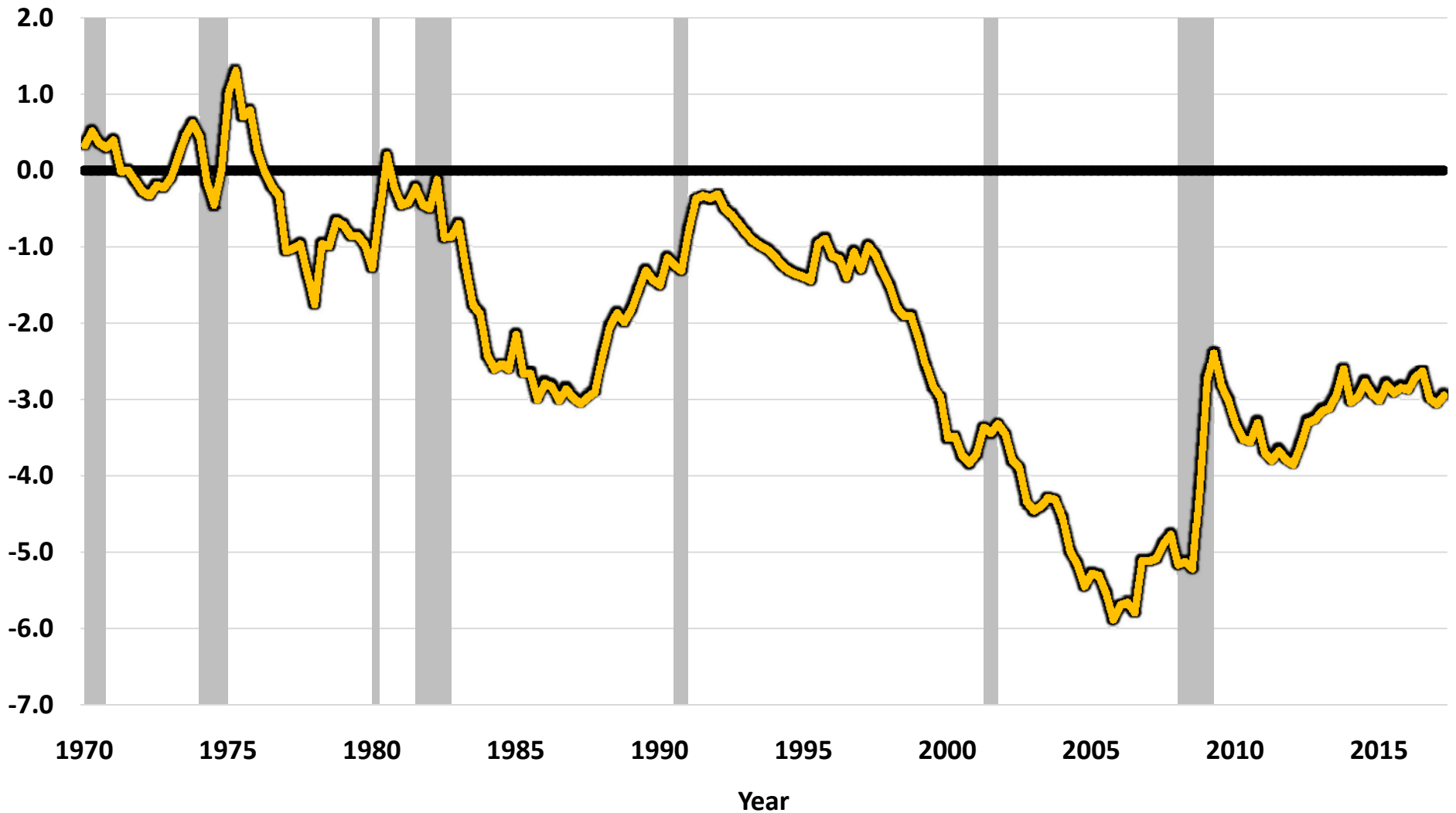
Comparison of Growth in Fixed Investment and Government spending, 2007-17



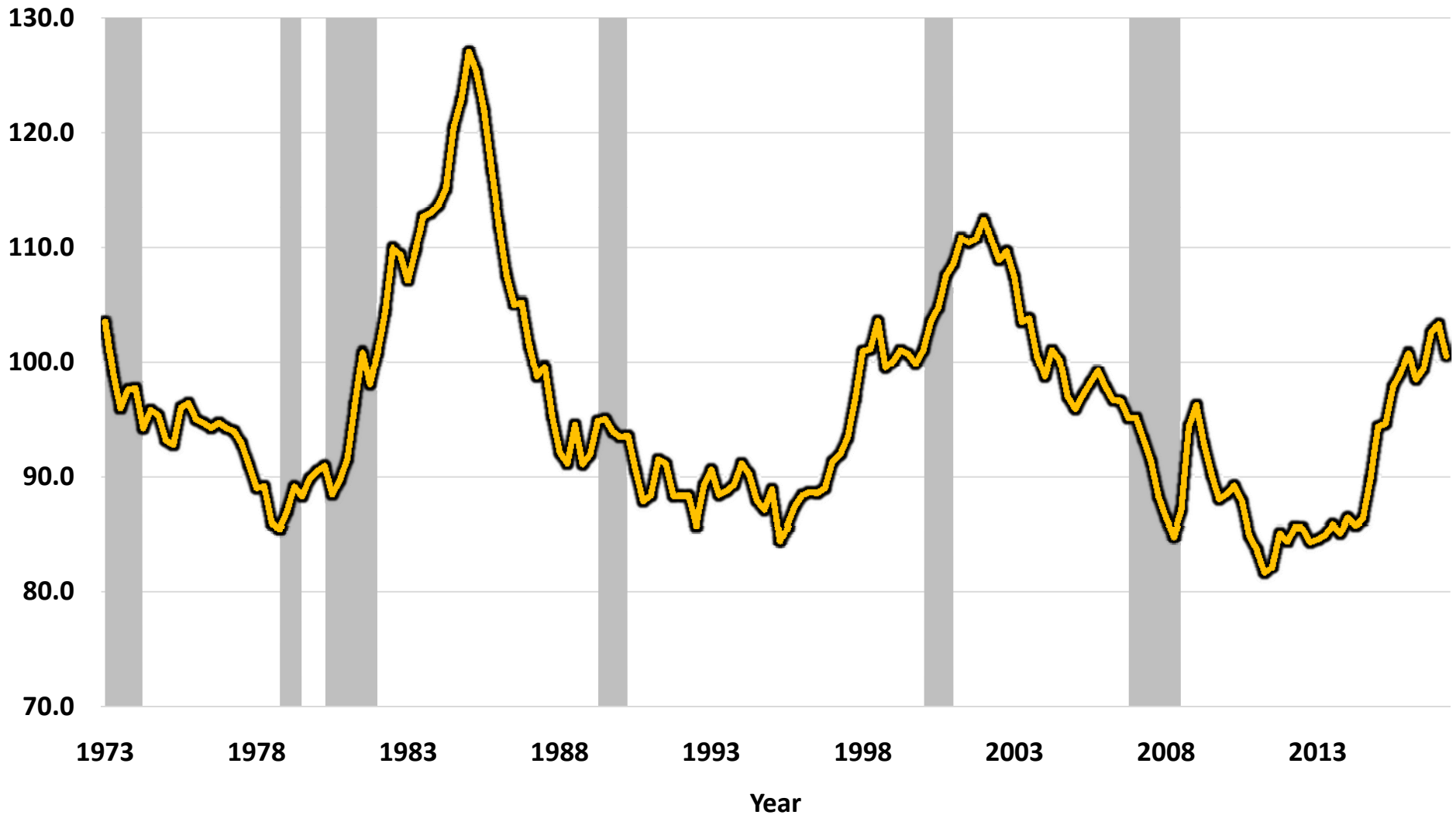
Negative Net Exports, A Drag on GDP

- **Net Exports Have Been Negative Since 1980**
- **Big Widening of the Gap 1995-2007**
- **Narrowing of the Gap after 2008-09 Recession**
- **Surprising stability in the Gap given the 2014-15 appreciation of the dollar**

Net Exports as a Share of GDP, 1970-2017



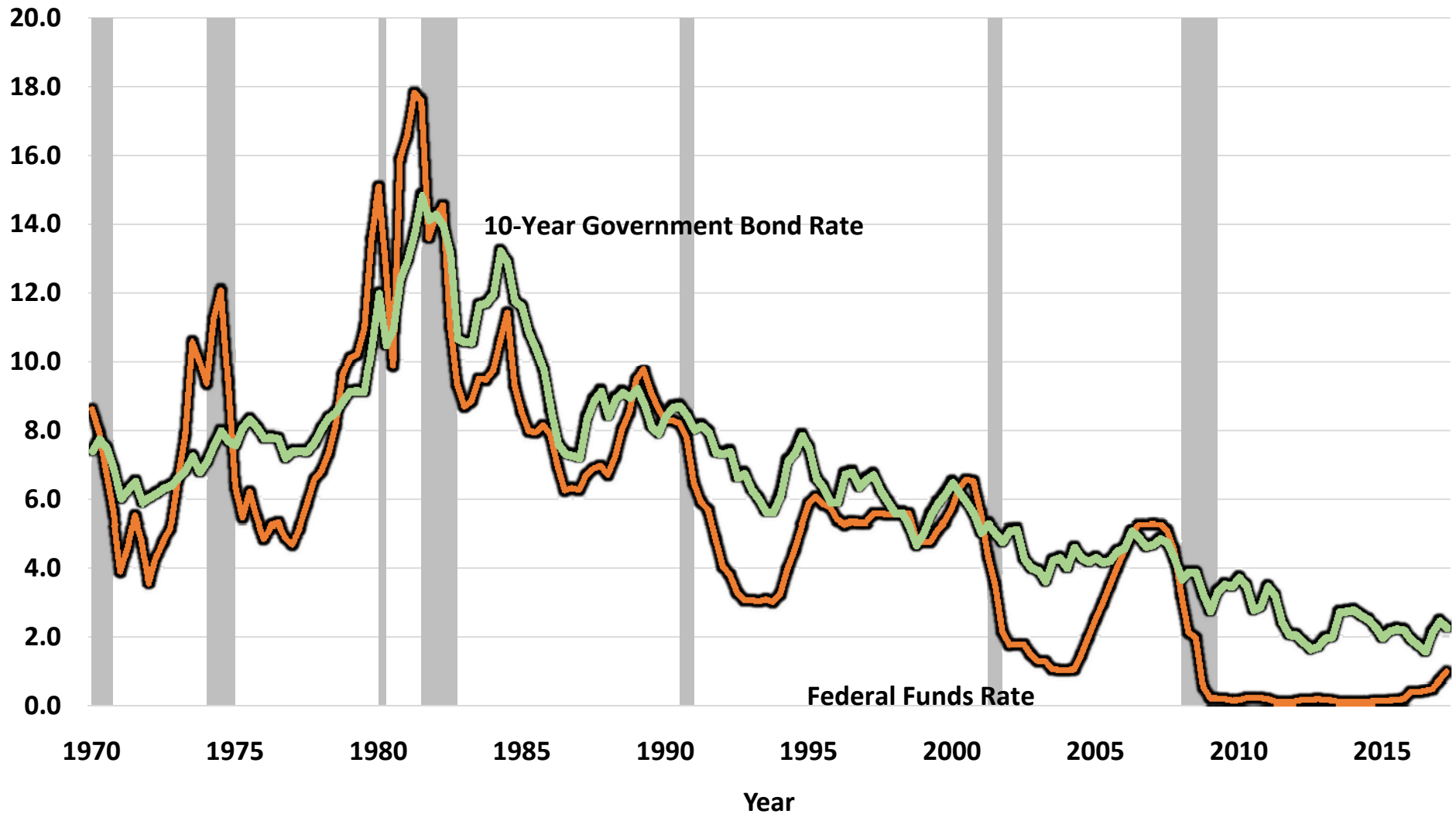
Effective Exchange Rate of the Dollar, 1970-2017



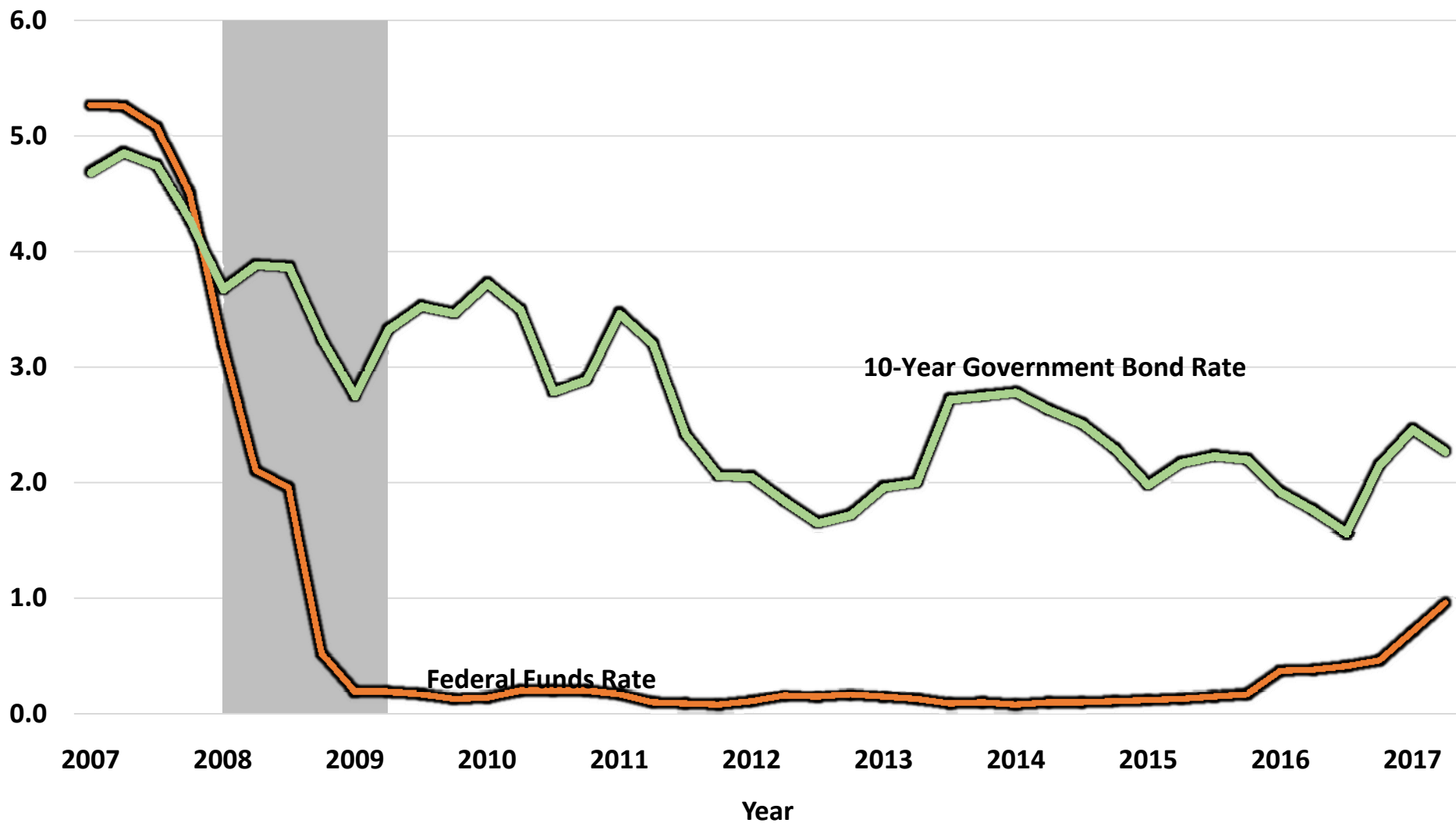
Will Monetary Policy Choke Off the Expansion?

- **Fed's Goal to Maximize Employment
Subject to Maintaining 2% Inflation Target**
- **Notice inverted yield curve before each
recession**
- **1974-75, 1979-80 Sharp Increases in
Interest Rates in response to oil shocks**
- **2004-06 Another Increase of Interest rates**
 - Beginning of housing collapse
- **2009-15 Long Period of ZLB**

Interest Rates: Federal Funds and 10-Year Treasury Bonds, 1970-2017



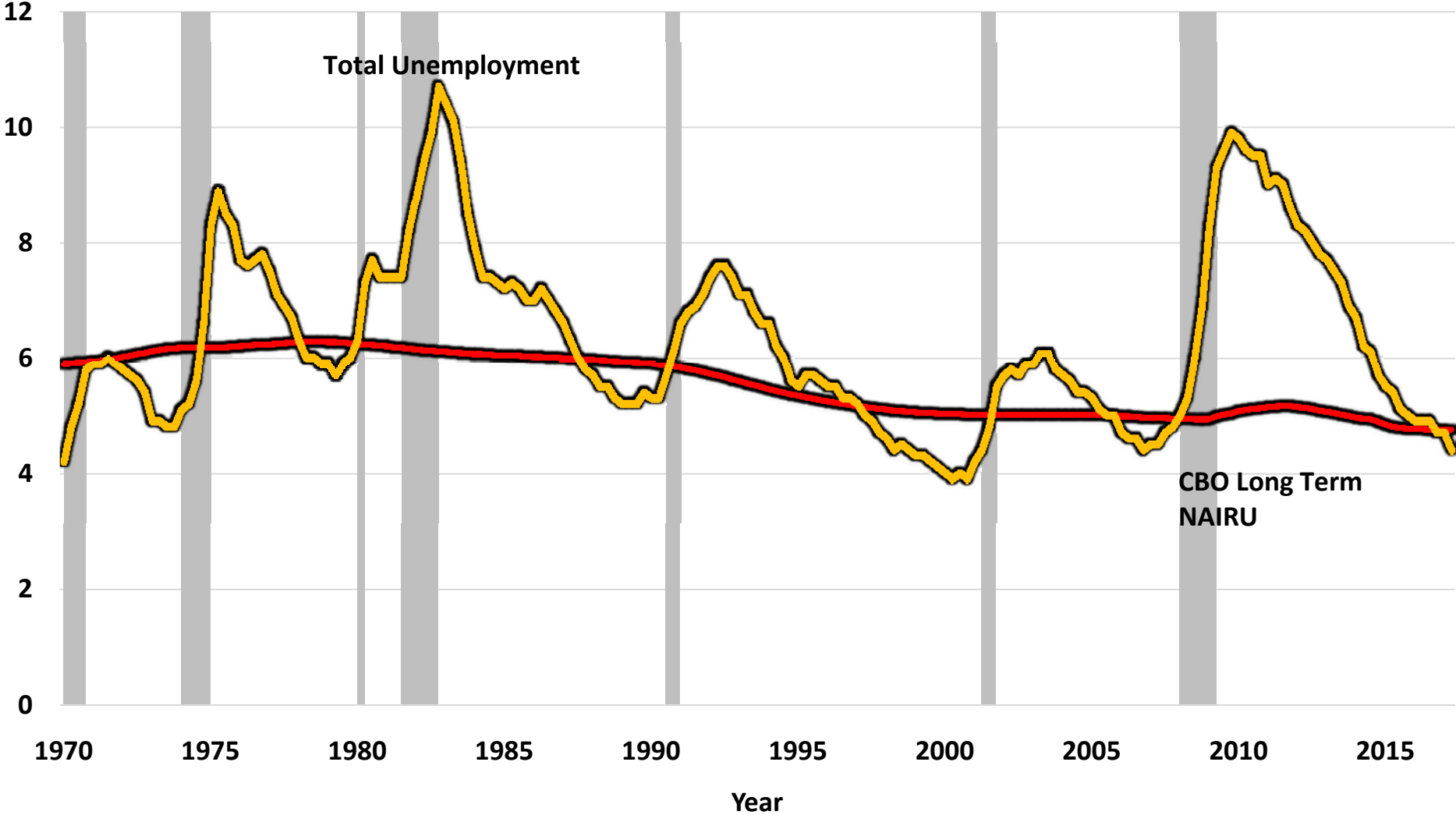
Interest rate Closeup, 2007-17



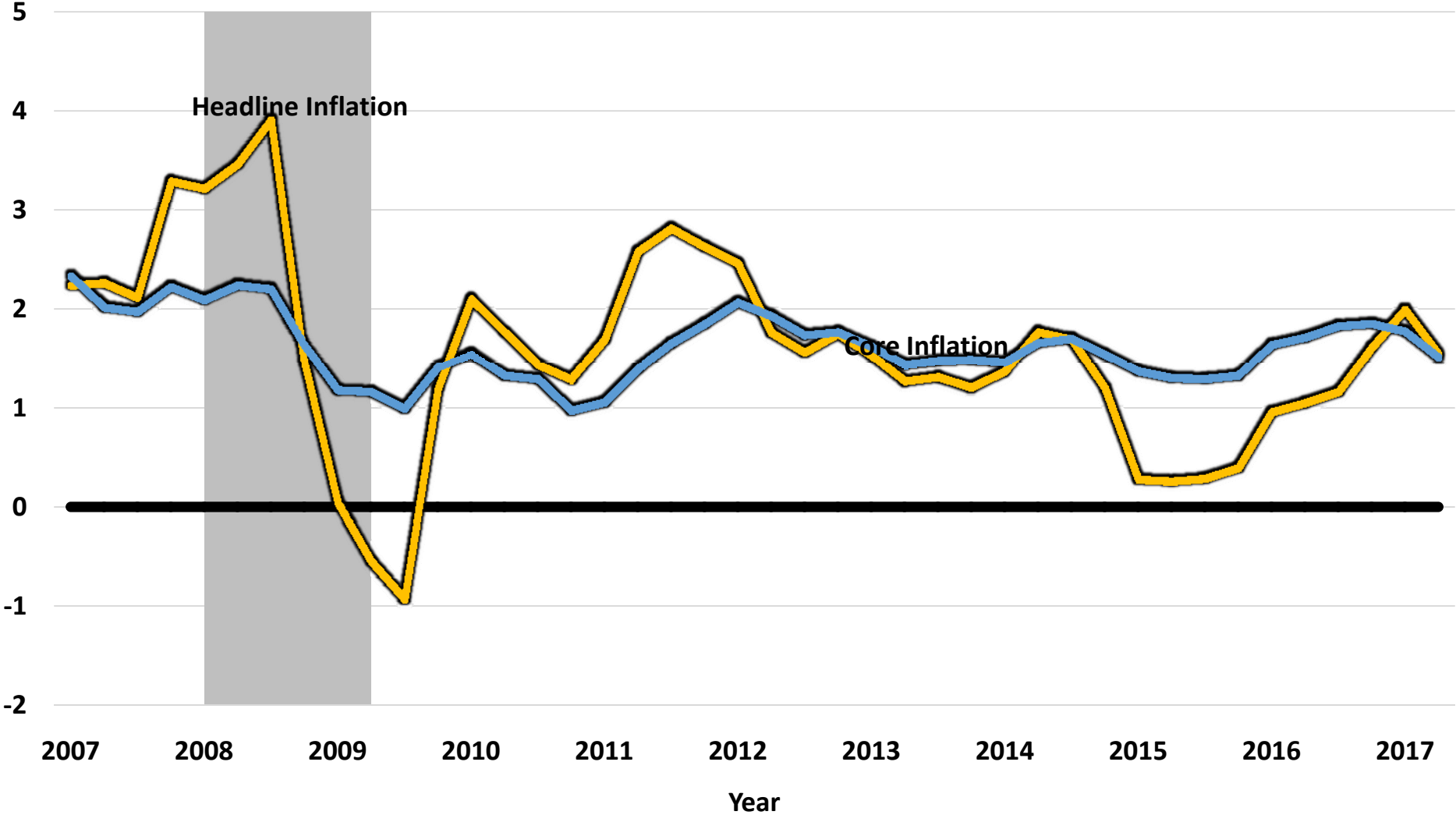
The Peculiar Behavior of U.S. Inflation

- **Given the Decline in the Unemployment Rate, the Fed expected inflation to start speeding up by now**
- **Let's Look Again at the NAIRU and Inflation**
- **Long Period of High Unemployment Pushed Inflation Well Below 2%**
- **So far unemployment gap too small to have measureable effect on inflation**
- **Is 2017 decline a short-term anomaly?**

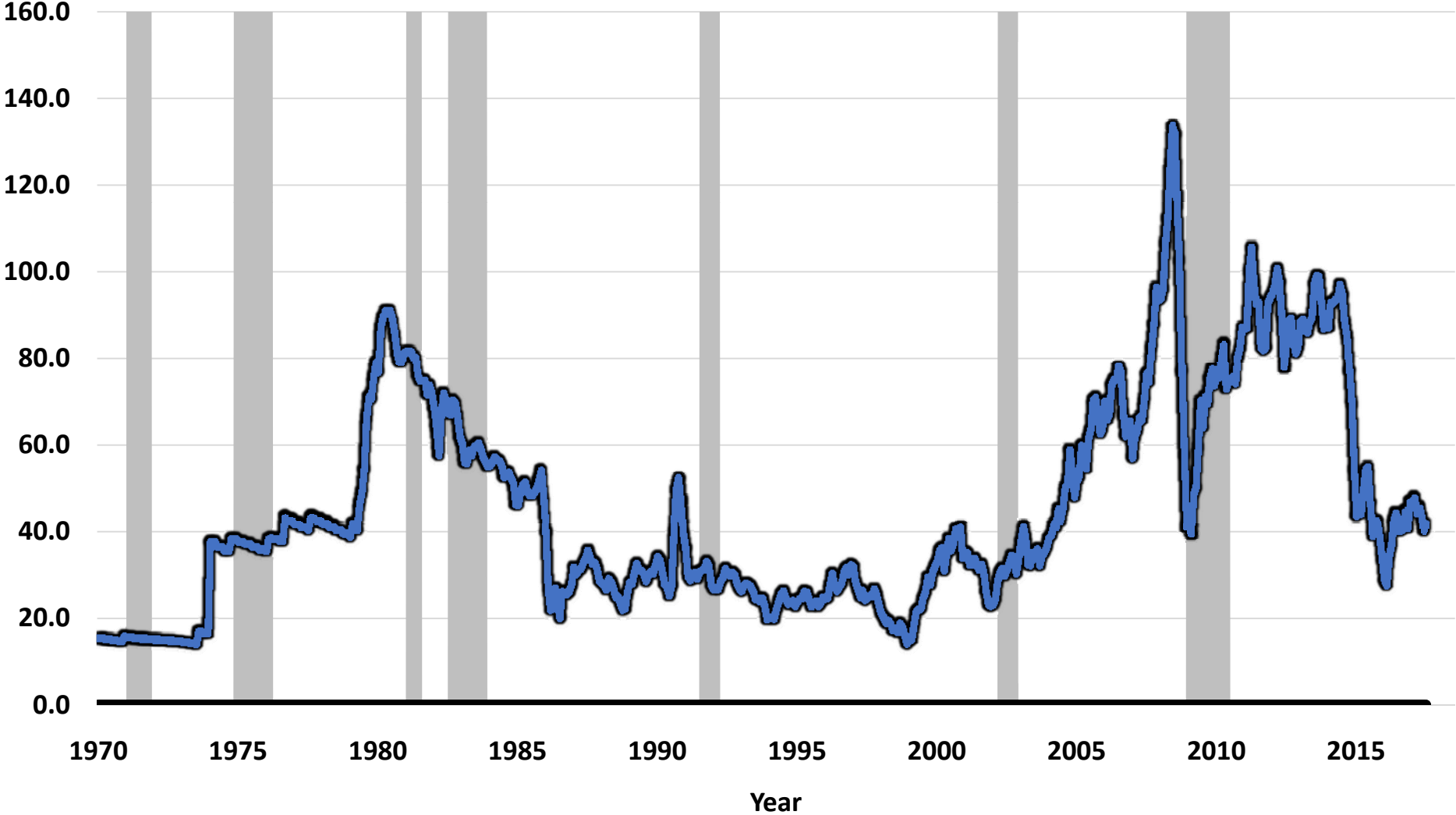
Repeat: Unemployment and NAIRU



Repeat: Inflation Closeup



Another Oil Price Shock?



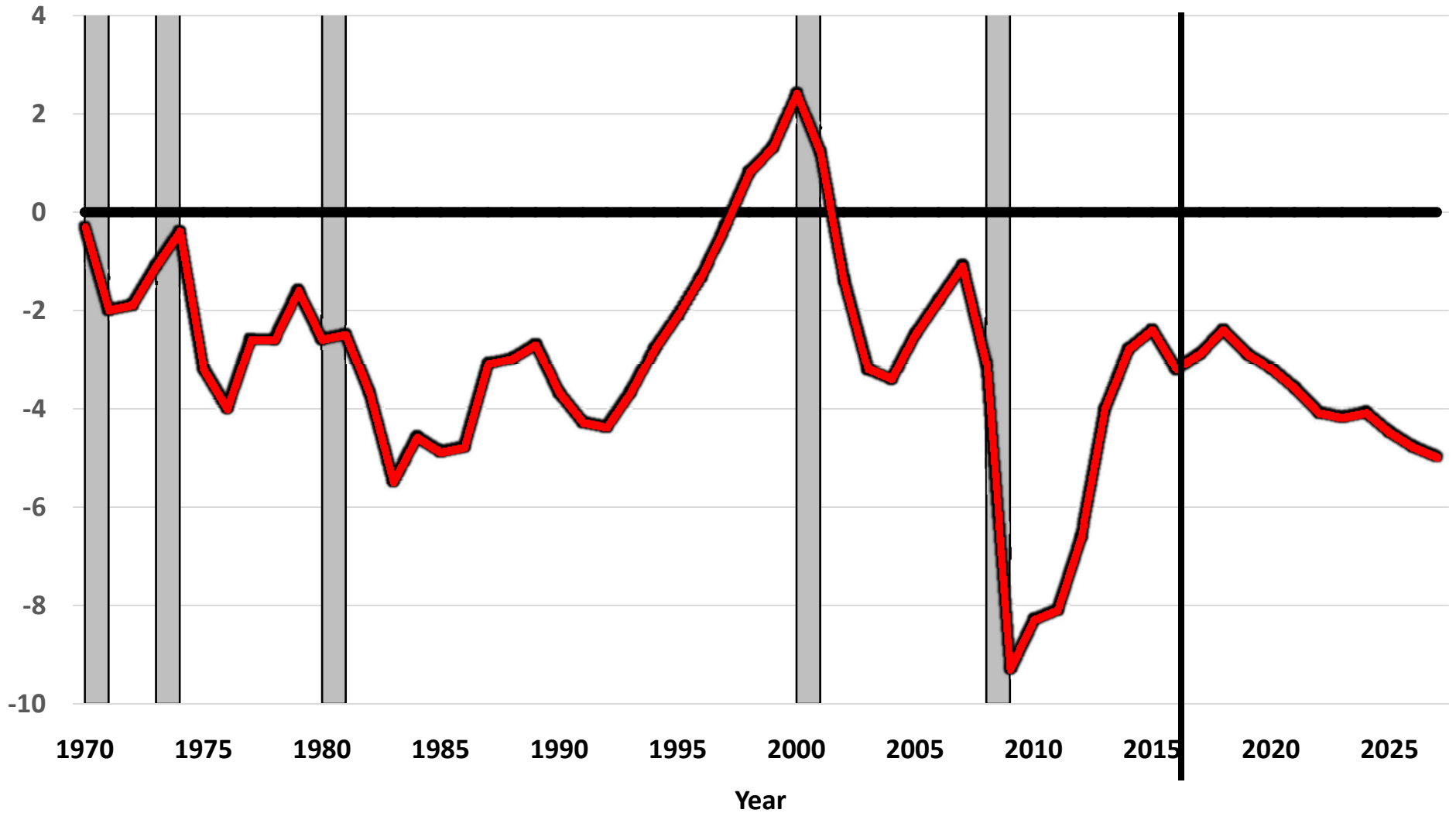
Outlook for Monetary Policy

- **Strong Support for Tighter Labor Markets to Attract Labor Force Dropouts**
- **In the Absence of a Significant Upturn of Inflation, Fed will slow pace of rate increases**
- **Consensus forecast for mid-2019, Federal Funds rate of 2.7 to 3.0**
- **Implications for 10-year bond, yield curve**
- **Fed will begin to run down balance sheet**

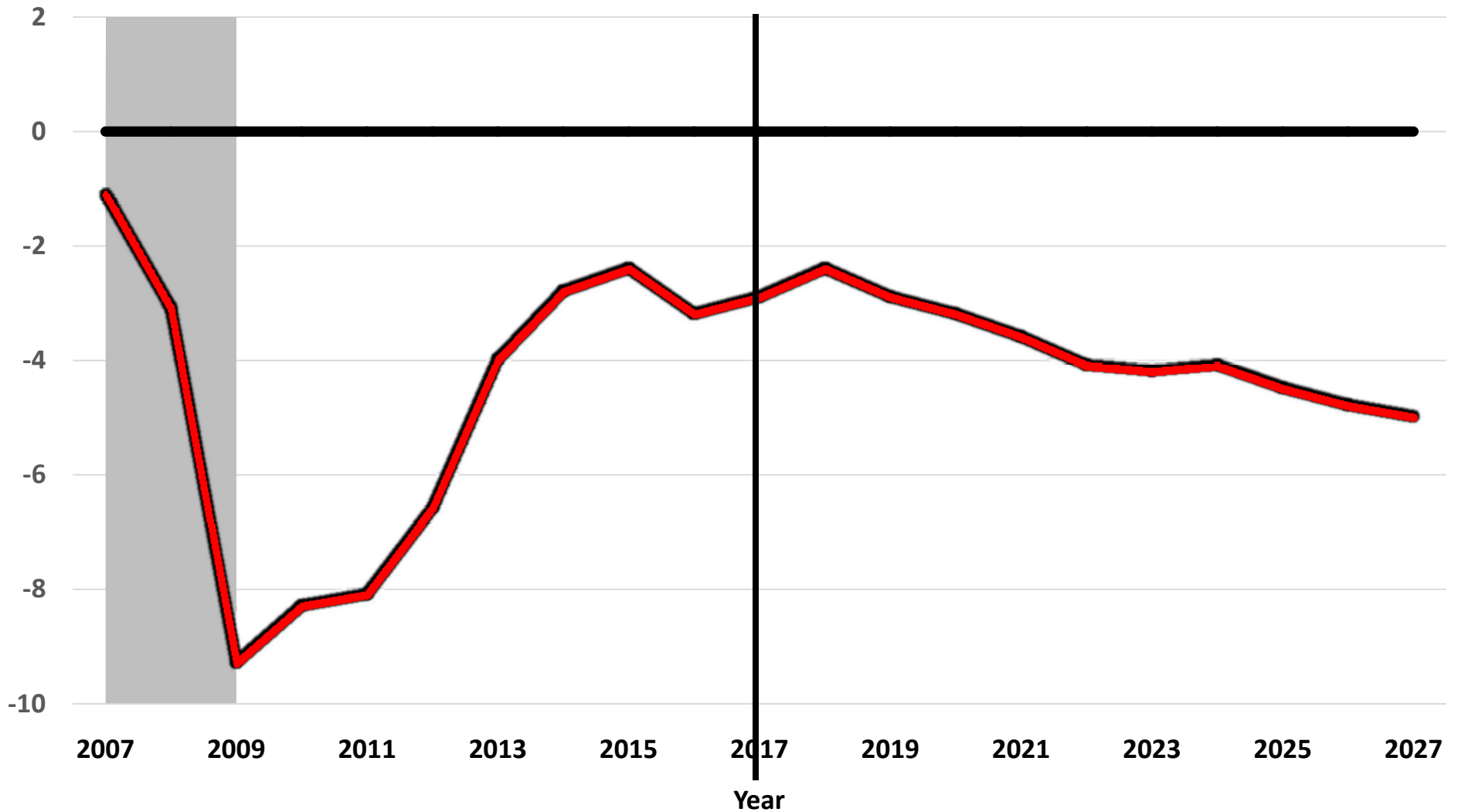
Setting the Stage for Fiscal Drama: The Deficit and Debt

- **Federal Deficit / GDP**
 - Big bulge from recession, Obama stimulus
 - Recent increase
- **Federal Debt / GDP**
 - Big increase from recession, Obama stimulus
 - Slow projected increase from now even with current tax rates
 - Big tax cuts will raise deficit, debt

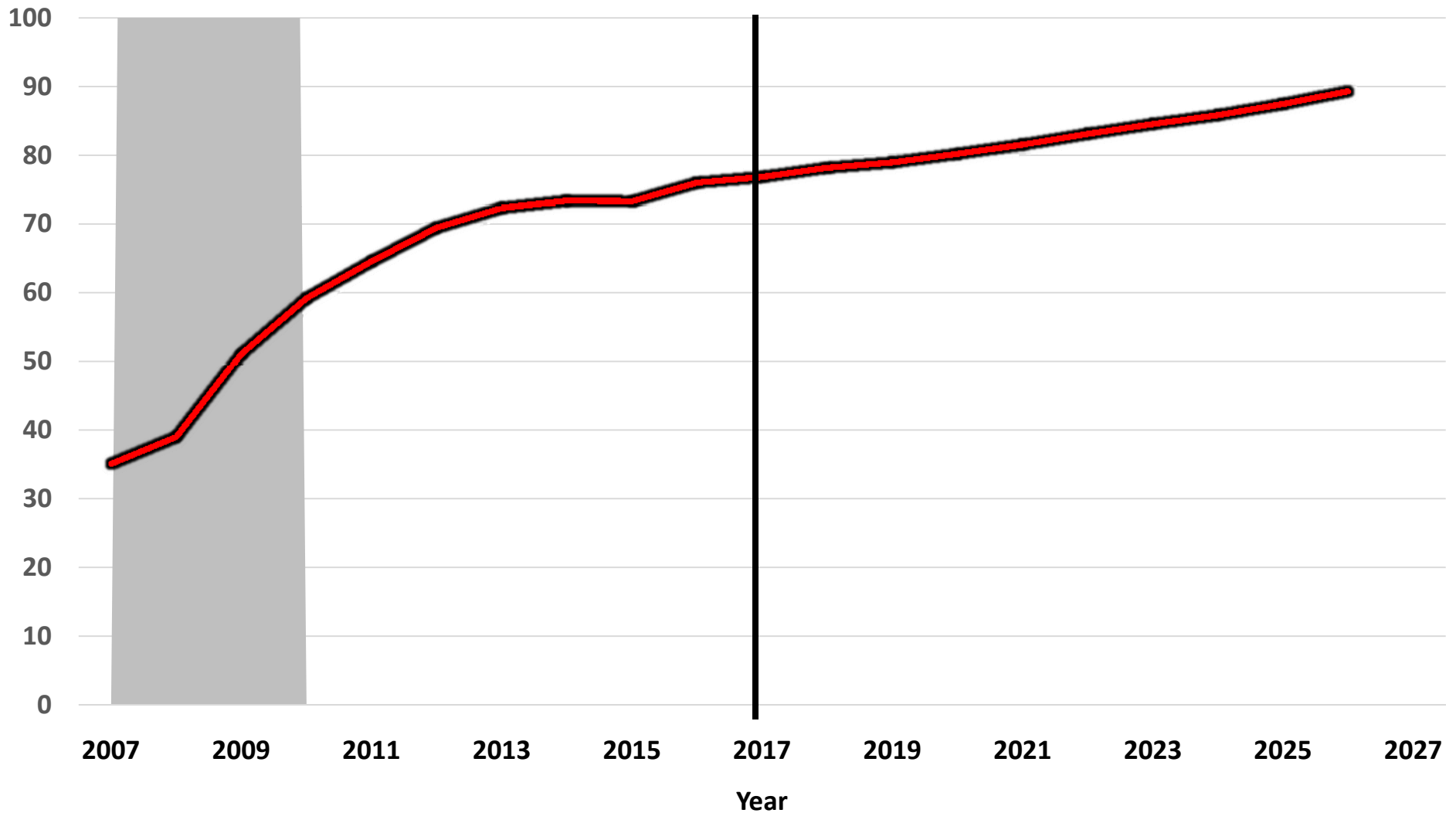
Federal Deficit / GDP Since 1970



Closeup of Federal Deficit / GDP Since 2007



Federal Debt / GDP Since 2007 Out to 2027



The Great Washington Drama

Starting Now: Tax Cuts and Reform

- **Corporate Tax Cuts from Current 35%**
 - Trump's Campaign Promised 15%
 - Congress Will Go for 20 to 25%
- **How to Pay?**
 - Initial Idea, Border-Adjusted Cash Flow Tax
 - Similar to a Value-Added Tax with a Wage Bill Deduction
 - Raises Revenue Because Imports > Exports

Corporate Tax Reform

- **Border-adjustment idea is dead**
 - Predicated on an appreciation of dollar
 - Political opponents didn't believe in dollar change
 - This source of revenue won't happen
- **Other changes**
 - Move to territorial tax system like other countries
 - Full expensing, end interest deduction
- **Revenue Cost 0.6% of GDP**

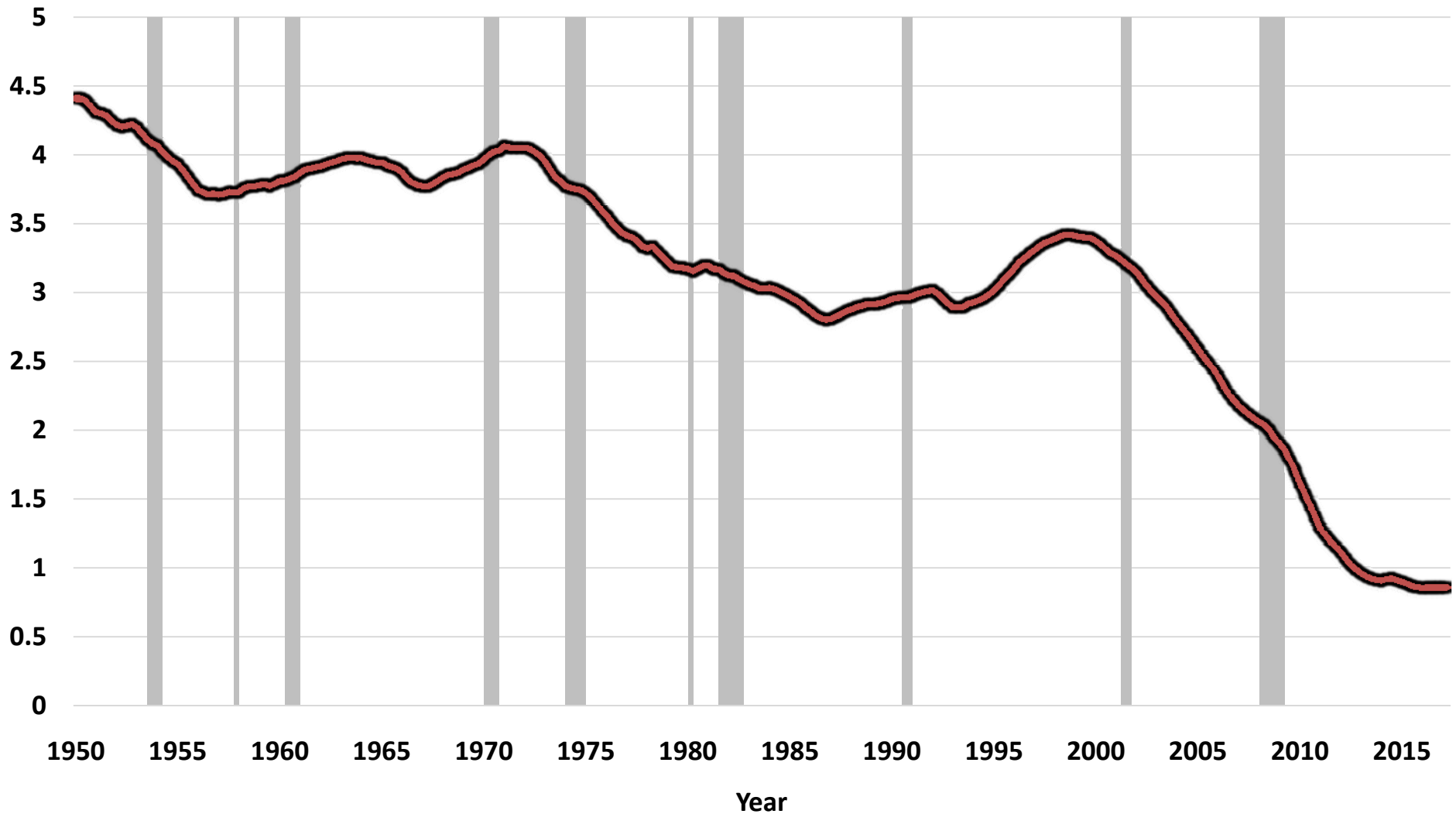
Personal Tax Reform

- **Move to Fewer and Lower Rates**
- **Not as Much of a Windfall to the Rich as the 2001 Bush Tax Cuts**
- **Possible reform: End deduction for state/local taxes (high tax states voted for Hillary Clinton)**
- **Deductions to remain: charitable contributions, mortgage interest, employer health plans**
- **Strong opposition to raising deficits, but a deficit-neutral policy will not stimulate economy**
- **How much will they dodge the deficit issue by optimistic growth forecasts?**

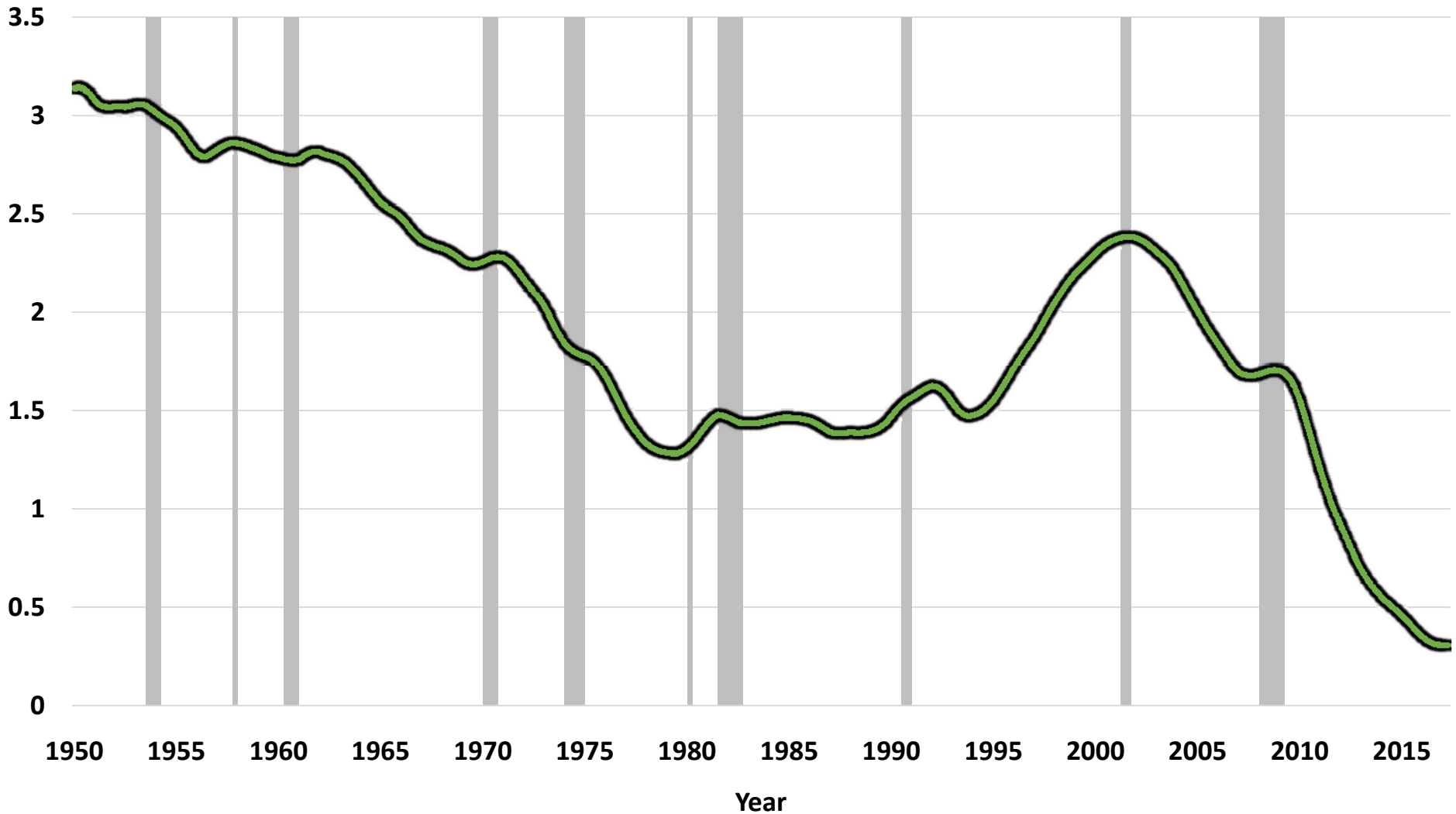
Is There Enough Supply to Meet Faster Demand Growth?

- **2.1 percent GDP growth since 2009 Made Possible by a Decline in U Rate from 10 to 4.4**
- **At some point the U Rate will stop declining**
- **How Fast Can the Economy Growth With a Constant Unemployment Rate?**
- **Actual Growth Rate 2006-2016 = 1.3%**
 - **Productivity Growth 0.9%**
 - **Hours Growth 0.4%**

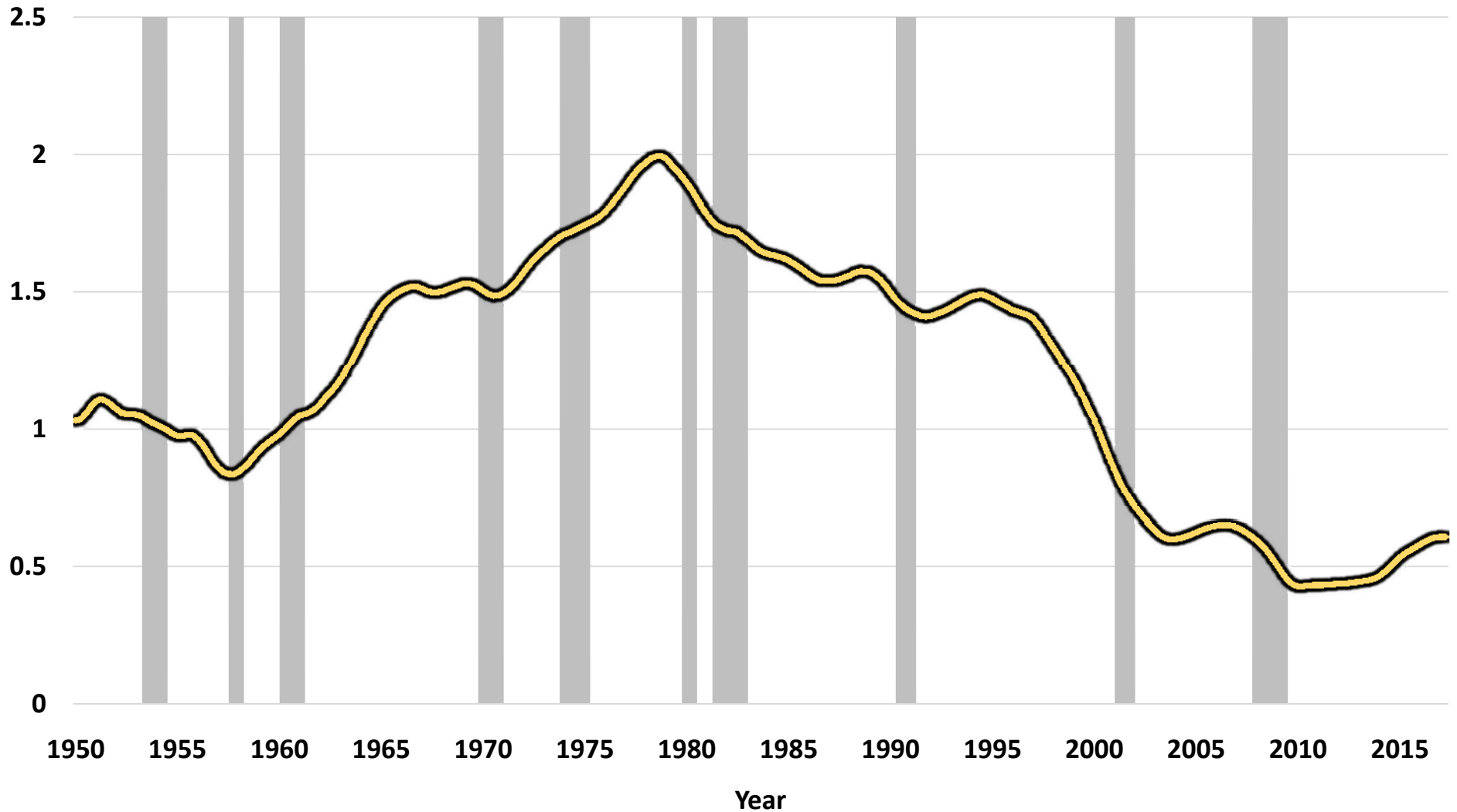
GDP Growth at a Constant Unemployment Rate



Productivity Growth at a Constant Unemployment Rate



Hours Growth at a Constant Unemployment Rate



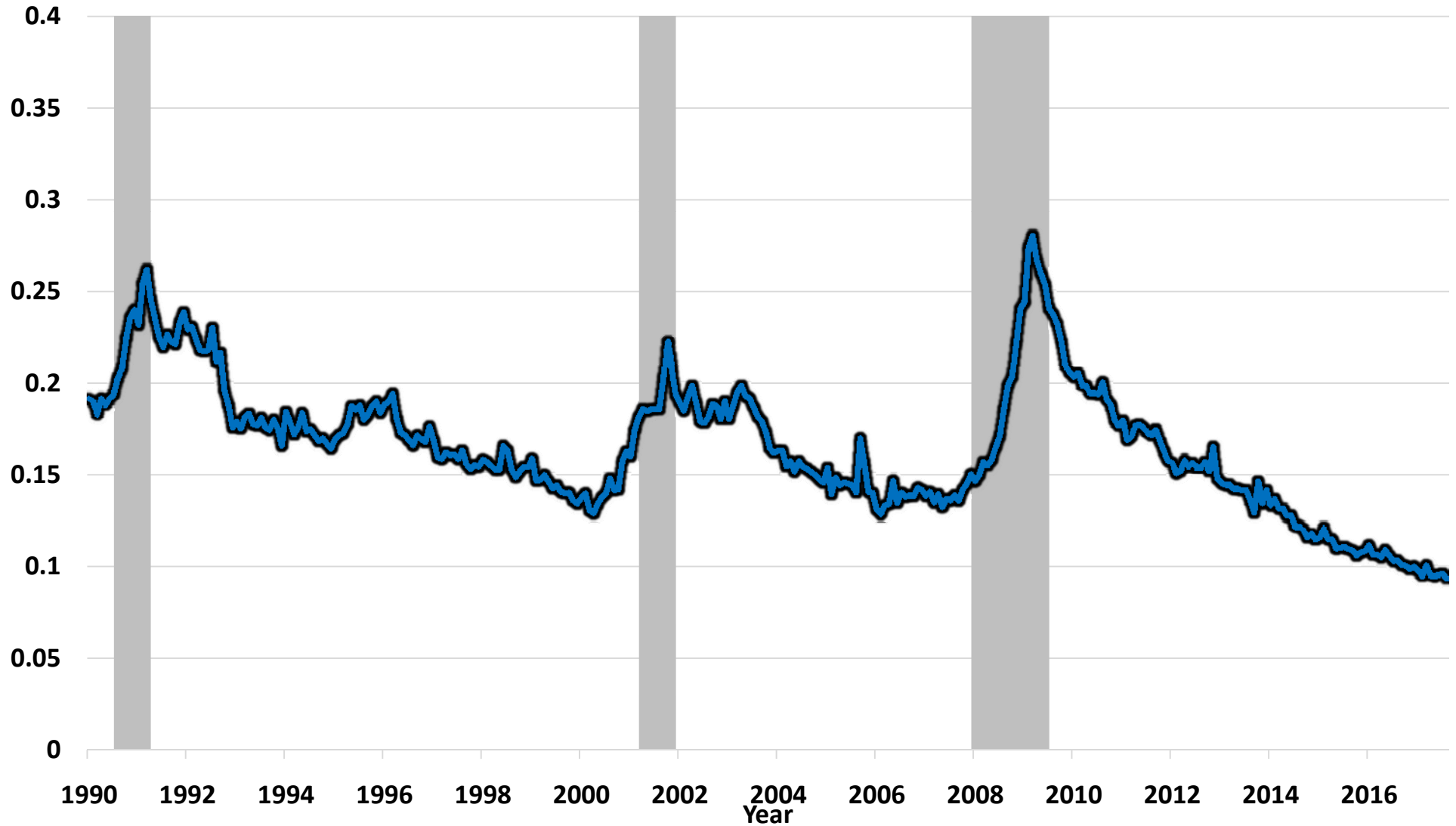
Two Questions: Productivity and Hours Growth

- **Productivity growth 0.6 percent for seven years since mid-2010**
- **Forecast for next 25 years in my book is 1.2 percent**
- **Big question: as labor markets tighten, will firms buy robots and other capital to replace workers?**
- **Evidence that trend productivity growth is faster when unemployment is low as in the 1960s and 1990s**
- **Possibility for next three years, 1.0 percent**

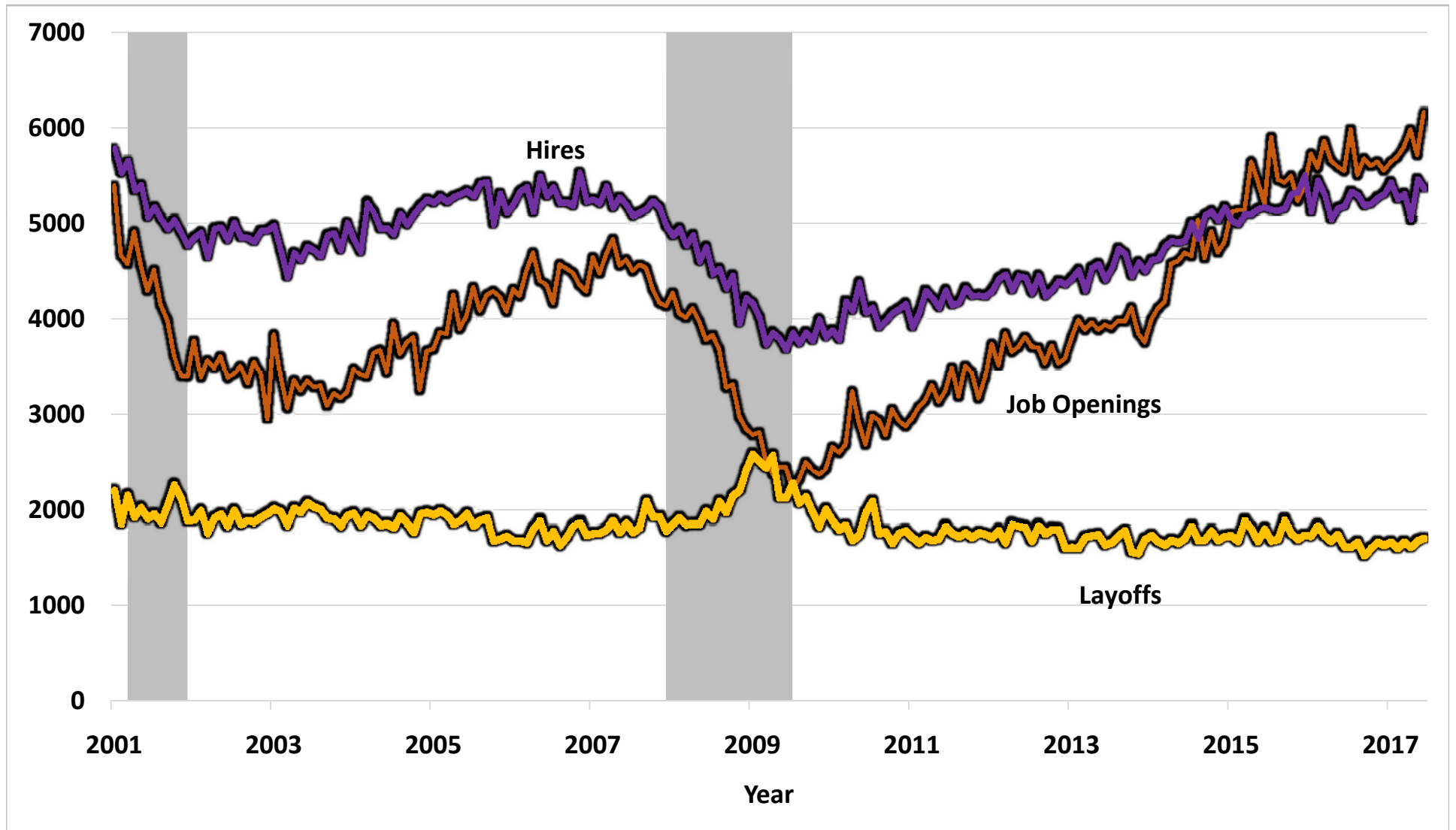
For GDP to Grow at 3%, We Need Hours Growth of 2%

- **Past Year:**
 - **Population +0.6%**
 - **Labor Force +0.8%**
 - **Hours +1.3%**
- **How Much Lower Can Unemployment Go?**
- **Evidence of Tightness in Labor Market**
- **Sources of Additional Labor Supply**
 - **Prime-Age Labor Force Participation**
 - **Employees Working Part-time Who Want Full-time Work**

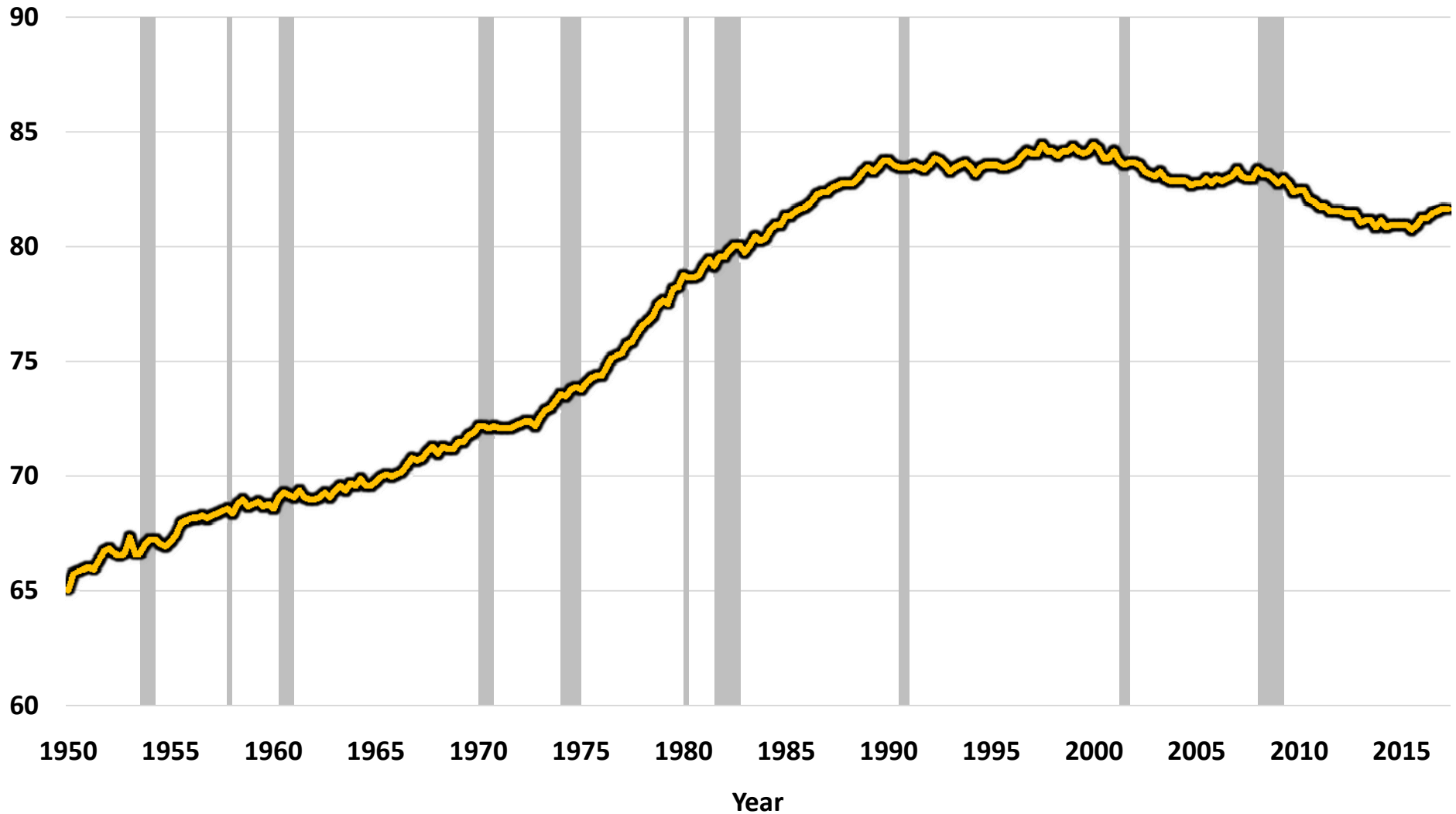
New Claims for Unemployment Insurance – An All-time Low



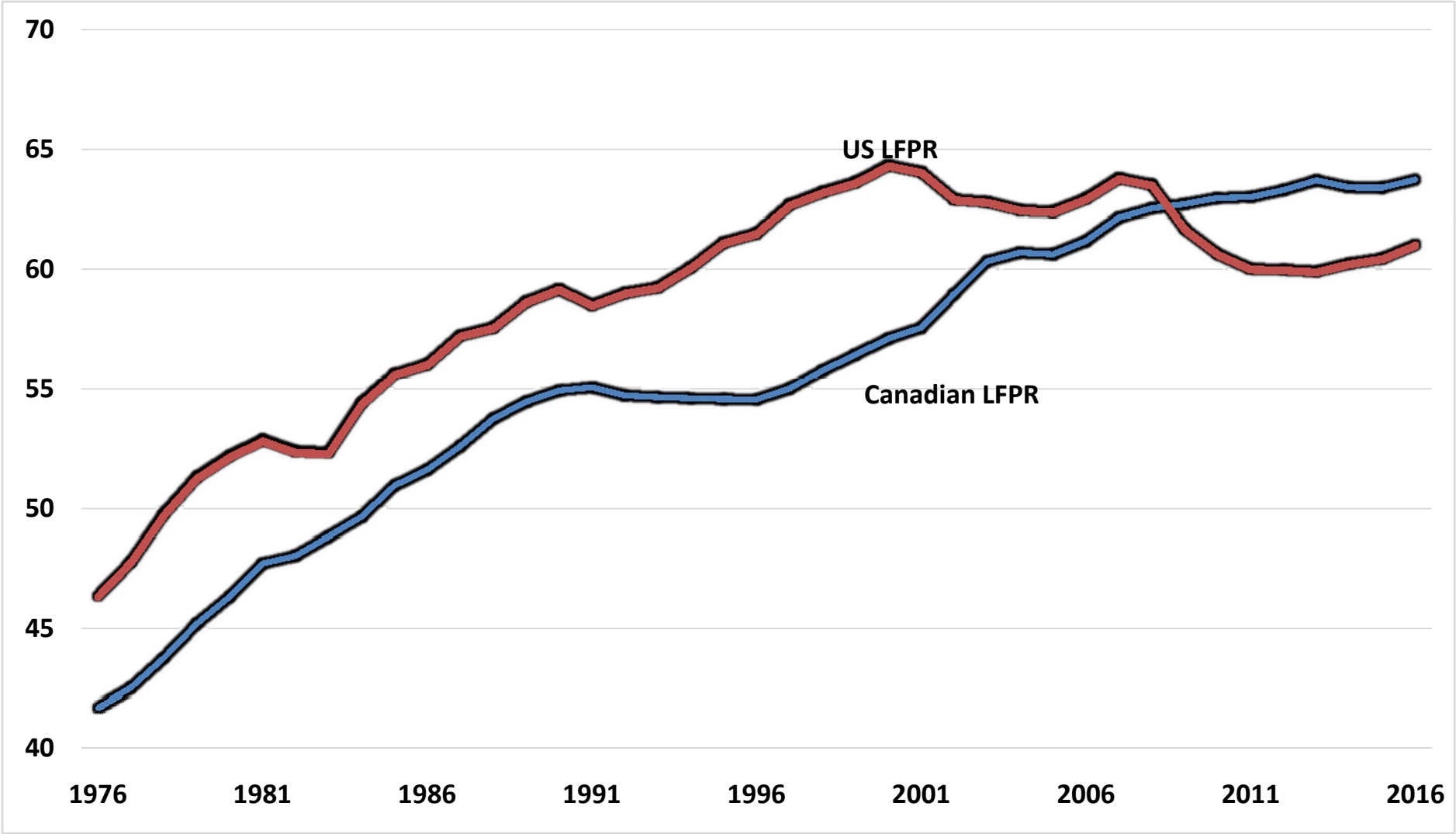
Job Openings, Layoffs, Hires



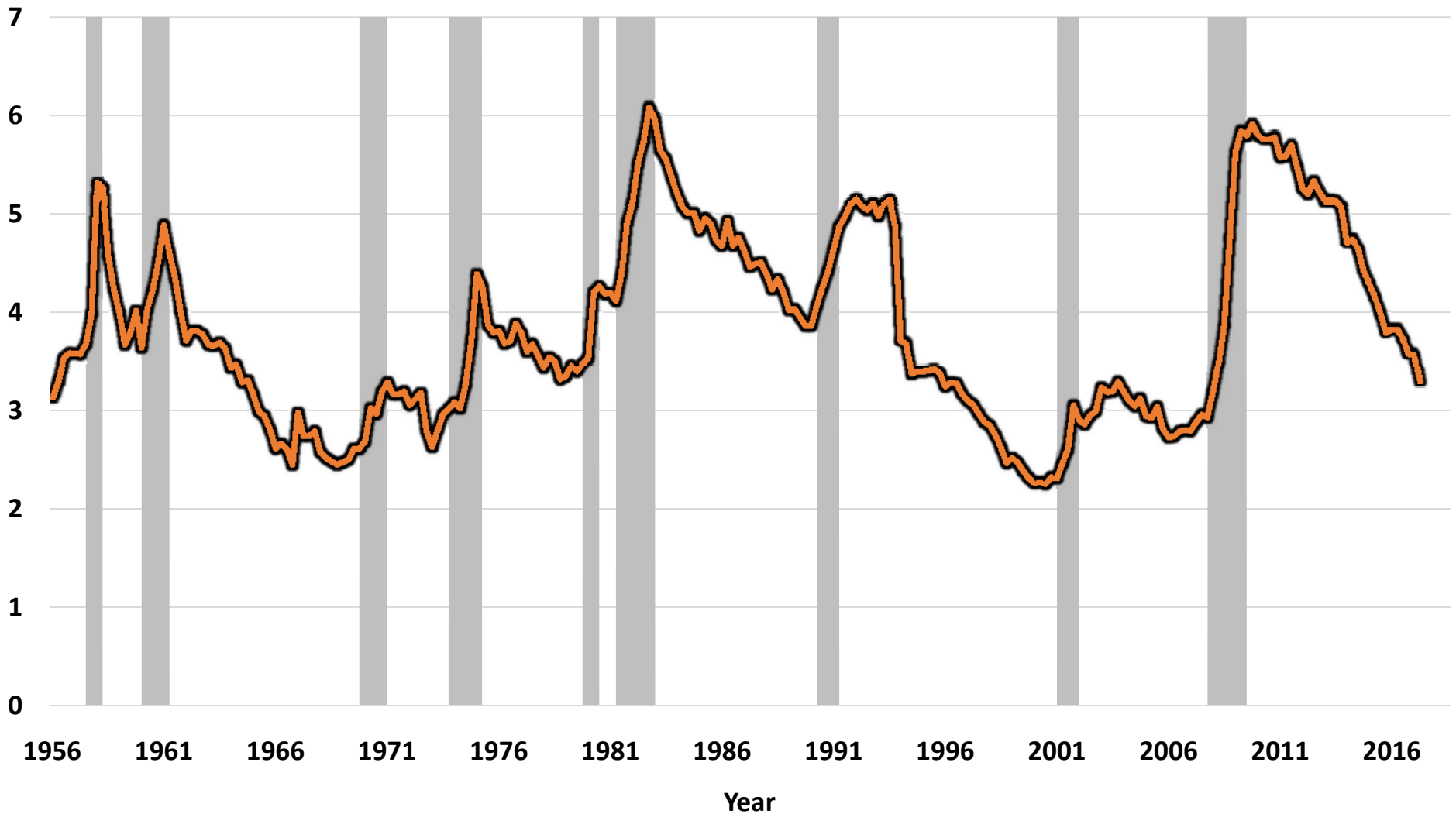
Prime-Age Participation Rate



Female Participation Rates, US vs. Canada, 1976-2016



Part-time Workers Who Want Full-time Work



Conclusion

- **Consensus GDP Forecast for 2018 and 2019: 2.3**
 - Productivity 1.0
 - Labor Force 0.8%
 - Hours 1.3%
- **Hours Growth Made Possible by Declining Unemployment, Labor Force Re-entry, and Shift from Part-time to Full-time Work**
- **Sources of Uncertainty**
 - How Much Will Tax Cuts Add to Deficit?
 - How Much Will Monetary Policy Fight Against Fiscal Stimulus?