Macroeconomic Policy Challenges

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Economics Department Alumni Reception
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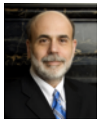
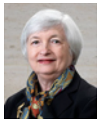
Notes for slides are at the end of the presentation.

About me

Harvard University
Economics Department

Federal Reserve Board

Brookings Institution

U.S. Treasury Department

Talk today

- Backdrop: strong short-term growth
- Challenge 1: rising federal debt
- Challenge 2: weak productivity growth
- Challenge 3: risk of recession
- Policy implications

Talk today

- **Backdrop: strong short-term growth**
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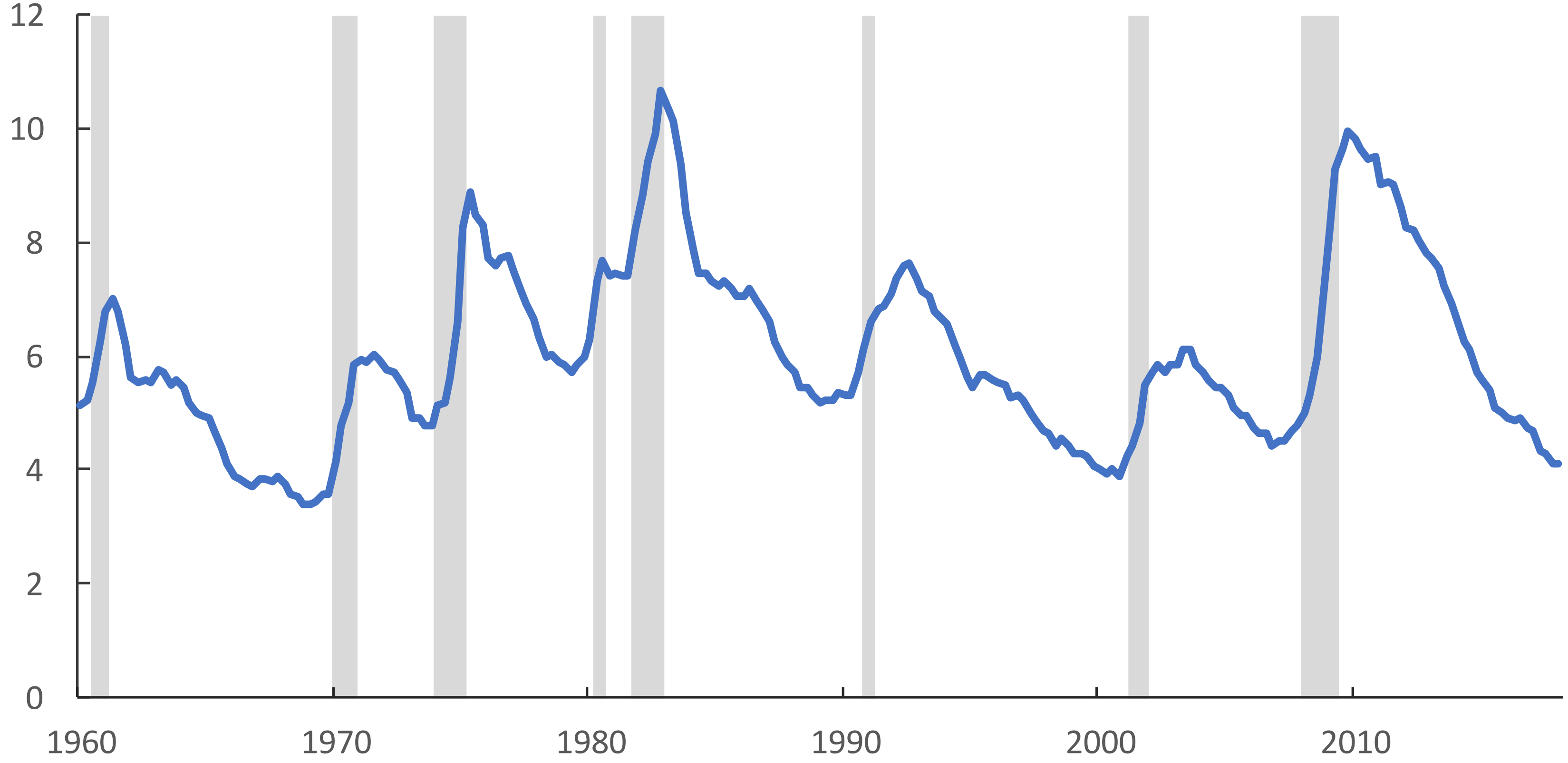
Healthy labor market

U.S. Unemployment Rate

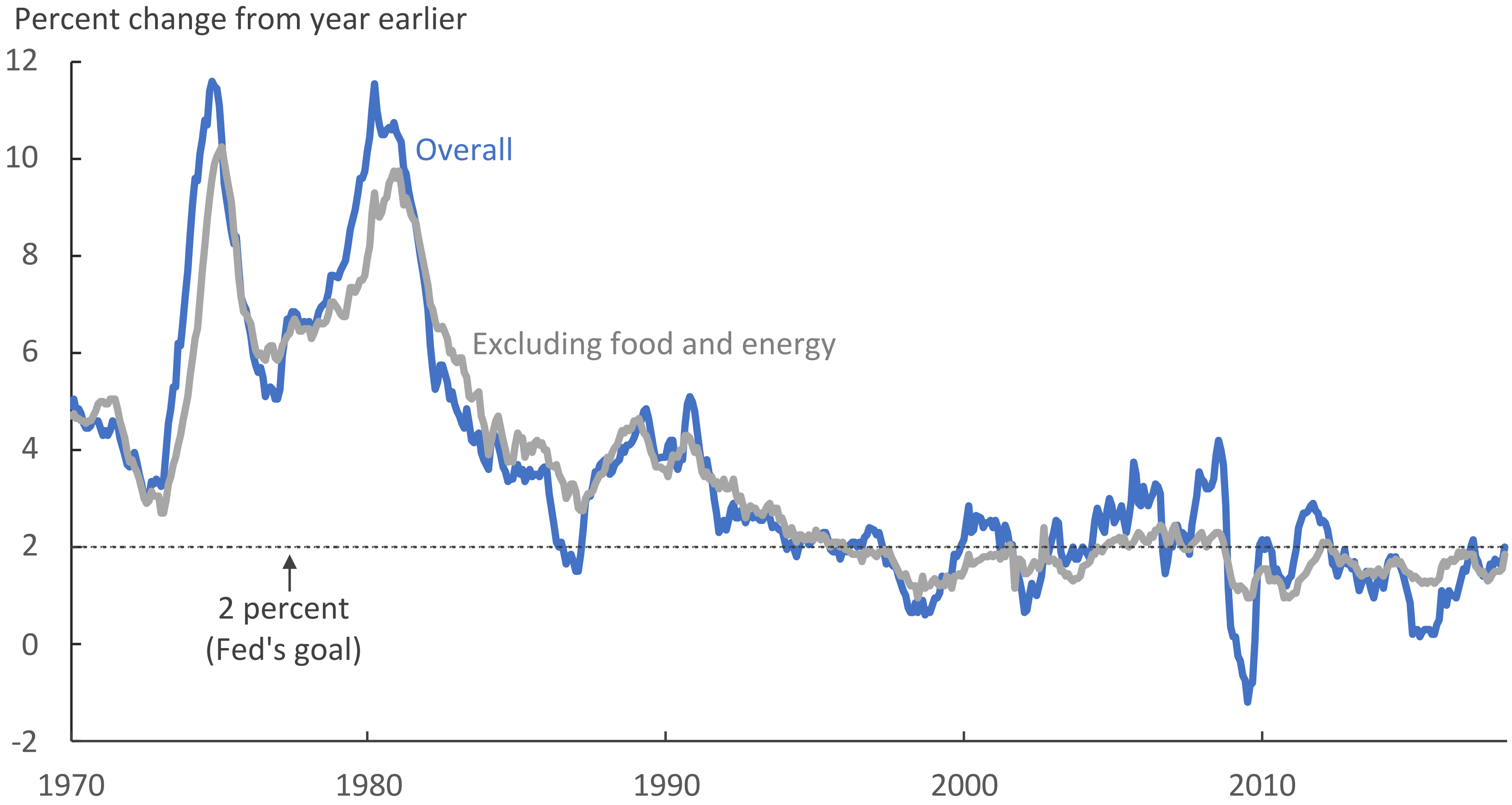
Percent of labor force



Source: U.S. Department of Labor. Shaded bars denote recessions.

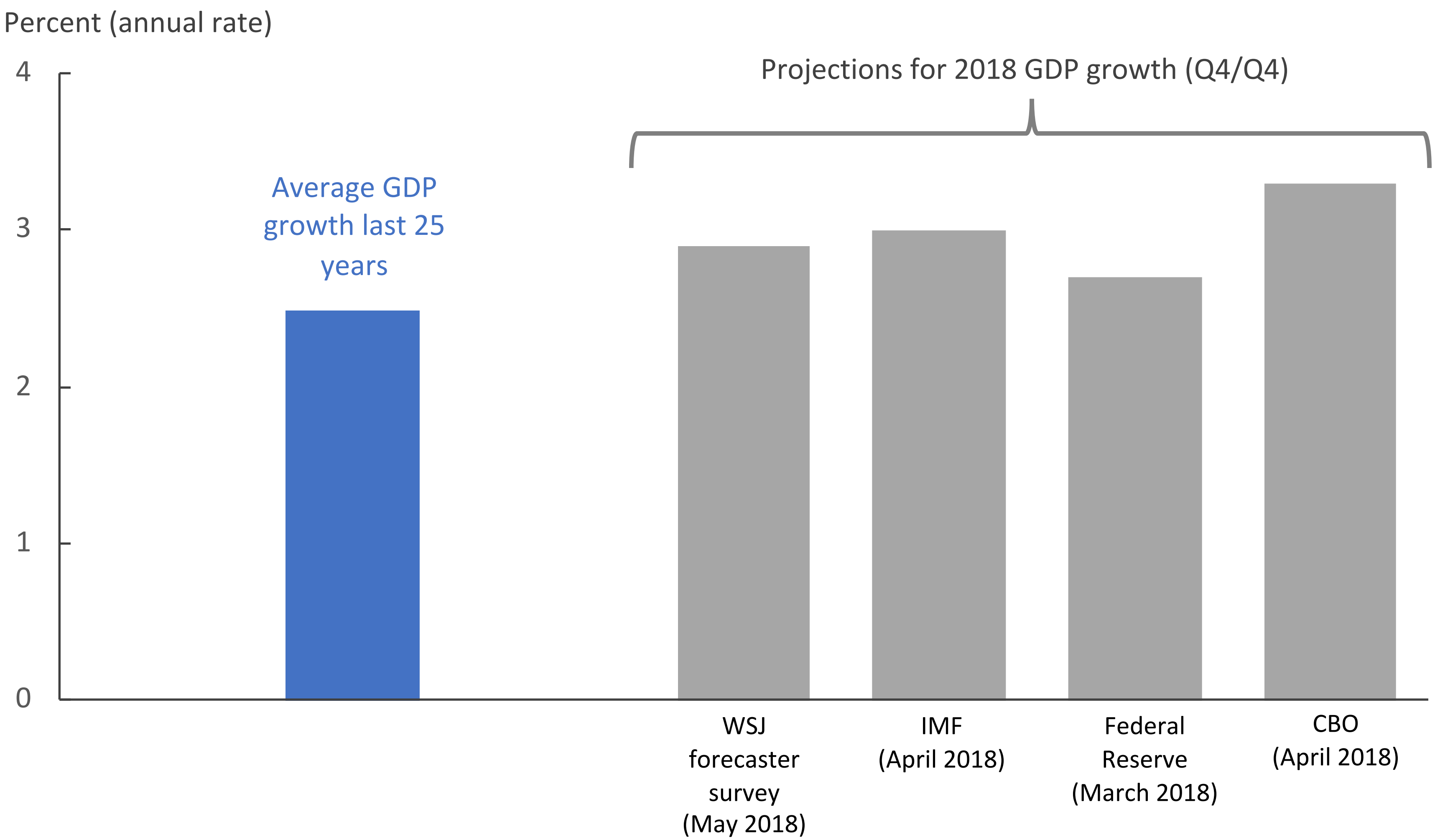
Low inflation

Consumer Prices



Source. U.S. Department of Commerce.

Strong GDP outlook for 2018



Why is the economy strong?

"Synchronized" global upswing

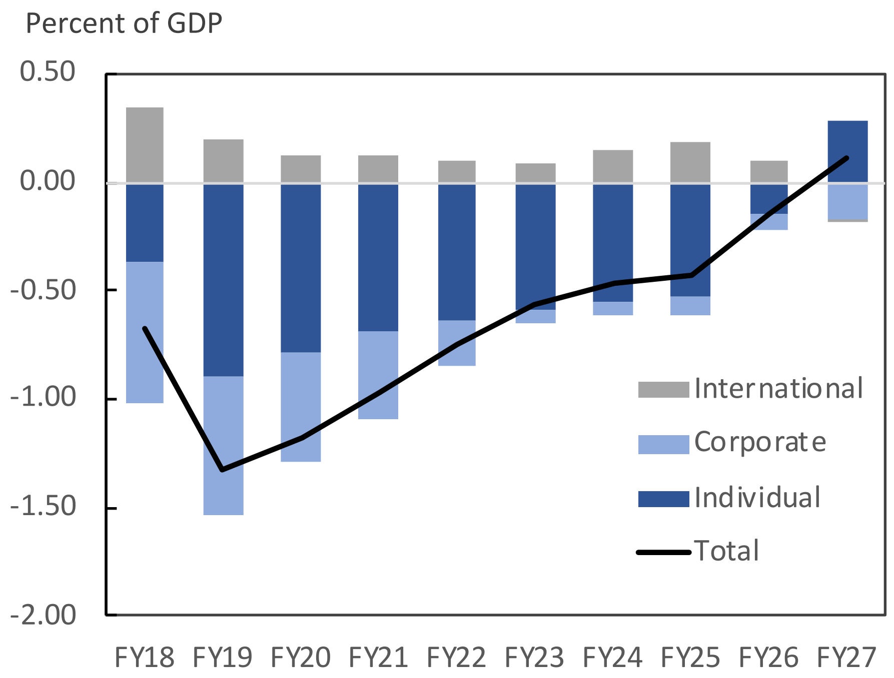
Financial conditions and monetary policy still supportive (on net)

Business and consumer confidence is high

Fiscal stimulus

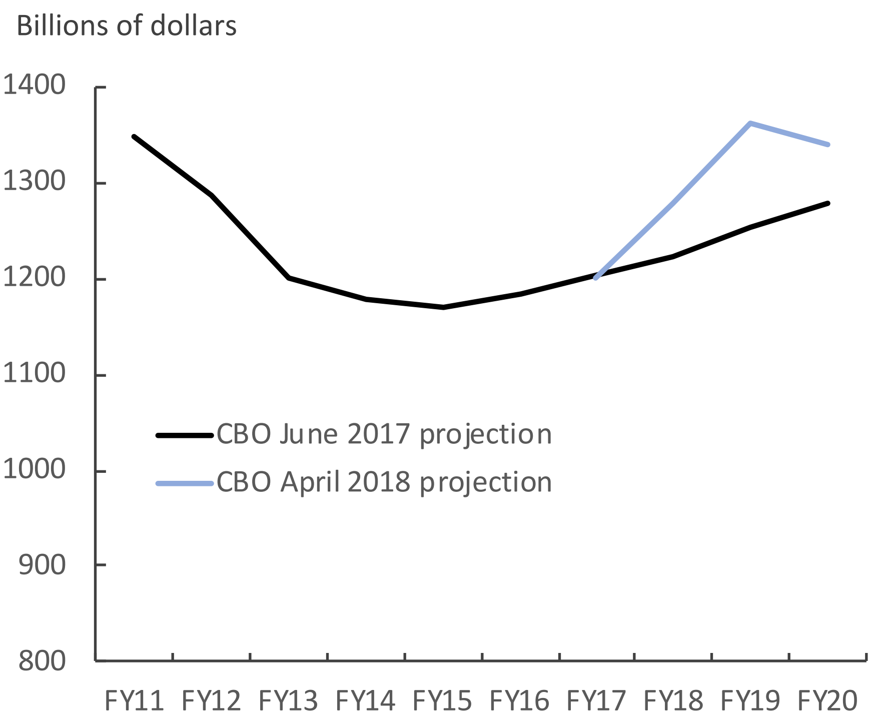
Big demand boost from both taxes and spending

Change in Tax Payments from 2017 Tax Act



Source: Author's calculations based on JCT and CBO data.

Federal Discretionary Spending



Source: Congressional Budget Office.

Talk today

- Backdrop: strong short-term growth
- **Challenge 1: rising federal debt**
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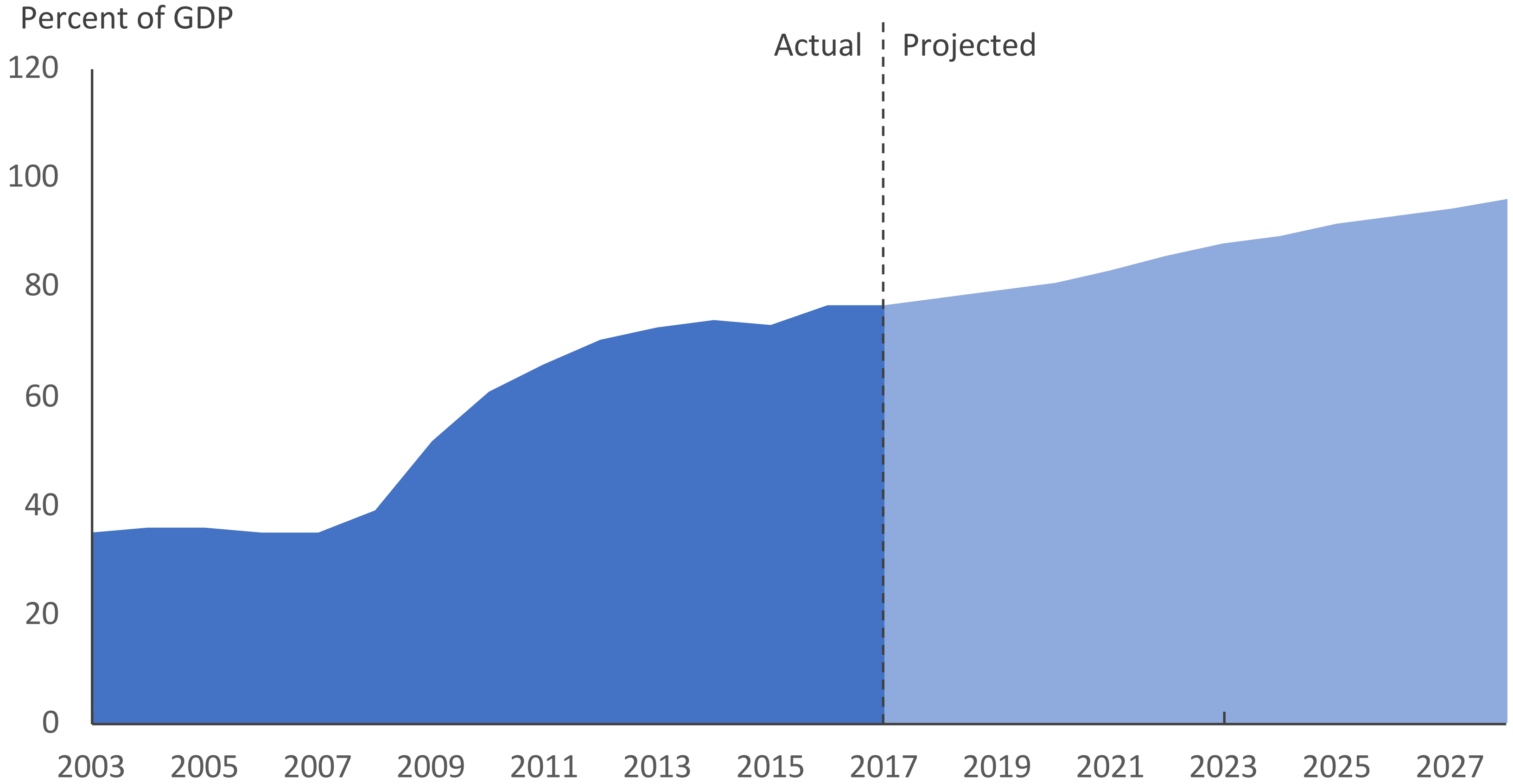
- Policy ideas

Rising federal debt

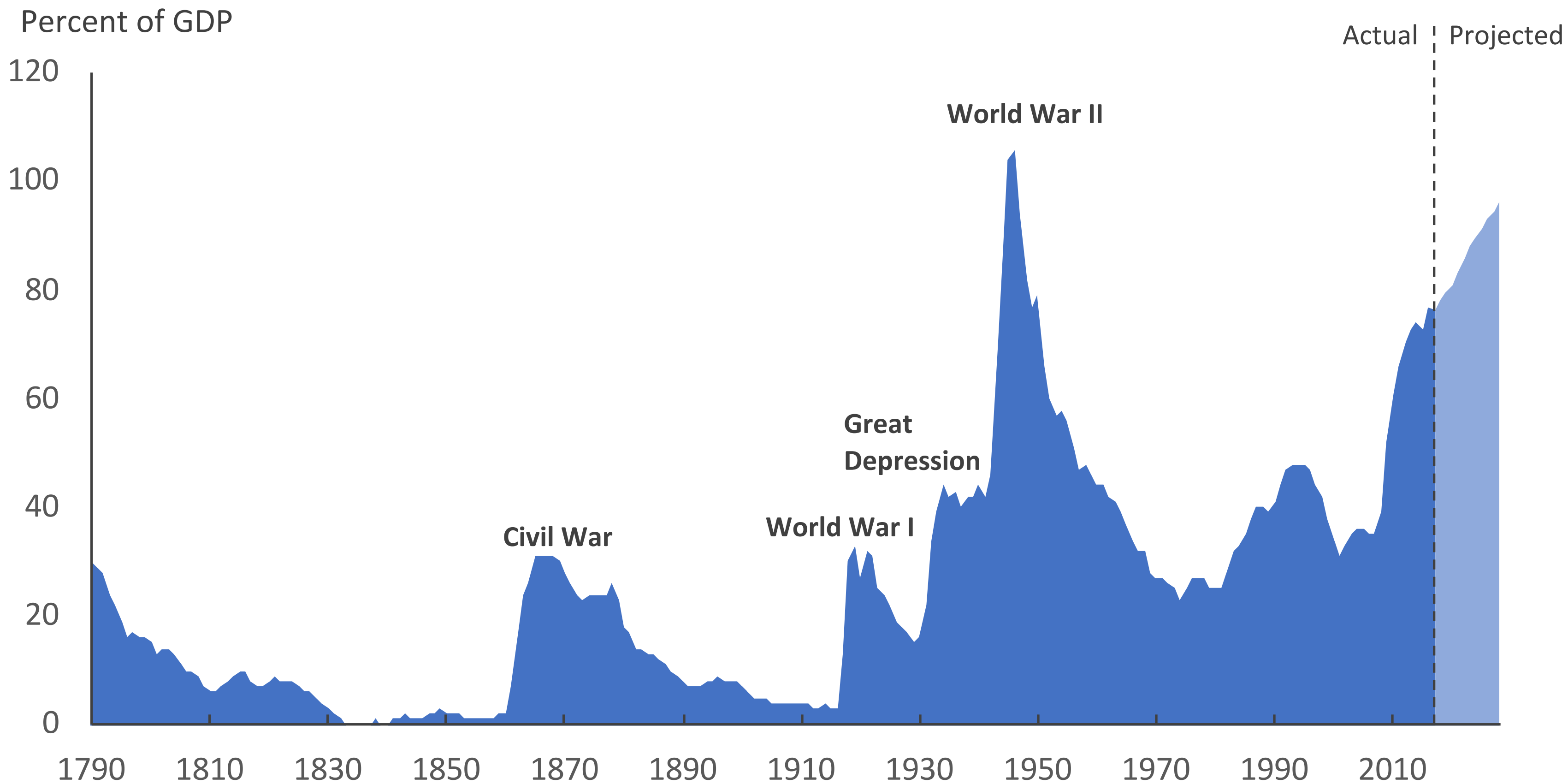
U.S. Federal Debt Held by the Public



Source. Congressional Budget Office (2018).

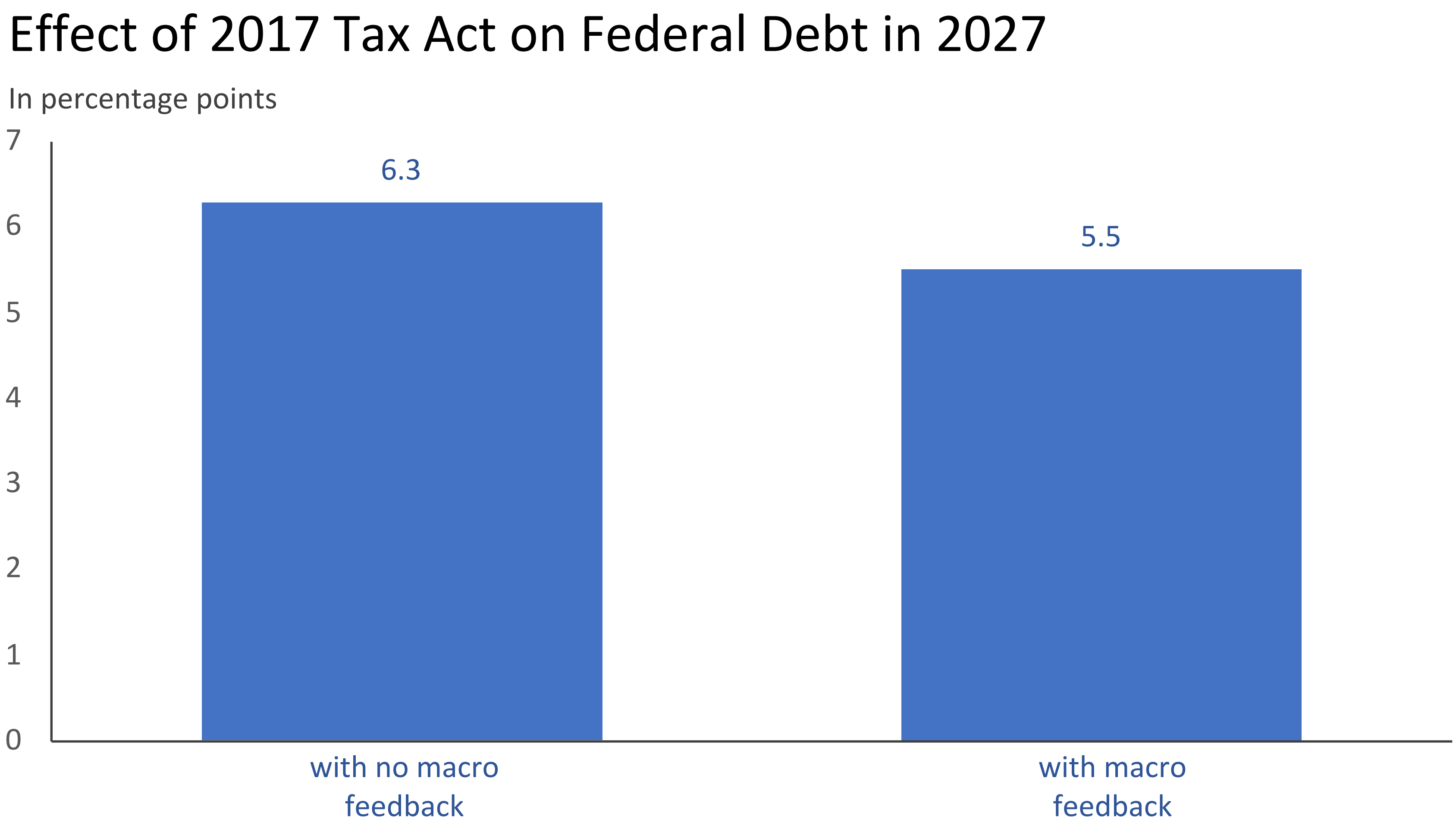
Rising federal debt (long view)

U.S. Federal Debt Held by the Public



Source. Congressional Budget Office (2018).

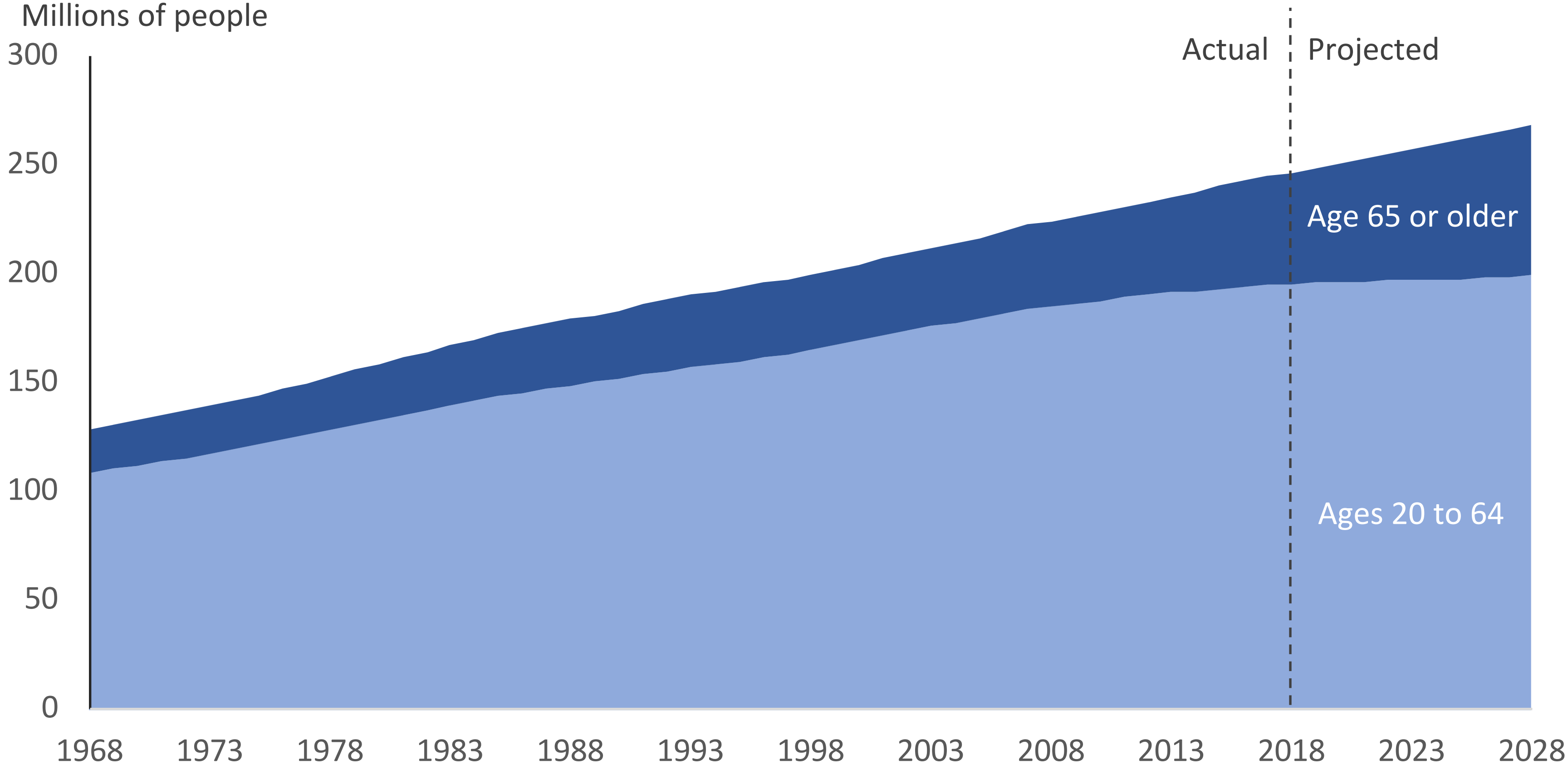
The 2017 tax act raises federal debt



Source: Brookings-Urban Tax Policy Center (2017).

Bigger issue—population aging

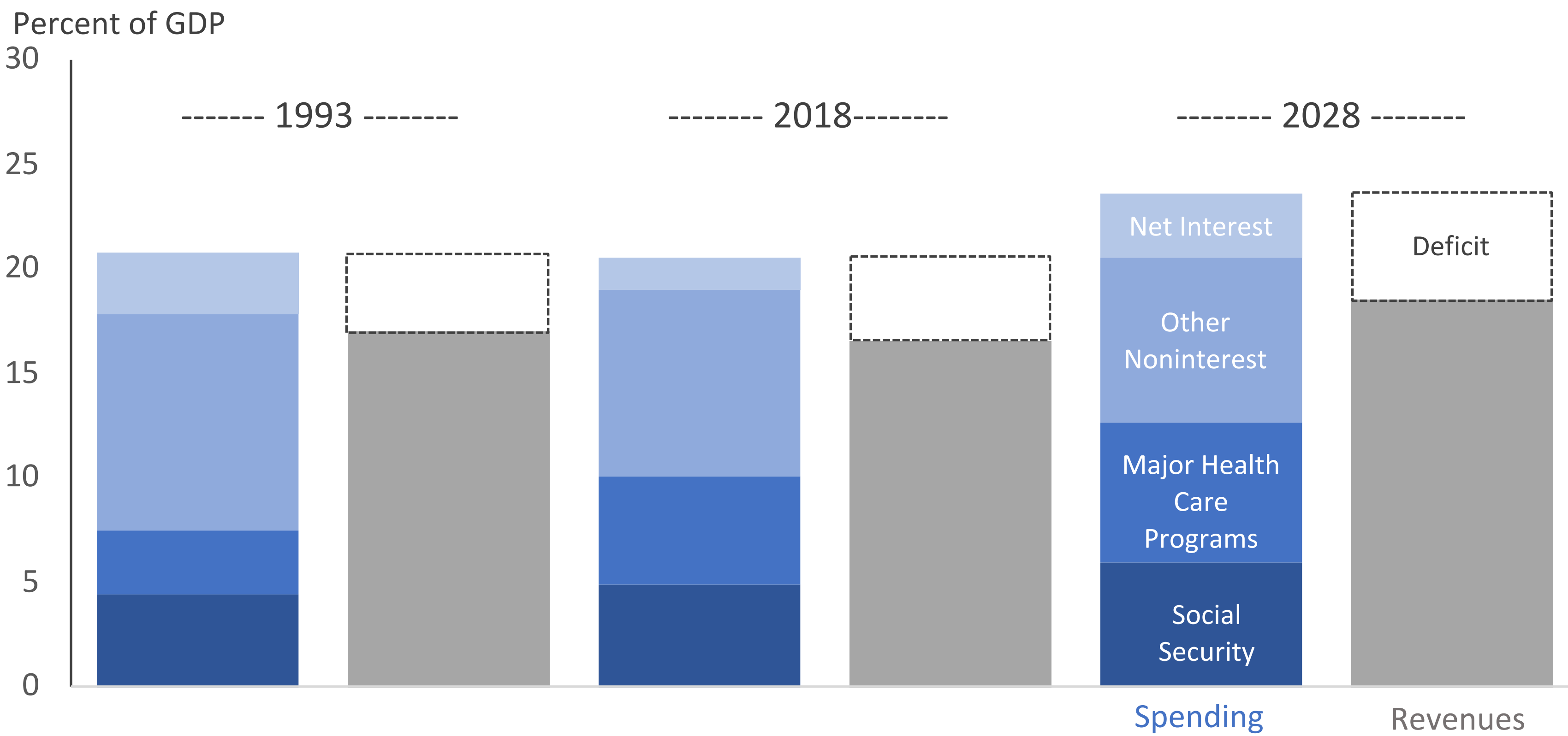
U.S. Population by Age Group



Source: Congressional Budget Office (2018).

Increase in deficit driven by higher spending on older population, health care, interest

Evolution of the Federal Budget over Time



Source. Congresssional Budget Office (2018).

Even without a debt crisis, we will see …

Crowding out of private investment

Pressure to cut discretionary spending

Insufficient financing for Social Security and Medicare benefits as scheduled

Key projections for Social Security and Medicare

Social Security:

OASI trust fund will run dry in 2035

% of projected benefits payable after that: 75 percent

Medicare:

Hospital insurance trust fund will run dry in 2029

% of projected costs fundable after that: 88 percent

Source: 2017 reports from the trustees of the Social Security and Medicare trust funds.

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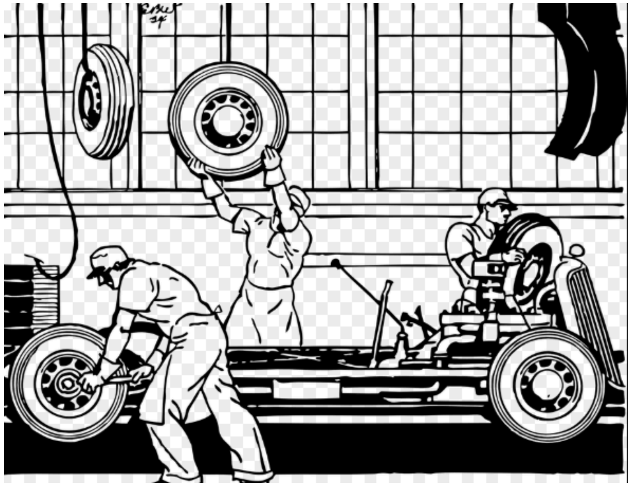
What is productivity?



productivity = output per hour

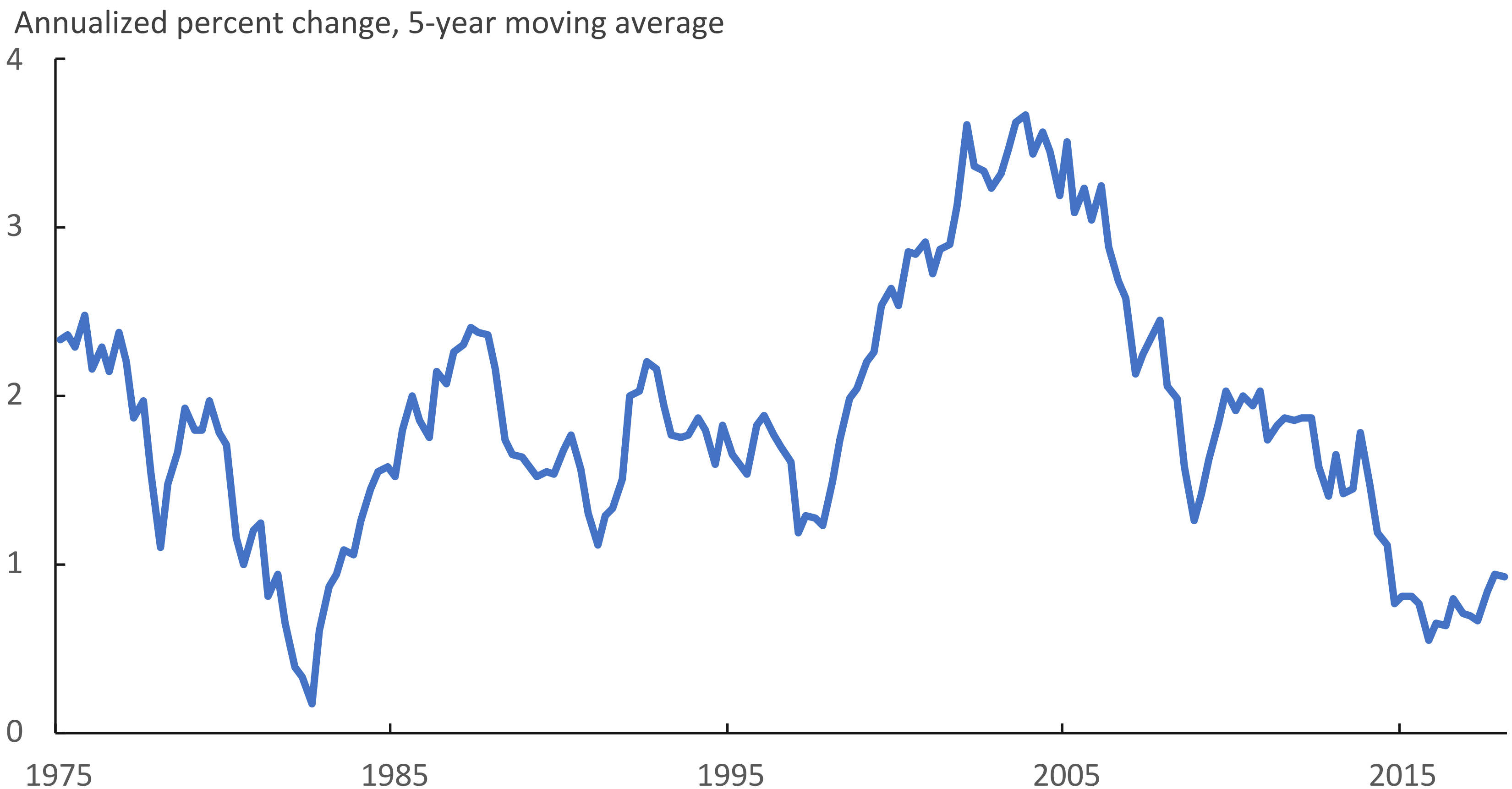
Especially important to the macro picture given that growth in the labor force has slowed because of population aging, women no longer surging into the labor force, and other trends

1.8% = annual growth labor force 1970-1999

0.5% = CBO's projection for next 10 years

Productivity has disappointed in recent years

Labor Productivity Growth

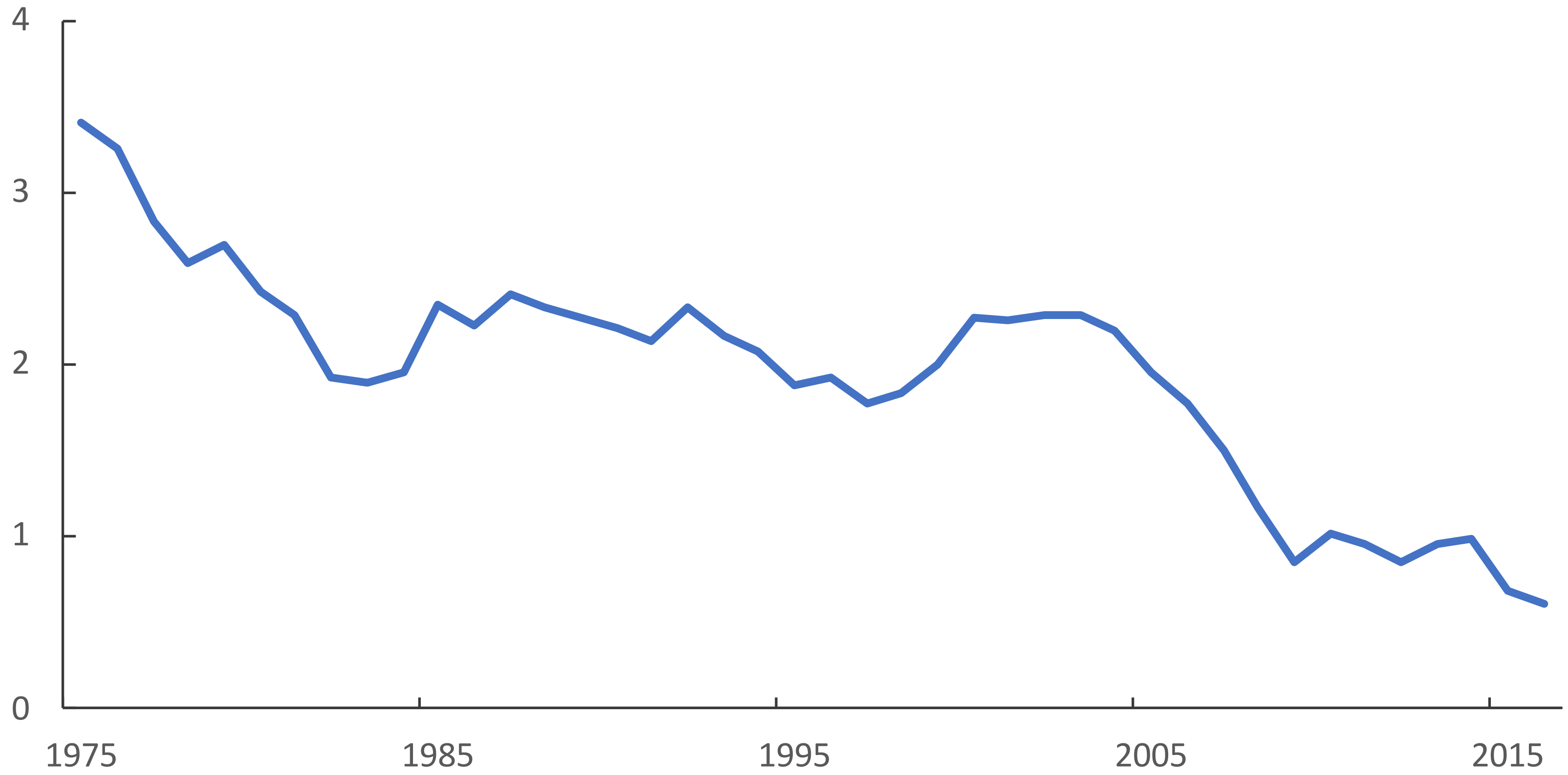


Source. U.S. Department of Labor.

Not just a U.S. challenge

Labor Productivity Growth in G-7 Countries

Annualized percent change, 5-year moving average



Source. OECD.

Not (primarily) a measurement issue

BPEA ARTICLE

The disappointing recovery of output after 2009

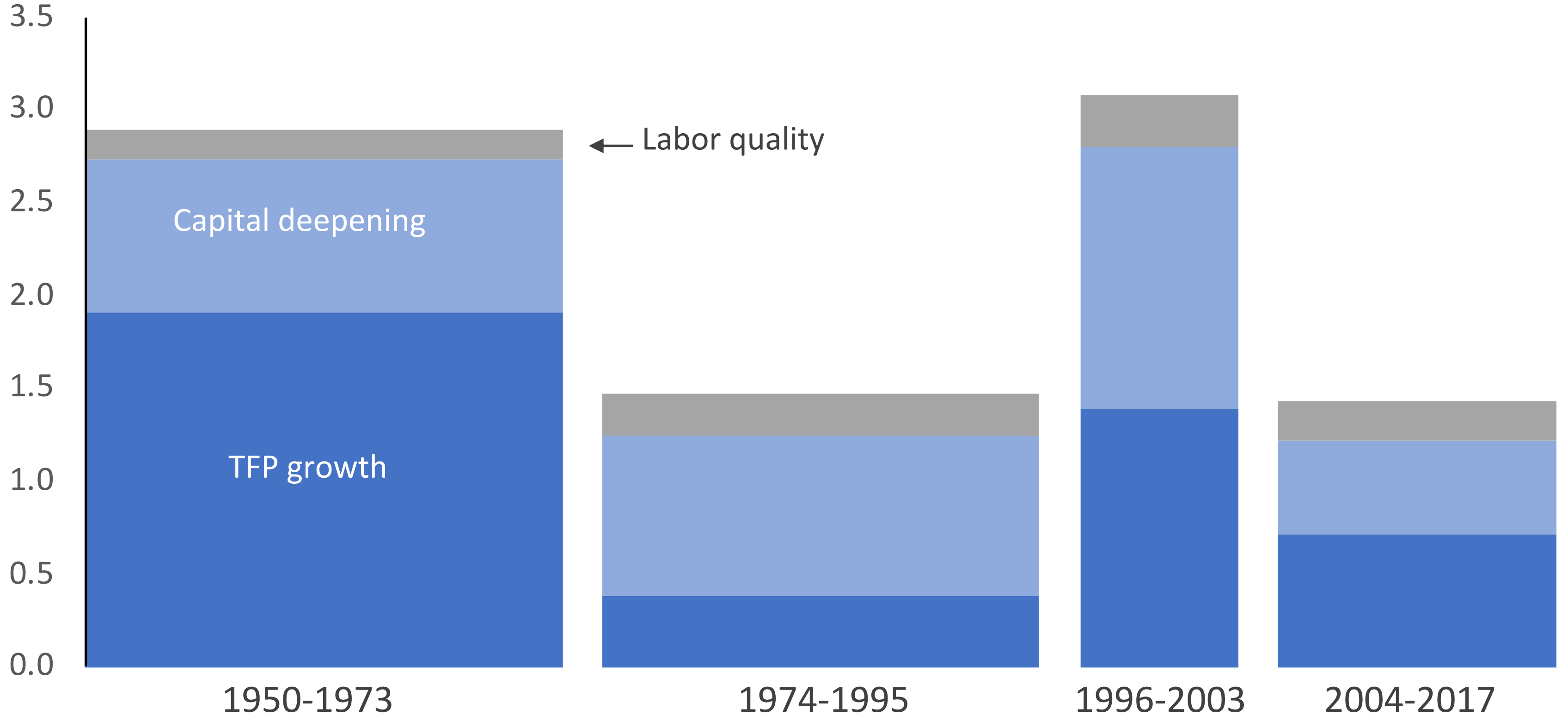
John Fernald, Robert Hall, James Stock, and Mark W. Watson ·
Thursday, March 23, 2017

optimism. The disappointing average pace of growth since 2009 included a large cyclical component that has, as of this writing, largely gone away. The remaining slow underlying pace of growth reflected underlying non-cyclical trends that predated the recession. To date, those trends have been persistent, and are not a mismeasurement mirage. Although a turnaround

Unpacking the slower growth

Composition of U.S. Productivity Growth

Percentage points, annual rate

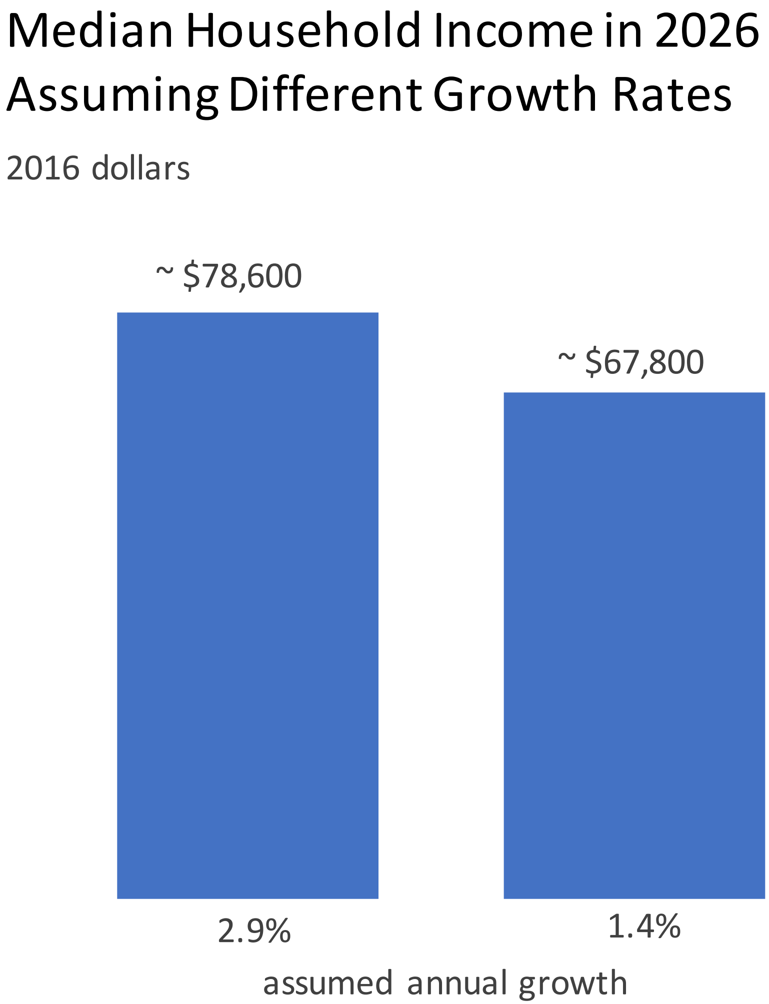


Source. U.S. Labor Department.

Important implications for the standard of living

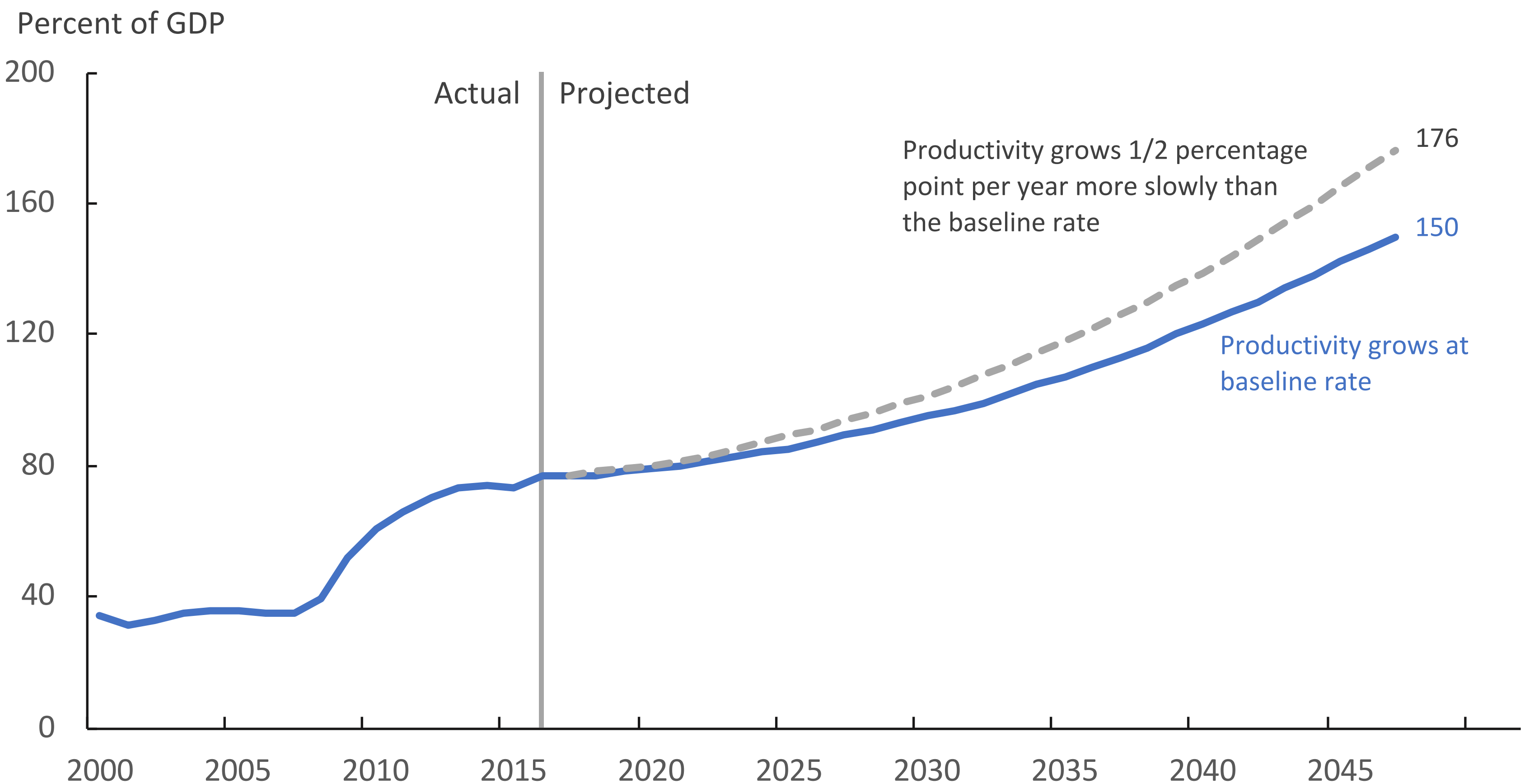
What happens if you project 2016 median household income forward 10 years with the productivity growth rate we saw from 1950-73?

With the rate we saw from 2004-17?



Important implications for the budget picture

Federal Debt Given Different Productivity Growth Assumptions



Source. Congressional Budget Office (2017). Assumes fiscal policy as of March 2017.

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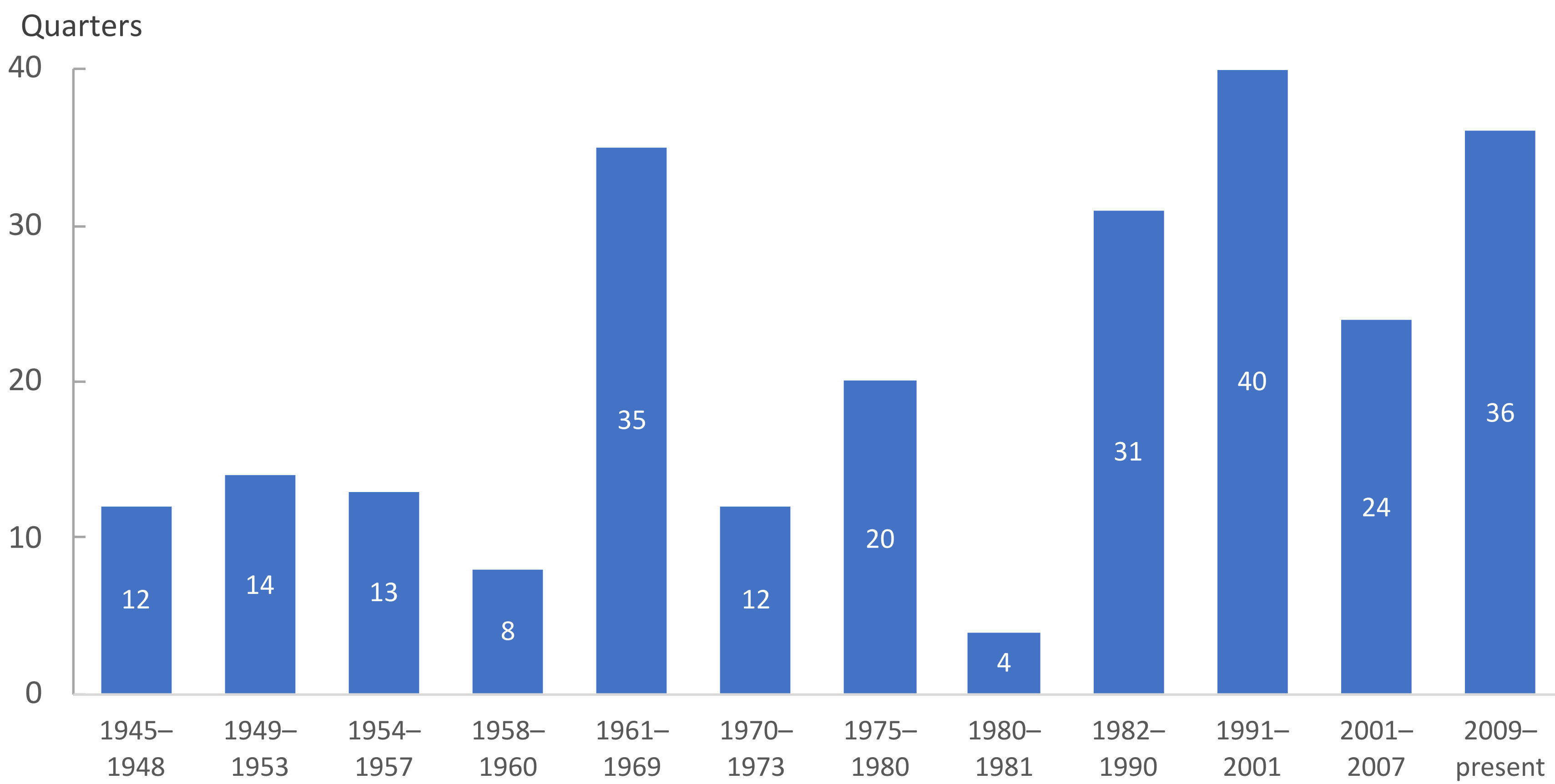
The current expansion has been very long

Duration of Economic Expansions since 1945



Source. Congressional Budget Office (2018).

What could derail the economy?

Trade war

“Overshooting” of full employment that leads to inflationary pressures, that, in turn, lead the Fed to raise interest rates more sharply than current expected

Financial market pullback arising from geopolitical events, financial instability abroad, valuations that may be high today

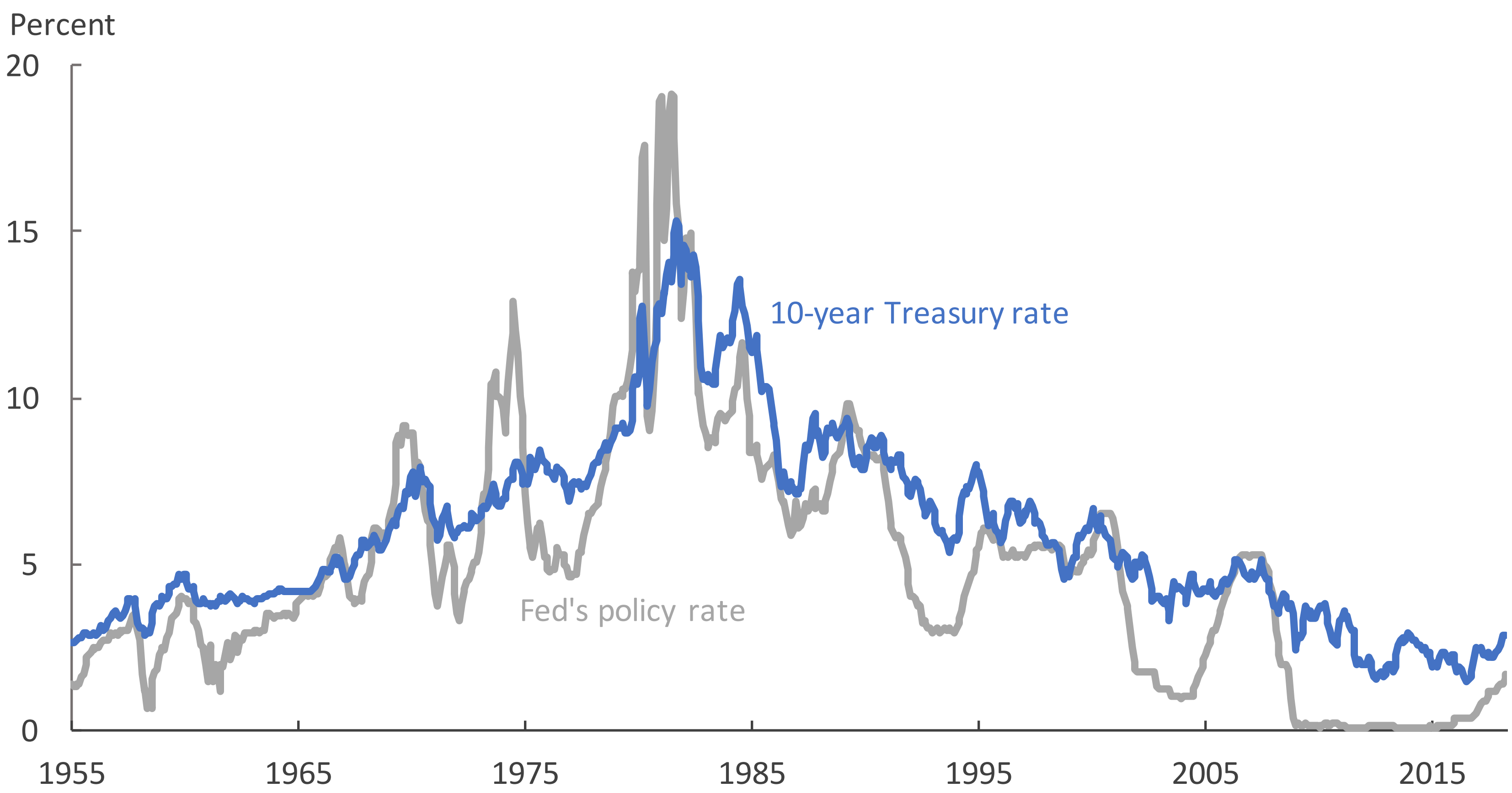
The problem: limited macroeconomic tools to mitigate the next recession

Already high levels of federal debt limit scope for lowering taxes or increasing government spending to increase demand

The “zero-lower-bound” problem will continue to be an obstacle for monetary policy because of the secular downtrend in interest rates

Interest rates have fallen considerably over time

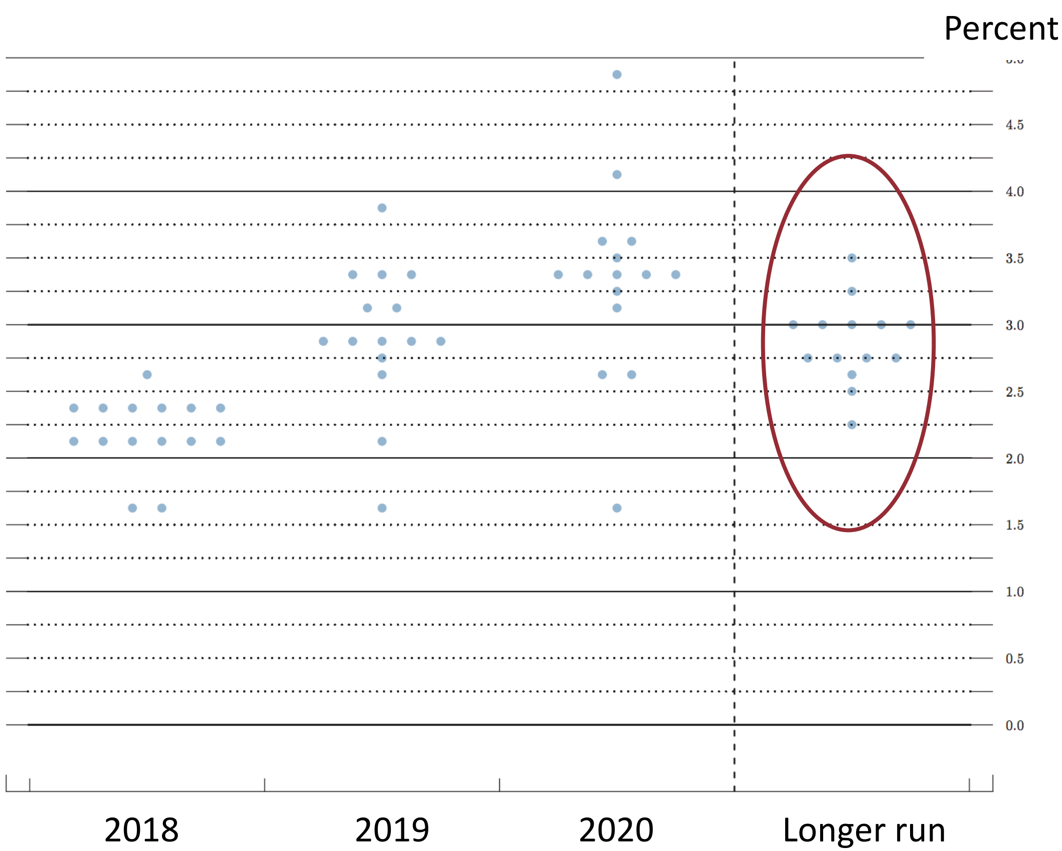
U.S. Interest Rates



Source. Federal Reserve Board.

Interest rates should rise as monetary policy normalizes but not by much

FOMC Participants' Projections for Federal Funds Rate



Implying much less room to lower rates than in earlier downturns

Rates were cut by more than 5 percent in last 3 recessions:

	Starting fed funds rate	Lowest fed funds rate	Cumulative cut
1990 recession	8.25 percent	3.0 percent	5.25pp
2001 recession	6.50 percent	1.0 percent	5.50pp
2007 recession	5.25 percent	~ zero	~5.25pp

So we should be concerned that the median FOMC participant sees the fed funds rate stabilizing at close to 3 percent.

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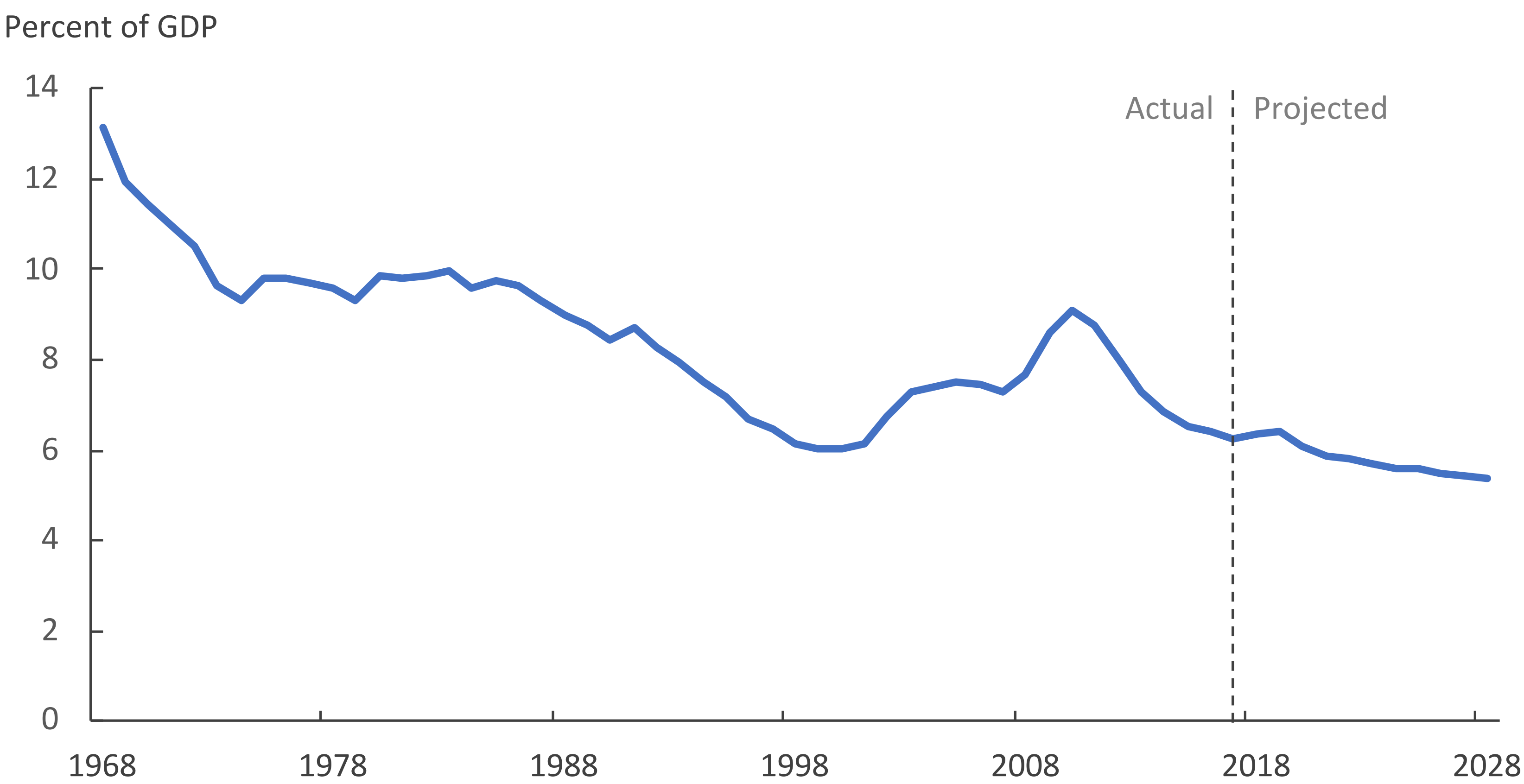
Get to work now on Social Security

Changes are usually phased in slowly

Desired policy changes may be affected by different experiences in recent decades for higher- and lower- income people regarding wage growth and changes in life expectancy

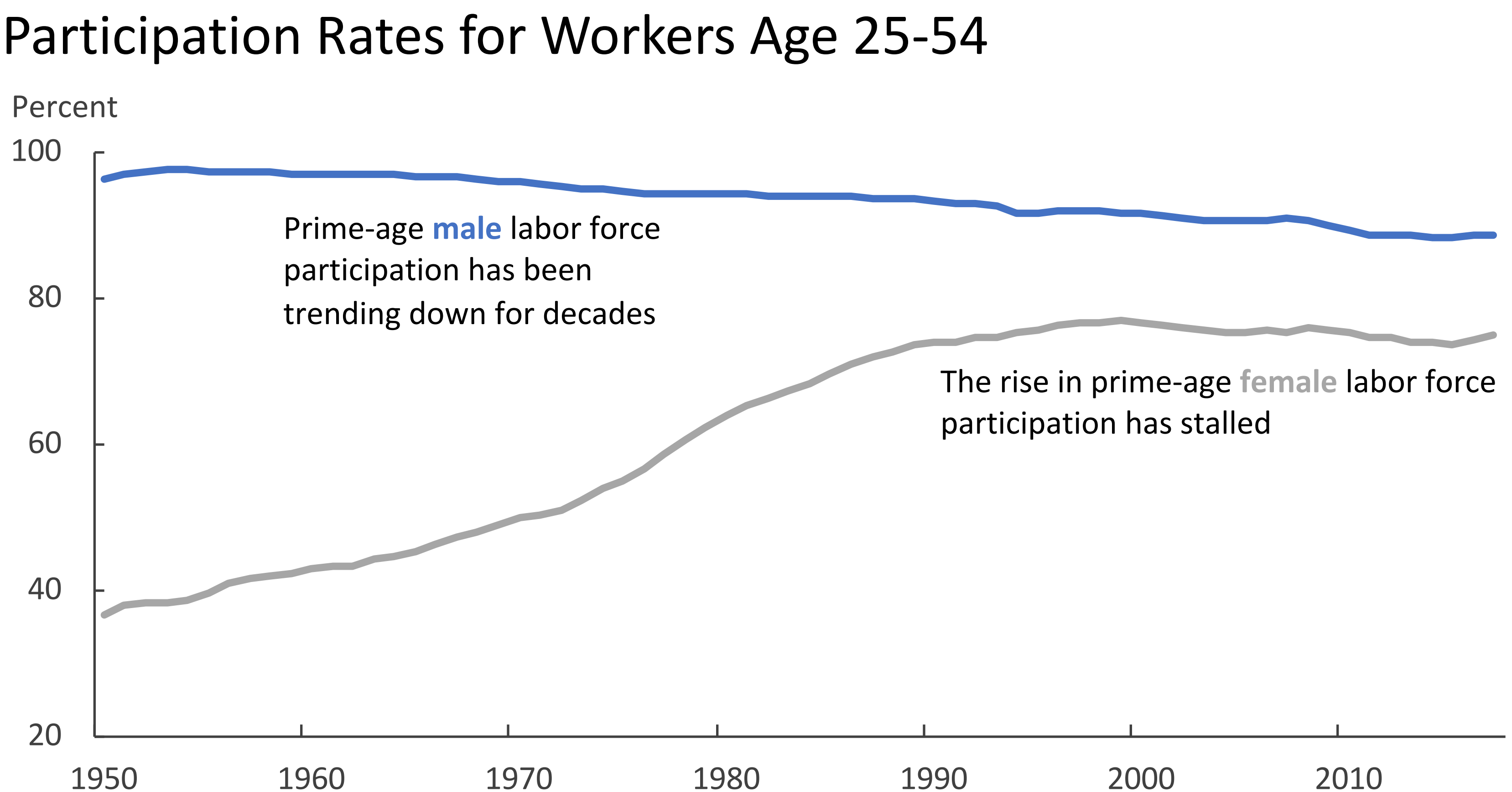
Maintain public investment spending

U.S. Federal Discretionary Spending



Source. Congressional Budget Office (2018).

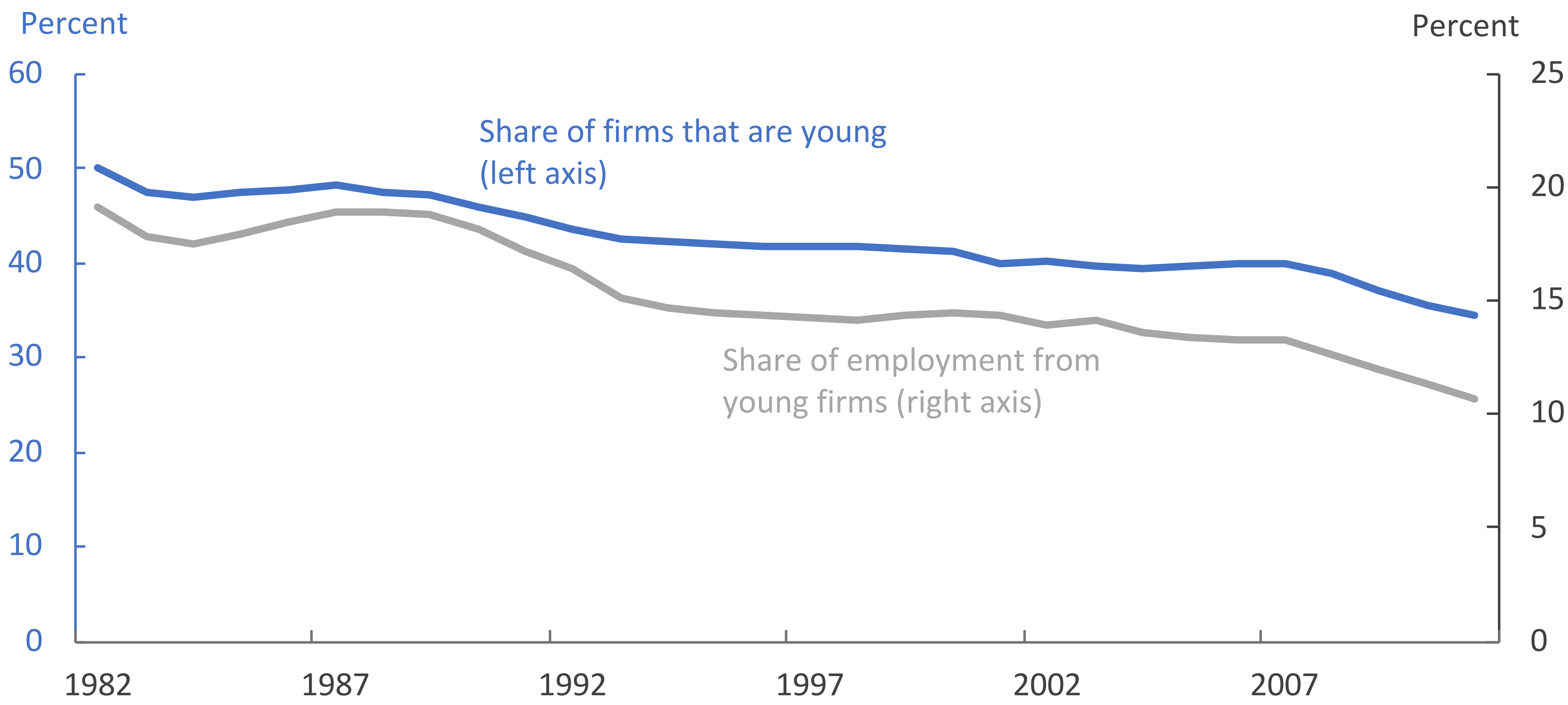
Take steps to boost working-age labor force participation



Source. U.S. Labor Department.

Consider regulatory obstacles that may be reducing dynamism

Changing Role of Young Firms (Age 5 or Less)



Source. Decker, Haltiwanger, Harmin, and Miranda (2014).

Use and refine alternative monetary policy tools

Don't be squeamish about **quantitative easing**

Evidence suggests that it worked

Explore and develop other tools

Forward guidance? Should we go further and use rules?

Negative interest rates? Can we overcome the practical and political obstacles?

Raise the Fed's target inflation rate? Would it unanchor inflation expectations?

Questions?

Notes

Slide 4: Quarterly data; last data point is for 2018:Q1.
Slide 5: Chart show consumer inflation based on the PCE price measure, which is preferred by the Fed. The series are monthly, and the last data points are for March 2018.
Slide 6: Numbers shown in chart are for real GDP. The Wall Street Journal projections can be found here: http://projects.wsj.com/econforecast/#ind=gdp&r=20; the IMF forecast can be found here: https://www.imf.org/en/Publications/WEO/Issues/2018/03/20/world-economic-outlook-april-2018; the Federal Reserve forecast can be found here: https://www.federalreserve.gov/monetarypolicy/fomcprojtabl20180321.htm; and the CBO forecast can be found here: https://www.cbo.gov/publication/53651.
Slides 10, 11, 13, 14: These graphs are all based on data from the CBO's latest budget and economic forecast, which can be found here: https://www.cbo.gov/publication/53651.
Slide 16: A summary of the trust fund reports can be found at: https://www.ssa.gov/oact/trsum/.
Slide 18: CBO's (2018) projection is available here: https://www.cbo.gov/sites/default/files/recurringdata/51118-2018-04-budgetprojections.xlsx.
Slide 19: Chart shows labor productivity growth for the nonfarm business sector.
Slide 20: OECD data are available here: https://www.oecd-ilibrary.org/employment/data/oecd-productivity-statistics/gdp-per-capita-and-productivity-growth_data-00685-en. Chart shows average growth in GDP per hour worked.
Slide 22: Chart shows average annual labor productivity growth (and its components) for the nonfarm business sector over different productivity "eras" identified by economists.
Slide 23: Median household income from the Census Bureau available here: https://www.census.gov/data/tables/2017/demo/income-poverty/p60-259.html. (Most recent estimate is for 2016.)
Slide 24: The CBO long-term projections were last published in March 2017, so the series shown here are based on fiscal policy as of that date. Incorporating the 2017 tax act would raise the level of both lines by about 5 percentage points. CBO long-term projections are available here: https://www.cbo.gov/sites/default/files/recurringdata/51119-2017-03-ltbo_1.xlsx. The CBO assumes that productivity will grow roughly 1.6 percentage points per year in the baseline.
Slide 34: The data can be found here: https://www.cbo.gov/system/files/115th-congress-2017-2018/reports/53651-dataunderlyingfigures.xlsx.
Slide 36: Data from figure 4 of Decker, Ryan, John Haltiwanger, Ron Jarmin, and Javier Miranda (2014), "The Role of Entrepreneurship in US Job Creation and Economic Dynamism," *Journal of Economic Perspectives* 28(3).