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

• Challenge 1: rising federal debt

• Challenge 2: weak productivity growth

• Challenge 3: risk of recession

• Policy implications
Healthy labor market

U.S. Unemployment Rate

Percent of labor force

Low inflation

Consumer Prices
Percent change from year earlier

Source. U.S. Department of Commerce.
Strong GDP outlook for 2018

Average GDP growth last 25 years

Projections for 2018 GDP growth (Q4/Q4)

WSJ forecaster survey (May 2018)
IMF (April 2018)
Federal Reserve (March 2018)
CBO (April 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

Federal Discretionary Spending

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

Source: Congressional Budget Office.
Talk today

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

U.S. Federal Debt Held by the Public

Percent of GDP

Actual  Projected

Rising federal debt (long view)

U.S. Federal Debt Held by the Public

The 2017 tax act raises federal debt

Effect of 2017 Tax Act on Federal Debt in 2027

In percentage points

<table>
<thead>
<tr>
<th></th>
<th>With no macro feedback</th>
<th>With macro feedback</th>
</tr>
</thead>
<tbody>
<tr>
<td>Effect</td>
<td>6.3</td>
<td>5.5</td>
</tr>
</tbody>
</table>

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

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

Annualized percent change, 5-year moving average

Not just a U.S. challenge

Labor Productivity Growth in G-7 Countries

Annualized percent change, 5-year moving average

Source: OECD.
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

- **Capital deepening**
- **TFP growth**
- **Labor quality**

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?

Median Household Income in 2026 Assuming Different Growth Rates
2016 dollars

- ~ $78,600 (2.9% assumed annual growth)
- ~ $67,800 (1.4% assumed annual growth)
Important implications for the budget picture

Federal Debt Given Different Productivity Growth Assumptions

Percent of GDP

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- **Challenge 3: risk of recession**
- Policy implications
The current expansion has been very long

Duration of Economic Expansions since 1945

Quarters

<table>
<thead>
<tr>
<th>Period</th>
<th>Duration</th>
</tr>
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<tbody>
<tr>
<td>1945–1948</td>
<td>12</td>
</tr>
<tr>
<td>1949–1953</td>
<td>14</td>
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<tr>
<td>1954–1957</td>
<td>13</td>
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<tr>
<td>1958–1960</td>
<td>8</td>
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<tr>
<td>1961–1969</td>
<td>35</td>
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<tr>
<td>1970–1973</td>
<td>12</td>
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<td>1975–1980</td>
<td>20</td>
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<td>1980–1981</td>
<td>4</td>
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<td>1982–1990</td>
<td>31</td>
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<tr>
<td>1991–2001</td>
<td>40</td>
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<tr>
<td>2001–2007</td>
<td>24</td>
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<tr>
<td>2009–present</td>
<td>36</td>
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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

<table>
<thead>
<tr>
<th>Year</th>
<th>2018</th>
<th>2019</th>
<th>2020</th>
<th>Longer run</th>
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<tbody>
<tr>
<td>Percent</td>
<td></td>
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<tr>
<td>0.0</td>
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<td>0.5</td>
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Implying much less room to lower rates than in earlier downturns

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

<table>
<thead>
<tr>
<th>Year</th>
<th>Starting fed funds rate</th>
<th>Lowest fed funds rate</th>
<th>Cumulative cut</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990 recession</td>
<td>8.25 percent</td>
<td>3.0 percent</td>
<td>5.25pp</td>
</tr>
<tr>
<td>2001 recession</td>
<td>6.50 percent</td>
<td>1.0 percent</td>
<td>5.50pp</td>
</tr>
<tr>
<td>2007 recession</td>
<td>5.25 percent</td>
<td>~ zero</td>
<td>~5.25pp</td>
</tr>
</tbody>
</table>

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

Percent of GDP

Actual | Projected

Take steps to boost working-age labor force participation

Participation Rates for Workers Age 25-54

Prime-age **male** labor force participation has been trending down for decades

The rise in prime-age **female** labor force participation has stalled

Source. U.S. Labor Department.
Consider regulatory obstacles that may be reducing dynamism

Changing Role of Young Firms (Age 5 or Less)

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.

Slide 16: A summary of the trust fund reports can be found at: https://www.ssa.gov/oact/ctsum/.


Slide 19: Chart shows labor productivity growth for the nonfarm business sector.


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.
