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AUSTRALIAN CENTRE FOR FINANCIAL STUDIES

ACFS Boardroom Briefing

"The Near-Term Outlook for the US Economy"
Speaker: Dr Christopher J. Waller, Executive Vice-President and Director of Research
Federal Reserve Bank of St. Louis

Wednesday 8 February, 2017

On Wednesday 8 February, ACFS hosted Dr Christopher J. Waller, Executive Vice-President and Director of Research at the Federal Reserve Bank of St. Louis, for a public Boardroom Briefing on the topic "The Near-Term Outlook for the US Economy". The views expressed by Dr Waller were his own and do not necessarily reflect the positions of the Federal Reserve Bank of St. Louis or the Federal Reserve System ('the Fed').

Dr Waller opened by noting that the US is now heading into its eighth year of expansion, which is long by traditional business cycle standards. Growth and inflation remain modest. While consumer spending is strong, net exports and corporate investment have weighed on GDP growth. Some economists question whether growth will ever revert to its long-run trend of 3%, or whether the 2% range is a 'new normal'. The economy appears to be trapped in a low-productivity growth regime.

There appears to be a divergence between the 'hard' data and 'soft' data on corporate fixed investment. Since the election, consumer and business confidence metrics have climbed dramatically (as measured by the Conference Board, the Duke CFO Survey, and the Fed's own liaison programs). Corporate profit forecasts have trended higher, even though GDP forecasts haven't changed. However, American firms have effectively stopped investing – capital formation is very low or negative. These different data points are difficult to reconcile. It is not clear if booming confidence levels are rational or the result of 'animal spirits'.

Some corporate optimism may be driven by recent promises from the Trump administration relating to infrastructure spending, military spending, reduced regulation, and a lowering of the US corporate income tax rate. Increased federal spending may boost aggregate demand. According to the Fed's liaison program, some executives cite regulatory burdens under the Obama administration as a hindrance to growth.

The labour market outlook is very robust, and the US is close to long-run full employment (unemployment is at 4.8%). However, real wages have grown slowly, in part due to anaemic labour productivity. The participation rate is on a long-term structural decline, perhaps in part due to demographic factors.

Inflation has been below the Fed's 2% target rate for the last four years. Market-based measures of inflation expectations have picked up, although they remain below pre-recession levels. According to the St. Louis Fed's probability model, there is a 50% chance that headline inflation will remain below 1.5% over the next 12 months. Shale oil production, fracking and other extraction technologies have acted to keep oil prices low.

Overall, the Federal Open Market Committee (FOMC) forecasts that economic conditions will remain roughly the same over the next three years, with low growth and steady unemployment. Commodity prices are not expected to take off, even though there has been agreement by the Organization of the Petroleum Exporting Countries (OPEC) to cut production.

The Dow Jones index is at historic highs. In Dr Waller's view, there are two possible explanations for the strength of equities markets: (1) they are pricing in future economic growth, or (2) there is an expectation that corporate taxes will be lowered. If taxes are indeed lowered, this will help to sustain high equities prices. But if analysts are pricing in future growth, and that growth does not materialise, the movement of equities prices may reverse.

In the aftermath of the election, Dr Waller was most surprised by the fact that 10-year treasuries rose by 70-80 basis points within a short period of time (a change that is on par with the 'Taper Tantrum'). Investors appear to believe that stimulative policies will generate inflation. Dr Waller noted that there is support from both sides of the political aisle for more infrastructure spending, as the quality of US infrastructure has been declining for years. Short-run benefits may accrue via the demand side through raw material usage and labour utilisation, while longer-term benefits may materialise on the supply side. However, he noted that infrastructure spending tends to show up in productivity metrics with a 10-15 year lag. In the short run, increased deficit spending may have a 'crowding out' effect, and new infrastructure construction may actually be detrimental (e.g. as roads are closed so that underground cables can be replaced).

Dr Waller noted that the Trump administration has proposed a border-adjustment tax that combines an import tariff with an export subsidy. This would drive up the US dollar. Since the election, the real value of the US dollar has appreciated against most of America's major trading partners.

The Fed's two key objectives are maximum employment and inflation around 2%. On composite measures, the Fed is as close now to achieving its dual mandate as it has ever been. So why is the policy rate so low? A common compliant is that the Fed is behind schedule on 'normalising' interest rates. However, a counterargument is that the economy is already back to 'normal', so there is no reason to raise rates further. Low interest rates reflect a world where safe assets are in short supply, so that even though yields on government bonds have fallen (and in some cases are negative in real terms) investors continue to buy them. The St. Louis Fed's view is therefore that there is no good reason to raise policy rates by 200 to 300 basis points.

The Fed's balance sheet is now around $4.5 trillion, on which it generates about $90 billion in profits each year (which are remitted to the US Treasury). The Fed stopped buying large-scale assets in October 2014 and its balance sheet has remained relatively constant since then (principal payments are reinvested). Fed leaders have communicated that they will not shrink the balance sheet until the Fed is well into the normalisation process. Surveys of primary dealers indicate that the market does not expect the balance sheet to start shrinking until mid-2018. The St. Louis Fed's regional president, Dr Jim Bullard, has pointed out that if the Fed raises short-term interest rates, while its balance sheet places downward pressure on long-term interest rates, this may "screw up" the yield curve.

There is no existing theory about the optimal size of a central bank's balance sheet. Economists like Professor Jeremy Stein (Harvard University) have argued that an enlarged balance sheet is good for financial stability, because it floods the system with short-term liquidity. A shortage of short-term instruments is a principal cause of past financial crises. One audience member asked about the implications of rising deficits on the Fed's balance sheet. Dr Waller noted that deficits could put upward pressure on interest rates. If rates rose very rapidly, this could theoretically trigger capital losses for the Fed, which would be a severe problem.

Dr Waller predicted that Congress will apply pressure on the Fed to reduce its holdings of mortgage-backed securities (MBS). All of the Fed's current Fannie Mae and Freddie Mac MBS holdings are backed by the US Treasury, and so are effectively no different to holding treasuries. Once Fannie Mae and Freddie Mac exit federal conservatorship, the Fed will no longer be able to buy/hold the debt of a private firm.

The other side of the Fed's balance sheet is reserve balances of depository institutions (banks). The Fed pays billions of dollars in interest to banks. The optics of this policy are unfavourable: to Congress, this looks a massive government subsidy. Dr Waller suggested that Congress may agitate to remove the Fed's power to pay interest on reserves, which would place it "in serious trouble".

An audience member asked about financial stability. Dr Waller noted that some regional Fed presidents are concerned about the possibility of asset bubbles. The stock market's aggregate P/E ratio is currently around 21, much higher than its historical average of around 16. Again, this may be the result of markets pricing in a future tax cut and the repatriation of foreign profits. He noted that regulations since the financial crisis have forced banks to bring

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everything onto their balance sheets (rather than use off-balance sheet vehicles to avoid regulation). It remains to be seen how the rollback of Dodd-Frank legislation will be implemented.

One audience member asked about the household sector. Dr Waller noted that households are saving more and have been cleaning up their balance sheets. (Interestingly, the US corporate sector does not need to borrow because of its retained earnings.) Dr Waller pointed to a growing area of household debt: student loans. Student loan debt now exceeds credit card debt, and default rates are high too. This may be part of the reason why new household formation amongst millennials is so low.

An audience member asked about the *effective* corporate tax rate, which some analysts estimate to be below 20%. Dr Waller agreed that the effective rate would be much lower than the statutory rate. He noted that there is a proposal to allow businesses to write off 100% of investment on equipment upfront, rather than amortise it over 5-7 years. This will have a huge effect on the effective corporate tax rate.

Another audience member asked about a recent letter by Congressman Rep. Patrick McHenry to the Chair of the Federal Reserve System, Dr Janet Yellen, asking her to withdraw the Fed from international negotiations on banking and insurance supervision. Dr Waller felt that the Fed would be extremely unlikely to comply.

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