The Global Economy: A Cyclical Boom (with Risks)

Karen Dynan
Nonresident Senior Fellow
Peterson Institute for International Economics
Professor of the Practice
Harvard University Department of Economics

April 4, 2018
Why is the near-term outlook strong?

Monetary policy is accommodative and financial conditions are supportive.

Fiscal policy is stimulative.

Confidence is high.

But:

Protectionist policies are spreading.

The risk of significant overshooting has increased.
# The global outlook: broad-based growth

<table>
<thead>
<tr>
<th>Real GDP Growth (Y/Y)</th>
<th>2017</th>
<th>2018</th>
<th>2019</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Global Output Growth (PPP weights)</strong></td>
<td>3.7</td>
<td>3.8</td>
<td>3.9</td>
</tr>
<tr>
<td>US: a fiscal bump</td>
<td>2.3</td>
<td>2.7</td>
<td>2.6</td>
</tr>
<tr>
<td>Euro Area: above-trend gains</td>
<td>2.5</td>
<td>2.2</td>
<td>2.0</td>
</tr>
<tr>
<td>Japan: growth continues</td>
<td>1.7</td>
<td>1.3</td>
<td>1.2</td>
</tr>
<tr>
<td>UK: modest growth</td>
<td>1.7</td>
<td>1.4</td>
<td>1.3</td>
</tr>
<tr>
<td>China: gradual slowdown</td>
<td>6.9</td>
<td>6.4</td>
<td>6.4</td>
</tr>
<tr>
<td>India: picking up</td>
<td>6.7</td>
<td>7.4</td>
<td>7.5</td>
</tr>
<tr>
<td>Russia: recovery underway</td>
<td>1.5</td>
<td>1.8</td>
<td>1.9</td>
</tr>
<tr>
<td>Brazil: modest upturn</td>
<td>1.0</td>
<td>2.0</td>
<td>2.1</td>
</tr>
</tbody>
</table>

The U.S. (modal case): A cyclical boom

<table>
<thead>
<tr>
<th>Forecast</th>
<th>2016</th>
<th>2017</th>
<th>2018</th>
<th>2019</th>
<th>2020</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real GDP Growth (Q4/Q4)</td>
<td>1.8</td>
<td>2.6</td>
<td>2.8</td>
<td>2.3</td>
<td>1.6</td>
</tr>
<tr>
<td>Unemployment (Q4)</td>
<td>4.7</td>
<td>4.1</td>
<td>3.7</td>
<td>3.5</td>
<td>3.7</td>
</tr>
<tr>
<td>PCE Price Inflation (Q4/Q4)</td>
<td>1.6</td>
<td>1.7</td>
<td>1.9</td>
<td>2.0</td>
<td>2.2</td>
</tr>
<tr>
<td>Core PCE Price Inflation (Q4/Q4)</td>
<td>1.9</td>
<td>1.5</td>
<td>1.9</td>
<td>2.0</td>
<td>2.2</td>
</tr>
</tbody>
</table>
Significant fiscal stimulus from tax reform

Change in Tax Payments from 2017 Tax Reform

Deficit Effects of Change of 2017 Tax Reform

Source: Author’s calculations based on JCT and CBO data.
Significant fiscal stimulus from spending

- Caps on discretionary appropriations were increased by $143B in FY 2018 and $153B in FY 2019.
- The additional spending will occur with lags.
- Caps for 2020 have not been increased but almost certainly will be later.
- (Discretionary spending will still be smaller relative to GDP than in almost any year since at least the early 1960s.)

**Federal Discretionary Spending**

Billions of dollars

Source: CBO, author's calculations based on CBO information about BBA 2018 and assumptions about 2020.
Macroeconomic effects of fiscal stimulus

Effect of Fiscal Stimulus on Q4 Level of GDP

<table>
<thead>
<tr>
<th>Year</th>
<th>Spending</th>
<th>Revenue</th>
</tr>
</thead>
<tbody>
<tr>
<td>2018</td>
<td>0.60</td>
<td>0.60</td>
</tr>
<tr>
<td>2019</td>
<td>0.10</td>
<td>0.10</td>
</tr>
<tr>
<td>2020</td>
<td>-0.55</td>
<td>-0.55</td>
</tr>
</tbody>
</table>

Effects on Economic Growth, All Else Equal

<table>
<thead>
<tr>
<th>Year</th>
<th>Q4/Q4 real GDP growth</th>
<th>Annual avg. real GDP growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>2018</td>
<td>0.60</td>
<td>0.50</td>
</tr>
<tr>
<td>2019</td>
<td>0.10</td>
<td>0.40</td>
</tr>
<tr>
<td>2020</td>
<td>-0.55</td>
<td>-0.50</td>
</tr>
</tbody>
</table>

Source: Author’s calculations. Effects are relative to counterfactual where fiscal policy is neutral for GDP.
The personal saving rate is low but household balance sheets are in good shape

Personal Saving Rate and Net Worth

[Graph showing personal saving rate and net worth over time, with key data points and trends.

Household Debt Service

[Graph showing household debt service as a percent of disposable income over time, with key data points and trends.

Sources: Federal Reserve and BEA.
Gradual recovery in housing continues

Total Housing Starts

S&P / Case Shiller National Home Prices

Sources: Census Bureau and S&P Dow Jones Indices LLC.
Momentum in business investment

ISM Manufacturing Indexes

New orders

New export orders

Contribution of Business Fixed Investment to Q4/Q4 Real GDP Growth

Sources: Institute for Supply Management, Commerce Department, author’s projection.
Some drag from net exports

Real Trade-Weighted US Dollar Index

Contribution of Net Exports to Q4/Q4 Real GDP Growth

Source: Federal Reserve, BEA, author’s forecast.
A tight labor market is getting tighter

Sources: Labor Department and author’s calculations.
A little remaining slack in participation

**Overall Labor Force Participation**

- Held down by retiring boomers

**Prime-age Labor Force Participation**

Source: Labor Department.
Wages have room to rise without putting much pressure on prices

Note: Atlanta Fed indicator was calculated as a quarterly average of monthly data.

Sources: Labor Department, Federal Reserve Bank of Atlanta, BEA, author’s forecast.
A slight overshooting of inflation is likely

Sources: Commerce Department, author’s forecast.
Gradual normalization of monetary policy, but rates will stay below historical averages

Sources: Federal Reserve, author’s forecasts.
Risk 1: More protectionism

- So far we have seen only trade skirmishes, not trade wars.
- But, one risk is that the U.S. takes more protectionist steps ... because the current account deficit does not improve or because it “sells well” with the base.
- Another risk is that other countries get fed up with the U.S. and put more retaliatory measures in place.

![Current Account Deficit Chart]
Risk 2: Chance of significant overshooting has increased

• The most likely case is that GDP will rise a bit above potential and that inflation will modestly overshoot its target => will require a period of “cooling off” in 2020 and 2021.

• In the post-war period, the unemployment rate has never risen by a material amount without the economy entering recession.
  
  • But those were also periods when the Fed raised rates to address already high inflation or the economy suffered some other shock.

• While it’s not a foregone conclusion that the correction will be tough, we are in uncharted territory.