Current Economic Conditions

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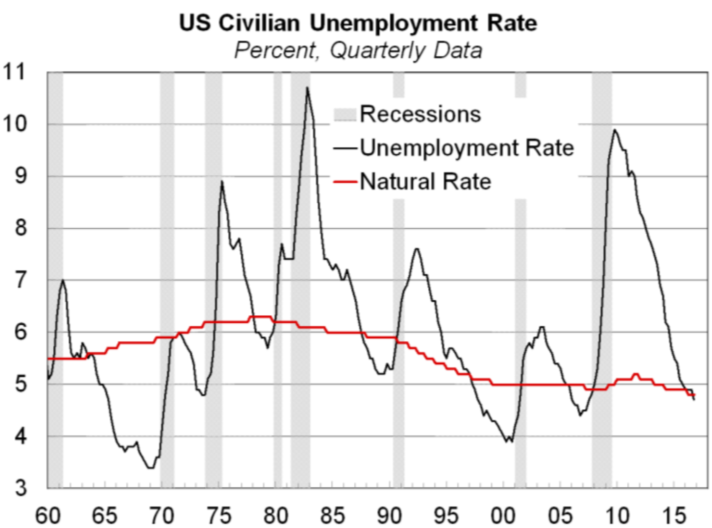
HOW FAST CAN THE ECONOMY GROW AT FULL EMPLOYMENT?

There is a common view among economists that U.S. economic growth cannot accelerate very much, even with better economic policies, because the U.S. economy is at full employment. Until recently, I subscribed to this view, but an analysis of history has convinced me that I was unduly pessimistic, and that the U.S. economy can grow rapidly for a sustained period even after it reaches full employment.

Economic growth can be broken down into two components: growth in labor input (hours worked) and growth in productivity (output per hour worked). When unemployment is high, labor input can be increased rapidly as the unemployed return to work, but once the economy returns to full employment, growth in labor input is constrained by growth in the working-age population. The headline unemployment rate stood at 4.7% in December, slightly below the Congressional Budget Office's 4.8% estimate for the Natural Rate of Unemployment, a commonly used measure of full employment. This suggests that the U.S. economy is at full employment and that further growth can only come from population growth and productivity growth, not from putting unemployed people back to work. However, during the long economic expansions of the 1980s and 1990s, the economy grew rapidly long after the unemployment rate fell below the CBO's estimate of full employment.

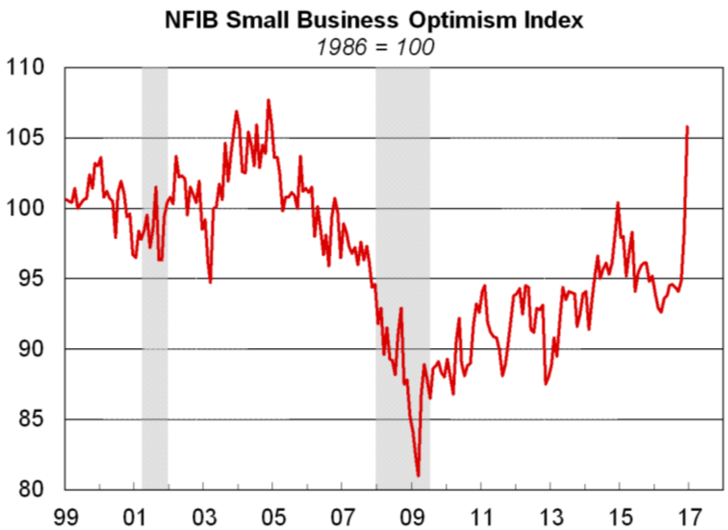


The unemployment rate fell below the CBO's measure of the Natural Rate in the fourth quarter of 1987. Even though the economy was seemingly at (or beyond) full employment, real Gross Domestic Product grew at a 3.8% annual rate over the next 10 quarters. The expansion of the 1990s provides an even more encouraging example, and one that might be more applicable to the current situation. The unemployment rate fell below the CBO's estimate of full employment in November 1997. (It fell to 4.6%, exactly where it was in November 2016.) Over the next 10 quarters, real GDP grew at a 4.8% annual rate. This suggests the U.S. economy could grow rapidly into early 2019. But many economists, including this one, believe that the headline unemployment rate understates the amount of slack in the labor force, and we prefer to focus on the U-6 unemployment rate, which includes part-time workers who would prefer to work full-time and "discouraged" working-age adults who have stopped looking for a job. The U-6 unemployment rate fell in August 1996 to 9.3%, exactly where it stood in November 2016. Real GDP grew at a 4.6% annual rate over the next 15 quarters. If the current economic expansion follows this precedent, strong growth could persist through the third quarter of 2020.

There are three possible explanations for rapid economic growth after the economy has seemingly reached full employment. The first is that when economists believe that the economy has reached full employment, it really hasn't. Part-time workers can take full-time jobs. The discouraged (and prematurely retired) who have stopped looking for work can start seeking work again. Even the U-6 measure of unemployment can understate potential growth in employment, as it includes people who haven't looked for work within the last month, but does not include those who haven't looked for work within the last year. Employment as a share of population for ages 25 to 54 remains below 1993-2008 levels, suggesting that employment could continue to grow at a solid pace despite the low headline unemployment rate.

The second possible explanation for rapid growth despite full employment is that productivity can grow rapidly late in an economic expansion. Indeed, growth in output per hour worked accelerated late in the 1990s expansion. Investment in plant and equipment, low energy prices, moving workers to higher-productivity jobs, and simply squeezing more out of existing employees when you can't hire more can all boost productivity growth. The third possibility is that rapid growth after reaching full employment is the result of fiscal or monetary policy errors and will ultimately lead to inflation and recession, as it did in the 1960s and 1970s. All expansions ultimately end in recession, but the 1990s expansion ended in the mildest recession in U.S. history, and inflation never rose above 3%. That confirms that strong growth when an economy is seemingly at full employment **can** be a good thing, not a policy error.

The experience of the 1980s and 1990s just shows that the U.S. economy **can** grow rapidly after it has seemingly reached full employment. Whether or not it **will** grow rapidly over the next few years depends on which of President Trump's policies are enacted, on the response of businesses to these policies, and on growth in the rest of the world. Deregulation, the immediate expensing of investment for tax purposes, and reforming corporate taxation in a way that encourages the repatriation of foreign profits being held offshore would significantly boost growth. Trade wars and mass deportations would seriously curtail growth. Policies that hurt the Mexican and Canadian economies – by far the top two destinations for U.S. exports – could be particularly harmful.



Surveys suggest that many Americans are optimistic that growth will accelerate. The Conference Board's Consumer Confidence Index rose to a 15-year high in December; the University of Michigan's Consumer Sentiment Index rose to a 13-year high. But optimism has improved most among small businesses. In December, the National Federation of Independent Business's Small Business Optimism Index posted its biggest one-month increase since going monthly in 1986, and that came on top of November's increase, which was the biggest since April 2010. The big increase in stock prices since the election also signals increased optimism.

Other data show that the U.S. economy is already accelerating. U.S. light vehicle sales rose in December to their highest seasonally adjusted annual rate since the "employee pricing for all" promotional incentive in 2005. Annual sales rose to a record high in 2016. Industrial production in U.S. manufacturing edged up 0.2% in December and was up just 0.2% from December 2015, but my leading index for industrial production surged in December, suggesting bigger gains ahead. Building permits for single-family homes, the most important data point in the monthly housing report, rose to a 9-year high. And the acceleration isn't confined to the United States. Industrial production in European manufacturing rose to an 8-year high in November. Purchasing managers' indexes rose around the world in December, signaling faster growth.

Economic growth in the United States has accelerated in recent months. Deregulation and business tax reform are likely to magnify and extend these gains, unless they are offset by bad trade and immigration policies. History tells us that this acceleration could persist for several years even though the headline unemployment rate is at a level that **seems** consistent with full employment.