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Economics Group

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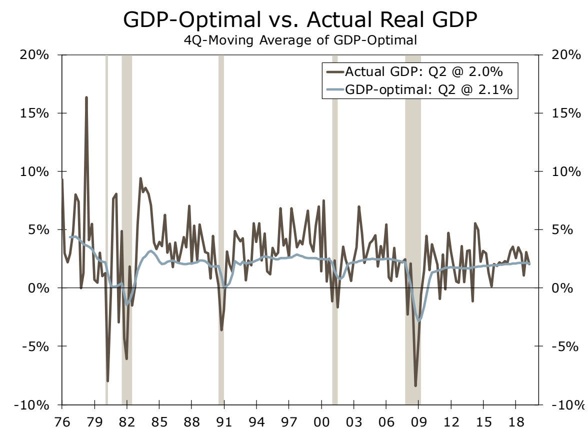
Stars Update: Optimal Levels of GDP, UR and Policy Rate

Our estimates of the optimal GDP, unemployment rate and policy rate are suggesting that the economy is operating close to its potential level. Trade related tensions, however, are clouding the near-term outlook.

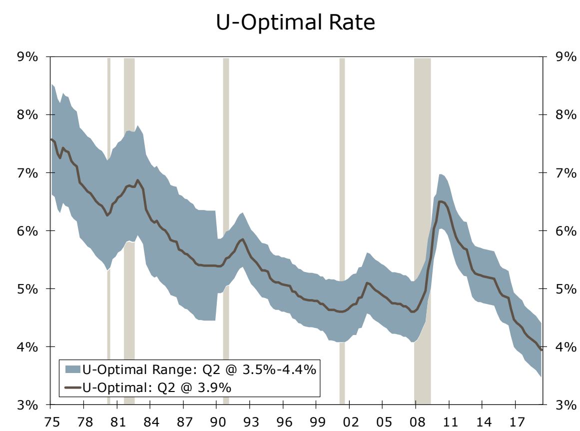
The GDP-Optimal: Neither Boom Nor Bust

Potential GDP, the natural rate of unemployment and the equilibrium interest rate are theoretical rates of macroeconomic variables at which the economy exists at equilibrium, or where there are no inflationary pressures and monetary policy is neither accommodative nor restrictive. In both of his speeches at Jackson Hole, Federal Reserve Chairman Jerome Powell has highlighted the importance of these concepts in guiding monetary policy, but also the difficulty in estimating them. In three previous reports (linked throughout this article), we have outlined our own measures of these variables and provided statistical justification for our methods. Our estimate of potential GDP, denoted as GDP-optimal, incorporates the evolving nature of the economy to estimate potential GDP. In theory, if actual GDP is below potential, then resources are underutilized and inflationary pressure is limited. However, when actual GDP rises above its potential, it suggests a risk of an overheating economy and rising inflation. At present, actual GDP is close to our estimate of GDP-optimal, suggesting a balanced inflation outlook (top chart).



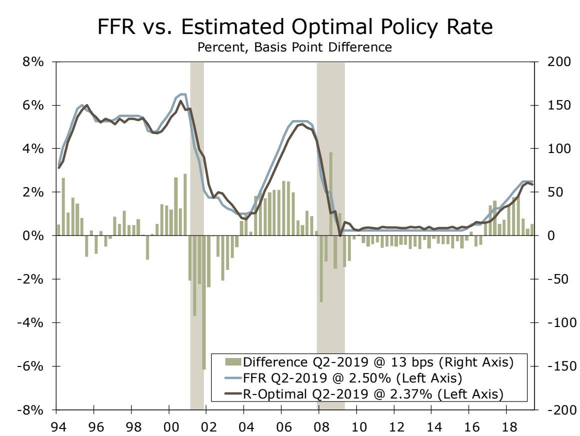
The U-Optimal and Optimal Policy Rate (R-Optimal)

Our estimate of the natural unemployment rate, referred to as U-optimal, is an alternative to the non-accelerating inflation rate of unemployment (NAIRU), which is a widely utilized gauge of the natural unemployment rate. In our view, estimates of NAIRU based on traditional methods, such as the Phillips Curve, fail to take the time varying relationships between macroeconomic variables into account. By taking these shifts into account, our method may offer a more effective estimation of the natural rate of unemployment and therefore a more accurate near-term outlook and better guide for monetary policy makers. Our current estimate of U-optimal is 3.9%, with a range of 3.5% to 4.4% (middle chart). At 3.7%, the actual unemployment rate is slightly below U-optimal, but falls within the estimation range. Consistent with our estimate of GDP-optimal, U-optimal suggests balanced risks to the inflation outlook.



We have also introduced a new method to estimate the appropriate target for the policy rate, R-optimal. Our estimate of R-optimal is forward-looking and utilizes time-varying weights, which allows us to take into account the changing nature of risks in an evolving economy. The Fed funds rate for the second quarter remains close to R-optimal (bottom chart). This suggests the current policy rate is not far from the appropriate policy rate based on our model.

The estimates of these three variables relative to their actual values suggest that the economy is operating near its equilibrium level and that fundamentals remain strong. However, ongoing trade tensions between China and the United States, the potential for a no-deal Brexit and slowing economies abroad are risks that do not feed clearly into this model of the economy. This pervasive uncertainty clouds the near-term economic outlook and provides some reason to proceed with caution.



Source: U.S. Department of Commerce, U.S. Department of Labor, Federal Reserve Board and Wells Fargo Securities

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