A Discussion of Economic Conditions and the Role of Monetary Policy

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Robert S. Kaplan
President and CEO
Federal Reserve Bank of Dallas

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Thank you for inviting me to speak with you.

I want to talk with you today about monetary policy—its proper role, how it's currently positioned, and the challenges facing policy makers in the years ahead.

Let me begin with a brief discussion of current economic conditions and the implications for monetary policy. I will then talk a bit about key issues facing economic policy makers.

Eleventh District Discussion of Energy

I'll start with a discussion of energy because of its impact on the Eleventh Federal Reserve District as well as its importance to the nation and the world.

Based on analysis as well as discussions with industry contacts, our Dallas Fed economists believe that global oil production and consumption will get into rough balance by early 2017. While there are varying estimates of the precise timing of this balancing process, the key to us is the trend—we are gradually moving toward balance. Our forecast is based on our expectation that global demand will grow by approximately 1.3 million barrels per day in 2016 as compared to 2015.[1]

Despite significant cuts in capital spending and rig counts in the U.S., global supply reductions have been slow to materialize over the past year. As supply reductions in the U.S. have occurred, they have been more than offset by production increases in Iran, Russia and other nations.

Based on a slowing rate of global supply growth (including significant supply cuts underway in the U.S.) as well as steady growth in demand, we expect excess oil inventories in OECD (Organization for Economic Cooperation and Development) countries to begin to decline in the near future. Inventory drawdowns will also be impacted by periodic supply disruptions, such as those which have occurred in Canada, Nigeria, Iraq and Kuwait.

As a result of these trends, we would expect oil prices to continue to firm in the coming months. Even with prices firming, because many energy companies are highly leveraged or operate in areas where the breakeven cost of production is above current market prices, we expect to see more bankruptcies, mergers and restructurings in the energy industry during the remainder of 2016.

(Note: Next week the Dallas Fed will release the results of its new quarterly energy survey. The survey samples nearly 200 upstream energy companies headquartered in the

Eleventh District, many with national and global operations. Respondents will report on their expectations for oil and gas prices, production levels, cost information, employment, capital spending and the overall outlook.)

The Eleventh District Overall Economic Conditions

The Eleventh District is comprised of Texas, northern Louisiana and southern New Mexico. The challenges of the energy industry continue to create headwinds for our district. The industry now comprises approximately 2 percent of Texas employment[2] and 7 percent of its gross domestic product [3] (versus 3 percent of employment and 13 percent of GDP in 2014).

Texas has substantially diversified its economy over the past three decades. Some of this diversification has occurred organically, and a significant portion has developed as a result of a sustained migration of people and firms to the state. Since 2000, population growth in Texas has exceeded that of the nation by a full 1 percentage point per year. This growth and diversification has helped contribute to the resiliency of the state despite recent headwinds from lower energy prices and a strong dollar.

In 2016, Dallas Fed economists expect Texas job growth of 1.3 percent—the same as in 2015, but down from 3.7 percent in 2014.[4] Manufacturing in Texas remains weak, but the state's service sector continues to show steady growth. While Houston and other energy-sensitive cities continue to face economic headwinds, Dallas, San Antonio and Austin are growing at healthy rates.

Due to an increasingly diversified economy as well as continued migration of people and firms to Texas, I am very optimistic about the growth prospects for Texas and the Eleventh District in the years ahead—particularly as the headwinds from energy and a strong dollar continue to dissipate.

Economic Conditions in the U.S. Economy

Gross Domestic Product and Employment

Estimates of first quarter 2016 GDP growth were disappointing. In addition, the recently released May jobs report showed a net increase of only 38,000 jobs.[5]

The labor force participation rate, which measures the population 16 and older that is either employed or actively looking for work, declined from approximately 62.8 percent to 62.6 percent.[6] While the unemployment rate fell to 4.7 percent,[7] the decline was driven primarily by the reduction in the participation rate.

Despite this most recent information, Dallas Fed economists continue to expect that GDP will grow approximately 2 percent in 2016. This forecast is based on our expectation of strong consumer demand in the U.S.

At this stage in the economic cycle, it is our updated view that job growth of between 60,000 to 120,000 per month will be necessary to keep the unemployment rate constant, depending on changes in the labor force participation rate.

The labor force participation rate is now 3.4 percentage points below its prerecession level. Dallas Fed economists believe that most of this decline is due to an aging population. It is our view that if current trends continue, the participation rate is likely to decline to below 61 percent by 2024.[8] This expected decline will have negative implications for future potential GDP growth in the U.S.

Inflation

Headline inflation continues to run below the 2 percent longer-run objective set by the Federal Reserve. The most recent PCE (Personal Consumption Expenditures) report indicated headline inflation of 1.1 percent on a 12-month basis.[9]

In addition to headline inflation, our economists carefully track measures of core inflation. In particular, we look at the Dallas Fed Trimmed Mean inflation rate, which trims out the most extreme upward and downward monthly price changes. This rate had been running between 1.6 and 1.7 percent from early 2014 until the end of 2015. Since the start of this year, it has edged up to between 1.8 and 1.9 percent. The stability and trend of this measure bolsters our confidence that headline inflation will reach 2 percent over the medium term as the effects of declining energy prices and a stronger dollar ultimately subside.

Global Economic Conditions

While we are the central bank of the United States, it is critical to assess how global economic conditions impact domestic economic conditions. Estimates of non-U.S. growth continue to be revised downward, and the composition of this growth continues to be uneven.

Brazil, Russia and Venezuela remain in recession in 2016 while advanced economies show modest but steady growth. One particular concern is China, which continues to be challenged by overcapacity in key industries, high levels of debt to GDP, aging demographics as well as an initiative to transition its economy from one that is heavily export and manufacturing based to one that is more consumer and service-sector based.

As China grapples with these issues, its future rates of GDP growth are likely to decline. As the world adjusts to these lower levels of growth, China may be vulnerable to periodic bouts of currency and financial turmoil, which have the potential to trigger a tightening of conditions across global financial markets. We saw this unfold in January and February when the devaluation of the Chinese currency was accompanied by a steep selloff in Chinese markets, which then transmitted to a tightening in global financial conditions. We will continue to carefully monitor this situation as it unfolds over the next several years.

Implications for Monetary Policy
As you know, the Federal Open Market Committee (FOMC) left policy unchanged at our recent June meeting.

In the coming weeks, I will be carefully assessing incoming economic data in order to gauge our progress towards achieving our dual mandate objectives regarding full employment and price stability.

I am closely monitoring how slowing growth, high levels of overcapacity and high levels of debt to GDP in advanced economies outside the U.S. might be impacting economic conditions in the U.S. I am also closely tracking how these issues might be affecting the slope of the U.S. Treasury yield curve as well as measures of tightness in financial conditions.

In light of these challenges, I have been suggesting that removal of accommodation should be done in a gradual and patient manner, based on a realistic assessment of economic conditions. I am also very cognizant that, from a risk management point of view, our monetary policies have an asymmetrical impact at or near the zero lower bound.

With that overview, let me turn to a broader discussion of the role of monetary policy.

Current Challenges of Monetary Policy
As you know, the target range for the federal funds rate stands at 25 to 50 basis points. The Federal Reserve raised the range by 25 basis points in December 2015 after seven years at the zero lower bound. Prolonged low rates, several rounds of quantitative easing and other extraordinary Fed policy actions came in response to the severe financial crisis and economic recession of 2008 and 2009.

It is worth noting that the last time that short-term interest rates in the United States were this low was during the middle and late 1930s, as the U.S. economy struggled to emerge from the Great Depression. Policy rates in other countries are also at historically low levels. Nominal rates in Japan, Switzerland, Denmark, and Sweden are actually *negative*, as are government bond yields in Germany and Japan, even at maturities over five years.[10] *Real* government bond yields—returns after inflation—are at or below zero across a wide swath of countries, including the United States.

Real and nominal yields at these low levels raise concerns for the economic outlook and for monetary policy. Low real returns challenge those trying to accumulate assets for retirement or those who rely on income from their investments. Low nominal yields can be a sign that monetary policy is struggling to maintain long-run price stability—or they can be a sign that central banks are pursuing highly accommodative policies. High levels of accommodation have the potential to distort asset-allocation decisions and the hiring and investment decisions made by businesses. The stakes are high: History has shown that real and financial market imbalances, once they accumulate, typically are painful to unwind. The difficulty is that these imbalances often aren’t obvious until after the fact.

Why are short-term interest rates so low? What can be done to stimulate growth and create an environment that is conducive to normalizing the level of interest rates in the United States? What should be the role of monetary policy, as well as other government actions, in this effort?

To address these questions, let me start with a discussion of the neutral real interest rate.

The Neutral Rate

As central bankers, we aim for monetary policy to be accommodative when the economy is operating below full employment and trend inflation is below target. We typically begin to remove accommodation as we move closer to achieving those dual goals. When our full-employment and price-stability goals are in conflict, the FOMC makes an assessment of the "balance of risks" to the two objectives.

While there are disagreements about how much slack remains in the labor market and about how best to gauge trend inflation, policy debates focus more fundamentally on how to gauge the appropriate level of tightness or easiness in monetary policy. This, in turn, depends on judgments about the "neutral rate"—the rate that signifies the dividing line between an accommodative and a restrictive monetary policy. This debate is complicated by the fact that the neutral rate is "unobserved"—that is, we infer this rate based on observations of financial and economic data.

In January 2012, Federal Reserve policy makers submitted their projections of the appropriate path of the federal funds rate over the medium term. Since that date, the median projection of these policymakers has declined from a 4.25 percent longer-run nominal funds rate to 3.0 percent in the most recent June submission. Given the FOMC's commitment to a 2.0 percent longer-run inflation target, these projections imply a reduction in the longer-run neutral real interest rate from 2.25 percent to 1.0 percent today. Trading levels of Treasury Inflation Protected Securities (TIPS) have signaled a substantially similar decline in the longer-run neutral real rate.[11]

Potential Reasons for Decline in Neutral Rate

A major driver of the decline in the neutral rate is a decrease in estimates of future growth. In the first quarter of 2003, the Congressional Budget Office projected five-year prospective growth would average 3.25[12] percent per year; in the first quarter of 2008, the prospective five-year growth estimate was 2.88[13] percent per year, and today, prospective five-year growth is estimated to be 2.28[14] percent per year.

This growth slowdown has been mostly due to demographics—baby boomers are moving into their retirement years—but weaker productivity growth also contributes significantly to this decline. Given the deterioration in U.S. growth prospects, it makes sense that the longer-run neutral real interest rate has declined. This deterioration appears to be occurring across all advanced economies, which helps explain the historically low level of rates we are seeing.

Another likely reason for the decline in the neutral rate is the emergence of the U.S. as chief supplier of safe assets to the world. In an increasingly globally connected world, the search for safety and return occurs globally—meaning that low rates in one country can quickly impact interest rates in other countries. Robert Hall of Stanford University and the Hoover Institution argues that the representation of risk-averse foreign investors in U.S. financial markets has increased and that this trend has contributed to downward pressure on the neutral real rate.[15]

My colleague John Williams, president of the San Francisco Fed, along with Thomas Laubach, on the staff of the Board of Governors, has done pioneering work on the neutral rate (r*) that argues the longer-run neutral real rate depends on the economy's potential growth rate, which varies over time, as well as other unobserved factors.[16] As of the first quarter of 2016, the Laubach–Williams model implied a 0.2 percent neutral real rate.

Evan Koenig and Alan Armen at the Dallas Fed use movements in slack to help identify the neutral real rate. They focus on shorter-run r* and, rather than make r* a direct function of growth in potential output, Koenig and Armen draw on signals from the financial markets and changes in household wealth. They argue that wealth growth and long-term yields do a good job of picking up changes in growth prospects and capture movements in other r* determinants.[17]

The Koenig–Armen model says that the short-run neutral real rate was *negative* 1.3 percent in the first quarter of 2016, about 1.5 percentage points below the latest Laubach–Williams estimate of the longer-run rate and only 15 basis points above the actual real rate. Policy was only modestly accommodative last quarter, according to Koenig–Armen.

While these approaches yield different estimates of the neutral real rate, they each indicate that there has been a significant decline over the past several years.

I am strongly persuaded by arguments that aging demographics in advanced economies, a decline in productivity growth and the continued emergence of the U.S. as a source of safe assets have all contributed to the decline in the neutral rate. I also believe that high levels of debt to GDP in advanced economies and higher levels of political polarization have, at a minimum, limited the capacity of these countries to use fiscal policy and structural reforms that could have stimulated higher rates of growth. This situation has, in turn, caused the neutral rate to be lower than it would be otherwise.

The Role of Monetary Policy

In light of the decline in the neutral rate, using monetary policy to help manage the economy has become more challenging. One of the implications of very low short-term rates is that there is less room for monetary policy makers to use these rates to increase the level of accommodation in situations where it is deemed advisable. This has led central banks around the world to try other, more "unconventional" policies to create greater accommodation. Examples include quantitative easing in various forms as well as negative interest rates.

Monetary policy has a key role to play in economic policy. However, at or near the zero lower bound, it may be less effective than other tools of economic policy. Monetary policy is not designed, by itself, to address the key structural issues we face today stemming from demographic changes, lower levels of productivity growth and high levels of debt to GDP as well as dislocations created by globalization and increasing rates of economic disruption. While monetary policy certainly has a key role to play, it is not a substitute for actions that address structural issues and other economic challenges.

For the past eight years, advanced economies have relied heavily on monetary policy and much less on fiscal policy as well as other structural reforms. However, at this stage, if we are going to generate higher sustainable rates of GDP growth and address key secular issues, there needs to be policy action beyond monetary policy. This action could take a variety of forms.

Potential Policy Actions Beyond Monetary Policy

Given that aging of the population is expected to continue to create headwinds for future economic growth, more could be done to examine policies that could ensure an inflow of workers to strengthen and grow the U.S. workforce. Appropriate immigration policy is a key element of this effort.

Investment in education is also a key element of ensuring that our population achieves sufficiently high levels of educational attainment so they can become productive members of the labor force. Many have argued that improving educational attainment is critical to raising workforce productivity in the U.S., thereby improving economic growth. Options for improving educational attainment must include beefing up public/private partnerships that focus on vocational training that equips workers for technical and other skills-based opportunities of the 21st century.

Public investments that upgrade aging infrastructure could potentially improve productivity and help to bolster sluggish demand. Given the sizable private pools of capital that exist today, some meaningful portion of this investment could come from public/private partnerships, with substantial capital coming from the private sector.

More broadly, tax reform and regulatory policies that create incentives for growth and investment could ultimately improve growth rates. Improved growth expectations could help to counter the forces holding down the neutral real interest rate, giving monetary policy makers greater scope for action without resorting to unconventional tools.

Some observers suggest conducting a comprehensive review of regulations at the national, state and local levels. They argue that, in some cases, excessive regulation and fees might be creating undue burdens on capital investment, lending, and the formation and growth of small business. This may help to explain why business investment and small-business formation have been disappointing over the past several years.

According to government estimates, the present value of future underfunding of "entitlements" is in excess of $45 trillion.[18] This underfunding is expected to increase annual U.S. budget deficits, as a percent of GDP, into the foreseeable future. Some have suggested that this level of underfunding may create growth in federal debt burdens that is unsustainable.

Entitlement reforms, which involve strengthening these programs without jeopardizing potential benefits for those already 55 or older, could help improve the sustainability as well as ease the future fiscal burden of these programs. In addition, reforms might reduce current disincentives to remain in the labor force, while helping to soften the demographic transition's depressing effects on growth and interest rates. Such reforms, insofar as they ease long-term concerns regarding the sustainability of debt to GDP, might also reduce uncertainty about future tax rates and boost growth expectations through that channel.

Historically during economic downturns, fiscal policy has often been used to assist monetary policy. However, due to high levels of debt to GDP as well as political polarization, governments have had difficulty coming to consensus on such action.[19]

These are some examples of policy actions which could be considered. There are certainly other examples, including efforts to implement more comprehensive trade policy. Policy makers would need to address which of these might make sense to pursue. Whichever choices policy makers prefer, my point is that some of these actions will be necessary to address the challenges we currently face.

Concluding Remarks

I am optimistic about the strength of the U.S. economy and the future of this nation. However, this optimism is based on a belief that we as a nation will address pressing secular as well as shorter-term cyclical challenges. Our ability to face key issues and come together to address them has been an essential element of the enduring strength and success of our great country.

I believe our country is at the stage where structural reforms, fiscal policy and other government actions need to join the menu of economic policy. That is, to address several of the key challenges we face, there needs to be economic policy action beyond monetary policy. While there may be good reasons why monetary policy has been the primary policy action over the past several years, we are now at the point where policy makers must enter a new phase in our thinking and actions.

We need to think more expansively about how to generate higher rates of GDP growth. Now, eight years after the Great Recession, we need to take a new and broader approach to our economic policy making.

Thank you. I look forward to taking your questions.

Notes

[1] Oil Market Report, International Energy Agency, June 2016.

[2] Data from the Bureau of Labor Statistics, Texas Workforce Commission and Dallas Fed.
[3] Data from the Bureau of Economic Analysis. The share of mining averaged 7.2 percent in fourth quarter 2015.
[4] See note 2.
[5] "The Employment Situation–May 2016," Bureau of Labor Statistics, June 3, 2016.
[6] See note 5.
[7] See note 5.
[8] See "Labor Force Projections to 2024: The Labor Force Is Growing, but Slowly," by Mitra Toossi, *Monthly Labor Review*, Bureau of Labor Statistics, December 2015, www.bls.gov/opub/mlr/2015/article/labor-force-projections-to-2024-1.htm.
[9] See "Personal Income and Outlays," Bureau of Economic Analysis, May 31, 2016.
[10] Government bond yield are negative for Japanese 10-year Benchmark Government Bonds according to the Japanese Ministry of Finance. In Germany, Fed Government Securities with Residual Maturities between 5–6 years are negative.
[11] Over the past five years, the five-year, five-year-forward TIPS rate has averaged just 0.8 percent, down from 2.5 percent in the five years leading up to the Great Recession.
[12] "The Budget and Economic Outlook: Fiscal Years 2004 to 2013," Congressional Budget Office, January 2003, and calculations by Dallas Fed economists.
[13] "The Budget and Economic Outlook: Fiscal Years 2008 to 2018," Congressional Budget Office, January 2008, and calculations by Dallas Fed economists.
[14] "The Budget and Economic Outlook: 2016 to 2026," Congressional Budget Office, January 2016, and calculations by Dallas Fed economists.
[15] See "Understanding the Decline in the Safe Real Interest Rate," by Robert E. Hall, manuscript, 2016.
[16] See "Measuring the Natural Rate of Interest Redux," by Thomas Laubach and John C. Williams, Federal Reserve Bank of San Francisco Working Paper no. 2015-16, 2015.
[17] See "Assessing Monetary Accommodation: A Simple Empirical Model of Monetary Policy and Its Implications for Unemployment and Inflation," by Evan F. Koenig and Alan Armen, Federal Reserve Bank of Dallas *Staff Papers*, no. 23, December 2015.
[18] 2016 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds, June 22, 2016.
[19] See "Income Inequality and Political Polarization: Time Series Evidence over Nine Decades," by John Duca and Jason Saving, *Review of Income and Wealth*, forthcoming.