Key Secular Trends and Implications for Monetary Policy

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The views expressed are my own and do not necessarily reflect official positions of the Federal Reserve System.

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Thank you for inviting me to speak with you. I have been coming to China regularly for the past 25 years. I've always enjoyed working with Chinese companies and getting to know leaders in this country. So, it's a real pleasure for me to be here today.

As you know, I have been president and CEO of the Federal Reserve Bank of Dallas since the beginning of September 2015. The Dallas Fed is one of the 12 regional banks in the Federal Reserve System. It has approximately 1,200 employees and oversees the Eleventh Federal Reserve District, which is comprised of Texas, northern Louisiana and southern New Mexico.

As head of the Dallas Fed, I participate in every meeting of the Federal Open Market Committee (FOMC), which is the key monetary policy making body within the Federal Reserve System.

Today, I'd like to speak with you about my assessment of economic conditions as well as my views regarding monetary policy. I will also discuss some of the key challenges facing policy makers in the years ahead.

I'd like to start my remarks with a brief discussion of some of the larger secular issues that I see forming the broader context for our work.

The Broader Context

Globalization

The world has become much more interconnected over the past several decades. Major companies have increasingly spread their operations throughout the world in order to serve customers and improve their competitiveness. As a result of this, S&P 500 companies now derive as much as 50 percent of their earnings from outside the United States.[1] While corporate revenue and profit growth have been enhanced by globalization, this trend has clearly created strains on cities and towns that have seen jobs and significant portions of key industries relocate to other geographic regions.

As global trade between countries has expanded, economic conditions in one nation now have a greater potential to impact economic conditions in other nations. These impacts are generally transmitted through the trade of goods and services as well as through capital flows and labor market dynamics.

While economies are more globally connected, financial markets have also become much more interconnected. Investment portfolios are increasingly global, and asset allocators increasingly think internationally when making investment decisions. Because financial

markets trade in real time, market strains or other challenges in one market now have the potential to rapidly affect currency, debt and equity markets globally.

We certainly saw the effects of this interconnectedness during the 2008–09 financial crisis. More recently, and on a much smaller scale, we saw how turmoil in currencies and local markets in certain countries in early 2016 helped lead to global market volatility and a rapid tightening of overall financial conditions. We are also seeing this trend in continuing increases in global investment demand for "safe" assets—particularly U.S. government securities.

Demographics

A second major challenge is demographics. The United States and other major economies, including Europe, Japan and China, are all facing the issue of aging populations. These demographic changes will bear directly on the rates of workforce participation and, in turn, impact rates of potential economic growth across the industrialized world.

For example, in the U.S., as the baby-boomer generation moves into retirement age, the fraction of the labor force age 55 or older is projected to increase from approximately 21.7 percent in 2014 to almost 25 percent in 2024.[2] Looking further ahead, the median age of the labor force is expected to rise steadily through 2060.

As you know, in China, the size of the working-age population peaked in 2014 as fertility rates have declined below the population replacement rate. The median age in China has increased from 22 in 1980 to 37 today and is estimated to be 50 by 2050. The Chinese working-age population as a share of total population is estimated to have peaked at 74 percent in 2011 and, based on current trends, is expected to fall to 59 percent by 2050.[3] This decline will create headwinds for the country's future economic growth.

High Levels of Debt to GDP

While these demographic trends continue to unfold, it is also the case that the ratio of debt to gross domestic product (GDP) has increased in Japan, China and the U.K. as well as most major countries in Europe. In the U.S., for example, household balance sheets have improved since the financial crisis, but business debt to GDP is somewhat higher and government debt to GDP has also increased.

While U.S. government debt held by the public is approximately 75 percent of GDP[4], it is estimated that the present value of unfunded "entitlements" is now in excess of $45 trillion.[5] These unfunded obligations will increasingly work their way into the annual budget deficit over the next five to 10 years and will tend to increase the U.S. budget deficit as a percentage of GDP.

China has also seen a significant increase in its debt levels. In the fourth quarter of 2015, Chinese nonfinancial debt to GDP was estimated at 255 percent (as compared to 148 percent at the end of 2008). This was composed of government debt of 44 percent,

household debt of 40 percent and private nonfinancial debt of 171 percent.[6] This debt growth may prove to be unsustainable.

Increasing Rates of Disruption

While these larger forces are unfolding, the rate of disruption in industry is increasing. More than ever before, consumers are able to use technology to rapidly compare prices for goods and services. New business models are emerging which offer products and services in a superior manner to older models. Amazon or Alibaba versus a retail store is a classic example.

These trends are encouraging companies to look for new ways to use technology to lower costs, improve productivity and enhance customer service. While the impacts can be hard to measure, I believe these changes are reducing the pricing power of companies and putting some degree of downward pressure on the prices of many types of goods and services. This, in turn, is affecting the way companies think about traditional capital spending and overall resource allocation.

It is difficult to fully determine the ultimate impacts of these secular trends on economic growth, labor market dynamics and price stability. However, I do believe that these underlying forces are likely to have a significant impact on economic conditions in the years ahead. These forces will also have significant implications for monetary as well as fiscal policy. As the world has become more complex, central bankers must work to better understand these issues in order to make sound judgments regarding monetary policy.

With this backdrop, let me turn to a discussion of the economic conditions in the Eleventh Federal Reserve District, the United States and the world. I will then talk about their implications for monetary policy.

Eleventh District Discussion of Energy

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

Based on analysis as well as discussions with industry contacts, our Dallas Fed economists believe that global oil production and consumption should move into rough balance by the first half of 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 analysis is based on our expectation that global demand for oil will grow by approximately 1.3 million barrels per day, on average, in 2016.

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.

Over the past few months, market prices have likely been impacted by periodic supply disruptions, such as those which have occurred in Canada, Nigeria, Iraq and Kuwait. We believe that the bulk of these supply outages have now been restored.

We expect continued price volatility as we head into year-end. In addition, because many U.S. 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.

Eleventh District Overall Economic Conditions

The challenges of the energy industry continue to create headwinds for our district. The oil and gas industry now accounts for approximately 2 percent of Texas employment[7] and 6 percent of its GDP[8] (versus 3 percent of employment and 13 percent of GDP in 2014).

Texas has substantially diversified its economy over the past three decades and has also become the top exporting state in the U.S. Texas has benefited from a sustained migration of people and firms to the state. Since 2000, population growth in Texas has exceeded that of the nation by almost 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 the negative impact on exports from a strong dollar.

In 2016, Dallas Fed economists expect Texas job growth of 0.5 percent, compared with 1.3 percent in 2015 and 3.7 percent in 2014.[9] Manufacturing in Texas remains weak, and some of this weakness has spread to the state's service sector. Jobs declined across most sectors and regions in the first quarter when oil prices fell sharply and exports were weakened by a stronger dollar. However, in the second quarter, job growth rebounded and leading indicators improved in the state.

As the headwinds from energy and a strong dollar continue to dissipate, I am very optimistic about the growth prospects for Texas and the Eleventh District in the years ahead. My optimism is due particularly to the increasingly diversified nature of the Texas economy as well as the continued migration of people and firms to the state.

Economic Conditions in the U.S.

Gross Domestic Product and Employment

Estimates of first and second quarter 2016 GDP growth in the U.S. have been disappointing. Despite this, Dallas Fed economists continue to expect that GDP will grow approximately 2 percent in 2016, based largely on our expectation of solid consumer demand.

While the most recent revision of the May jobs report showed a net increase of only 11,000 jobs, the June report showed an increase of approximately 287,000 jobs.[10] The three-month average pace of growth was 147,000 jobs. This deceleration from last year's

200,000-plus pace should not be unexpected as the economy has moved closer to full employment.

The labor force participation rate, which measures the population 16 and older that is either employed or actively looking for work, stands at 62.7 percent. The unemployment rate is now 4.9 percent, after five years of steady declines.[11]

The labor force participation rate is now 3.3 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.[12] 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 0.9 on a 12-month basis, up from 0.3 percent one year ago.[13]

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 on a yearly basis from early 2014 until the end of 2015. Since the start of 2016, it has edged up to roughly 1.8 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 global growth continue to be revised downward, and the composition of this growth continues to be uneven.

Brazil, Russia and Venezuela are expected to remain in recession in 2016, while advanced economies are expected to show only modest growth. In addition, as you know, China continues to be challenged by overcapacity in key industries, high levels of debt to GDP and aging demographics as well as managing an initiative to transition from an export- and manufacturing-based economy 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, we will continue to carefully monitor the potential spillover effects on currencies as well as global financial conditions.

We will also continue to monitor and assess the implications of Brexit in the United Kingdom. While this decision has had some ripple effects on global financial markets

(particularly regarding currencies and interest rates), it will take time for events to unfold before we know the ultimate impact of this decision on growth in the U.K., Europe and the rest of the world.

Implications for Monetary Policy

I am closely monitoring how slowing growth, high levels of overcapacity and high levels of debt to GDP in major 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 progress toward achieving the Federal Reserve's dual-mandate objectives regarding full employment and price stability. 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.

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 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. In addition, government bond yields in Germany and Japan are actually negative, even at maturities over five years.[14] Real government bond yields—returns after inflation—are at or below zero across a wide swath of countries, including the United States. This situation has been accentuated in the aftermath of Brexit.

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 accommodation 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 have to infer this rate based on observations of financial and economic data.

Economists and other forecasters have lowered their estimates of the longer-run neutral rate over the past several years. Yields on Treasury Inflation Protected Securities (TIPS) have also signaled a decline in the longer-run neutral real rate.[15]

A major driver of the decline in the neutral rate is a decrease in estimates of future growth. Longer-run estimates of future GDP growth have been declining across most advanced economies. This growth slowdown has been mostly due to demographics, but weaker productivity growth also contributes significantly to this decline.

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 interconnected 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.[16]

My colleague John Williams, president of the San Francisco Fed, along with Thomas Laubach, on the staff of the Federal Reserve Board of Governors, has estimated that, as of the end of the first quarter of 2016, the longer-run real neutral rate was approximately 0.2 percent.

Evan Koenig and Alan Armen at the Dallas Fed estimate of the shorter-run real neutral rate was negative 1 percent as of the end of the second quarter of 2016. By this measure, the Fed was only modestly accommodative last quarter.

While there are different approaches to measuring the neutral rate, it is clear that there has been a significant decline in estimates of the neutral rate over the past several years.

I am strongly persuaded by arguments that aging demographics in advanced economies, slower 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 implement 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.

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 rates of productivity growth and high levels

of debt to GDP as well as dislocations created by globalization and increasing rates of economic disruption.

For the past eight years, advanced economies have relied heavily on monetary policy and much less on fiscal policy or 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.

In the U.S., 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 would ensure an inflow of workers to strengthen and grow the U.S. workforce. Appropriate immigration policy is a key element of this effort.

Public investments that upgrade aging infrastructure could help to bolster sluggish demand in the near term while boosting productivity in the long run. 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 counter the forces holding down the neutral real interest rate, giving monetary policy makers greater scope for action without resorting to unconventional tools.

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.

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

Concluding Remarks

I believe advanced economies around the world are 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 sustained 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] "Yardeni: No U.S. Recession in Sight," by Leslie P. Norton, *Barron's*, Feb. 6, 2016, www.barrons.com/articles/yardeni-no-u-s-recession-in-sight-1454736560?mod=yahoobarrons&ru=yahoo.

[2] "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.htm.

[3] United Nations World Population Prospects (revised), July 29, 2015.

[4] Federal debt held by the public was 75.6 percent of GDP in second quarter 2016, according to the U.S. Treasury and the Bureau of Economic Analysis (BEA).

[5] 2016 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds, June 22, 2016.

[6] Bank for International Settlements, *BIS Statistical Bulletin*, June 2016.

[7] Data from the Bureau of Labor Statistics, Texas Workforce Commission and Dallas Fed.

[8] Data from the Bureau of Economic Analysis. The share of mining averaged 6 percent in first quarter 2016.

[9] See note 7.

[10] "The Employment Situation–June 2016," Bureau of Labor Statistics, July 8, 2016.

[11] See note 10.

[12] See note 2.

[13] See "Personal Income and Outlays," BEA, June 29, 2016.

[14] Government bond yields are negative for Japanese 10-year benchmark government bonds, according to the Japanese Ministry of Finance. In Germany, federal government securities with residual maturities between five and six years are negative.

[15] Over the past five years, the five-year, five-year-forward TIPS rate has averaged just 0.8 percent based on monthly data ending in June, down from 2.5 percent in the five years leading up to the Great Recession.

[16] See "Understanding the Decline in the Safe Real Interest Rate," by Robert E. Hall, manuscript, 2016.