A Discussion of Economic Conditions, Key Secular Trends and the Limits of Monetary Policy

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Remarks before the Economic Club of New York

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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 having me here today at the Economic Club of New York.

I spent 23 years working on Wall Street. Much of my business career and many of my nonprofit activities have been based in this city. Many of my closest friends and mentors live in New York, and some are in attendance this morning. So I am very glad to be visiting with you here today.

As most of you know, I have been president and CEO of the Dallas Fed since September 2015. In this role, I have now participated in 10 Federal Open Market Committee (FOMC) meetings and am firmly ensconced in performing the key duties of a Federal Reserve Bank president. In that regard, I have spent a substantial amount of time getting to know business and community leaders throughout the Eleventh District and have developed good working relationships with the other Federal Reserve Bank presidents and the Board of Governors.

The Dallas Fed is one of the 12 regional Federal Reserve Banks in the United States. We represent the Eleventh District, which is composed of Texas, northern Louisiana and southern New Mexico.

As you probably also know, Texas now accounts for 8.7 percent of U.S. gross domestic product (GDP).[1] It is the largest exporting state in the U.S. and is home to 52 Fortune 500 companies. The characteristics of our district help give the Dallas Fed excellent insight into energy, trade, immigration and other key aspects of the regional, national and global economies.

Today, I would like to speak with you about my assessment of economic conditions as well as my views regarding monetary policy. After that, I will look forward to taking your questions.

Discussion of Economic Conditions

Energy

Let me begin my remarks by talking about energy, given its importance to the Eleventh District as well as the United States. As you know, energy prices have substantially declined since June of 2014. In early 2014, the mining sector, composed substantially of oil and gas exploration and services, accounted for approximately 2.8 percent of U.S. GDP. By early 2016, the sector had declined to approximately 1.3 percent of GDP.[2]

At the Dallas Fed, we believe that global oil production and consumption will get into rough balance by sometime in the first half of 2017. This balancing process could be accelerated if there is a more explicit agreement worked out between OPEC (Organization of the Petroleum Exporting Countries) nations to limit production levels.

While there are varying estimates of the timing of reaching balance, we believe that the overall trend is the key—we are moving toward balance. Our analysis is based on the expectation that global oil supply will grow at a slower rate and that daily demand will continue to grow, on average, at approximately 1.3 million barrels per day for the remainder of 2016 and at a similar rate in 2017.

This balancing process has been more painful and slower than some had anticipated. While average daily U.S. oil production has declined by as much as 1 million barrels over the past year, this decline has been more than offset by production increases in Iran, Saudi Arabia, Russia and other countries. As a result of these developments, global oil supply reductions have been slow to materialize, and excess inventories of oil products now stand at record-high levels.

As we look ahead to 2017 and 2018, we expect to see continued price volatility. However, as the market moves toward balance, we expect to see excess inventories stabilize and then begin to decline, and prices continue to firm. Despite this firming, we expect to see more bankruptcies, restructurings and merger activity in the energy sector in the U.S. While rig count has increased over the past few months, based on our energy surveys and discussions with market participants, we believe that rig count is unlikely to increase significantly in the U.S. until prices rise to between $55 and $65 per barrel.

The Eleventh District

A weak energy sector and a stronger dollar have created headwinds for our district. The rate of job growth in Texas for the first half of 2016 was just below 1 percent. We saw continuing job losses in energy as well as weakness in the state's manufacturing sector and slowing growth in its service sector. However, as the headwinds from energy begin to subside, we are starting to experience faster growth. In this regard, we now expect to see approximately 2 percent job growth in the second half of 2016 and a similar rate of growth in 2017.

Texas continues to benefit from the migration of people and firms to the state. The population in Texas stood at approximately 27.5 million in 2015 versus 22.8 million in 2005.[3] As a result of an increasingly diversified economy as well as continued migration of people and firms to the state, I am very optimistic about the growth prospects for Texas and the Eleventh District in the months and years ahead.

The Nation and World

U.S. GDP growth in the first half of 2016 was a disappointing 1.1 percent.[4] Underpinning this weak growth was the financial turmoil in the first quarter of this year as well as a sizable inventory deceleration in the second quarter. Estimates of third-quarter GDP growth now show an improvement to 3.2 percent. Based on these estimates and our confidence in the strength of the U.S. consumer, we now expect full-year 2016 GDP growth of approximately 2 percent.

This is sluggish growth by historical standards but should still be sufficient to continue to drive down the unemployment rate and remove slack from the labor market. In assessing labor slack, we look at the headline rate of unemployment of 4.9 percent, but we also track the participation rate, estimates of the number of people working part time for economic reasons and other

measures of labor market utilization. The participation rate stands at 62.8 percent versus 66 percent in 2007.[5] Our economists at the Dallas Fed believe that much of this decline is due to changes in demographics—that is, workers are aging out of the labor force. This trend is expected to continue in the U.S. as well as almost all advanced economies. For example, within the next 10 years, we expect the participation rate to fall below 61 percent if no mitigating actions are taken.[6] Without a material improvement in the rate of U.S. productivity growth, this trend is likely to have significant negative implications for future potential GDP growth.

Regarding inflation, our Dallas Fed economists track headline inflation and other measures of core inflation, including the Dallas Fed's Trimmed Mean PCE inflation rate. This measure trims out the most extreme upward and downward monthly price movements. It has been running consistently at 1.7 percent since the start of 2016, up from 1.6 percent in 2015. The stability and trend of this measure gives us confidence that the headline inflation rate should gradually reach the Federal Reserve's 2 percent target in the medium term. Progress in reaching this objective has been frustratingly slow over the past few years.

In assessing economic conditions in the U.S., my research team is closely monitoring economic developments outside the U.S. to assess how these developments might impact economic growth domestically. In this regard, we are closely watching the impact of Brexit on the U.K. and European economies as well as monitoring the risk of contagion. At this stage, I believe that the impact of Brexit is likely to be very manageable for the U.S.

Our Dallas Fed research team is also monitoring emerging-market countries, particularly China. China has a high degree of overcapacity (particularly in state-owned enterprises), high and growing levels of debt, and is in the midst of a multiyear transition from being a manufacturing- and export-driven economy to one that is based on consumer spending and services. We think this transition is likely to take many years, and the world is going to have to become accustomed to lower rates of Chinese growth. This deceleration, coupled with high levels of debt, is likely to create currency volatility and make global markets more vulnerable to periodic bouts of turmoil—which could have the potential to tighten global financial conditions.

Broader Secular Trends

In addition to monitoring key cyclical trends in the economy, I also closely monitor more persistent secular drivers, which help explain shorter-term economic results. I am particularly focused on four key drivers:

- Aging-workforce demographics in the U.S. and across major economies which, on balance, will reduce labor force participation rates and create headwinds for potential GDP growth. These demographic trends are also likely to impact the "dependency ratio" for most major economies—that is, an increasing share of the population will "depend" on those of working age to pay for future medical and retirement benefits.
- Limits to the sustainability of the so-called debt super-cycle—raising questions about the ability of countries to further boost debt to GDP in order to generate future economic growth. For example, while China has been increasing its overall leverage rather dramatically in order to generate economic growth, there are questions regarding the

sustainability of this approach. In the U.S., while household balance sheets have improved since the Great Recession, government debt relative to GDP has grown. U.S. government debt held by the public now stands at approximately 76 percent of GDP, and the present value of future unfunded entitlements is now estimated at $46 trillion.[7] These underfunded obligations will increasingly work their way into U.S. budget deficits over the next five to 10 years. At a minimum, high levels of debt to GDP, along with political polarization have, up to now, constrained fiscal policy as a tool of overall economic policy.

- Globalization. Economies and financial markets are more closely intertwined than ever before. This means that events in one country can much more easily impact economic and financial conditions in other countries. The first quarter of this year was a good example; currency devaluation in China and a steep stock market selloff led to a rapid tightening of global financial conditions, which threatened to slow underlying economic growth.
- Disruption. Most industries are facing a disruptive competitor that is offering lower-cost goods or services. This disruption is often technology enabled. Think Amazon or Alibaba versus retail stores, Kahn Academy versus brick-and-mortar schools, Uber versus taxis, and so on. Technology-enabled disruption is also helping consumers to much more easily shop for merchandise and services in a way that allows them to choose the lowest price. This trend, at a minimum, is reducing the pricing power of businesses and likely putting downward pressure on margins. This may be one reason why companies have been much more hesitant to make major capital investments. One other likely impact of this disruption is on workers, which might help explain why the employment rate of prime-age workers in the U.S. has not recovered to prerecession levels.

Implications for Monetary Policy

As you know, the Fed has a mandate to pursue full employment and price stability. Regarding our full-employment objective, as I just discussed, I believe we are making good progress toward reaching our goal. I do believe that, in a more interconnected world, labor slack should be assessed in a global context. Excess capacity outside the U.S. may be dampening inflation pressures in the U.S. As a result, I think we may still have some capacity for further job growth without overheating the economy or unduly stressing the capacity of the U.S. workforce.

In terms of price stability, even though headline inflation continues to run below our 2 percent objective, I believe that, as the impacts of lower energy prices and a stronger dollar begin to dissipate and as the labor market continues to tighten, headline inflation will likely trend toward our 2 percent objective in the medium term.

In light of the challenges posed by the broad secular drivers I discussed earlier, I have been suggesting that removal of accommodation should be done gradually and patiently. I am cognizant that, from a risk-management point of view, our monetary policy tools are asymmetrical at or near the zero lower bound—that is, it is easier to tighten policy than to ease policy at this point in the normalization process.

Lastly, I have repeatedly stated that I believe it is important that we strive to take steps to "normalize" monetary policy because there is a cost to excessive accommodation in terms of penalizing savers, as well as creating potential distortions and imbalances in asset allocation, investing, hiring and other business decisions. These imbalances are often easier to recognize in hindsight and can be very painful to address.

Based on these considerations, as we continue to make progress in achieving our dual mandate, I would advocate that we take action to remove some amounts of accommodation.

Let me now turn to a discussion of the appropriate role of monetary policy.

The Role of Monetary Policy

As you know, the target range for the federal funds rate stands at 25 to 50 basis points. 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. struggled to emerge from the Great Depression. While policy rates are historically low, real government bond yields—returns after inflation—are also at historically low levels across a wide swath of countries, including the United States.

A major driver of these historically low rates is the decline in expectations for future economic growth. As I have discussed, key persistent trends—particularly aging-workforce demographics, as well as weak productivity growth—are having a negative impact on growth prospects in the U.S. as well as in most other advanced economies. An additional likely reason for the persistence of low interest rates is the emergence of the U.S. as a chief supplier of safe assets to the world. In an increasingly financially interconnected world, the search for safety and return occurs globally—which means that low rates in one country can quickly impact interest rates in other countries.

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, high levels of debt to GDP, as well as the dislocations created by globalization and increasing rates of technology-enabled economic disruption. While monetary policy certainly has a key role to play, it is not a substitute for actions that could address more fundamental economic challenges.

For the past eight years, in the aftermath of the Great Recession, advanced economies have relied heavily on monetary policy and much less on structural reforms and fiscal policy. However, at this stage, if we are going to generate higher sustainable rates of GDP growth and address key secular challenges, 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-workforce demographics are expected to create headwinds for future economic growth, more could be done to explore policies that could grow the workforce in the years ahead. Appropriate immigration policy is likely to be a key element of this effort. Historically,

immigration has played an important role in economic growth in the U.S. It is estimated that immigrants and their children have comprised more than half of the growth in the labor force in the U.S. over the past two decades.[8]

Policies that involve greater emphasis on improving levels of educational attainment are likely to be critical in order to ensure that an increasing percentage of our population can become more productive members of the workforce. Options for improving educational attainment could include beefing up public/private partnerships that focus on vocational training that equips workers for technical and other skill-based opportunities of the 21st century. These programs could help to grow the workforce and address the skills gap that has been identified by numerous companies we speak with in the Eleventh District.

Public investments that upgrade aging infrastructure could potentially improve productivity and help 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 could be considered in order to create increased incentives for growth and investment, which might ultimately improve future rates of GDP growth. Improved growth expectations could help to counter the forces holding down global interest rates, 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 businesses. This may help explain why business investment and small-business formation have been disappointing over the past several years.

Entitlement reforms, which involve strengthening Social Security and Medicare without jeopardizing potential benefits for those already 55 or older, could help improve the sustainability and 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 impact of aging-workforce demographic trends on growth and interest rates. Such reforms, insofar as they ease long-term concerns regarding the sustainability of future government debt burdens (as a percentage of GDP), might also reduce uncertainty about future tax rates and boost growth expectations through that channel.

These are some examples of policy actions that could be considered. There are certainly other examples, including efforts to implement more comprehensive trade reforms, which could create a more level global playing field for the movement of goods and services. Policymakers would need to address which of these options might make sense to pursue—but my point is that some of these actions will be necessary to address the fundamental challenges we currently face.

Closing

Monetary policy is a key element of economic policy—but it shouldn't be the only element of policy. To improve future economic outcomes for our citizens, we need to consider structural and fiscal policies alongside sound monetary policy.

It has been a pleasure speaking with you today. I would now be happy to take your questions.

Notes

[1] Gross Domestic Product by State data, North American Industry Classification System series, Bureau of Economic Analysis, first quarter 2016. U.S. values may differ from National Income and Product Accounts (NIPA) values because of revisions to the NIPA values and the GDP-by-state accounts excluding federal military and civilian activity located overseas (because it cannot be attributed to a particular state).
[2] Bureau of Economic Analysis, 2016. Numbers are from first quarter 2014 and first quarter 2016.
[3] Census Bureau.
[4] "National Income and Product Accounts, Gross Domestic Product: Third Quarter 2016 (Second Estimate)," Bureau of Economic Analysis, Nov. 29, 2016.
[5] "The Employment Situation–October 2016," Bureau of Labor Statistics, Nov. 4, 2016.
[6] "Labor Force Projections to 2024: The Labor Force Is Growing, but Slowly," *Monthly Labor Review*, Bureau of Labor Statistics, December 2015, www.bls.gov/opub/mlr/2015/article/labor-force-projections-to-2024.htm.
[7] 2016 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds, June 22, 2016.
[8] *The Economic and Fiscal Consequences of Immigration*, National Academies of Sciences, Engineering and Medicine, Washington, D.C.: National Academies Press, 2016, p. 50, www.nap.edu/catalog/23550/the-economic-and-fiscal-consequences-of-immigration.