Assessment of Current Economic Conditions 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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I have been president and CEO of the Dallas Fed since the fall of 2015. The Dallas Fed is one of the 12 regional Federal Reserve Banks in the United States. The Eleventh District is composed of Texas, northern Louisiana and southern New Mexico. Texas accounts for 8.9 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 give the Dallas Fed unique insights into energy, trade and immigration issues, as well as great insight into the regional, national and global economies.

With that backdrop, I'm going to briefly discuss my assessment of economic conditions in the U.S. and globally and the implications for monetary policy.

Energy

Let me start with a discussion of energy, given its importance to my district as well as the national and global economies.

It is our view at the Dallas Fed that global consumption and production of oil will get into rough balance sometime during the first half of 2017. This process could be accelerated if there is implementation of the agreement between OPEC (and some non-OPEC) nations to limit production levels.

While there is some debate about the timing of reaching balance, we believe that the overall trend is the key—we are moving toward balance. This balancing process has been more painful and taken longer than many expected. While U.S. crude oil production has fallen as much as 1 million barrels per day over the past year, this decline has been more than offset by production increases in Saudi Arabia, Russia, Iran and other oil-producing countries. As a result of these developments, global oil supply reductions have been slow to materialize, and inventories of oil products now stand at record-high levels.

The move toward balance is based on the expectation that global supply will grow at a slower rate and that global demand will to continue to grow, on average, at approximately 1.3 million barrels per day in 2017. As this process unfolds, we expect the price of oil to be volatile but, overall, continue to firm.

In this context, our economists at the Dallas Fed expect U.S. crude oil production to rise throughout 2017. Using rough numbers, it is estimated that U.S. production bottomed out at approximately 8.6 million barrels per day in the fall of 2016 and is now closer to 8.9 million barrels per day and is likely to steadily increase as the year unfolds.[2] These estimates are subject to oil prices ranging between $55 and $60 per barrel.

Based on the expectation of firming prices, our latest Dallas Fed Energy Survey reports a notable increase in plans for capital spending in 2017 by exploration and production firms. We believe that the bulk of this spending will be focused on shale production and is likely to involve investment in technologies that will create greater production efficiencies.

Much of our recent discussions with industry contacts are focused on the substantial potential supply upside from the Permian Basin in the years ahead. The Permian Basin has oil-bearing deposits that are layered, allowing multiple horizontal wells to run off a single well pad and much higher resource recovery per acre. The Permian currently produces approximately 2.2 million barrels per day.[3] With technological advances, many of our contacts believe that the Permian can grow production very substantially in the years ahead. As a result, we expect that major oil companies, in the near term, may continue to avoid large long-lived capital projects and will, instead, focus their capital spending on more flexible and shorter life cycle shale opportunities in the U.S.

The District

Texas' 2016 employment grew 1.4 percent. The year was very much a tale of two halves, with just 0.8 percent annualized job growth over the first six months and 2 percent growth over the final six months. Based on our surveys and discussions with business contacts, we expect job growth of approximately 2 percent in 2017, the strongest rate of growth in three years.

Texas continues to benefit from the migration (as well as immigration) of people and firms to the state. Aided by this trend, the state's economy has become increasingly diversified. In addition, the population of Texas is estimated to have grown from approximately 22.8 million in 2005 to almost 28 million in 2016.[4] Based on these trends, as the headwinds from a weak energy sector continue to dissipate, I am very optimistic about the growth prospects for Texas and the Eleventh District in the months and years ahead.

Against this optimistic backdrop, my team of economists is closely monitoring policy decisions that might negatively impact our outlook—in particular, policy decisions that could negatively impact U.S. trading and cross-border investment relationships with Mexico, which we believe are important to enhancing job growth and competitiveness in the U.S. as well as economic growth in the Eleventh District. Mexico is the top destination for Texas exports. Manufactured goods exports supported an estimated 1 million jobs in Texas in 2015, equal to 8.2 percent of the state's employment.[5] In 2016, Texas exports to Mexico were $92.7 billion. Dallas Fed economists believe that the trading relationship with Mexico has helped various industries in Texas[6] (as well as the U.S.) gain global competitiveness. In addition, Texas border cities have benefited tremendously from the increasing U.S.–Mexico economic integration—leading to job gains, primarily in service sectors, that have resulted in higher wages and improved standards of living for many Texans.[7]

The U.S.

GDP in the U.S. grew approximately 2 percent in 2016—reflecting an improvement in growth in the second half of the year. Underpinning weak growth in the first half of the year was the financial turmoil in the first quarter as well as a sizable inventory deceleration in the second quarter. We had expected a second-half bounce back due to our confidence in the health of the U.S. consumer. While the U.S. consumer has spent the past nine years deleveraging from record levels of debt to GDP in 2008, as we sit here today, we believe the U.S. consumer is in relatively good shape and has the capacity to spend.

Based on our confidence in the continuing health of the U.S. consumer, we forecast 2017 GDP growth of approximately 2.3 percent. We believe this pace of growth will be sufficient to remove any remaining slack from the labor market. Forthcoming fiscal policy and structural reforms have the potential to provide upside to this forecast.

Unemployment

We are making good progress toward reaching our full-employment objective. The headline unemployment rate is 4.8 percent. In addition to the headline unemployment rate, we also look at several measures of labor market slack, including estimates of discouraged workers and people working part time for economic reasons (otherwise known as U-6 unemployment), as well as the labor force participation rate. The U-6 reading now stands at 9.4 percent, which is still more than a full percentage point above its prerecession lows—which suggests there could still be some amount of remaining slack in the U.S. labor force.

The labor force participation rate now stands at just under 63 percent, which compares with approximately 66 percent in 2007. We believe that a majority of the decline is due to the aging of the population. This aging trend is expected to continue in the U.S. as well as across almost all advanced economies. Furthermore, over the next 10 years, it is estimated that the U.S. participation rate will decline to below 61 percent.[8] Without a material improvement in the rate of U.S. productivity growth, this trend is likely to have significant negative implications for potential GDP growth in the years ahead.

When we look at measures of discouraged workers and those who are part time for economic reasons, I would note the high correlation between participation rates (as well as unemployment rates) and levels of educational attainment. To the extent that there is slack in the labor market, it is primarily associated with lower levels of educational attainment. This analysis suggests to me that the U.S. must do much more to beef up public/private partnerships that focus on vocational training in order to help workers attain the skills needed to find employment in the 21st century economy. These statistics also reinforce the need to invest in programs that improve early-childhood literacy and generally enhance the level of educational attainment among our younger population. Both of these types of programs also have the added benefit of helping to potentially reduce income inequality by creating broader workforce productivity and prosperity.

Inflation

Progress toward reaching our 2 percent inflation objective has been frustratingly slow over the past few years. This had been due to a strong dollar and weak energy prices, as well as a number of persistent secular forces, such as globalization (see “Broader Secular Trends” below).

In addition to headline inflation, we closely track measures of core inflation, particularly the Dallas Fed’s Trimmed Mean PCE inflation rate. This measure trims out the most extreme upward and downward monthly price movements. It is currently running at approximately 1.8 percent, after having gradually increased from 1.7 percent through most of 2016 and approximately 1.6 percent in 2015. The gradual upward trend of this measure gives me confidence that, as slack continues to be removed from the labor force, the headline inflation rate should reach the Fed’s 2 percent objective in the medium term.

Non-U.S.

In assessing economic conditions in the U.S., my research team closely monitors 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 new developments in Europe. At this stage, I believe that the impact of Brexit is likely to be manageable for the U.S., although we are continuing to carefully monitor political developments and other policy decisions that could create a risk of contagion among other European countries.

We also monitor emerging-market countries, particularly China. China has a high degree of overcapacity (particularly in state-owned enterprises) and high and growing levels of debt. The nation is also in the midst of a multi-year transition from being a manufacturing- and export-driven economy to one that is based on consumer spending and services. This transition is likely to take many years, and the world is going to have to become accustomed to lower rates of Chinese growth. In the meantime, China has worked to manage capital outflows and currency volatility. As we saw in the first quarter of 2016, this situation has the potential to create periods of financial market volatility and lead to bouts of tightening in global financial conditions, which can lead to slower domestic growth in the U.S.

Broader Secular Trends

In addition to monitoring cyclical trends, my economic research team carefully considers and works to understand several key secular drivers. These drivers can have a powerful influence on unfolding economic conditions.

I am particularly focused on four key secular drivers:

- Aging-workforce demographics in the U.S. and across major economies. As discussed earlier, aging-population trends, on balance, reduce labor force participation rates and ultimately create headwinds for potential GDP growth. These demographic trends are also likely to impact the “dependency ratio”—that is, they are likely to lead to a situation in which an increasing share of the population is depending on those of working age to pay for future medical and retirement benefits. These trends are likely to exacerbate the issues regarding the sustainability of U.S. government fiscal obligations (discussed further below).

- Limits to the sustainability of the so-called global debt super cycle. Historically, the U.S. and other countries have used increasing debt—often through tax cuts and increased government spending—to boost economic growth. At this point, there are likely limits to the ability of countries, including the U.S., to further increase debt to GDP in order to generate higher levels of economic growth. As I discussed earlier, we have seen a deleveraging of the U.S. household sector since 2008. This has likely created some headwinds for economic growth over the past several years. The good news is that the household sector is in much better shape today. However, while household balance sheets have improved since the Great Recession, government debt held by the public now stands at approximately 77 percent of GDP, and the present value of future unfunded entitlements is now estimated at $46 trillion.[9] These obligations will increasingly work their way into U.S. budget deficits over the next five to 10 years—raising questions regarding fiscal sustainability which, if not addressed, could negatively impact longer-run economic growth.

- Globalization. Economies, financial markets and companies are more closely intertwined than ever before. For example, regarding trade, estimates indicate that approximately 40 percent of the content of U.S. imports from Mexico is of U.S. origin.[10] This is because much of this trade is related to integrated supply chains and logistical arrangements between U.S. and Mexican companies. As mentioned earlier, it is our view at the Dallas Fed that these arrangements have helped improve U.S. competitiveness and created jobs in the U.S. Without these arrangements, these jobs might have otherwise been lost to other areas of the world, particularly Asia.

  While trade and globalization have yielded net economic benefits for the U.S. economy, they have also created severe local hardships that the U.S. and other advanced economies have struggled to address. The challenge is how to reap the benefits of globalization while addressing the disruptions it creates—failing to do so is likely to have negative implications for trade and the pace of economic growth in the U.S. and globally.

- Technology-enabled disruption. In order to improve their competiveness, many companies are actively investing in technology, which is leading to a significant reduction in the number of workers needed to produce goods and services. The result is that U.S. workers across a range of industries are finding their jobs being eliminated.

  Many industries are facing a disruptive competitor that is offering lower-cost goods or services. Think the digital camera versus the old film industry, Amazon versus retail stores, Kahn Academy versus brick-and-mortar schools, 3-D printing versus traditional manufacturing, Uber versus taxis and so on. This technology-enabled disruption has allowed consumers to achieve better value and more easily shop for merchandise and services in a way that lets them easily choose the lowest price. It has also reduced the pricing power of many companies and caused them to intensify their focus on creating greater operational efficiencies.

I believe that the dislocations resulting from technology-enabled disruption are sometimes confused with the impacts of globalization. This is a powerful trend, apart from globalization, which may help explain why employment among prime-age workers in the U.S. has not recovered to prerecession levels. It may also help explain why companies have been more hesitant to make capacity expansion decisions as well as invest in major capital projects.

Fiscal and Structural Policies Beyond Monetary Policy

In light of these secular trends and the sluggish economic growth over the past several years, I have been speaking the last several months about the need for structural reforms and fiscal policy to join the menu of economic policy. Monetary policy is not designed, by itself, to address the key structural challenges we face today stemming from changing demographic trends and lower levels of productivity growth, as well as dislocations created by globalization and increasing rates of technology-enabled disruption. While monetary policy has a key role to play, it is not a substitute for actions that could address deeper fundamental 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.

Given aging-workforce demographics, 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 constituted over half the workforce growth in the U.S. over the past 20 years. Over the next two decades, this percentage is likely to increase substantially.[11] In Texas, immigration has been instrumental in bolstering the high-skilled labor force. Today, it is estimated that foreign-born workers in the state make up approximately 54 percent of medical scientists, 46 percent of computer software developers, 31 percent of physicians, and over a quarter of chemical and mechanical engineers and nurses. Foreign-born workers also constitute a substantial share of college instructors in the state.[12]

Policies that involve greater emphasis on improving levels of educational attainment and workforce skills are needed to help ensure that an increasing percentage of the population can become productive members of the workforce. As discussed earlier, these efforts should include a focus on substantially increasing the number of public/private partnerships that focus on vocational training that would increase the skill levels and/or retrain discouraged or underemployed workers. These programs could help 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 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 and regulatory policies could be considered in order to create increased incentives for growth and investment. Some observers suggest conducting a thoughtful 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.

Entitlement reforms could help improve the sustainability of Social Security and Medicare and ease the future fiscal burden of these programs. In addition, reforms might reduce disincentives to remain in the workforce while helping to soften the impact of aging-workforce demographics.

These are some examples of policy actions that could be considered. Whatever policy actions are enacted, I believe they need to center on the goals of growing the workforce and improving workforce productivity. They should focus on sustainable economic growth over the medium and long term—that is, avoiding policies that create short-term growth while creating future problems or raising government debt relative to GDP, thereby leaving future generations to resolve fiscal and/or other imbalances.

My Views Regarding the Current Stance of Monetary Policy

As I mentioned earlier, I believe we are making good progress in accomplishing our dual-mandate objectives of full employment and price stability. Regarding our full-employment mandate, I believe there is still some amount of slack in the U.S. workforce. In addition, I continue to believe that in a more interconnected world, excess capacity outside the U.S. may be dampening inflation pressures in the U.S. As a result of these factors, I think we still may have some scope for further job growth without overheating the economy or unduly stressing the capacity of the U.S. workforce. However, having said that, it is my view that we are moving closer to full employment.

Regarding inflation, I believe that as the impact of lower energy prices begins to dissipate, and as the labor market continues to tighten, headline inflation is likely to move toward our 2 percent objective over the medium term.

While the key secular drivers I discussed earlier will continue to pose challenges for economic growth, I also believe there is a cost to excessive accommodation in terms of penalizing savers, as well as creating distortions and imbalances in 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 objectives, I believe that we should be taking steps to remove additional amounts of monetary accommodation. I believe that future removals of accommodation can likely be done in a gradual and patient manner. However, it is my view that moving sooner rather than later will make it more likely that future removals of accommodation can be done gradually—that is, reduce the likelihood that the Fed will get "behind the curve" and feel the need to remove accommodation more rapidly.

In addition, as we make further progress in removing accommodation, I believe we should be turning our attention to a discussion of how we might begin the process of reducing the size of the Federal Reserve balance sheet.

Notes

[1] Bureau of Economic Analysis, Third Quarter 2016.

[2] Energy Information Administration, *Short-Term Energy Outlook*, Feb. 7, 2017.

[3] February forecast from the Energy Information Administration, *Drilling Productivity Report*, Feb. 13, 2017.

[4] Census Bureau.

[5] "Texas Border Cities Illustrate Benefits and Challenges of Trade," by Jesus Cañas, Federal Reserve Bank of Dallas *Southwest Economy*, Fourth Quarter, 2016. Also see "Jobs Supported by State Exports 2015," by Jeffrey Hall and Chris Rasmussen, Office of Trade and Economic Analysis, International Trade Administration, U.S. Department of Commerce, May 31, 2016.

[6] "Texas Comparative Advantage and Manufacturing Exports," by Jesus Cañas, Luis Bernardo Torres and Christina English, in *Ten-Gallon Economy: Sizing Up Texas' Economic Growth*, Pia M. Orrenius, Jesus Cañas and Michael Weiss, eds., New York: Palgrave MacMillan, 2015.

[7] "So Close to Mexico: Economic Spillovers Along the Texas–Mexico Border," by Roberto Coronado, Marycruz De León and Eduardo Saucedo, in *Ten-Gallon Economy: Sizing Up Texas' Economic Growth*, Pia M. Orrenius, Jesus Cañas and Michael Weiss, eds., New York: Palgrave MacMillan, 2015. Also see "El Paso and Texas Border Cities Close the Gap in Per Capita Income," by Roberto Coronado and Robert W Gilmer, *Crossroads*, Issue 2, 2012.

[8] "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.

[9] 2016 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds, June 22, 2016.

[10] Give Credit Where Credit is Due: Tracing Value Added in Global Production Chains," by Robert Koopman, William Powers, Zhi Wang and Shang-Jin Wei, National Bureau of Economic Research, NBER Working Paper no. 16426, December 2011.

[11] *The Economic and Fiscal Consequences of Immigration*, National Academies of Sciences, Engineering and Medicine, Washington, D.C.: National Academies Press, 2016, www.nap.edu/catalog/23550/the-economic-and-fiscal-consequences-of-immigration.

[12] 2013–15 American Community Survey three-year estimates.