Discussion of Economic Conditions and Key Challenges Facing the U.S. Economy

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The Federal Open Market Committee (FOMC) in its January meeting decided to leave the federal funds rate unchanged in a range of 125 to 150 basis points. In our FOMC statement after the meeting, the committee explained that it expects "economic conditions will evolve in a manner that will warrant further gradual increases in the federal funds rate." The purpose of this essay is to briefly discuss my views regarding economic conditions, the implications for monetary policy and address a few of the fundamental challenges facing the U.S. economy.

Economic Conditions

The Dallas Fed expects that U.S. GDP will grow at approximately 2.5 to 2.75 percent in 2018. We believe that consumer spending will be strong, owing to a healthy jobs market and the multiyear improvement in household balance sheets. We also expect business investment to be stronger than in 2017, and we believe that improved global growth could also help support economic growth in the U.S.

Our forecast reflects the positive near-term impact of the recent tax legislation. It is our view that the bulk of this impact will be felt in 2018 and to a lesser extent in 2019 and 2020.

Based on our forecast, we expect U.S. labor market conditions to tighten this year. We forecast that headline unemployment will decline from 4.1 percent to approximately 3.6 percent by year end. We also expect U-6—a measure of labor slack that tracks the number of unemployed plus "marginally attached workers" (workers who indicate that they would like a job but have stopped looking for one) plus those working part time for economic reasons—to decline from 8.2 percent to well below 8 percent. It is the judgment of Dallas Fed economists that current levels of headline unemployment as well as U-6 are indicative of an economy that is either at or has moved past the level of full employment.

Our economists expect cyclical inflation pressures to build during 2018. While these pressures will likely be at least partially offset by the impact of technology-enabled disruption (see Appendix A), I believe the headline rate of inflation is likely to firm during the year, and we are likely to make progress toward reaching the Fed's 2 percent longer-run inflation target. I also believe we'll see firming in the Dallas Fed Trimmed Mean measure of core inflation, which excludes extreme price movements (both high and low) in goods and services. This measure continues to be the Dallas Fed's preferred gauge of underlying inflation in the U.S.

Implications for Monetary Policy

Based on these expectations, I believe the Federal Reserve should be gradually and patiently raising the federal funds rate during 2018. While my views on the appropriate path of policy will be impacted by economic conditions as they unfold during the year, I continue to believe that

gradual and patient removals of accommodation will increase the likelihood of extending the economic expansion in the U.S.

History suggests that if the Fed waits too long to remove accommodation at this stage in the economic cycle, excesses and imbalances begin to build, and the Fed ultimately has to play catch-up. In my judgment, getting behind the curve and then trying to catch up would increase the likelihood of recession in the U.S.

Challenges Facing the U.S. Economy

While Dallas Fed economists forecast strong economic growth in 2018, they also expect growth to moderate to 1.75 to 2 percent by 2020. In addition, our view is that "potential" GDP growth, the sustainable underlying growth capability of the U.S. economy, is approximately 1.75 percent. This level of potential GDP growth is lower than we've historically been accustomed due to several structural issues discussed below. Dallas Fed economists believe that the current level of growth above potential is due to accommodative monetary policy as well as recent fiscal stimulus. As the impact of this stimulation wanes, we expect U.S. GDP growth to trend back toward potential.

Why is potential GDP growth lower than we have historically been accustomed? Specifically, why are current assessments of potential GDP growth materially lower than during the 1990s and early 2000s? What has changed?

There are a few key structural drivers that are impacting prospects for medium-term economic growth in the U.S. How we manage and adapt to these structural challenges will fundamentally impact prospects for future growth and prosperity in the U.S.

Aging Demographics

GDP growth is composed of growth in the workforce plus growth in labor productivity. Due to the aging of our population, workforce growth in the U.S. is slowing and is likely to continue slowing. The labor force participation rate has declined from 66 percent in 2007 to approximately 63 percent today. Dallas Fed economists believe that the bulk of this decline is due to aging of the workforce. Unfortunately, our economists believe that these demographic trends will cause the labor force participation rate to decline to below 61 percent over the next 10 years.

Possible remedies to the effects of aging demographics could include incentives for workers to work later in their careers, inducing discouraged workers to return to the workforce and/or other measures that could help improve the rate of workforce growth in the U.S.

In addition, immigration has historically been an important element of our nation's workforce growth. Based on published data, our Dallas Fed economists estimate that immigrants and their children have comprised over half of the workforce growth in the U.S. over the last 20 years and expect this group to comprise an even higher percentage over the next 20 years.[1]

Our economists have done extensive research regarding U.S. immigration as well as the immigration policies of other countries. This research indicates that it would be appropriate for the

U.S. to consider reforms to the current immigration system to more heavily take into account immigrant skills as well as other employment-based criteria. Such reforms could help enhance the economic and societal benefits from immigration.[2] Whatever policy decisions are made, it is clear that the resolution of current debates relating to immigration policy has the potential to either supplement or create headwinds for future workforce growth in the U.S.

One potential offset to these demographic trends could be improvements in labor productivity. Labor productivity is a key driver of GDP growth. However, average growth in labor productivity over the past decade has been sluggish at approximately 1.1 percent per year.[3] Labor productivity growth averaged approximately 2 percent from 1977 through 2007. While Dallas Fed economists are hopeful that increased capital spending could help improve labor force productivity, they also observe that technological progress may not contribute to productivity growth as much as it once did. One reason for this sluggishness may be lagging skills and educational achievement levels of the U.S. workforce.

The Skills Gap and Lagging Educational Achievement Levels

The U.S. is a leader in many areas versus the rest of the world. Unfortunately, several studies suggest that skill levels and educational achievement levels of our workforce have lagged other developed countries for the last several years. According to recent Organization for Economic Cooperation and Development (OECD) surveys, the U.S. ranks 24th out of 35 developed countries in measures of math, science and reading skills among 15-year-olds.[4] In addition, in surveys of 29 participating OECD countries, the U.S. ranked 20th in assessments of adult literacy and math skills.[5]

Research by Eric Hanushek of Stanford University with Ludger Woessmann of the University of Munich suggests that improvements in U.S. math and science skills could translate into meaningful improvements in potential GDP growth in the U.S.[6] While these efforts are likely to take years, they could have substantial potential to improve future growth and prosperity in the U.S.

In addition, in the most recent National Federation of Independent Business small-business survey, 49 percent of respondents said they were unable to find qualified workers to fill open positions.[7] Similarly, respondents to Dallas Fed surveys report that they are unable to find workers with adequate technical, organizational and other basic skills to fill open positions.

Kansas City Fed economists estimate that approximately 43 percent of all jobs in the U.S. are so-called "middle-skills" positions.[8] These include pipe fitters, automotive technicians, registered nurses, IT specialists and so on. Every one of these jobs that goes unfilled means a lost opportunity for higher GDP. These positions require more than a high school education. Due to technology-enabled disruption, the training levels for these middle-skills positions have intensified over the last several years. In order to train these workers, local junior colleges and high schools must work with local businesses to provide training opportunities in order to close this "skills gap."

There are approximately 46 million members of the labor force in this country with a high school education or less.[9] It is our view at the Dallas Fed that, due to technology-enabled disruption, these workers are increasingly finding that their jobs are being restructured or eliminated. Unless they

have sufficient levels of math and reading capability and/or are retrained, these workers are likely to struggle to adapt to the changing nature of the job market. As a result, they are likely to see their incomes and productivity decline.

Improving math, reading and science capabilities, improving college readiness and beefing up the availability of skills training for potential workers will likely be essential to improving our workforce productivity, reducing the number of discouraged workers and contributing to higher GDP growth in the U.S.

The Projected Path of U.S. Government Debt

When assessing the level of debt in the economy, Dallas Fed economists look at debt held by the household sector, the business sector and the U.S. government. Since the Great Recession, the household sector in the U.S. has substantially deleveraged. The financial health of the household sector is crucial because the consumer comprises approximately 70 percent of GDP. In 2008, the household sector was historically highly leveraged relative to their incomes. It was not as apparent because household assets, particularly home prices, were elevated and appeared to support higher leverage. While consumer leverage helped fuel GDP growth leading up to 2007, in 2008, it became apparent that the consumer had to deleverage. It has taken several years—along with an improving job market—for the consumer to reduce debt relative to their income. Today's healthy consumer provides a key underpinning to the U.S. economy.

Unfortunately, while the U.S. consumer has deleveraged since the Great Recession, business debt as a percentage of GDP has increased, and U.S. government debt levels have increased substantially. While increased business debt is likely manageable, U.S. government debt held by the public is now 75 percent of GDP, [10] and the present value of underfunded entitlements is now approximately $49 trillion.[11] There is a legitimate concern that the projected path of U.S. government debt relative to GDP is unlikely to be sustainable.

The corporate tax reform elements of recent tax legislation should help to encourage greater business formation and investment, which should lead to greater productivity and some increase in the growth potential of the U.S. economy. However, the debt-financed tax cuts included in the legislation are likely to temporarily stimulate demand, with effects that will peak in 2018, and gradually fade in 2019 and 2020. Ultimately, we believe that growth will return back to trend. Dallas Fed economists believe that the expected near-term boost to GDP needs to be balanced with the concern that debt to GDP is likely to materially increase in the years ahead. This projected increase in government debt to GDP comes at a point in the economic cycle when it would be preferable to be moderating the rate of debt growth at the government level.

While leverage can stimulate the economy as it is being added, deleveraging is likely to be depressing to GDP growth. At a minimum, higher government leverage will make it less likely that fiscal policy will be a realistically available tool during the next recession. While addressing this issue involves difficult political considerations and policy choices, the U.S. may need to more actively consider policy actions that would moderate the path of projected U.S. government debt growth.

Conclusion

Dallas Fed economists are optimistic about economic prospects for 2018. We expect progress this year on our dual mandate of full employment and price stability.

Despite this optimism, we believe longer-term challenges remain. These challenges present opportunities for the U.S. to take action and adopt policies that could improve sustainable economic growth and prosperity. Addressing these challenges is likely to require fundamental structural reforms and a broader menu of policy actions beyond monetary policy.

Appendix A

A Background Note on Technology-Enabled Disruption and Its Implications

As I have been discussing for the past two years, technology-enabled disruption means workers increasingly being replaced by technology. It also means that existing business models are being supplanted by new models, often technology-enabled, for more efficiently selling or distributing goods and services. In addition, consumers are increasingly being able to use technology to shop for goods and services at lower prices with greater convenience—having the impact of reducing the pricing power of businesses which has, in turn, caused them to further intensify their focus on creating greater operational efficiencies. These trends appear to be accelerating.

It is likely that disruption is a factor in economic outcomes being increasingly skewed by educational attainment levels of workers. That is, for those who have a college degree, the unemployment rate stands at 2.1 percent, and the labor force participation rate is 73.4 percent. If you have some college education, the unemployment rate is 3.4 percent and participation rate is 66.0 percent; a high school diploma, the unemployment rate is 4.5 percent and participation rate is 57.5 percent; and some high school education, the unemployment rate is 5.4 percent and participation rate is 44.8 percent.[12]

Increasingly, workers with lower levels of educational attainment are seeing their jobs restructured or eliminated. Unless they have sufficient math and literacy skills or are retrained, these workers may likely see their productivity and incomes decline as a result of disruption. This may help explain the muted levels of wage gains and overall labor productivity growth we see in the U.S. as well as other advanced economies.

The impact of technology-enabled disruption on the workforce is likely less susceptible to monetary policy—addressing this challenge requires structural reforms. The reforms could include actions which would be aimed at improving early childhood literacy and improving math, reading and science achievement levels among high school students. These efforts could help boost overall college readiness in order to increase the percentage of students who graduate college in six years or less—now estimated at 59 percent in the U.S.[13] As mentioned in this essay, addressing the impacts of technology-enabled disruption will also require stepped up efforts to increase middle-skills training in cities across the U.S. in order to improve employment, close the skills gap (not enough workers to fill skilled jobs) and raise worker productivity. These initiatives could improve educational achievement levels in order to help our citizens better thrive in a world that increasingly demands greater education, training and adaptability.

Disruption may also help explain why companies, facing one or more disruptive competitors, have been more cautious about making capacity-expansion decisions as well as investing in major capital projects. The recent tax legislation may help create incentives to improve the level of capital investment.

To deal with disruptive changes and lack of pricing power, many companies are seeking to achieve greater scale economies in order to maintain or improve profit margins. This may help explain the record level of merger and acquisition activity globally over the past few years.

[1] "Immigration Projected to Drive Growth in U.S. Working-Age Population Through at Least 2035," by Jeffrey S. Passel and D'Vera Cohn, Pew Research Center, March 8, 2017, www.pewresearch.org/fact-tank/2017/03/08/immigration-projected-to-drive-growth-in-u-s-working-age-population-through-at-least-2035/.
[2] *Beside the Golden Door: U.S. Immigration Reform in a New Era of Globalization,* by Pia M. Orrenius and Madeline Zavodny, American Enterprise Institute Press, Washington, D.C., 2010.
[3] Applies to nonfarm business sector output per hour of all persons. Source: Bureau of Labor Statistics, as of fourth quarter 2017.
[4] According to the 2015 Program for International Student Assessment (PISA) by the Organization for Economic Cooperation and Development (OECD), the U.S. ranks 19th in science, 20th in reading and 31st in mathematics out of 35 OECD countries. An average of the scores across the three categories places the U.S. in 24th.
[5] According to the Survey of Adult Skills (Program for International Assessment of Adult Competencies) (2012, 2015) by the OECD, the U.S. ranks 17th in literacy and 23rd in math out of 29 countries and 15th in problem solving in technology-rich environments out of 26 countries. An average of scores across the literacy and math categories places the U.S. 20th.
[6] Hanushek and Woessmann (2016) estimate that a sustained 25-point increase in the U.S. students' average PISA scores could lead to an increase of 0.5 percentage points in potential GDP growth in the longer run. Source: "Skills, Mobility, and Growth," by Eric Hanushek and Ludger Woessmann in *Economic Mobility: Research & Ideas on Strengthening Families, Communities & the Economy,* Alexandra Brown, David Buchholz, Daniel Davis and Arturo Gonzalez, ed., St. Louis, Federal Reserve Bank of St. Louis and the Board of Governors of the Federal Reserve System, 2016, pp. 423–49. Also, see "Human Capital in Growth Regressions: How Much Difference Does Data Quality Make?" by Angel de la Fuente and Rafael Doménech, *Journal of the European Economic Association*, vol. 4, no. 1, 2006, pp. 1–36; and "Growth and Human Capital: Good Data, Good Results," by Daniel Cohen and Marcelo Soto, *Journal of Economic Growth*, vol. 12, no. 1, 2007, pp. 51–76.
[7] *Small Business Economic Trends,* National Federation of Independent Business, January 2018.
[8] Data are restricted to workers ages 16 to 64 who are not self-employed and are not employed in military or agricultural occupations. Source: "The Vanishing Middle: Job Polarization and Workers' Response to the Decline in Middle-Skill Jobs," Didem Tüzemen and Jonathan Willis, Federal Reserve Bank of Kansas City, 2013. Data were provided by Didem Tüzemen and updated to be current through December 2017.
[9] Bureau of Labor Statistics, as of January 2018. Comprises civilian labor force, age 25 and older.
[10] As of fourth quarter 2017. U.S. Department of the Treasury and Bureau of Economic Analysis.
[11] "The 2017 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds," U.S. Social Security Administration, July 13, 2017; "The 2017 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds," Centers for Medicare & Medicaid Services, July 13, 2017.
[12] As of January 2018. Source: Bureau of Labor Statistics.
When assessing prime-age workers (25–54 years), those with a college education have an unemployment rate of 2.1 percent and participation rate of 87.6 percent; with some college, 3.7 percent and participation rate of 83.0 percent; with high school diploma, 4.7 percent and participation rate of 77.3 percent; with some high school education, 6.0 percent and participation rate of 66.7 percent. (Sources: IPUMS-CPS, University of Minnesota, www.ipums.org, and Census Bureau.)
[13] "The Condition of Education 2017," U.S. Department of Education, National Center for Education Statistics, May 2017; Undergraduate Retention and Graduation Rates, U.S. Department of Education, National Center for Education Statistics, 2017.