

# Economic Conditions and Monetary Policy in a Changing World

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*Remarks before the Dallas chapters of Financial Executives International, the Association for Corporate Growth and the National Association of Corporate Directors*



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Dallas  
January 11, 2016

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

# **Economic Conditions and Monetary Policy in a Changing World**

Robert S. Kaplan

Thank you for that kind introduction. Thank you for having me here this evening. It's a great pleasure for me to speak with you.

For those who I haven't had a chance to meet yet, I was an investment banker and financial services executive for almost 23 years and then a professor at Harvard Business School for 10 years. I grew up in Kansas, went to the University of Kansas and spent a lot of time as a youngster traveling the state of Texas with my father, who was a jewelry salesman. I have always had a desire to do public service, so I was very glad to have the opportunity to lead the Dallas Fed.

I have been president of the Dallas Fed since the beginning of September. It's a great honor to be able to serve the people of the Eleventh Federal Reserve District (which includes Texas, northern Louisiana and southern New Mexico) and the nation. I have spent the past four months getting to know business and community leaders, as well as talking with many other people throughout this district. I have attended three Federal Open Market Committee (FOMC) meetings and developed good working relationships with the other Federal Reserve Bank presidents as well as the Board of Governors.

I have been impressed with the people who live and work in this district and with our dedicated staff at the Dallas Fed, as well as those who work in the Federal Reserve System across the nation. I say regularly that, as a citizen, if you could see what I get to see every day, you would be very proud and gratified by the work of the people of the Federal Reserve.

With that background, I'd like to speak tonight about the regional, national and global economies and then talk about implications for monetary policy. If there's a theme, it's how the world has changed and keeps changing. Our job at the Fed is to work to understand these changes, be continually open to learning and asking questions, and then strive to make good decisions for the citizens of this country.

As I speak this evening, my remarks represent my own views and do not necessarily reflect the views of my colleagues in the Federal Reserve System.

### **The Eleventh District: Discussion of Energy**

I'll begin my remarks with a discussion of the energy industry, given its vital importance to this district and the nation. Since the December Organization of the Petroleum Exporting Countries (OPEC) meeting, the overall tone in the oil and gas sector has soured, as expectations have decidedly shifted to an "even lower for even longer" price outlook.

OPEC seems to have abandoned any pretense of production quotas, and Saudi Arabia seems to be determined to maintain its market share of production. As a consequence, it appears that any reduction in supply from Saudi Arabia will have to be accompanied by proportionate declines from other middle-eastern nations and Russia—this, so far, seems unlikely.

Organization for Economic Cooperation and Development (OECD) inventories continue to increase and now stand at roughly 300 million barrels above their historical five-year average.<sup>1</sup> For 2015, the Department of Energy estimates that global supply exceeded global demand by an average of 1.7 million barrels per day.<sup>2</sup> As of today, this gap has declined to approximately 1 million barrels per day and is expected to ultimately drop to 600,000 barrels per day by year-end 2016.<sup>3</sup> Our economists at the Dallas Fed believe that global excess inventories aren't likely to begin falling until 2017. If we are wrong, the risks are that this rebalancing process will take even longer.

This situation is further complicated by the expectation that Iran sanctions will likely be lifted in early 2016, and Iran will increase its production shortly thereafter. Furthermore, our industry contacts suggest that Iran has 30–40 million barrels of oil in storage which, over time, could be sold into the world markets. The prospect of all or a portion of this supply coming into the market sooner than expected has increased uncertainty and negatively impacted oil prices.

Another complicating factor is that, despite rig count declines and additional cuts in capital spending, U.S. oil production declines have been slow to materialize. This reflects increased output from the Gulf of Mexico, the time lag between capital spending cuts and production declines, as well as the fact that shale-well productivity has improved over the past several years.

All this suggests that 2016 will be a challenging year for oil producers. On the positive side, lower oil prices translate into lower gasoline prices for consumers. These lower prices have helped generate stronger automobile driving activity as well as record auto sales in the U.S., and underpin our expectation of a 1.4-million-barrel-per-day increase in global consumption in 2016.<sup>4</sup>

Given these various cross-currents, the ultimate timing of reaching market production/consumption balance remains uncertain. As a consequence, we expect to see continued low prices and price volatility, as well as more bankruptcies, mergers and restructurings in the energy industry.

### **Broad Economic Conditions in the Eleventh District**

Certainly, the Eleventh District economy has been adversely impacted by low oil prices as well as strength in the dollar. As a result of these challenges, Texas job growth slowed to approximately 1.3 percent in 2015, and Dallas Fed economists expect similar growth in 2016.<sup>5</sup> This compares with the 3.6 percent job growth the state experienced in 2014.<sup>6</sup>

While the Texas energy and manufacturing sectors have been losing jobs, the state's service sector has shown steady, moderate expansion. We have seen particular strength in the health care and the leisure and hospitality industries. We have also seen recent strength in construction employment in the state.

It is worth noting that migration of firms and people has been a key underpinning of economic growth in this state. Since 2000, the average annual rate of population growth in Texas has been almost a full percentage point higher than the rest of the nation.<sup>7</sup> Despite some slowing due to the downturn in energy, I expect this migration trend to continue albeit at a slower rate. Due to the diversified nature of the state's economy and continued attractiveness of the state as a destination for firms and people, I am very optimistic about the resiliency and overall economic outlook for this district in the years ahead.

### **Economic Conditions in the Nation**

#### *Gross Domestic Product (GDP) and Employment*

Dallas Fed economists estimate that the U.S. economy grew approximately 2 percent in 2015. While this rate of growth is sluggish by historical standards, it was sufficient to drive down the rate of unemployment from 5.6 percent at the beginning of the year to 5.0 percent by year-end.<sup>8</sup> Our economists expect 2016 GDP growth of somewhere between 2.0 and 2.5 percent.

As with the Eleventh District, the U.S. service sector has been the primary growth engine in the United States. A strong dollar combined with relatively weak growth abroad continues to weigh on U.S. manufacturing and net exports.

In 2015, nonfarm payroll job growth averaged 221,000 jobs per month. Dallas Fed economists estimate that the economy needs to add somewhere between 100,000 and

150,000 jobs per month in order to keep the unemployment rate roughly constant. We expect sufficient job growth in 2016 to continue to drive down the rate of unemployment.

To gauge progress toward our full-employment mandate, we closely monitor various measures of labor market slack beyond the headline unemployment rate. In particular, we look at the labor force participation rate, which is the share of the population age 16 and older that is either employed or actively looking for work. This percentage is currently at 62.6 percent, which is 3.5 percentage points lower than its prerecession level.<sup>9</sup> At the Dallas Fed, we assess that while some of this decline is cyclical, more than half is due to aging workforce demographics. (I'll talk more about this in a few moments.)

We also closely monitor the number of “would be” workers who are “discouraged” and have given up looking for work, as well as the number of part-time workers who would convert to full time in a stronger job market. Both of these measures have recently shown improvement, which suggests to us that labor slack is declining and we are making progress toward our full-employment objective.

### *Inflation*

Headline inflation readings continue to run below the 2 percent longer-run objective set by the Federal Reserve. In November, the Personal Consumption Expenditures (PCE) price index was only 0.4 percent higher than a year earlier.<sup>10</sup>

At the Dallas Fed, our preferred measure of inflation is the Trimmed Mean PCE inflation rate, which “trims out” items with the most extreme upward or downward monthly changes. We believe this trimming gives us a measure of trend inflation that is more reliable than so-called “core” inflation, which excludes food and energy prices. The 12-month change in the trimmed mean has run between 1.6 and 1.7 percent since early 2014. The stability of this measure, in combination with anticipated further reductions in labor market slack, gives us confidence that headline PCE inflation will gradually increase to 2 percent by year-end 2017.

### **World Economic Conditions**

We estimate that 2015 global GDP growth, excluding the U.S., was 2.5 percent.<sup>11</sup> This headline growth rate masks a very uneven underlying picture. For example, emerging economies with high levels of exposure to commodities showed significant declines in growth rates. Brazil, Russia and Venezuela were in outright recession during 2015, and we expect negative GDP growth again in these countries in 2016. On the other hand, India's GDP growth rate was 7.3 percent in 2015 and is expected to increase further in 2016.<sup>12</sup>

Looking ahead to 2016, Dallas Fed economists expect global growth, excluding the U.S., to gradually improve to 2.9 percent. While this reflects improvements in both advanced as well as emerging-market economies, it is relatively sluggish compared with past rates of growth and comes with some meaningful level of downside risk.

One potential concern is China. The International Monetary Fund forecasts that China growth will slow to approximately 6.3 percent in 2016 versus a reported growth rate of 6.9 percent in 2015.<sup>13</sup> This slowing has been manifested in dramatic swings in the Chinese stock market (which have, in turn, spilled over into global financial markets), as well as in Chinese government actions intended to address some of their key economic challenges.

Overcapacity in key industries (particularly in state-owned enterprises), higher levels of leverage, and aging demographics are key challenges likely to impede growth. These issues are secular and will take years to address. In addition, China has embarked on a longer-term initiative to transition its economy to be more consumer and service-sector based from one that is heavily manufacturing and export based.

As a result of these factors, it seems probable that the world will have to adjust to lower levels of Chinese growth in the years ahead. Slower Chinese growth has the potential to further impact commodity prices and create headwinds for GDP growth in the U.S. and other economies.

### **Openness to Learning in a Changing World**

As I mentioned earlier, I grew up in Kansas and went to college in Kansas. As I was starting my professional career, there were a few things that I (and seemingly) everyone else knew to be true:

- A morning and an afternoon local newspaper were essential for most major cities.
- Japan would dominate the world economy for the foreseeable future. If you wanted to understand cutting-edge business, it was wise to intensively study Japan and its practices.
- Home prices might not always go up, but we knew that they would never substantially go down. My parents were lucky to have gotten a home mortgage at a rate below 8 percent—and I was unlikely to be so lucky.

We had never heard of the Internet, mobile devices or online news/content providers, which would allow us to get information immediately and would substantially disrupt the traditional newspaper industry. Japan suffered through decades of slow growth and increasingly challenging issues with high levels of government debt, a shrinking

population and aging demographics. And we know what happened with housing and interest rates.

The point is, what we know “for sure” is not always correct. The world evolves, and we have to be open-minded and adapt to the changes. We have to be willing to learn and, when the facts warrant, modify our views. This way of thinking is particularly important to me as a participant in the monetary policy deliberations of the FOMC.

Because the world has changed and keeps changing, some of the key tools we use to assess economic conditions must be assessed and reassessed in this context. For example, the Phillips curve has been a critical tool in analyzing the interaction of unemployment rates with inflation. In this current recovery, we are moving toward increasingly low rates of unemployment, but we have not yet seen an increase in headline inflation. Of course, this inflation shortfall may be due to transitory factors, but we are also aware there may be other more fundamental issues at play here.

Additionally, during this recovery, the labor-force participation rate has remained low by historical standards. As a result, some have questioned whether the headline unemployment rate remains the best measure of labor slack.

Why is this happening?

I believe there are several key factors that may be impacting economic conditions and should influence the way we think about monetary policy.

#### *Demographic Trends*

The United States and other major economies, including Europe, Japan and China, are all facing the challenge of aging demographics. For example, in the United States, 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.<sup>14</sup> Looking further ahead, the median age of the labor force is expected to rise steadily through 2060.<sup>15</sup>

Aging demographics are likely to negatively impact labor force participation rates. As I mentioned earlier, the labor force participation rate in the U.S. has fallen about 3.5 percentage points since late 2007.<sup>16</sup> While the 2008–09 recession certainly had a great impact, we believe that more than half of the decline can be explained by aging. Individuals age 55 and over tend to have lower participation rates than do younger individuals.

Based on current demographic trends, the Bureau of Labor Statistics predicts that the overall labor force participation rate will decline 2 percentage points further to 60.9 percent by 2024.<sup>17</sup> Since GDP growth is substantially impacted by growth in the labor force plus improvements in labor productivity, these trends suggest that, assuming no mitigating actions are taken, potential GDP growth rates may well be negatively impacted in the future.

In addition, these demographics suggest that the “dependency ratio”—which is crudely measured as the ratio of population under age 18 or over 64 to the population 18–64—will rise. The implication is that an increasing share of the population will “depend” on those of working age to pay for future medical and retirement benefits. This higher dependency ratio may have implications for the ability of countries to meet their obligations for retirement and medical benefits.

Of course, these demographic forecasts are just that—forecasts. Policymakers and other agents have the ability to take actions, and events can occur, which alter or offset these trends, improve productivity or otherwise mitigate their impact. The point is that, as policymakers, we have to be aware of them and be open to adjusting our thinking and our policies in ways that take them into account.

#### *Levels of Debt to GDP*

Another factor potentially impacting economic conditions is growth in the levels of debt relative to GDP. For much of my lifetime, the household, business and government sectors of the United States have been able to increase their levels of debt relative to overall GDP. This has had the effect, during some periods, of increasing GDP growth rates. Some have referred to this as the so-called “debt super cycle” and suggested that, in the future, additional borrowing will more likely need to be supported by corresponding growth in incomes.

Certainly, since the Great Recession, the household sector in the U.S. has been deleveraging. However, business debt as a share of GDP has grown somewhat (although importantly, the financial sector has deleveraged), and government debt to GDP has also risen. Currently, federal debt held by the public is approximately 73 percent of GDP, up from 33 percent in 2000<sup>18</sup> and, in addition, the present value of future unfunded obligations for Medicare, Social Security and other entitlement programs is estimated by the Congressional Budget Office to be approximately \$40 trillion.<sup>19</sup> These unfunded nondiscretionary obligations are expected to cause the U.S. budget deficit to materially increase as a percentage of GDP over the next 10 years and beyond.<sup>20</sup> This path may prove to be unsustainable.



Outside the U.S., high levels of debt to GDP in certain countries are likely to impact these countries' future ability to grow. China and Japan, for example, may find it difficult to stimulate GDP by growing debt beyond levels supported by income growth.

The level of borrowing relative to GDP is a key factor I will be watching, in the U.S. and abroad, in assessing economic conditions in the months and years ahead.

### *Globalization*

Today, U.S. companies are able to source and produce products and services in multiple countries to lower their costs. Increasingly, U.S. consumers are able to benefit from lower-cost imports as well as lower-cost services due to globalization. Companies increasingly think about their labor, products and services with a global mindset. This greater amount of global connectivity means that economic conditions in each country can much more quickly impact economic conditions in the U.S. and other countries.

One implication of this is that domestic labor slack has to be assessed in a global context. This means that the headline unemployment rate necessary to achieve full employment can likely be lower for a time than we've been historically accustomed to without triggering undue inflation pressures.

The point is that, as the world becomes even more interconnected and the "transmission" of global economic conditions accelerates, we have to increasingly consider world economic conditions in assessing our own.

### *Increasing Rates of Disruption*

Consumers increasingly are able to use technology to rapidly compare prices for goods and services. In addition, new business models are emerging, which offer products and services that "disrupt" older models—think Uber versus a taxi or car service, Airbnb versus a hotel room, Amazon versus a retail store. These new business models are having the impact of lowering prices and improving service and convenience. They are also helping improve the bargaining power of consumers.

These trends are encouraging many companies to look for new ways to use technology to lower their costs as well as improve productivity and customer service. It may be hard to measure, but I certainly believe these changes are putting some downward pressure on the prices of many types of goods and services.

Certainly, there are various exceptions to this trend such as prescription drugs and affordable luxuries (like a Starbucks coffee). However, increasingly, business models are being disrupted in ways that would not have been imagined only a few years ago. These

changes are impacting the way companies think about traditional capital spending and their choices for how to spend additional resources.

It is difficult to determine the ultimate impacts of aging demographics, high levels of indebtedness, globalization and increasing disruption. However, these are key issues that policymakers will need to better understand in order to assess economic conditions and formulate appropriate economic policies.

### **Monetary Policy**

I agree with, and argued for, the decision made in December by the FOMC to increase the federal funds rate. In our post-FOMC meeting statement, we emphasized that, even with this increase, monetary policy remains accommodative. We also emphasized that future removals of accommodation will likely be done gradually and will depend on our ongoing assessment of incoming economic data and overall economic conditions.

As we go forward, I will be closely monitoring various measures of labor market slack to assess progress toward our full-employment objective. As the unemployment rate moves below 5 percent, I would expect to see the inflation rate gradually increase toward our 2 percent objective in the medium term. Additionally, our economists will be considering how a stronger dollar and more subdued rates of growth outside the U.S. might adversely affect GDP, unemployment and inflation in this country. We'll also be working to better understand the potential impact of some of the secular issues I have discussed tonight.

I believe that continuing along the path of monetary policy normalization is important. There are various costs to maintaining excessive accommodation for too long—particularly in terms of potential distortions in investment, inventory and hiring decisions, which may need to be (painfully) unwound when policy normalizes. My experience is that these imbalances are sometimes easier to recognize in hindsight.

In thinking about these questions, we're sensitive to the fact that monetary policy affects the economy with a lag. As consequence, if we delay further normalization until we actually see evidence of excessive accommodation, there is a risk that we will have waited too long.

In addition, as we go through this period, I would not be surprised to see more bouts of volatility in the financial markets. The challenge for policymakers is to appropriately consider these movements, without over-reading or misinterpreting them, in assessing underlying economic conditions.

Thank you for the opportunity to speak today. I look forward to getting to know you better in the months and years ahead. Now, I would be very happy to take your questions.

## Notes

<sup>1</sup> See “Short-Term Energy Outlook,” Energy Information Administration, December 2015; additional calculations made by the Federal Reserve Bank of Dallas.

<sup>2</sup> See note 1.

<sup>3</sup> See note 1.

<sup>4</sup> See note 1.

<sup>5</sup> Sources are as follows: 2015 employment annualized year to date through November—Bureau of Labor Statistics and Texas Workforce Commission, with seasonal and other adjustments by the Federal Reserve Bank of Dallas.

<sup>6</sup> Sources are as follows: 2014 employment—Bureau of Labor Statistics and Texas Workforce Commission, with seasonal and other adjustments by the Federal Reserve Bank of Dallas.

<sup>7</sup> Census Bureau.

<sup>8</sup> Unemployment drop measured from December 2014 to December 2015.

<sup>9</sup> Bureau of Labor Statistics.

<sup>10</sup> See “Personal Income and Outlays,” Bureau of Economic Analysis, Dec. 23, 2015.

<sup>11</sup> Real global GDP (excluding the U.S.) grew 2.5 percent in 2015, according to estimates by the Federal Reserve Bank of Dallas economists using a weighted average aggregate with weights equal to U.S. trade weights.

<sup>12</sup> IMF World Economic Outlook, October 2015.

<sup>13</sup> See note 12.

<sup>14</sup> 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](http://www.bls.gov/opub/mlr/2015/article/labor-force-projections-to-2024-1.htm).

<sup>15</sup> See Census Bureau 2014 National Population Projections: Summary Tables, Table 9, [www.census.gov/population/projections/data/national/2014/summarytables.html](http://www.census.gov/population/projections/data/national/2014/summarytables.html).

<sup>16</sup> Bureau of Labor Statistics.

<sup>17</sup> See note 14.

<sup>18</sup> U.S. Department of the Treasury. Year 2000 number is an annual average. Current number is as of the third quarter 2015.

<sup>19</sup> 2015 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds.

<sup>20</sup> “The 2015 Long-Term Budget Outlook,” Congressional Budget Office, June 2015, [www.cbo.gov/publication/50250](http://www.cbo.gov/publication/50250).