

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

Remarks before the Official Monetary and Financial Institutions Forum



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London

April 29, 2016

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

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I want to thank the Official Monetary and Financial Institutions Forum for inviting me here today. I have worked extensively with British and European companies over the past 25 years, so I am very pleased to be able to talk with you today.

I have been president of the Federal Reserve Bank of Dallas since the beginning of September. The Dallas Fed has approximately 1,200 employees and oversees the Eleventh District, which is comprised of Texas, northern Louisiana and southern New Mexico.

As you know, the Federal Reserve is the central bank of the United States. It was legally established by Congress in 1913 and is charged with the mission of ensuring the stability and flexibility of the nation's monetary and financial systems. It is responsible for monetary policy, regulation and supervision of banking institutions, and providing certain financial services to banks and the U.S. federal government (which includes playing a key role in the nation's payment system). It is comprised of a Board of Governors in Washington, D.C., as well as 12 regional banks distributed across the United States. Each region is numbered and referred to as a "district."

The Federal Open Market Committee (FOMC) is the key monetary policymaking body within the Federal Reserve System. It holds eight scheduled meetings a year to assess economic conditions in the U.S. and decide on the stance of monetary policy. FOMC participants include all members of the Board of Governors as well as the 12 regional Bank presidents. The governors, the president of the Federal Reserve Bank of New York, and a rotating group of four other regional Bank presidents vote on policy at each FOMC meeting.

The Fed has been structured to be independent within the federal government, and the chair of the Board of Governors provides regular reports to Congress on the economy and monetary policy. Most central banks globally have been set up in a similar manner, with independence (that is, insulation from short-term political pressure) as a key feature of their operating models.

Since joining the Fed, I have participated in six FOMC meetings. I have also spent a substantial amount of time getting to know business and community leaders throughout the Eleventh District and developed good working relationships with the other Federal Reserve Bank presidents and the Board of Governors.

I have so far been very impressed with the dedication and commitment to excellence of my Fed colleagues in the Eleventh District and across the nation. I have also learned that the Fed benefits greatly from a diversity of views and a process which seeks out insight from members of the private sector, community leaders and other citizens. I have been impressed with the substantial amount of time volunteered by business leaders and nonprofit leaders in monthly board meetings, economic surveys and one-on-one meetings which inform and supplement our analysis of economic conditions.

Today, I'd like to speak with you about my assessment of economic conditions as well as my views regarding monetary policy. I'd like to start my remarks with a brief discussion of some of the larger secular issues that I see forming the broader context for our work.

The Broader Context

I came to the Fed because I believe that, as challenging as the past eight years have been, the next period of time is likely to be just as complex. While the U.S. and the world have made good progress in recovering from the economic crisis, we still face a number of significant challenges. Many of these issues arise from longer-term secular forces that have been taking shape over the past several years and are likely to exert even greater influence in the future.

Globalization

The world has become much more interconnected over the past several decades. Major companies have become more global and have increasingly spread their operations throughout the world in order to serve customers and improve their competitiveness. This geographic expansion has improved flexibility in sourcing and producing in order to manage logistics and lower costs.

Companies increasingly think about their labor, products and services with a global mindset. By and large, corporate revenue and profit growth have been enhanced by globalization even though this trend has clearly created strains on cities and towns which have seen jobs and industries relocate to other geographic regions. As evidence of this trend, S&P 500 companies now derive as much as 50 percent of their earnings from operations outside the United States.¹

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

While economies are more globally connected, financial markets have also become much more interconnected. Investment portfolios are increasingly global, and asset allocators increasingly think globally in making investment decisions. Because financial markets trade in real time, market strains or other challenges in one market now have the potential to rapidly affect currency, debt and equity markets globally.

We certainly saw the effects of this interconnectedness during the financial crisis of 2008–09. More recently, and on a much smaller scale, we saw how turmoil in currencies and local markets in certain countries in early 2016 helped lead to global market volatility and a rapid tightening of overall financial conditions.

Demographics

A second major challenge is demographics. The United States and other major economies, including Europe, Japan and China, are all facing the issue of aging populations. For example, in the U.S. as the baby-boomer generation moves into retirement age, the fraction of the labor force age 55 or older is projected to increase from approximately 21.7 percent in 2014 to almost 25 percent in 2024.² Looking further ahead, the median age of the labor force is expected to rise steadily through 2060.

In the Euro area, we estimate that the working-age population, as a percentage of the total population, has been declining since 1990. Further, we estimate that the absolute size of the working-age population likely peaked in 2010 at approximately 219 million and has since declined in absolute terms and will continue to decline in the coming decades.³ In the United Kingdom, we expect the working-age population will continue to grow, although at a somewhat slower pace than growth in the total population.

These demographic trends bear directly on the rates of workforce participation and, in turn, impact rates of potential economic growth in advanced economies. For example, based on current demographic trends, the U.S. Bureau of Labor Statistics estimates that the labor participation rate in the U.S. will decline 2 percentage points to approximately 61 percent by 2024.⁴ Assuming no mitigating actions are taken, this will likely have some negative impact on potential GDP (gross domestic product) growth rates in the future.

High Levels of Debt to GDP

While these demographic trends continue to unfold, it is also the case that levels of debt to GDP have increased in advanced economies. In the U.S., for example, household balance sheets have improved since the crisis but business debt to GDP is somewhat higher and government debt to GDP has also increased.

While the U.S. government debt held by the public is approximately 75 percent of GDP,⁵ it is estimated that the present value of underfunded “entitlements” is now in excess of \$40 trillion.⁶ These underfunded obligations will increasingly work their way into the annual budget deficit over the next five to 10 years and will help to increase the U.S. budget deficit as a percentage of GDP.

The demographic trends I just described are likely to put increasing strains on the ability of advanced economies to meet these growing obligations. In light of these demographics, there is some question as to whether these U.S. budget trends will prove to be unsustainable and whether similar strains will be felt in Japan, China and the U.K. as well as most major countries in Europe.

In addition, the rising future burden of entitlements, coupled with a higher degree of political polarization in certain countries, has likely impaired the capacity for fiscal policy actions, which could have potentially contributed to economic recoveries around the world. This, in turn, has put substantial focus on the role of monetary policy to address important economic challenges. While monetary policy has a key role to play in this regard, it was never designed nor intended to act in isolation; fiscal policy as well as other governmental actions must also play key roles.

Increasing Rates of Disruption

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

These trends are encouraging companies to look for new ways to use technology to lower costs, improve productivity and enhance customer service. While the impacts can be hard to measure, I believe these changes are reducing the pricing power of companies and putting some degree of

downward pressure on the prices of many types of goods and services. This, in turn, is affecting the way companies think about traditional capital spending and overall resource allocation.

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

With this backdrop, let me turn to a discussion of economic conditions in the Eleventh District, the United States and the world. I will then briefly discuss the implications of these conditions for U.S. monetary policy.

Eleventh District Discussion of Energy

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

As we sit here today, Dallas Fed economists estimate that global daily oil production exceeds daily consumption by more than 1 million barrels per day.⁷ It is our current expectation that global oil supply and demand will get into some degree of daily balance by early 2017. This current estimate assumes that non-OPEC (Organization of the Petroleum Exporting Countries) production will decline significantly during the latter half of this year. This estimate is also underpinned by our forecast that global demand will grow by approximately 1.2 million barrels per day in 2016.⁸ Lastly, this forecast assumes that supply disruptions, such as those that have occurred in Nigeria, Iraq and Kuwait, are ultimately resolved, with production being restored.

It is worth noting that, despite very significant cuts in capital spending in the U.S., supply reductions have been slow to materialize over the past year. When supply reductions have occurred in non-OPEC nations, they have been more than offset by production increases from Iran, Russia and other nations.

As a result of this recent prolonged period of oversupply, excess inventories in the OECD (Organization for Economic Cooperation and Development) member countries now stand at approximately 440 million barrels.⁹ This is a record level of excess inventory and has raised concerns about whether there is sufficient storage capacity in certain geographic areas.

We believe that market participants have taken some comfort—potentially too much comfort—from discussions of a potential production freeze by OPEC members as well as Russia. We have consistently believed that any such negotiations would be unlikely to lead to actual production declines, and that Iran intends to increase its production until its output reaches pre-sanction levels.

With these various crosscurrents, we expect 2016 to be a year of continued price volatility as production estimates continue to fluctuate and forecasts regarding the timing of supply/demand balance continue to be adjusted. We also expect to see a continuing high level of restructurings, bankruptcies and (where possible) mergers in the energy industry.

Eleventh District Overall Economic Conditions

As I mentioned earlier, the Eleventh District of the Federal Reserve is comprised of Texas, northern Louisiana and southern New Mexico. While energy is an important part of this region, its share of GDP has declined over the past two years. In particular, the energy industry is now approximately 2 percent of Texas employment¹⁰ and 9 percent of GDP¹¹ (versus 3 percent of employment and 14 percent of GDP in 2014).

Texas has substantially diversified its economy over the past 25 years. Some of this diversification has occurred organically, and a significant portion has developed as a result of a sustained migration of people and firms to the state. Since 2000, population growth in Texas has exceeded that of the nation by a full 1 percentage point a year. This growth and diversification have helped contribute to the resiliency of the state despite headwinds from energy as well as a strong dollar.

In 2016, Dallas Fed economists expect job growth between 0.5 and 1 percent, as compared with 1.3 percent in 2015 and 3.7 percent in 2014.¹² Manufacturing remains weak, but the state's service sector continues to show steady growth. Risks to our forecast are to the downside as depressed conditions in the energy sector continue to ripple through the Texas economy.

As a result of a more highly diversified economy as well as the continued migration of people and firms to Texas, I am very optimistic about the growth prospects for Texas and the Eleventh District in the years ahead—particularly as the negative impacts of declining oil prices begin to dissipate.

Economic Conditions in the U.S. Economy

Estimates of first-quarter GDP growth in the U.S. have been disappointing. Based on a strong consumer, our economists at the Dallas Fed expect that GDP growth will improve over the remainder of this year—and we now forecast growth of approximately 2 percent in 2016. This is sluggish growth by historical standards but should be sufficient to continue to drive down the unemployment rate below the current 5 percent reading.

In addition to the headline unemployment rate, we also closely watch the labor participation rate, which now stands at approximately 63 percent.¹³ While the participation rate is lower than the 66 percent reading in 2007, Dallas Fed economists believe that more than half of the decline is due to aging of the population. We also track estimates of the number of part-time workers who might convert to full time in a stronger job market. Both of these measures have shown signs of improvement in recent months.

It is my own view that labor market slack needs to be viewed in a global context. That is, excess capacity outside the United States may impact the level of labor slack within the U.S. as companies increasingly think globally about their workforce configuration and deployment. As a result, I believe that we may be able to achieve levels of unemployment that are lower than we have been historically accustomed, without creating near-term inflation pressures.

In terms of inflation, our economists look at headline levels but also look closely at the Dallas Fed's Trimmed Mean PCE (personal consumption expenditures) measure of core inflation. This measure trims out those items with the most extreme upward and downward monthly price movements. While the headline measure of inflation has been running well below our 2 percent objective, the 12-month change in the trimmed mean ranged consistently between 1.6 and 1.7

percent from early 2014 until the end of 2015. This measure has ticked up to between 1.8 and 1.9 percent in 2016.¹⁴ These readings give us confidence that headline inflation will ultimately increase toward our 2 percent objective over the medium term.

Global Economic Conditions

Our economists at the Dallas Fed closely monitor economic conditions outside the U.S. because, in a globally connected world, these conditions have the potential to impact the U.S. economy.

2016 estimates of growth outside the U.S. continue to decline. The underlying composition of these growth estimates is highly uneven. In particular, commodity-sensitive countries such as Venezuela, Brazil and Russia are in recession, while most advanced economies show steady but moderate rates of growth.

As mentioned in my opening comments, most advanced economies are challenged by aging-demographic trends as well as high levels of debt relative to GDP. In my view, both these trends create headwinds for current and future economic growth. These issues are particularly acute in Japan, where the population is declining and its dependency ratio—the ratio of those age 14 and under plus those 65 and over relative to those 15–64—has been rising since the early 1990s.¹⁵ Similar dynamics, although less severe, are also unfolding in Europe.

In addition, we are closely watching China, given its size and importance to world GDP growth. China grew at a reported rate of 6.9 percent in 2015.¹⁶ We estimate that this growth rate will slow to 6.5 percent in 2016 and likely trend lower in subsequent years.¹⁷ China is dealing with high levels of overcapacity (particularly in state-owned enterprises), high levels of debt and an aging workforce. In addition, it has embarked on a longer-term transition from being an export- and investment-driven economy to one that is dominated by services and the consumer. This is likely to be a very difficult transition, which will play out over many years as opposed to quarters. Given these various challenges, we believe that the world is going to need to adjust to lower levels of Chinese growth in the years ahead.

China's challenges are likely to have some spillover effects on emerging-market countries as well as the U.S. and other advanced economies. Possibly more significantly, China's challenges have the potential to transmit to financial markets through heightened currency volatility as well as periodic bouts of tightening in global financial conditions.

Implications for Monetary Policy

As you know, the Fed has a mandate to pursue full employment and price stability. Regarding our full-employment objective, I believe we are making good progress toward reaching our goal.

As I mentioned earlier, I believe that, in a more interconnected world, labor slack should be assessed in a global context. Excess capacity outside the U.S. may dampen inflation pressures in the U.S. at a given level of unemployment. I am encouraged by the recent uptick in the labor participation rate to 63 percent. I think it suggests that we can make even further progress on so-called discouraged workers reentering the labor force. As a result, we may still have capacity for healthy job growth without overheating the economy or unduly stressing the capacity of the U.S. workforce.

In terms of price stability, headline inflation continues to run below our 2 percent objective. However, I believe that, as the impacts of lower energy prices and a strong dollar ultimately

dissipate, headline inflation will gradually trend toward our core inflation readings. As mentioned earlier, the Trimmed Mean PCE now stands at between 1.8 and 1.9 percent, and we expect this measure to rise to 2 percent over the medium term as we move toward full employment.

I am monitoring how slowing growth, high levels of overcapacity, and high levels of debt to GDP in advanced economies outside the U.S. impact economic conditions in the U.S. I am also closely monitoring how these issues might be affecting the slope of the U.S. Treasury yield curve as well as measures of tightness in financial conditions.

In light of these challenges, I have been suggesting that removal of accommodation should be done gradually and patiently. I am also very cognizant that, from a risk-management point of view, our monetary policies have an asymmetrical impact at or near the zero lower bound.

However, I do believe that the effort to “normalize” monetary policy is important and that excessive accommodation has a cost in terms of creating distortions in investing, hiring and other decisions which can create unhealthy imbalances. These imbalances are often easier to recognize in hindsight and can be very painful to address.

As a result, as we continue to make progress in achieving our dual mandate, I will advocate that we take actions to remove some amount of accommodation. However, I will also advocate that we take these steps in a gradual and patient manner.

Thank you for the opportunity to speak with you today. Now, I would be very happy to take your questions.

Notes

¹ “Yardeni: No U.S. Recession in Sight,” by Leslie P. Norton, *Barron’s*, Feb. 6, 2016,

www.barrons.com/articles/yardeni-no-u-s-recession-in-sight-1454736560?mod=yahobarrons&ru=yahoo.

² “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.

³ Based on World Population Prospects, United Nations, July 29, 2015.

⁴ See note 2.

⁵ Federal debt held by the public was 76.4 percent of GDP in first quarter 2016, according to the U.S. Treasury and the Bureau of Economic Analysis (BEA).

⁶ 2015 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds.

⁷ Oil Market Report, International Energy Agency, April 2016.

⁸ See note 7.

⁹ Short-Term Energy Outlook, Energy Information Administration, April 2016.

¹⁰ Data from the Bureau of Labor Statistics (BLS), Texas Workforce Commission and Dallas Fed.

¹¹ Data from the BEA. The share of mining averaged 8.77 percent in third quarter 2015.

¹² See note 10.

¹³ BLS, household employment data, Table A-1, www.bls.gov/news.release/empsit.t01.htm.

¹⁴ See the Dallas Fed’s Trimmed Mean PCE report, www.dallasfed.org/research/pce.

¹⁵ See note 3.

¹⁶ China National Bureau of Statistics.

¹⁷ *World Economic Outlook*, International Monetary Fund, April 2016.