

A Shot in the Arm: Stimulating the American Workforce

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The views expressed today are my own and not necessarily
those of the Federal Reserve System or the FOMC.

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Good morning, it's a pleasure to be here.

I'm Pat Harker, president of the Federal Reserve Bank of Philadelphia, and a lot of people have no idea what that means.

I'm sure most of you do, or you likely wouldn't be here. But if you'll bear with me, I'm going to spend the first couple of minutes today on a brief overview of the Federal Reserve System and the role we play in the economy. The Fed has been the subject of a lot of talk and debate lately, so it seems like a good time to revisit the basics.

Since I'm wading into the subject of public commentary, I should deliver the standard Fed disclaimer now: I'm speaking for myself today, and my views do not necessarily reflect those of anyone else within the Federal Reserve System.

The Fed: An Overview

The Fed has been criticized in the past for the quality of our communication. Some of this criticism is about the way we signal our intentions about policy, but some of it is really about the fact that we can't seem to speak in sentences shorter than 70 words. And we're fond of terms like, "downward nominal wage rigidity," which don't do much to capture the public's attention.

So, I'd like to speak to you plainly, I hope, and directly about what the Fed is doing and the current economic conditions. I'll talk in more detail about some of the issues that are at the forefront of the national conversation. And I'll address some of the factors that can help change the trajectory of the economy.

First off, the overview. There are 12 regional Federal Reserve Banks around the country, each of which has a president, and a Board of Governors in Washington, D.C. We all meet every six weeks or so in D.C. for the FOMC, the Federal Open Market Committee, to make a decision about what we're going to do — or not do — about monetary policy. The 12 presidents don't always have a vote — although New York always does, as do the governors — but we all participate in the discussion. The structure of the Fed is different than most nations' central banks, which is beneficial for a country so vast and varied.

I find two things particularly important about this structure. First, it gives voice to communities and industries all over the country, so we're not making policy through the lens of one myopic view. We're the world's third largest country, both by geographical size and by population, with a wide-ranging economy, and that's a lot to cover. The economy is very different in Seattle than it is in Camden, and it's important that we assess conditions on a District level as well as a macro one. Second is that it adds a richness of perspective to the discussion because we all have different backgrounds, different ways of looking at the data, and different methods by which we judge economic outcomes. It helps to avoid groupthink.

Despite meeting in the most politically charged place in the country, politics actually never plays a role. The FOMC is just a bunch of policy wonks analyzing data so we can make the best decisions for the American economy.

Those decisions focus on achieving our two goals, which were set for us by Congress: maximum employment and price stability. When Fed officials and talking heads discuss the Fed's "dual mandate," that's what they're referring to here. The Fed is also rare among the world's central banks for having two goals; most just have a single focus.

It's not really the technical definition, but we think of maximum employment as more or less that the job market in the United States is good enough that you can find a job if you're looking.

Price stability is low and steady inflation.

Neither of the numbers associated with these goals is zero. The Fed has an inflation target rate of 2 percent; that is, we want prices to rise on average about 2 percent in the medium term. That should allow the economy to grow without devaluing your paycheck.

The labor market is measured in a variety of ways, but the number most frequently cited is the unemployment rate. Economists have an estimate of what's called the "natural rate" of unemployment, which is basically the rate we expect in a healthy economy. Currently, most people put it somewhere around 5 percent. It's not zero because the unemployment rate tracks people who are actively looking for jobs. So, when people graduate from school, for instance, or return to the workforce after taking time off to raise children, they're counted as unemployed while they search. And people get laid off and quit jobs all the time, so they're counted, too.

Labor Force Participation in Greater Detail

This gets me to the first issue that's receiving a lot of interest. You all know that we don't just determine the health of the labor market by one metric. You've probably heard a lot about the "real" or "hidden" unemployment rate lately. And I want to address that.

We are always circumspect when we look at these numbers because finding the pulse of the American workforce is important; it's not something we, as policymakers, are looking to dress up or obfuscate. Our goal is maximum employment, and we want to be sure we're achieving it. We're not affected by election cycles or influenced by politics, and that independence means we can focus on finding the best solutions possible.

There are many ways to look at the data, and they tell us different things. The unemployment rate I just referred to — technically called U3 unemployment — is currently at 5.0 percent, right about the natural rate. Despite frequent talk about a sub-par economy, we're actually doing pretty well. It's important to remember that during the worst of the recession, unemployment hit a 10 percent high.

The U6 measure — which takes U3 and adds people who are working part time but would like to be full time as well as people who say they want a job but have stopped looking — is higher, at 9.7 percent. That's higher than we might expect but not drastically so.

Then there is the labor force participation rate, which has been the focus of a lot of recent discussion and debate.

The labor force participation rate looks at the number of people working in the U.S. as a proportion of the working-age population, which seems logical. But it is a very basic calculation, and the specifics might surprise you.

We define *working age* as everyone over the age of 16. That's a lot of people, and many of them aren't working for reasons that have nothing to do with the job market. My mother is part of that equation, even though no one would expect her to still be punching a timecard at her age. The high school and college students in the audience today are also counted, even though a lot of you aren't working because you're focused on your studies.

But there has been a lot of concern over the decline in participation. In particular, concern over the driving forces.

Forces Behind the Declining Participation Rate

Labor force participation can be affected by both “cyclical” and “structural” issues. That is, the rate can reflect the overall economy and its ups and downs — the cycle of the

economy — or perhaps something that has shifted fundamentally in the structure of the labor market.

In the aftermath of the global financial crisis and subsequent recession, labor force participation plummeted as people were laid off and couldn't find new work. That's the unfortunate normal for recessions, which is worse in one as deep as the one we experienced. The deeper the recession, the longer it takes for people to find jobs, and a lot of them give up looking altogether. This time was no exception.

We hope and expect that those people will start job hunting again, once the economy picks back up. That's what would normally happen as a recovery continues its progress. But over the past six years, that hasn't happened to the extent we might have predicted. This raises the possibility of underlying issues or a hidden segment of the unemployed that we're not accounting for — people who are still on the sidelines who might at some point rejoin the workforce.

Research by my staff shows that's not the case. They've found that the fall in the labor force participation rate is mostly due to demographic factors.¹

The most influential impact is coming from the first wave of baby boomers starting to retire. This generation will be the biggest group of older Americans in our nation's history, which is going to have an obvious impact on the percentage of people working.

There's also the simple fact that we're living longer, so there are just more people in the mix, which I think is something to be celebrated, personally.

There are other contributory factors: We've seen a record number of high school graduates in the U.S., and college attendance rates are, on average, rising as well. That's

¹ Shigeru Fujita, "On the Causes of Declines in the Labor Force Participation Rate," *Research Rap Special Report*, Federal Reserve Bank of Philadelphia (February 2014).

delaying some people from entering the workforce, and many students are foregoing work while they're studying.

Additionally, there seems to be a shift in views on work-life balance, with more people deciding a one-income household is worth the tradeoff. For some people, it's a matter of leisure time or the preference to have one stay-at-home parent; there's any number of reasons.

All of those factors affect the very basic equation of labor force participation, and they should be taken into account.

But we also have to look at historical precedent and whether we're measuring by the right yardstick. Part of the reason the labor force participation rate rose so dramatically in the past was also due to demographics. The post-World War II period was marked first by the baby boom and its attendant influx of workers to the economy. And it also saw the rapid entrance of women into the workforce. Female participation rates increased from less than 35 percent to around 60 percent in this period. That wave of people joining the workforce made a huge difference to participation.

But we're no longer in a situation that will allow for a similar boost or a similar rate. There's no large portion of society that's left out. There's no one group whose entry to the market will have that significant an effect. And the population is growing more slowly, meaning we won't see the kind of boost the baby boom gave us either.

After accounting for all those factors, the lower rate of labor force participation is understandable. And in the case of people living longer and enjoying their retirement or more people able to make choices that fit their life preferences, it's a positive.

But the effects of the drop in the participation rate are something we need to look at here. Because the vast majority of the decline is the result of the baby boomers' retirement

onset, my staff doesn't think the trend will reverse. In fact, they project that the participation rate will drop a further 2 percentage points over the next five years.

If the low participation rate doesn't reflect a portion of the population that still wants, but can't get, work, does this matter?

The answer is yes. Or YES.

Some Consequences of the Declining Labor Force Participation Rate

It matters because labor force participation affects growth. We can see that by studying the U.S. economy during the recovery. After bottoming out in mid-2009, real GDP grew at an average of about 2 percent for the subsequent six years. That's very slow for a recovery; it's even slow by historical averages. To put that in context, growth averaged 3.5 percent in the second half of the 20th century — of which 1.7 percent came from the expansion of the American workforce. By contrast, the labor force has only grown by 0.5 percent over the recovery, less than half the historical average.

With all those people in retirement and with people living longer, there are more economic pressures to contend with. We need a labor force that can help meet that challenge.

The consequence of a declining participation rate means that output will shrink. That is, with fewer workers, the United States will produce less. When we produce less, growth stalls.

Then there are the demographic shifts: The changes to the American labor force in age, in educational attainment, and in expertise in certain sectors are actually harming productivity. In general, productivity is higher in mid-career workers, and their

proportion of the U.S. labor market is smaller than it was during the height of the baby boom's working years.²

We therefore have a workforce that is less productive than it used to be with the pressure of caring for a retiring segment of the population that is bigger than it's ever been before. There will be a strain on Medicare and Social Security, leaving fewer resources for the country to spend on other areas — for instance, maintaining our competitive global edge.

Ultimately, places with a high participation rate are more successful, healthier economies. If that is the case, and we've all but tapped our resources, can anything be done?

Again, the answer is yes.

An Alternative Policy Measure: Immigration

Part of the Fed primer is that we make monetary policy, not fiscal or other policy. So the points I make today are from the perspective of someone who is affected — both as a policymaker and a citizen — by the decisions made in legislative halls, but not as someone who's in a position to make those changes himself.

Monetary policy is actually limited in its scope. Taxes and spending, debts and deficits, government funding and laws that affect the labor force are all out of our purview. The Fed's job is to create the conditions for a strong and healthy economy. Changing the trajectory of U.S. growth will take legislative action, like investments in human and physical capital, which we can't do. But we can point out the economic benefits.

The fact is that we have a strong labor market. We're a far cry from the worst of the crisis when unemployment reached 10 percent. The issue now is that employers are struggling to fill the jobs they have open. Even with workforce development programs, which are

² James Feyrer, "Demographics and Productivity," *The Review of Economics and Statistics*, MIT Press, 89:1 (February 2007), pp. 100–109.

also necessary, we don't have the people to fill them. We need to close the gap in the workforce. And given the long-term demographic trends, we need to turn to outside sources.

We need people.

That's the missing ingredient in the participation rate and in growth.

One potential source is immigration. Again, I want to be clear: I'm not suggesting immigration policy or telling anyone how to go about legislating. I don't want to get into a debate about immigration or the questions of documented or undocumented residents. I want to talk about the numbers and the data and their potential effect on the U.S. economy.

And from an economic standpoint, immigration, particularly high-skilled immigration, is a source of immense potential for economic growth.

Today, immigration accounts for 13-plus percent of the U.S. population. This share has been steadily increasing over time: In 1990, it was 8 percent.

Much of the immigration debate surrounds the level of skill and contribution of new arrivals to the U.S. But the truth is that much of the flow of immigration over the past 15 years has been highly skilled and well educated. Over that period, the college-educated immigrant population grew from 5.9 million to 10.5 million. The native-born college-educated population also grew but at a much slower pace.

Most important, immigrants tend to have a higher participation rate — something we need.

This touches on the most prevalent concern about immigration: the fear of losing American jobs. There is, however, scant evidence to support the anxiety, especially

where skilled immigrants are concerned. In fact, most studies have shown that it's a net benefit for the rest of us.

One recent paper examined how the increased flow of immigrants in the STEM fields — that is, science, technology, engineering, and math — affected the labor market outcomes of native born workers.³ The researchers found that a 1 percentage point increase in the number of foreign STEM workers actually increased wage growth of the college-educated population by 7–8 percentage points in the long run, and 3–4 percentage points for those without a college education.

They also found that inflows of foreign STEM workers increase productivity growth more generally, accounting for somewhere between 30 and 50 percent of the aggregate U.S. productivity growth between 1990 and 2010. Other research backs this up.⁴

This reflects the “scale effect” in economic theory — that greater population growth is tied to higher per-capita growth rates. In this model, scale comes from the theory that more ideas are developed when more people are engaged in research. Because anyone can use the same idea at the same time, any single idea can be used by lots of people to produce growth. Therefore, more people equals more ideas equals more growth.⁵ More

³ Giovanni Peri, Kevin Y. Shih, and Chad Sparber, “Foreign STEM Workers and Native Wages and Employment in U.S. Cities,” National Bureau of Economic Research Working Paper 20093 (2014).

⁴ William R. Kerr and William F. Lincoln, “The Supply Side of Innovation: H-1B Visa Reforms and U.S. Ethnic Invention,” *Journal of Labor Economics*, University of Chicago Press, 28:3 (2010), pp. 473–508, 07.

Jennifer Hunt and Marjolaine Gauthier-Loiselle, “How Much Does Immigration Boost Innovation?” *American Economic Journal: Macroeconomics*, American Economic Association, 2:2 (April 2010), pp. 31–56.

⁵ Charles I. Jones and Paul M. Romer, “The New Kaldor Facts: Ideas, Institutions, Population, and Human Capital,” *American Economic Journal: Macroeconomics*, American Economic Association, 2:1 (January 2010), pp. 224–245.

than 80 percent of U.S. per capita growth in the second half of the 20th century can be attributed to this scale effect.⁶

The bottom line is that a larger and more highly skilled labor force fuels economic growth, something we will need to meet the demands of demography.

I said I'd be academic, but on a personal note, I'd add this: Pretty much all of us are the product of immigration. At some point, near or far down the line of our ancestry, someone came to this country and helped make it what it is today. America is a constantly evolving nation, which is one of our strengths. Much of that is due to the influence of waves of immigration that brought over new ideas and swelled the workforce. It's as true today as it was during the Industrial Revolution or at the turn of the 20th century.

One of the comparative advantages of the United States, since our inception, has been our ability to assimilate immigrants from all over. It built both the greatest economic power on the planet and the American dream that defines it. We're good at this. We're arguably better than anyone else on earth. So let's play to our strengths. It's in our own economic interest.

Implications for Monetary Policy

Since I've just spent some time talking about other people's areas of policy, I'll be fair and talk about what lessons this has for my own.

Falling participation rates pose important challenges for monetary policy. Both the aging of the population and lower productivity will likely deliver a lower natural rate of interest

⁶ C.I. Jones, "Sources of U.S. Economic Growth in a World of Ideas," Papers 99–29, United Nations World Employment Programme (2000).

and slower potential GDP growth. These are difficult to measure in the first place, so changes to their fundamental nature complicates monetary policy.⁷

A lower natural funds rate has implications for the speed at which current monetary policy should normalize. The lower the natural funds rate, the closer the current funds rate will be to that level, which means policy will have a shorter distance to travel to full normalization. That's important because it gives us less room to maneuver. Monetary policy is a relatively blunt tool; a smaller window for operation is more appropriate for a scalpel.

And it may be that our toolbox is getting duller: Recent studies have found that monetary policy's efficacy has been waning since the mid-1980s, and that this can be linked to the aging of the population.⁸ Given our demographic realities, this puts even more pressure on fiscal and other policies to take a long-term look at policies that can nurture growth.

Conclusion

So, there you have it. The U.S. labor market is strong, but participation is waning. Our economy needs a boost and immigration could be the stimulant. I'm not directing anyone which path to go down, but I am saying that we need to take one.

⁷ Gauti B. Eggertsson and Neil R. Mehrotra, "A Model of Secular Stagnation," National Bureau of Economic Research Working Paper 20574 (2014).

⁸ Jean Boivin, Michael T. Kiley, and Frederic S. Mishkin, "How Has the Monetary Transmission Mechanism Evolved Over Time?" National Bureau of Economic Research Working Paper 15879 (2010).

Patrick A. Imam, "Shock from Graying; Is the Demographic Shift Weakening Monetary Policy Effectiveness," International Monetary Fund Working Papers 13/191 (2013).