

An Economic Outlook

Main Line Chamber of Commerce

Malvern, PA

January 12, 2017

Patrick T. Harker

President and Chief Executive Officer
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FEDERAL RESERVE BANK
OF PHILADELPHIA

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

Good morning; it's a pleasure to be here. This is my first public speech since we raised rates in December as well as my first as a voting member of the Federal Open Market Committee (FOMC). I'm trying not to take it personally that people seem to find my opinions much more interesting nowadays.

Today, I'd like to give an overview of the economy, talk about the implications for monetary policy, and explore some of the issues affecting the region — particularly workforce development.

Before I start, however, I should add the usual disclaimer that the views expressed today are mine alone and do not necessarily reflect those of anyone else in the Federal Reserve System.

Growth

The headline is that things are looking pretty good, or as I should say as a policy wonk: “The economy is displaying considerable strength.” Gross Domestic Product continued to grow in the third quarter at an even faster pace than in Q2. Third-quarter growth was recently revised up to 3.5 percent. That was driven largely by consumption.

Consumer confidence is strong, retail sales are still solid — though slightly slower than previously anticipated — and equity markets are up.

The New Orders Index, though positive, fell slightly in December, though the Regional Business Activity Index increased sharply.

All in all, the snapshot is of a robust American economy.

Inflation

As you know, the Fed has a dual mandate of maximum employment and price stability. In its simplest terms, that means that most people can find a job if they're looking, and inflation stays low and stable.

Starting with inflation, we aim for an average of 2 percent. A little higher or a little lower from time to time is not something to worry about. We don't need to be exactly at 2 percent all the time. We're looking for an average over the medium term.

People sometimes assume that the Fed worries more about inflation being too high than too low. But we give equal weight to the distance from our goal regardless of the direction. Over the past few years, inflation has been below target. That's the main reason interest rates have been so low for so long. We're starting to see some upward movement in the price index for personal consumption expenditures, which excludes food and energy. This is a long name for the Fed's preferred inflation measure. Most economists simply call it "the core PCE," and it has increased to 1.7 percent, near our target.

I know the joke is that Fed policymakers must not eat or drive, because we prefer the core measure. But we're looking for underlying trends and stripping out those volatile components gives us a better read. That said, the yearly growth in the headline PCE index has also increased, rising to 1.0 percent in the third quarter of 2016, from 0.3 percent a year earlier.

Additionally, inflation expectations are starting to rally around the 2 percent goal. One important facet of economics is that expectations can play a role in outcomes, particularly in inflation. It's something of a monetary self-fulfilling prophecy. If markets believe inflation will remain low, it's more likely to do so. And over the past few years, not everyone was on the same page with their predictions. But as expectations consolidate around our target rate, it makes it more likely that our target will become reality.

Looking at all the information and the trends over the past few years, I see inflation on course to meet our target sometime this year or next.

Labor market

On the employment side of things, we're doing very well. We had another month of solid gains in December, with the economy adding 156,000 jobs. That's an average of 165,000 over the last quarter of 2016.

The unemployment rate remains low at 4.7 percent, which is at, or below what most economists believe is its natural rate of about 5 percent. The natural rate is the rate that we expect in a healthy economy. Unemployment is never zero, because people will always move from job to job, and we add new people to the workforce every day.

Of course, we don't just look at the headline unemployment rate. And it should be noted that joblessness hits some portions of the population worse than other demographics. For instance, the unemployment rate for African-American males was 8.6 percent in December, almost four percentage points higher than the average for the entire adult population.

There's also a lot of talk about hidden pockets of unemployment, with particular concern that people may have dropped out of the labor market entirely, out of frustration. But even the broadest measure of unemployment has declined. That's the U6 measure, which takes into account people who aren't currently looking for a job but say they want one and people who are working part-time but would like to be full-time. That rate has dropped to 9.2 percent. While that's still higher than headline unemployment, it's worth noting that U6 peaked at about 17 percent during the worst of the recession and its aftermath.

Demand for labor also remains strong and more people are quitting their jobs. That's good news for the economy — it shows workers are more confident they can find another one — though I suppose some overworked HR managers might not be 100 percent thrilled about it.

Layoffs also remain at all-time lows and job postings are near historical peaks. We continue to hear from our business contacts that finding workers, especially in certain occupations, is getting progressively more difficult.

Taking all these factors into account, it's safe to call the U.S. labor market more or less at full health.

You'll note my previous remarks referred to the economy as a whole. Things aren't evenly distributed across this huge and diverse country. We're in Pennsylvania and things are different here. The state's unemployment rate has been higher than the national average, though it finally edged down in November, from 5.8 percent in October to 5.7 percent. That's the first decrease since January of last year.

Employment growth has been slower as well: While the country has experienced a rate of 1.7 percent in job growth, we've seen a rate of just 0.6 percent.

I point this out in part because this is when I get to praise the structure of the Federal Reserve System. I think it's uniquely American to have a decentralized central bank. To have a structure that makes policy for a huge and incredibly varied economy, but takes into account the differences between regions. We know that the economic fortunes of Camden don't look like those of Seattle. And when the FOMC comes together, the presidents of the 12 banks get to be a voice for their communities and businesses.

I also mention it because I'm interested to hear your take on the employment situation in the area and the state. How are you faring? Something I've heard over and over again from businesses of

all sizes is that they have the jobs; they just can't find the people. There seems to be a skills void that can't be filled by the existing workforce.

My staff recently conducted a study on what they call "opportunity occupations." These are jobs that pay at or above the national median income, but that don't require a traditional four-year degree. They make up close to 30 percent of the job market nationally. If we reconsider the way we are training people and further promote the occupations that require special skills, but not a traditional bachelor's degree, we can start to maximize the potential of our workforce. Let's stop trying to make post-secondary education "one-size-fits-all" when our job needs and workforce are so varied.

This is something that I think and talk a lot about. I'm a son of the district and an unapologetic cheerleader for it. I'm invested, not just as the president of the Philadelphia Fed, but as someone who sees the great potential of this region. I want to see us become a destination for business, and that means making the best use of our greatest resource: Our people.

I should be clear that I don't have the power to change any policy or enact any law that can bring that kind of investment. But I can make the economic case to the people who do. We need to attract talent, train the people we have, and make the tristate area a top destination, in part by offering a world-class workforce.

It's Peter Drucker 101: Play to your strengths. I always tell people that the best business advice I have is: Make yourself invaluable. I'd offer the same advice to any city or region looking to become a business destination.

Labor Force Participation Rate

I will also note that despite positive overall trends in the labor market, the participation rate is lower than I'd like.

The labor force participation rate is a fairly basic calculation. It divides the workforce — those employed plus those looking for work — by the population over the age of 16. That does not include people who've taken themselves out of the labor force.

The participation rate has been declining over the years, and it plummeted in the aftermath of the crisis and recession, which is what we would expect. Recessions cause dips in the participation rate, and it tends to rebound as the economy does. But over the past six years, the rate hasn't risen back up as much as we might have thought. We can explain a number of reasons for this, but later on I will talk of one trend that's something of a mystery.

A portion of the drop is that we simply can't meet historical surges. In the 60s and 70s, as women entered the workforce in greater numbers, the rate surged. But we no longer have a large, untapped portion of the population that can offer the same boost. So, we have to readjust expectations somewhat.

Another contributing factor is lifestyle fit: Fewer high school and college students are working while they're in school, and some people have decided that they're content to have single-income households.

Then there is the big one: Demographics. The initial wave of the baby boom generation has started to retire. As the boomers exit the workforce, they're not being replaced in the same numbers. Not to mention, we're living longer, so the share of people on the retirement end is even larger. This is the overwhelming factor affecting participation, and I'll return to it shortly.

First, however, the mystery of the missing prime-aged males: This very unfairly named group consists of men aged 25 to 54. For reasons that we're not quite sure of, their participation has been dropping. In 1954, the rate for all males was 98 percent, compared to 88 percent today.¹ This makes for one of the lowest participation rates for prime-age males among developed countries, and one of the most rapid declines.

Again, the impact has not been felt evenly. Among prime-age African-American men, the participation rate has fallen from 91 percent in 1972 — the oldest data available — to 80.3 percent today.

There are some troubling features of this decline among all men. The first is that dropping out seems to be a persistent state. The majority of men who report not working in any given month hadn't worked in the previous year either. The second is that this demographic, when working, adds to overall productivity, so the economy feels their loss when they are out of the workplace.

I do want to reiterate that the group we're talking about is men who are out of the labor force. For prime-age males *in* the workforce, the unemployment rate is low, and the U.S. fares a lot better than our counterparts.

As I said, we don't really know why this is happening to any degree of certainty. It could be that men participate in the workforce more intensively in their thirties and forties, so it's reasonable to assume the ageing population is playing a role. But when we analyze the data, it turns out that nonparticipation goes up as the age goes down. That is, the younger the age group, the more likely they are to be out of the workforce. The data also show that participation rates follow educational attainment.

The consequences for this group's lack of participation are severe, both for them and the economy. Around one-third of nonparticipants live below the federal poverty line. Most get by on government assistance or financial support from spouses or other family members.

¹ Council of Economic Advisors, June 2014. "The Long-Term Decline in Prime-Age Male Labor Force Participation," June 2014, available at www.whitehouse.gov/sites/default/files/page/files/20160620_cea_primeage_male_lfp.pdf (last accessed January 9, 2017).

For the rest of us, a lower participation rate all-around means lower productivity, which means lower growth.

It's essential to have a robust workforce. Research by my staff shows that, due to demographics and the retiring baby boomers, they don't think the low participation trend will reverse. In fact, they project labor force participation could drop up to 2 percentage points further over the next five years.² That's from where we stand now at 62.7 percent.

Monetary Policy

So, what does this all mean for monetary policy? After December's meeting, that makes a brisk average of one 25-basis-point hike per year for the last two years. But I see three modest hikes as appropriate for the coming year, assuming the economy stays on track. Fed policymakers enjoy saying we're data-dependent and this is an area where that rings especially true.

I've said it before, and it's worth repeating, that monetary policy is a fairly limited set of tools with a fairly limited reach. We will respond to changes in the economy with moves in the federal funds rate, and we can do a very good job of creating the conditions that are consistent with economic growth. But the kinds of policies that will deliver that growth — employment programs, development, taxation, and trade policy — is up to elected officials at the local, state, and national levels.

Conclusion

All in all, things are looking good. The labor market is strong and we're creating jobs at a good pace. The drop in labor force participation must be addressed, but that will take legislative action. Inflation is moving back up to our 2 percent goal, and growth is solid. We're starting 2017 off on a good foot.

² Fujita, Shigeru. "On the Causes of Declines in the Labor Force Participation Rate," *Research Rap Special Report*, Federal Reserve Bank of Philadelphia (February 2014), available at www.philadelphiafed.org/-/media/research-and-data/publications/research-rap/2014/on-the-causes-of-declines-in-the-labor-force-participation-rate.pdf?la=en.