Economic Outlook: The Labor Market, Rates, and the Balance Sheet

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Market News International (MNI)

Connect Roundtable

New York, NY

May 23, 2017

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President and Chief Executive Officer
Federal Reserve Bank of Philadelphia

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The views expressed today are my own and not necessarily those of the Federal Reserve System or the Federal Open Market Committee (FOMC).

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Good evening; it's a pleasure to be here.

Tonight, I'd like to give you an overview of my outlook for the economy going forward, including my preferences for the path of monetary policy. Which, I assume, is what you're expecting from me.

I also assume you expect the standard disclaimer, which I'll get out of the way immediately: The views I express here this evening are mine alone and do not necessarily reflect those of anyone else in the Federal Reserve System.

Economic Outlook

Let's jump right in.

Starting off, the advance estimate of first quarter GDP was that it grew only 0.7 percent. That's prompted a lot of concern, which I think is an overreaction. It's not a good idea to get caught up in a single data point, or report, or even a quarter's numbers. It's more important to look at underlying trends and what they say about the economy's trajectory in the medium term.

A slow first quarter isn't something to ignore entirely, but weak first quarters have been a feature of the economy for the past several years. It's essentially the norm now. Seasonality, weather, and low inventory investment were the main culprits this time, and those are likely transitory — they've been issues in the past, and they've retreated as the year wore on. So, it's not enough to make me think that we're headed in the wrong direction. It is enough to make me revise my growth projection down by 0.1 percentage point for the year, but that's about the extent of it. Overall, that means I see growth of about 2.3 percent for 2017.

Turning to the inflation side of our mandate, we're still on track. While numbers have retreated slightly, again, I'm looking at the trend. A month or two in the wrong direction isn't enough to make me lose faith.

On employment, things are looking very good. The unemployment rate has dropped to its lowest point in a decade, quits are up, and we're starting to see upward pressure on wages. I estimate 2.5 to 3 percent wage growth this year, which is good. It's what has been missing from this recovery.

I expect the unemployment rate to continue to edge down, dropping as low as 4.2 percent around the end of next year. As for job creation, I estimate a rate of about 200,000 a month on average for 2017, falling to about 100,000 a month by the end of 2019.

Here's another point I want to make about headlines making more waves than they should. In the relatively near future, we're not going to need the same pace of job creation as we did over the past several years. We had a lot of ground to make up for then, but we won't need the same rate going forward. Estimates vary, but somewhere between 70,000 and 100,000 a month is what many believe is appropriate to keep up with population growth.[1]

Ultimately, we're looking at a labor market with very little slack left.

In the near term, that means we should start to see movement on wage growth. In the medium term, it means we're going to be seeing a more moderate pace of job creation. In the longer term … it means a serious talk about the labor market.

Labor Force Participation

The labor force participation rate is still low. In the past couple of years, it's moved roughly sideways, which was an upward surprise to some, given demographic motivators. And it was a downward surprise to others who speculated that more people would start to come back off the sidelines as the recovery continued.

[1] See, for example, Daniel Aaronson, Scott A. Brave, and David Kelley, "Is There Still Slack in the Labor Market," *Chicago Fed Letter*, 359, Federal Reserve Bank of Chicago (2016).

I'm in the camp that says we're still projected to stay at a lower rate than previous years and that we won't see a reversal in that trend going forward. Research by my staff is clear that the fall in the labor force participation rate is mostly due to demographic factors.[2]

The most influential impact is coming from the first wave of baby boomers starting to retire. 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 contributing factors: students not working while they're in school, for instance. A shift in views on work–life balance that has more people making the tradeoff of a single-income household. And then there's the one that's received the most attention: the declining participation of the prime age male cohort. There are a lot of theories and research on where they've gone. Alan Krueger's much-talked-about recent paper found that close to half of the prime age men not in the labor force may have a serious health condition that keeps them from working.[3]

That said, there is some nuance to the prime age male conundrum. While the overall participation rate is low and there's no evidence that it will surge upward, there is some room for prime age men's participation to edge up a bit. The largest contributor to this group's nonparticipation in recent years has been disability. Which theoretically should be long-lasting or permanent. But my staff's research shows that at least some of that can be cyclical.

That, of course, will contribute marginally to the overall rate, although it won't give us the boost we need to keep up with growth.

If we look at the U.S. economy during the recovery, we can already see some effects of low participation. 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, and it's even slow by historical averages. Growth averaged 3.5 percent in the second half of the 20th century — 1.7 percent of that 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.

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

[3] Alan B. Krueger, "Where Have All the Workers Gone?" Princeton University and National Bureau of Economic Research (October 2016).

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 midcareer 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.[4] Even though millennials outnumber us, they aren't all fully in the workforce, and even the oldest ones aren't quite in their prime earning years.

With all those people in retirement and with people living longer, there are more economic pressures to contend with. And the consequence of a declining participation rate means that output per capita will grow more slowly.

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.

My remarks today will be heavy with caveats. The first being that as a Fed president, I'm not in the business of telling other people how to conduct their policy. So, the points I make today are from the perspective of someone who is affected — 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 fairly limited in its scope. The Fed's job is to create the conditions for a strong and healthy economy. Changing the trajectory of U.S. growth takes legislative action.

The fact is that this is basically it. This is the labor force we have. And if we expect our economy to expand, we need people to do the jobs we have now and the ones that are coming in the future.

Employers are struggling to fill the positions they have open. Even with workforce development and training programs, which are necessary, we just don't have the people. We need to close the

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

gap in the workforce. And given long-term demographic trends, that means we need to turn to outside sources.

Again, I want to be clear: I'm not suggesting immigration policy or telling anyone how to go about legislating. But from a purely economic standpoint, immigration, particularly high-skilled immigration, is a source of immense potential for economic growth. Fundamentally, we need more people; that's how we get more growth.

Monetary Policy

But let me talk about the policy that *is* within my purview.

First and foremost, based on the strong economic outlook, I continue to see three rate hikes for 2017 as appropriate. That, as ever, is assuming that things unfold in line with my projections.

Then there's the 800-pound gorilla in the room. Or, should I say, the $4.5 trillion gorilla in the room: the balance sheet.

I know everyone here has the specifics down, but for the benefit of anyone who might not, and for posterity's sake, a very quick primer on where we are and how we got here.

In normal times, the Fed holds mostly short-term treasuries. In extraordinary times, like in the recession and its aftermath, we've turned to unconventional policies, including QE. Which meant we were buying assets on a much larger scale and venturing into longer-term treasuries along with mortgage-backed securities. That swelled the balance sheet to $4.5 trillion, which is significantly larger than the $2 trillion it was when we started extraordinary monetary policy and the roughly $900 billion it was before the crisis.

Since we stopped the purchases, in late 2014, we've simply reinvested the proceedings as they've come to maturity to keep the balance sheet constant. The discussion now is how and when to begin unwinding those assets, and, to some extent, why.

The why part is easy: As the economy continues its march toward normal, we'll need to start removing accommodation. That's a point I want to emphasize. Monetary policy has been very accommodative for almost nine years. As we start the process of normalization, it's important to remember that tightening policy isn't the same thing as *tight* policy. We're talking about easing our foot off the proverbial gas — very slowly, I might add — we're not talking about applying the brakes.

We will still be holding a lot of assets, we'll still have rates that are historically very low, and the overall stance of monetary policy will still be very supportive of growth.

This is about recognizing that we're headed toward an economy at full health and that means we start hovering over the punch bowl again, just in case we need to take it away. We don't have our hands on it yet; we're just edging toward it in case the economy starts to look like it's overheating.

Another factor of the "why" is that we want our unconventional tools to be at their most effective. As productivity has dropped, it's taken the neutral funds rate with it, which means the zero lower bound is closer and we have less room for maneuver. That constricts the efficacy of using the fed funds rate. And if something were to happen, if another crisis were to occur, further asset purchases may prove less effective, or perhaps even more difficult to execute, with a large balance sheet still in place.

As for the "when" part, I'm going to disappoint the journalists in the room by saying that the timing isn't tied to a specific date or number. It's the same discussion we had about when to start raising rates: We don't want to get too far behind the curve on inflation and get forced into an abrupt or steep correction course that could cause market disruption. But we also don't want to commit to a course of action if the data were to start moving in the wrong direction. I do think we'll start sometime this year, but I'm not tying it to any numerical determinant, whether that's a decimal point on inflation or a day in the calendar.

The "how" is predictable, slow, and as boring as possible. There are different options under discussion, but we're looking for a normalization process that is gradual and essentially on autopilot. If something happens, of course we'll intervene, but we fundamentally want to push the start button and leave it to churn slowly away. We'll still discuss the balance sheet in meetings, but if things are good, we'll leave it to gradually unwind in the background.

And we'll let you know. I can say with absolute certainty that markets will get a heads up with a good amount of time.

I can also definitively say that it will be boring. It will be the policy equivalent of watching paint dry. Fed presidents had a brief encounter with people finding us interesting over the past few years. Now we're headed back to the natural state of things, where people try to avoid getting stuck next to us at dinner parties.

The funds rate will be our primary monetary policy tool, and we'll keep the unconventional ones in the arsenal in case we need to use them again, which I hope we won't.

So, that's it. I know I've probably disappointed some of you by not giving dates and times and the secrets of the chamber … although I'm sure you're going to ask me in Q&A anyway. And with that, I'll turn it over to you to do exactly that.

Thank you.