

An Economic Outlook

Temple University

Philadelphia, PA

February 28, 2017

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OF PHILADELPHIA

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

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Good afternoon. It's a pleasure to be here, and I want to thank everyone for coming, even those of you who are just trying to get out of class.

Today I'd like to talk about the economy as a whole, which I'm sure you expect of a Fed president. But I'd like to start with a refresher course on the Fed and what it is we do as well as a sort of monetary policy 101. That's not to assume no one knows what we do, although I'm often surprised at cocktail parties to hear how much power people think I have. I can't single-handedly move markets, although it's flattering people think so.

It's more to reset the wider conversation about where the U.S. economy is today, what challenges we're facing, and what can be done to really change its course. And, frankly, since I have a captive audience, I'm not missing an opportunity to talk to the next generation of potential Fed employees.

Before I begin, the first rule of the Fed club is: Don't talk about the Fed club until you've delivered the standard disclaimer — the views I express today are mine alone and do not necessarily reflect those of anyone else in the Federal Reserve System.

The Fed: Overview

First, the very basic overview. The Federal Reserve System is made up of 12 regional Banks across the country and a Board of Governors in Washington, D.C. I'm president of the

Philadelphia Fed, which covers eastern Pennsylvania, southern New Jersey, and Delaware. Each of the regional Banks is an independent entity, and we represent our Districts when we meet in D.C. to formulate monetary policy.

We do that roughly every six weeks at the Federal Open Market Committee, or FOMC, meetings. That's where we vote on monetary policy, which is now mostly about moving interest rates.

The governors always have a vote as does the president of the New York Fed. The rest of us rotate onto voting positions. I'm voting this year for the first time. I've noticed people care a lot more about what I have to say recently, which I'm sure is just a coincidence.

When we're not in a voting position, we're still part of the conversation. One of the benefits of the System is that we get to be the voices for the people in our regions.

The Federal Reserve has a dual mandate outlined by Congress: price stability and maximum employment. We also regulate banks, process payments, and conduct economic research.

And — the part that never gets enough attention, in my opinion — we do research and work in our communities to help strengthen local economies. We have an exceptional team in Philadelphia, and I'm not just saying that because they make me look good. We recently had Chair Yellen come with us to visit the West Philadelphia Skills Initiative, which connects unemployed people in the area with employers. The Philadelphia Fed's Community Development team works with organizations to promote stronger economies through everything from skills training to research on economic mobility. And they connect people and issues to the resources they need.

Different Banks also sometimes specialize in particular research areas. Obviously, Dallas does a lot on energy markets. New York has a special focus on international financial markets. In Philadelphia, our area of expertise is consumer credit: cards, household debt, student loans, etc.

So, that's the Fed overview. We do a lot of things other than monetary policy.

Monetary Policy: The Basics

That said, monetary policy is still the big one. And that's where I come — if you'll indulge me — to my second primer of the day: monetary policy 101.

Monetary policy is not the all-powerful tool it's often portrayed as. It's relatively limited in its scope, and it's a relatively blunt instrument. In normal times, monetary policy is mostly raising and lowering interest rates — or keeping them the same.

In extraordinary times, we may use tools like quantitative easing or forward guidance. But the majority of it is the somewhat boring business of keeping rates at a level that encourages a healthy economy and helps us meet our dual mandate.

Fiscal and other policy areas are where you'll find the decisions that really affect things like growth. The Fed creates the conditions in which a healthy economy can thrive. We till the land and make the soil fertile, if you will. But the actual thriving part — planting the seeds and tending the crops — are decisions beyond our control, which brings me to where we stand now in our role and our decisions.

The economy, overall, is in pretty good shape. After eight-plus long years of recovery, the economy is more or less back to full health.

We added 227,000 jobs in January, continuing a steady pace of employment. The unemployment rate stands at 4.8 percent, at or below my estimate of the natural rate.

I want to say here that when Fed policymakers talk about employment, we're doing it at a national level. I'm not blind to the realities on the ground, particularly in my own District. There are pockets here and around the country that have been left out of the rebound. There are demographics that have been persistently cut out of that good labor-market fortune. The unemployment rate for African American men, for example, was 8 percent in January.

We make policy at a national level, so we look at national averages. But we understand that there are areas that still need particular focus. It's part of the reason we, as presidents, make sure we feed back the realities on the ground in our Districts. Some of the issues we can help address through our community development work, but most of it is up to fiscal and other policy.

As for inflation, that's been a little more stubborn, but we're on track there as well. The myth about inflation is that the Fed is only concerned about it when it gets too high. In truth, we have a goal of 2 percent, and we worry about deviation in either direction. I don't mean we run around with our hair on fire if it's a little higher or a little lower once in a while. We're looking for an average over the medium term.

It surprises some people that the issue with inflation over the past few years is that it's been too low. That sounds odd to a lot of people, especially those of us who lived through the high inflation of the late '70s and early '80s. The students in the audience definitely won't remember that, and I think some of the faculty might even be too young.

In any event, we're starting to see upward movement on our goal, and I see inflation rising to meet our target sometime late this year or early next, which means that we're essentially at our goal.

Our job now is to maintain the land and keep conditions right for economic growth.

For our part, that's about how we manage interest rates. I see three hikes as appropriate for 2017, assuming things stay on track.

Growth

The growth part, however, is up to fiscal and other policy.

So, what really does move the economy?

And what problems are we actually facing?

I think it's safe to say there are a lot of opinions about both of those. And I hear most of them. Whether I like it or not ...

So, I'd like to cut through the noise.

With employment generally at our goal and inflation on track to meet it, the issue now is growth.

From an economic modeling standpoint, growth right now is more or less what we should consider normal. My forecast for 2017 is a touch above 2 percent.

If we want to move that needle, we need to address the underlying factors that are keeping it at its current rate.

Growth is fundamentally productivity plus growth of the labor force, and therein lie two of the bigger problems facing the American economy.

Productivity

I'll start with productivity. Productivity has been falling lately — not just in the U.S., incidentally, but globally. And to some extent, the reasons are a mystery.

There is one school of thought, popularized by the economist Robert Gordon, that productivity has been spurred throughout history by big, game-changing inventions. Think steam engine, electricity, the Internet. And that the only way we will see productivity on par with past surges is if some revolutionary new invention again changes the way we do business. Well, wait a minute. Doesn't the vast world of Internet-enabled work count? In this theory, not really. The explanation would be that in the first tech revolution, most of the innovation went to making businesses work more efficiently, letting them produce more with less. In this iteration, the majority of the disruption has been in areas of leisure rather than business. Some might even argue that the availability of such personal distractions has caused us to be less productive because we're more distracted.

This might sound terrifying because what else is there to invent? But in this view of the world, all isn't lost because we never really know when the next big revolution is around the corner.

I'm not personally dedicated to this theory. I think there are ways to increase productivity. But it's been a potent and interesting point of discussion.

The other question most often posed is whether we're measuring productivity correctly. With all the web-based business out there, is it even possible to measure output? Aren't we assessing productivity on an outdated scale?

The first thing I'll say is that productivity is notoriously difficult to measure. And the economy may be changing in ways that make it even harder. We have the best minds available working on this, but they fully admit it's difficult to keep up. For example, how do we include smartphone

apps that are downloadable for free in measures of output? Research at our Bank suggests that, even if we correct for this, it would only make a small difference in the rate of output growth. So, our best guess remains that productivity has slowed, while at the same time, there is widespread agreement that output and productivity are likely somewhat greater than we think. Welcome to the dismal science.

Labor Force Participation Rate

The second factor in the growth equation is the labor force.

There's been a lot of talk lately about the "real" or "hidden" unemployment rate. There is some thought that it might be significantly higher than the official numbers say.

To dig into this, I should outline a few measures of how we gauge the health of the labor market.

Some of it is what you hear frequently: U3 unemployment. You're all econ and finance majors, so you know that's the basic measure of the unemployed as a percentage of the labor force.

You're unemployed if you're looking for a job. If you've just graduated and you're on your first search, you're part of that number. If you're looking for work after some time off, you're part of it, too. If you've retired, if you're not working by choice, if you're taking a break, you're not considered unemployed. U3, as I said, is currently 4.8 percent.

You also know that the U6 measure is more involved. For the uninitiated, that one takes U3 and adds people who are working part-time but would like to be full-time, and people who say they'd like a job but stopped looking. U6 currently stands at 9.4 percent.

We also look at how many people are quitting their jobs, which reflects how confident they are that they'll find another. We look at how many net new jobs were created. We look at what we hear from businesses about how hard it is to fill positions, and a host of other information.

Then there is the labor force participation rate. This is where things get sticky.

The labor force participation rate is a measure of what proportion of the working-age population is either employed or looking for a job. It's easy to look at this and draw some unsettling conclusions, especially when I tell you that the labor force participation rate is currently 62.9 percent.

This is the number that alarms some people, but there's more to it than meets the eye.

First of all, we define the working-age population as everyone over the age of 16. So, that means your kid brother who's a junior in high school and my 92-year-old mother are both counted.

Second of all, we're dealing with a different population than we have in the past. The baby boomers represent the biggest generation in history to start moving into retirement, and we're living longer in general. I'm pretty pleased about the last one, frankly. Ultimately, the pool of people not seeking employment for very good reasons is much larger, skewing the overall number.

So, in the sense that low labor force participation points to an unemployment rate that is radically higher than official numbers suggest, that's not really the case.

It is, however, a problem. Just for different reasons.

The participation rate has been declining in recent years. There are a few factors that influence that. For one, people are staying in school longer, and many younger people aren't working while they're there. For another, some people have decided that they're happy with a one-income household, often reflecting preferences of work-life balance.

The third, as I mentioned, is that the baby boomers are heading into retirement. This is the big one.

I say this is the big one because research by my staff shows that the fall in the labor force participation rate is mostly due to demographic factors.¹

And since the vast majority of the decline comes from the onset of the baby boomers' retirement, they don'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.²

This is a big deal.

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

² Fujita.

It's a big deal because participation affects growth. As an example, if you look at the U.S. economy during the recovery, you'll see that after the bottom out in 2009, real GDP grew at an average of about 2 percent for the next six years. That's not just slow for a recovery; it's slow by historical averages. In comparison, in the second half of the 20th century, growth averaged 3.5 percent. A full 1.7 percent of that came just from the expansion of the American workforce. Over the course of the recovery, by contrast, the labor force has grown by an average of about 0.5 percent. That's less than half the historical average.

We also have to think about the economic pressures that demographics put on us as a country. With an unprecedented wave of Americans heading into retirement and living longer to boot, we're talking about a lot of resources. Social Security, Medicare, living expenses in general. While the millennial generation is slightly larger than the boomers, they're not yet fully in the workforce, and even the oldest of them still aren't in their prime earning years.

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.³

Declining participation equals shrinking output. That is, with fewer workers, the U.S. will produce less. When we produce less, growth stalls. Ultimately, successful and healthy economies have high participation rates.

Policy Possibilities

Now that I've scared the daylight out of everyone, can anything be done?

Again, the solutions to these problems lie in areas outside monetary policy. Since I know how it feels to have someone else comment on the job you're doing, let me be clear that I'm not telling elected officials what to do. I'm just a policy wonk with too much data on my hands, and I follow the numbers.

So, please take this next part as simply the analysis of an impartial, data-driven party.

³ James Feyrer, "[Demographics and Productivity](#)," *The Review of Economics and Statistics*, MIT Press, 89:1, February 2007, pp. 100–109.

As pertains to productivity and growth overall, investment in human and physical capital are vital; that is, education, science, health, and the infrastructure of our cities and towns. These help create a strong and diversified workforce and will help America keep its edge as a leader in innovation across sectors.

One of the areas we've focused on at the Philadelphia Fed is skills training and alternative routes to education and professional readiness.

The data show that there's a skills gap. There are jobs out there that can't be filled because people just don't have the right training. That's the big problem in many industries: They can't fill jobs because not enough people are trained to do them.

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 train people, especially for occupations that require special skills, 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.

On the participation side of things, we can only grow as fast as our workforce can take on the work. Right now, we just don't have the people, unless we want my mother and her friends to come out of retirement. But I'm pretty sure we'd have a fight on our hands ...

We need more bodies in the workforce. How and whether we make the decision to do something about it is again out of my hands. And I don't want to wade into turbulent political waters. But the bottom line is that we don't have enough people, and pulling talent in from outside the United States is one way to solve the problem.

Conclusion

The United States is and has been an economic powerhouse for most of the past century. We're the world's largest economy, and we have consistently been a source of innovation and invention. If we want to keep our global edge, it's time to think about broad policies that look to where we'll be in the future. When I was playing football, we ran where the ball was headed to

catch it; that's how we have to look at policy — monetary, fiscal, and other — not where we are on the field but where we're headed.

With that, I'm happy to turn the floor over to some questions.