

Trade and Training

European Economics and
Financial Centre
London, United Kingdom

June 27, 2017

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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 or the Federal Open Market Committee (FOMC).

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Good afternoon and thank you. It's a pleasure to be in London and a special pleasure to be standing in the truly beautiful Palace of Westminster.

People generally invite a Fed president to speak about the U.S. economy, and I certainly plan to oblige. So today, I'd like to start with an outlook and discussion of my view of the path of monetary policy. But I'd also like to address something that binds not just our two countries but nations across the globe: international trade.

I'm standing in a building that is steeped in history and tradition, from Black Rod and the Queen's Speech to the dragging of the Speaker in the House of Commons. So, I feel a need to honor that tradition by sharing one of our own. And while our history is obviously shorter in term than yours, this is nonetheless a time-honored Fed custom: the standard disclaimer that the views I express today are mine alone and do not necessarily reflect those of anyone else in the Federal Reserve System including my colleagues on the Federal Open Market Committee (FOMC).

U.S. Outlook

With that, I'll start off with a snapshot of the American economy.

Growth for 2017 so far is more or less what we expected. The first quarter was relatively weak, which has been the case for first quarters over the past several years. That's what we've come to expect at this point, so it's not cause for alarm. This year's 1.2 percent Q1 growth was influenced by factors I believe are transient, like weather, seasonality, and low inventory investment. I

expect second quarter growth to rebound and overall GDP growth for 2017 to average about 2.3 percent.

I'm aware of the pitfalls of economic forecasting — I believe the old maxim is that economists are people who will know tomorrow why the things they predicted yesterday didn't happen today. But I'll tempt fate by saying that I predict growth of just above 2 percent for 2018 and 2019. That's assuming that things unfold the way they have been. And if things do continue on their current path, that's frankly the rate of growth we should consider normal in the U.S.

Inflation has been a hot topic of conversation recently. The latest PCE numbers are from April, which show a downtick in both headline and core inflation, to 1.7 and 1.5 percent year-on-year, respectively. That was the second report in a row that had PCE heading in the wrong direction. Coupled with the most recent CPI data for May, which makes for the third of those reports to trend downward, it's prompted a lot of questions for Fed policymakers. Will soft inflation data derail our normalization plans?

I make this point frequently, but policymakers are wont to be repetitive, so I'll make it again. It's a mistake to get caught up in a single decimal point, report, or even a quarter's worth of data. The importance lies in underlying trends, and, in the case of inflation, I've seen the factors exerting downward pressure as temporary. That said, the Fed is data dependent, and, as information comes in, there's the possibility that those transitory factors may be less transitory than we thought.

For the meantime, therefore, I'm sticking to my outlook that we're on the right path, but I'm adjusting my view slightly on meeting our inflation goal from the end of 2017 to the beginning of 2018. This is the advanced economic practice of "hedging one's bets."

As for the labor market, I see very little slack left. The most recent data show an unemployment rate of 4.3 percent, the lowest the U.S. has seen in 16 years. That's either at or below the natural rate and reflects a steady tightening over the course of the expansion. I see that rate edging down even further over the course of the next couple of years before moving a few tenths of a percentage point back up again.

Job creation remains strong, and you can see clearly in the JOLTS data that openings and quits continue to indicate a fairly tight market. I think we'll see an average of about 190,000 jobs a month for this year, which should fall to about 100,000 jobs a month by the end of 2019. Many headlines and commentators have responded to any month of job creation below 200,000 with, in my opinion, overreaction; much of the narrative around May's 138,000 number was anguished. But it was a good number for where we are right now. As we move forward on a downward glide path over the next couple of years, eventually reaching a pace of about 100,000 jobs a month, we should remember: That's going to be more than adequate to keep pace with population growth.

An area I have been hoping to see more improvement in is wage growth, and we're finally starting to see some upward pressure. I see wage growth of about 2.5 to 3 percent this year, which is very welcome.

Based on the strength of the economy, therefore, I still support the continued gradual removal of accommodation.

I still see another rate hike as appropriate for 2017, having already implemented two this year.

And we've recently announced the plan to unwind our \$4.5 trillion balance sheet. We debated a number of options but ultimately decided on a reduction of reinvestment in both Treasuries and mortgage-backed securities. It will start off slowly, build gradual momentum, and begin sometime this year — though I don't want to tie that to a date in the calendar or a rung on the inflation ladder. It will be predictable to the point of boredom; we will communicate our intentions clearly, with a good amount of lead time; and once the process commences, it will be essentially on autopilot.

The caveat, of course, is that this is dependent on things continuing to unfold as they have been. To adopt an adage from my host country this evening, policymakers agree with Macmillan on what we're wary of: "Events, dear boy, events."

Those events can take many forms, and, in the years following the financial crisis and subsequent recession in most of the world, we were reminded that sometimes they come from outside our own borders. I'm aware that the U.S. in some cases is more resilient; we're the ones who give the world the proverbial cold when we sneeze. But we're not immune. All our

economies have become more and more intertwined, and the discussion of national economics is now also a discussion of global economics.

Trade Gains: The Classics

The fact is that all advanced economies rely on trade. It makes simple economic sense for nations to use their comparative advantages, focusing on goods that are relatively cheap for them to produce and importing those that are relatively expensive to make at home. International trade allows countries to focus on what they're good at, rather than spending valuable time and resources attempting to produce *every* good they need.¹ International trade also addresses cyclical ups and downs, letting countries borrow in the lean times and build nest eggs in the boom ones.

More importantly, many countries would fail to be completely self-sustaining, owing to the simple limitations of natural and other resources. But even a country like the United States, which covers enough diverse territory with multiple resources to source most of what we need, relies on trade, because our economy depends on selling to our partners.

Then there is the overwhelming body of work arguing that trade fosters peace and cooperation. I don't believe I'm allowed to deliver a speech in the United Kingdom without mentioning the great Adam Smith, so here's my reference: From Adam Smith's view of mutually beneficial trade relationships fostering harmony to Bastiat's positing that trading nations will avoid war with one another, the idea that peace is wrought by intertwined economic fortunes is a well-established principle of economic thought.

The Production Chain Conundrum

That, however, is the philosophical, borne out by data as it may be. From the practical side, there is the reality that many supply chains have become as intertwined as global economies. Products whose provenance is a single country no longer make up the entirety of trade. A tractor, for instance, may be made out of raw materials shipped from Asia to South America for processing,

¹ David Ricardo, *On the Principles of Political Economy and Taxation*. John Murray, Albemarle-Street (1817), print.

then to North America to make the frame, then *back* to South America for finishing touches, then back to North America for sale, some domestically and some via the export market.

While this is an extensive chain of custody for any one product, it's generally done for efficiency's sake, utilizing countries' expertise and saving businesses money while delivering quality.² It makes sense and benefits all parties involved.

But this kind of global production is particularly sensitive to trade protection because every time that tractor's parts cross a border, they face a potential tariff.

Here I will tread with extreme caution — I'm not in the business of dispensing advice to other policymakers, and I'm definitely not weighing in on trade policy for the U.S. or any other nation. From a purely economic perspective, however, our economies have become too integrated with one another to turn back. Trade on this level is unlikely to disappear — on the contrary, it's likely to increase — and that means even modest tariffs, if they are applied several times over to the same production chain, would be enough to disrupt a host of industries.

Trade's Influence on Growth and Income

That would be a disservice to everyone, because trade is a net positive both on a national and individual level. Research shows that a 10 percent increase in trade is associated with a 5 percent increase in income per capita.³ Likewise, doubling a country's trade share can lead to an increase in GDP of an estimated 25 percent over the span of a decade.

History chronicles trade's effects. Economic development from 1800 to 1980 saw a steady rise in global inequality precisely because only developed economies were open to trade. When previously closed economies subsequently opened up, the trend was reversed.⁴ China is just one

² David Hummels, Jun Ishii, and Kei-Mu Yi, "The Nature and Growth of Vertical Specialization in World Trade," *Journal of International Economics*, 54:1 (June 2001), pp. 75–96.

³ James Feyrer, "Trade and Income — Exploiting Time Series in Geography," National Bureau of Economic Research Working Paper 14910 (2009).

⁴ David Dollar and Aart Kraay, "Trade, Growth, and Poverty," *Economic Journal*, 114:493 (February 2004), pp. F22–F49.

— but perhaps the most discussed — example of how trade can rapidly reverse economic fates. Korea is another example, as are, increasingly, Vietnam and the Philippines.

Ultimately, international trade has helped mitigate global poverty: Although the world's population grew by 1.6 billion between 1980 and 2000, the number of people living in extreme poverty actually declined by up to 200 million.⁵ While trade can't take all the credit for that shift, it certainly played a role.⁶

Harm over Help?

If trade's benefits are so overwhelmingly positive, why has there been such animosity toward it? I think there are two reasons: First, there are common myths attached to trade and its effects. Second, there are, in fact, losers in the trade game, which is something we should take seriously.

One of the arguments against trade is the belief that low-wage countries unfairly compete against mature economies. Some believe this delivers the double blow of taking jobs away from developed countries while simultaneously allowing advanced economies to exploit their less developed counterparts.

A more accurate depiction is that low wages go hand in hand with lower productivity, meaning less developed economies do not, on the whole, have an edge. Additionally, as trade in these goods shifts, it frees up resources in more developed economies, letting them concentrate on more specialized goods made by skilled workers, who, in turn, earn higher wages.

As for lower wage countries, the simple math is that, without trade, those wages would be even lower.

The Costs of Trade

That said, there are people who feel the downside of global trade more acutely than others.

⁵ "Poverty," World Bank, n.d., <http://data.worldbank.org/topic/poverty> (accessed September 27, 2016).

⁶ Matthias Busse and Jens Koeniger, "Trade and Economic Growth: A Re-examination of the Empirical Evidence," *Economics Bulletin*, 35:4, (2015), pp. 2862–2876.

Trade, on the whole, is a benefit. It makes products cheaper, including necessities like food, and countries tend to reap the rewards on a macro level.

But the many who benefit don't do so in a life-altering way; we aren't moved by a price change of a few dollars or cents in our everyday purchases. In the case of the United States, the relatively abundant supply of skilled workers benefit, while the unskilled portion of the labor force can, in fact, lose out to competition from abroad.

The rewards are reaped in breadth, spread among the 320-plus million people who live in the U.S. Those who suffer, however, do so on a profound level. Entire industries and the populations that depend on them are affected. Those effects are big and are taken on by a small number of people, increasing their burden.

There are a lot of reasons jobs in certain sectors have disappeared. Automation, changes in market preferences, and other factors have contributed to industry shifts. So, while trade does have real effects for some workers, much of the debate is muddied by the multiple contributors.

So, what can we do to help the people who've been negatively affected?

A Skilled Workforce

Again, there isn't much that can be done to stop the trade train. The natural state of the human condition is to search for not just subsistence but for substance, and opening the door to trade generally makes things better, faster, and more affordable.

But we have to do something to help those who are displaced or disadvantaged. This is something of a conundrum with a labor market with so little slack left. We've reached a point where the competition is among employers vying for candidates rather than applicants vying for jobs. While there's some debate on the subject of the skills mismatch, research by my staff shows this is absolutely an issue. And while I know that the plural of "anecdote" isn't "data," it's definitely something I'm hearing from the business community across my District. A businessman I know has doubled the bays for his trucking repair business to keep up with demand, but half of them are empty because he can't find qualified mechanics. He's paying salaries of over \$100,000 a year, but he can't fill the jobs. That's because trucking repair doesn't

just involve basic maintenance anymore; it requires digital skills. It reflects what we're consistently seeing: There are jobs but not enough people with the right training.

I'm using examples from my District, but we're seeing examples across the country. I should note that the Federal Reserve System is made up of 12 regional Banks in Districts across the country, along with the Board of Governors in Washington, D.C. My District is the smallest, comprising about two-thirds of Pennsylvania, southern New Jersey, and all of Delaware. In total, that's a little less than half of the United Kingdom.⁷ So, small for the U.S., but not insignificant by any means. And it's made up of multiple and diverse economies from postindustrial to rural, urban to suburban.

One solution to the skills gap is obviously training programs and more investment in practical education. My staff recently completed a guide to apprenticeships in our area to provide private sector organizations with information on how they can get involved. This is a good start, and the more research and data the better. But there also needs to be a cultural shift. At some point, vocational education took on a negative connotation, and that's a problem. Education shouldn't be one-size-fits-all. Not everyone wants or needs — or frankly should — take the traditional university route.

More research by my staff identified what they're calling “opportunity occupations,” jobs that pay at or above the median wage but don't require a traditional four-year degree. If we can be more strategic about the way we train our rising and existing workforce, we can benefit both workers and employers.

We can't guarantee that every industry will be immune to whatever creative destruction comes its way. But we can instill a culture that prizes training and is therefore better able to adapt to change.

Again, I'm not telling anyone how to legislate. My only job is to offer data and economic reality.

⁷ Robert Feenstra and Gordon Hanson, “Global Production Sharing and Rising Inequality: A Survey of Trade and Wages,” National Bureau of Economic Research Working Paper 8372 (2001).

That reality is that trade is not a zero sum game; a win for one country is not a loss for another. Rather, it is a contribution to a global market that ebbs and flows in an overall benefit to everyone.

And international trade is an overall positive. There is nothing in this world that is without risks, and no progress comes without paradigm shifts. But we have it in our power to take those shifts and turn them to our advantage by thinking of new — and reprising old — ways of adapting to change.

Thank you.