CHAPTER FOURTEEN

US Economic Conditions and Monetary Policy Considerations

Robert S. Kaplan

Thank you for inviting me. Congratulations to John Cochrane and John Taylor on this conference.

One of the main reasons I came to the Fed was because I thought "normalization" of monetary policy was going to be very challenging. As difficult as the crisis was, it has been my view that normalization would be as or more challenging. I think this conference and today's debate reinforce that view. While we have talked about normalizing the federal funds rate, how we deal with the balance sheet is going to be just as important. With that background, I'm going to talk about some of the challenges I see in the US economy and then address four or five points which pertain to the key themes of this conference. I look forward to expanding on these points in the Q&A.

So, let me start with my view of the economy. While the near-term outlook for the US economy is very positive, and we're making very good progress in meeting our dual-mandate objectives of full employment and price stability, I think the medium-term picture is much more challenging. Dallas Fed economists expect US gross domestic product (GDP) growth to be strong in 2018, but we also expect growth to moderate in 2019 and by 2020. It is our forecast that GDP growth in the United States will ultimately drift down toward "potential" of somewhere between 1¾ and 2 percent by 2020.

Why do we expect this move down to potential? Why is potential growth so low? There are four key structural drivers that are critical to this analysis. While the news and the press headlines tend to be focused on the shorter-term cyclical developments and the near-term growth of the US economy, these structural drivers get far less attention. But I believe they are much more important to understanding the situation we're facing.

KEY STRUCTURAL DRIVERS

Aging Population

The first structural driver is the aging population in the United States, which translates into slowing workforce growth. We've made much of the fact that the labor force participation rate has declined from 66 percent in 2007 to approximately 62.8 percent today, and it's our view at the Dallas Fed that this participation rate will decline below 61 percent over the next ten years.[1] While we're very hopeful that discouraged workers and other workers on the sideline may come into the workforce, we don't think there's going to be a magic bullet to offset this inexorable trend of slowing workforce growth due to aging demographics. This trend has a substantial impact on GDP growth. It certainly should have profound impacts on how we think about updating our immigration policies as well as other policies which affect workforce growth. GDP growth is made up of growth in the workforce plus growth in productivity—and, based on demographics, we believe growth in the workforce is going to be sluggish.

1. Bureau of Labor Statistics, April 2018.

Technology-Enabled Disruption and Its Implications for Education and Skill Levels

The second structural issue relates to productivity. It is our view at the Dallas Fed that, while technological advances and increases in overall capital spending should help improve productivity in a variety of industries in the United States, we are concerned that lagging educational achievement and skill levels will mute these gains for the US workforce. In particular, we note that approximately 46 million workers in this country (age twenty-five and over) have a high school education or less.[2] In terms of the talent pipeline, we note that US students are lagging in terms of math, science, and reading skills. We rank twenty-fourth out of thirty-five OECD (Organization for Economic Cooperation and Development) countries in terms of math, science, and reading skills among fifteen-year-olds.[3]

While we're improving middle-skills training in the United States, we are not improving fast enough to keep up with the skills needs of employers. This may help explain why approximately half of all small businesses in the United States report they are unable to find enough "qualified" workers to fill open positions.[4]

While companies and industries are improving their productivity (and profitability), overall workforce productivity growth has been sluggish. It is our hypothesis at the Dallas Fed that this could be at least partially explained by lagging educational achievement and insufficient progress in ramping up skills training to meet the "skills gap" in our economy. Specifically, if you're one of those

2. Ibid.

3. According to the Program for International Student Assessment (2015) by the Organization for Economic Cooperation and Development (OECD), the United States ranks nineteenth in science, twentieth in reading, and thirty-first in mathematics out of thirty-five OECD countries. An average of scores across the three categories places the United States twenty-fourth.

4. National Federation of Independent Business.

46 million workers who has a high school education or less, it's likely you're seeing your job either restructured or eliminated. In a good job market, you'll likely find another job. But, unless you get retrained—easy to say, harder to do in practice—it's likely that you will go to a job where your productivity is lower. Because we measure productivity workforce-wide, it's our concern that lagging educational levels as well as lagging skill levels are not improving sufficiently to keep up with the changing workforce needs created by technology-enabled disruption. As a result of these human capital issues, I am concerned that productivity growth is going to remain sluggish.

Potentially Unsustainable Path of Government Debt to GDP

The third structural issue is the expected path of government debt to GDP. I think this path is likely to be unsustainable. US government debt held by the public is now 77 percent of GDP.[5] The present value of unfunded entitlements is now $54 trillion.[6] This high level of indebtedness will likely squeeze out the opportunity for fiscal policy in the next downturn, and it may, depending on how it's managed, create other headwinds for economic growth in the future.

Globalization

The last big structural trend is globalization. Of course, the trend toward globalization has been going on for most of our lives. We

5. US Department of the Treasury and Bureau of Economic Analysis as of first quarter 2018.

6. "The 2018 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds," US Social Security Administration, June 5, 2018; "The 2018 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds," Centers for Medicare and Medicaid Services, June 5, 2018.

know that financial flows and our economies are much more integrated, and global competitiveness is more important, than ever before. The issue is how we handle this trend—is it a threat, or is it an opportunity? I will put forward the view that while trade and immigration may have been threats to jobs in the United States fifteen years ago, today they are more likely to be opportunities for growth at a time when we need to grow faster in order to service government debt and entitlement obligations.

The development of integrated supply-chain and logistical arrangements with Mexico is an example of how trade may help improve US jobs and competiveness. While the North American Free Trade Agreement (NAFTA) needs to be modernized, our research at the Dallas Fed indicates that in excess of 70 percent of US imports from Mexico are "intermediate goods"—that is, part of complex logistical and supply-chain arrangements that our research shows help the United States and North America take share from Asia.[7] Our research indicates that these arrangements improve our competitiveness and add jobs in the United States which might otherwise be lost to other regions of the world.

In addition, while other countries, particularly China, are making dramatic investments (and maybe overinvestments) in improving their education, their infrastructure, and their technology, America appears to be lagging in terms of making these investments—particularly in education and infrastructure. We have to be concerned that unless policy makers make the right decisions on globalization and make key investments in improving our global capabilities, we will in fact lose global competitiveness in the United States, even though the short-term prospects for GDP growth look good.

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7. Jesus Cañas, Aldo Heffner, and Jorge Herrera Hernández, "Intra-Industry Trade with Mexico May Aid U.S. Global Competitiveness," *Southwest Economy*, Federal Reserve Bank of Dallas, second quarter 2017, accessed August 10, 2018, www.dallasfed.org/~/media/documents/research/swe/2017/swe1702b.pdf.

IMPLICATIONS

So, these are four key forces that we closely monitor at the Dallas Fed. Of course, policy solutions to deal with many of these structural drivers are outside the control, to a great extent, of the Federal Reserve. However, how these drivers are managed is going to play a key role in how well we are able to meet our dual-mandate objectives of full employment and price stability. These forces may help explain why potential GDP growth is only 1¾ to 2 percent. These sluggish medium-term and longer-term growth expectations may help explain why the yield curve has been flattening and why the expectations for the longer-run federal funds rate by Federal Open Market Committee (FOMC) participants have declined substantially in the Fed's Summary of Economic Projections from 2012 through today. This may also help explain why forecasts for r-star are historically low.

As John Williams said at lunch today, a lower r-star means there's less room for the FOMC to deal with the next downturn or the next shock. As most of you who've heard me speak before have heard me say, I believe the Fed should be gradually removing accommodation, moving toward a neutral stance in monetary policy, and I do believe we should be gradually reducing our balance sheet. However, due to the structural drivers discussed here, I think the path of rate hikes is likely to be much flatter than we've historically been accustomed. More important for the subject of this conference, I think, in the next downturn there's likely to be less capacity for fiscal stimulus, which means that the Fed may well need more tools beyond the federal funds rate in order to address economic conditions in that scenario.

THE FED BALANCE SHEET

With that backdrop, let me just address three or four points pertaining to the Fed's balance sheet. Point number one, I was very struck by Charlie Plosser's paper on the use of the Fed balance sheet and the risks of having a large balance sheet.[8] I was particularly struck by the thought that the willingness of the Fed to use its balance sheet might be having an effect on fiscal policy, i.e., may be leading to a lack of discipline in fiscal policy. This is a jarring issue to consider, and I think it *should* be considered.

The second point I want to address relates to Peter Fisher's comments about whether we should be "presuming" that the Fed will use quantitative easing in the next downturn. My own view is that, as we've said in our policy normalization principles and plans, the Fed should be prepared to consider using a full range of tools in the next downturn, including making use of the balance sheet. This conference is raising a question about whether we should be more fully debating this thinking. I think this is a healthy debate.

I also agree with John Williams that, in addition to our normal conversations at FOMC meetings, we should be doing a periodic strategic review of our frameworks and our approaches. I think the issues debated at this conference fall into this strategic review. I think it is very healthy to debate these questions. They need to be debated, and as a member of the FOMC, I would welcome the discussion.

Lastly, I feel very strongly that the Fed needs to continue making demonstrable progress in reducing its balance sheet. I think this progress gives us operating flexibility so that, in the event of an economic shock or downturn, we at least have the option of deciding whether and how to use the balance sheet. I think the country

8. Charles I. Plosser, "The Risks of a Fed Balance Sheet Unconstrained by Monetary Policy," Economics Working Paper no. 17102, Hoover Institution, Stanford University, Palo Alto, CA, May 4, 2017.

is well served by the Fed having a wide range of tools beyond the federal funds rate.

I believe that, over time, it would be preferable for the Fed to have a balance sheet primarily comprised of Treasury securities. I am struck by the argument that the Fed being a large owner of mortgage-backed securities made sense during the crisis. However, it is a legitimate question as to whether, at this point, it makes sense for the Fed to have such significant influence on housing policy.

In addition, I think the balance sheet issue and the low r-star issues are related, and we would also be well served by a broad discussion of whether some type of price-level or nominal GDP targeting is appropriate. In this regard, I would particularly look forward to a discussion of nominal GDP targeting. I'm not sold yet on this approach, but I do feel strongly that a broad policy debate on these issues would be healthy and advisable. My colleague Evan Koenig of the Dallas Fed has done substantial work on the subject of nominal GDP targeting and the wisdom of making greater use of this approach in monetary policy.[9] The debate on nominal GDP targeting may affect how we think about the appropriate size of the Fed balance sheet and how we might use the balance sheet in a future downturn.

MACROPRUDENTIAL POLICY CONSIDERATIONS

Macroprudential policy is also an element of these considerations. I believe that the extraordinary policies implemented by the Fed in response to the Great Recession—various rounds of quantitative easing—were necessary because we had a severe financial crisis and we had severe financial instability. So, with that in mind, I'm

9. See Evan F. Koenig, "Like a Good Neighbor: Monetary Policy, Financial Stability, and the Distribution of Risk," *International Journal of Central Banking* 9, no. 2 (June 2013): 57–82. Also see Evan F. Koenig, "All in the Family: The Close Connection Between Nominal-GDP Targeting and the Taylor Rule," Staff Papers, Federal Reserve Bank of Dallas, no. 17 (March 2012).

particularly attuned to our policies in place today, to make sure we don't have this type of financial crisis in the future. In this regard, I think we've been extremely well served over the last eight or nine years by having very tough capital requirements and rigorous stress testing for large, systemically important financial institutions. As we look to find ways, which I favor, to tailor requirements for small to midsize banks, I would be very concerned if we went too far in relaxing capital standards and stress-testing approaches for large, systemically risky institutions. I think the economy has been very well served, and I think it will continue to be well served, by having very tough requirements for large financial institutions.

In addition, as we think about the next crisis and financial instability, I am very concerned about the shadow financial system. In particular, we need to be cognizant of excess debt buildup, possibly in the form of derivatives and volatility-targeting strategies and other forms of risk-parity investing. I'm concerned that visibility into these areas is poor. It's not that we don't have data—it's that derivatives are netted, and sometimes, as we learned in the first two weeks of February, it's difficult to realize how much leverage is out there until you have a stress event. The volume of short "put" positions may not look excessive until you have a stress event. What happened in early February, I would hope, is a healthy warning to us that we probably need more oversight. While the Fed does not regulate or oversee nonbank financials, I hope that we and other agencies try to gain better visibility in these areas. I'm concerned that the next crisis will likely come from embedded leverage that is not visible to us, à la credit default swaps and other put-like structures. So I hope there is stronger oversight and monitoring of the shadow financial system—e.g., the nonbank financials.