Unlocking Our Potential

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Thank you for inviting me to speak with you this morning. Since I joined the Fed in January, I've been traveling throughout our district, which extends from Maryland to South Carolina and also includes most of West Virginia, to talk with the people who live and work here. This is my first trip to the Roanoke Valley, and I look forward to coming back.

I came to Richmond after a 30-year career in consulting at McKinsey, where I served as chief financial officer, chief risk officer and led our offices in the Southeast. So while I'm new to "economics" in the sense that I don't have a Ph.D., I'm not new to the economy. I've spent my professional life helping firms make decisions about hiring, compensation and prices, and I've made a lot of those decisions myself. (I'm also not new to the Fed; I served on the Atlanta Fed's board from 2009 to 2014, including two years as chair.)

My colleagues on the Federal Open Market Committee (FOMC) are some of the most talented macroeconomists, bankers, academics and financial regulators in the country. But as the only committee member coming from management, I hope I can bring a different perspective. This morning, I'll share some of that perspective with you. I'll start with what I'm seeing in the economy *today*. Then I'll look forward to *tomorrow*, including some key questions I'm wrestling with. And then I'll be glad to take your questions.

Before I say more, I have to note that the views I express are my own and don't represent those of the FOMC or the Federal Reserve System.[1]

Today

GDP Growth

In the 1970s, economist Arthur Okun invented the Misery Index, the sum of the inflation and unemployment rates. At its peak in 1980, the index was almost 22 percent. Today, it's about 6 percent. The economy is strong.

What’s contributing to that? Let’s start with growth. Real GDP grew at about 2.6 percent last year and topped 4 percent in the second quarter of this year. Underlying that growth, in my view, is confidence. Small business optimism is historically high, and the University of Michigan’s Index of Consumer Sentiment is as high as it’s been since the early 2000s. We’ve had fiscal stimulus in the form of tax cuts and the omnibus bill. There’s a sense that we’re in a deregulatory moment. People have jobs, and the markets are strong. Overall, it’s starting to feel like we’ve got some tailwinds rather than headwinds.

That said, I’m with the Fed now, so I have to be cautious. And certainly, tariff concerns are making people more nervous than they did a few months ago. In the Michigan Survey, the number of households that mentioned tariff concerns has more than doubled since May. In another survey conducted by the Conference Board, we’re seeing a large gap open up between people’s perceptions of today and their expectations for tomorrow. We’ve also got supply chain constraints, geopolitical instability, market volatility and the potential effects of higher interest rates.

At least for now, though, businesses and consumers seem to be looking through these risks. Many people are forecasting growth in the high 2s, or even 3 percent, for the remainder of the year.

Labor Markets

One reason they're doing so is the strength of the labor market. The economy has added an average of more than 200,000 jobs per month since the start of the year. That's a very large number; for perspective, the "breakeven" to keep up with our country's population growth is around 80,000 – 100,000 jobs per month. Strong job growth has contributed to unemployment below 4 percent, in the range of our lowest levels since the late 1960s. At the same time, companies still want to hire — at 4.3 percent, the job vacancy rate is higher than the unemployment rate and about the highest it's been since the Bureau of Labor Statistics started tracking the data in 2000. Vacancies are especially high in fields such as nursing, skilled trades and truck driving.

In short, the labor market is really tight. And we all were taught that when the labor market is tight, companies raise wages. To date, however, wage growth has been modest. Why? One thing I've been hearing is that companies don't think, from a competitive standpoint, that they can raise prices or capture enough productivity to compensate for higher wages. So they're trying different strategies, such as outsourcing and offshoring, retraining existing employees or just delaying filling jobs. Some firms are also expanding their hiring pool; for example, I spoke with one firm that's relaxed its view on hiring people with criminal records.

In addition, until recently, turnover hadn't escalated significantly, perhaps because employees were still experiencing a "hangover" from the Great Recession that reduced their confidence in switching jobs for a modest pay increase. This is a trend I'm watching closely, because until turnover becomes a consistent issue, businesses are unlikely to give the significant across-the-board wage increases that drive significant moves in overall wages.

We're also hearing increasingly about businesses finding innovative ways to give workers more nonwage compensation — everything from flexible work hours to culture improvement efforts to one contact who has started beer cart Fridays. (As an aside, beer cart Fridays are often seen as a leading negative economic indicator.) Of course, these practices aren't all free, but it's possible employers have found that, at least for now, such benefits are a less costly way than direct compensation to increase employee satisfaction and reduce turnover.

Inflation and Monetary Policy

Let's turn to inflation. We're coming off a fairly long stretch where inflation ran below the Fed's 2 percent target. The numbers have firmed around our target in recent months, but it's reasonable to ask why we're not seeing more inflation, given not only the tightness of the labor market, but also commodity cost pressure in places like pulp, steel and oil.

Part of the answer, as I mentioned, is that many firms don't think they can pass on higher costs to consumers. There are a number of reasons for this, including the buying power of big-box retailers, the price transparency provided by the internet and competition from lower-priced imports. Another factor keeping inflation in check is that people believe the Fed is going to keep inflation in check. The 1970s taught us that inflation expectations play a large role in determining future inflation. Currently, multiple measures of inflation expectations are holding steady in line with the Fed’s 2 percent target.

So now I imagine you’re wondering, is the FOMC going to keep raising rates? And if yes, how far and how fast? I’m not going to tell you — and in fact, we don’t know yet, because it will depend on incoming data. But I can tell you about the underlying thinking.

The case for further gradual rate increases goes like this: Although the FOMC has begun raising interest rates, they are not yet back to normal levels. It is difficult to argue that lower than normal rates are appropriate when unemployment is low and inflation is effectively at the Fed’s target. In addition, we don’t want to risk the credibility of our commitment to low and stable inflation. That means when the economy calls for moving back to normal levels, as do the conditions I just described, we should follow through. Given the strength of the underlying economy and the recent additional fiscal stimulus, the risk of normalization is reduced. How high rates will ultimately need to rise depends on economic growth: The higher the underlying growth prospects, the higher the policy rate — which brings me to the topic of tomorrow.

Tomorrow

In my former life as a consultant, it was my job to find opportunities for improvement. So let me do a bit of that now. Despite the fairly rosy picture I just painted, I'm concerned about our economy's ability to keep growing. That's because the math of growth is pretty simple: We need more people to work, and/or we need them to be more productive.

The Labor Force and Productivity

The first thing to look at, then, is the labor force — and if current trends continue, it's going to grow slowly. Population growth has been slow, around 0.7 percent per year, and the Census Bureau projects it will slow even more in the future. (It's not just us; fertility rates have fallen in nearly every developed country.) In addition, since the 1990s, immigration has contributed about half of the growth in the working-age population. But that seems unlikely to continue in the present environment. Also, labor force participation (percent working or looking for work) has been trending down, and it’s projected to fall further as my generation retires. Our Richmond team estimates a 2 percentage point drop over the next five years based on demographics alone. It’s a challenge facing the greater Roanoke Valley: For every 100 people of working age in the area, there are 31 people of retirement age or older. That’s in contrast to Richmond, where there are 24 per 100 working-age people. (To be clear, my recent retirement from McKinsey isn’t included in the Richmond numbers.)

So labor force growth requires tackling the many labor segments operating under their full potential. For example, there’s a large divide between urban and rural areas; here in Virginia the employment-to-population ratio among working-age adults is about six points higher in urban areas than in rural areas. People in rural areas often don’t have the same opportunities as people in urban areas. I’ve seen it as I’ve traveled around the district, including driving here today; it’s striking how quickly things change as you leave the city. The textbook economics answer would be that people should move to the cities, but there are many valid reasons why people don’t want to, or can’t, relocate.

At the same time, there are divides within cities. Roanoke’s downtown revitalization has been remarkable: The city itself is attracting young people, there’s a craft brewery on every corner and new businesses continue to move in. At the same time, the poverty rate in the city is 22 percent, well above the national average of 13 percent — clearly, not everyone has been equally able to participate in Roanoke’s success.

We also see a divide by education. Employment rates are much lower for people who don’t have a four-year college degree. But there are well-paying jobs that don’t require a degree that employers are desperate to fill, such as truck drivers, airline mechanics or skilled trades in construction and manufacturing. There are opportunities to let students know about these jobs and help them develop the skills they need to access them.

And, finally, after increasing steadily for decades, women’s labor force participation started to decline around 2000. The United States used to have one of the highest rates of women’s participation; now we’re in the bottom half of developed economies.

Given slow labor force growth, productivity matters. But a lot of research suggests that productivity growth has declined and that over the past decade it's only grown about half as quickly as the long-term average. The Richmond Fed estimates that today it's around 1.25 percent.

That's lower, in my view, than the potential of American businesses. In my conversations with businesspeople, they believe they are driving more productivity than the data suggest, via automation, capital investments and operating efficiencies. They might be wrong — or it might just take time to realize the benefits of those strategies, as happened in the mid-1990s. It's also possible some businesses are getting more productive at the expense of their competitors, thus dampening the effect in aggregate.

Challenges for Policymakers

Growth matters in and of itself. It also matters for our resilience in the next downturn. As I mentioned, the appropriate policy rate depends on how quickly the economy can grow. So in a slow-growth environment, interest rates are likely to be lower. This creates some challenges for monetary policymakers, as they have less ability to lower rates to stimulate the economy in the event of a downturn.[2] As a result, we might at some point have to come back to "unconventional" (and controversial) policies like those employed after the Great Recession. It is not clear how large an impact these policies would have or how well supported they would be.

The other critical lever in a downturn is fiscal stimulus. But our nation's fiscal capacity is limited. The debt-to-GDP ratio is nearly 80 percent — the highest it's been since the late 1940s — and the Congressional Budget Office projects it could rise to 100 percent by 2028, depending on whether the recent tax cuts are made permanent. For comparison, it was 48 percent in 1994 and 35 percent in 2007. This fiscal situation challenges our resilience. Will the government have enough stimulus available during the next downturn? Will those efforts be offset by investors requiring a higher yield on our debt?

Policies to Promote Growth

Given these challenges, I'm concerned about monetary and fiscal policymakers' capabilities to provide an effective backstop in the next recession. But stronger underlying growth would address this concern. Stronger growth would allow the FOMC to raise rates higher without constraining the economy, giving us more ammunition when we need it. Stronger growth would create revenues to reduce our deficit, giving us more capacity for fiscal stimulus. Stronger growth would help to lessen the pain that many people in our communities are feeling.

Creating growth is easier said than done, of course, and I won't presume to have all the answers. And I should point out that monetary policy has a limited effect on the factors that ultimately determine long-run growth. But I can share what I think are important themes.

Education and workforce development are critical. If we expect the labor force to grow slowly, that means our country has to do a stellar job educating and training the workers we already have. In part, that means ensuring students who want to attend college receive the preparation they need to be successful, because far too many students do not.[3] Roughly 40 percent of students who enroll in a four-year college don't graduate within six years, and many of those who leave without a degree are still left with significant debt. It also means ensuring that young people have viable alternatives other than four-year colleges and that they're aware of those alternatives.[4]

There might be other levers policymakers can pull to increase the labor force, such as providing more opportunities to rural and inner-city communities. That includes creating jobs in both places as well as investing in initiatives that enable people to travel to, or live near, the jobs. As a country, we can look at ways to support women's participation in the workforce, such as greater availability of child care and paid leave,[5] and to admit more legal immigrants, who bring with them much-needed skills and entrepreneurial energy. Policymakers might also look at how to continue investing in delivering productivity and in incentive strategies that drive such investments. For example, although business investment has grown rapidly over the past four quarters, it's still low as a share of GDP relative to previous expansions. And, of course, we should all support efforts to responsibly address our nation's fiscal situation.

I do want to leave you with the thought that the economy's pulse, as we sit here today, is strong. Growth is solid, unemployment is low and inflation is at target. The challenge isn't so much today, but rather unlocking the sustained growth that will make the country healthier and more resilient tomorrow.

Thank you, and I look forward to your questions.

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[1] Thank you to Jessie Romero for assistance preparing these remarks.
[2] See John C. Williams, "Monetary Policy in a Low R-star World," Federal Reserve Bank of San Francisco *Economic Letter* no. 2016-23, August 15, 2016.
[3] See Urvi Neelakantan and Jessie Romero, "Falling Short: Why Isn't the U.S. Producing More College Graduates?" Federal Reserve Bank of Richmond 2017 *Annual Report*, pp. 4-13.
[4] For example, see Kartik B. Athreya, Urvi Neelakantan, and Jessie Romero, "Expanding the Scope of Workforce Development," Federal Reserve Bank of Richmond *Economic Brief* no. 14-05, May 2014.
[5] See Janet L. Yellen, "So We All Can Succeed: 125 Years of Women's Participation in the Economy," Speech at the "125 Years of Women at Brown Conference," sponsored by Brown University, Providence, Rhode Island, May 5, 2017.