The Outlook for Tomorrow: Five Numbers to Watch

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West Virginia Economic Outlook Conference
Charleston, West Virginia
October 3, 2018

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 to talk with the people who live and work here. This is my first trip to Charleston, and my goal is to be interesting enough that you'll invite me 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. 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. 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*. But my real focus is the outlook for *tomorrow*, including some key indicators I'm watching. And then I'll be glad to take your questions. Before I say more, the views I express are my own and not necessarily 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 — they might want to rename it.

What's contributing to the economy's strength? 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. We won't know for a few more weeks if that pace continued in the third quarter, but most estimates put it above 3 percent. Underlying that growth, in my view, is confidence. Business optimism is 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, so I will be cautious. And certainly, trade disputes 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. The economy also faces supply chain constraints and the risks of geopolitical instability and market volatility.

Labor Markets

At least for now, though, businesses and consumers seem to be looking through these risks. 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 4.4 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. In short, there are more job openings than there are people looking for work. Vacancies are especially high in fields such as nursing, the skilled trades and truck driving.

I should note, however, that there are parts of the country still struggling. Here in West Virginia, for example, there are counties where the unemployment rate remains near or even above 8 percent, and the employment/population ratio is the lowest in the country at around 50 percent. These are real challenges, and it's important we do not lose sight of them when we talk about the strength of the U.S. economy as a whole.

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 the tightness of the labor market, the impact of tariffs and commodity cost pressure in places like pulp and oil.

Part of the answer is that many firms don't think they can pass on higher costs to consumers. There are a number of reasons for this, including lagging productivity at rates that don't offset wage increases; 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.

Tomorrow

Now you might be wondering, how long can this continue? After all, the current economic expansion has been going on for more than nine years — one of the longest upturns on record.

Well, I should be humble here: Economists are not the best at predicting the future. (Maybe I should be doubly humble: Guys with 30 years in management aren't that great at it either.) So instead of telling you what's going to happen, I'll tell you about the numbers I'm watching, which hopefully will be of interest to you as well. Please recognize that when I talk about these numbers, I'm not trying to anticipate shocks, such as a hard Brexit or a political crisis.

Business Investment

I watch business investment closely. It's a strong indicator of continued confidence — firms aren't going to invest in the future unless they feel good about where we're headed. This, in my view, is the major challenge presented by the discussions we're having right now about tariffs. They unsettle businesses at a time when strong growth ought to be motivating them to invest.

Investment has lagged for the past 10 years. Of course, we had a severe recession, but even during the recovery it's looked low relative to previous periods and relative to corporate profitability. The last four quarters have been quite strong, however — as we've seen here in West Virginia with, for example, the major expansions Toyota and Hino announced last fall. Some of that might be catch up; some of it might be those tailwinds I mentioned earlier. Either way, we need that confidence to continue for the economy to keep growing at its current rate.

Productivity

I'm also paying attention to productivity. That's because if we want the economy to grow, we need more people to work and/or we need them to be more productive. But the labor force is growing quite slowly for a variety of reasons, including declining fertility rates, an aging population and less immigration. This is certainly a challenge facing West Virginia, where the population has been declining since 2010 and which has the highest ratio of older adults to working-age adults of any state in the Fifth District.

If the labor force is growing slowly, then that means economic growth depends on faster productivity growth. But productivity growth also has been slow: Between 2006 and 2017, it averaged just 1.3 percent, compared to an average of 2.9 percent between 1995 and 2005.[2] I have to confess that I find this challenging to explain because it's lower than what I think is the potential of American businesses. In my professional experience and in my conversations with contacts throughout the district, businesses believe they are driving more productivity than the data suggest, via automation, capital investments and operating efficiencies. Many are.

It's unlikely that the slowdown is simply the result of measurement error, so there must be something else going on. It's possible that the past decade of underinvestment has had an impact on productivity. In addition, economists have found a lot of evidence pointing to decreased entrepreneurship.[3] Startups are responsible for a lot of innovation, so this could be contributing to slower productivity growth overall. Another explanation could be that some businesses are getting more productive, but they're doing so at the expense of their competitors, thus dampening the effect in aggregate.

Productivity growth was strong in the second quarter of this year, at 2.9 percent. If that marks the start of a sustained upturn due to investments paying off and technology coming to fruition, it could drive long-term healthy growth. If it's a one-quarter blip and productivity returns to its slower trend, it could limit our economy's potential growth.

Compensation Growth for Job Stayers

I'm watching growth in compensation. As I mentioned, the labor market is very tight. Yet wage inflation has been sluggish, averaging just 2.4 percent since 2015 (although it climbed to 2.9 percent in August). During previous upswings, wage inflation approached 4 percent. One factor restraining wage growth is that absent faster productivity, companies don't think they have the ability to increase prices to compensate for paying higher wages. Another major factor, in my view, is that turnover has been relatively low. A high percentage of wage costs goes to the retained base, and wages tend to rise more when people change jobs. We typically see faster wage increases when companies are competing for each other's employees. But we're not really seeing that competition yet.

I see three potential paths for the evolution of the labor market. One possibility is that we find ways to draw more people into the labor force. Although the decline in labor force participation over the past two decades is largely the result of demographic changes, there are large gaps by geography, race, gender and education.[4] If we can address these gaps and more people come off the sidelines, we would likely see continued economic growth combined with moderate wage growth. West Virginia is a state where the opportunities are huge.

The second possibility is that we see more of the same: The labor market remains tight but companies are unable to pass on wage increases so they accept supply constraints instead. In this scenario, wage growth is moderate and job growth eventually falls.

The third path is that companies decide they need to hire from their competitors. Turnover increases, and companies start paying their current employees more to retain them. That could drive faster inflation. For this reason, compensation growth for job stayers will be a number I'm watching closely.

Consumer Durables Prices

I pay attention to prices for durable consumer goods, such as cars and refrigerators. Their prices are a key indicator of core inflation. Until around 1995, the price indices for durables, nondurables and services increased in tandem. But since then, prices for durable goods have declined while prices for nondurables and services have continued to increase.

As I noted, the internet and big-box retailers have likely been holding prices down, which has both benefited consumers and restrained inflation. But as consumer goods companies' margins continue to be squeezed due to increasing pressure from commodity costs and tariffs, they may have no choice but to try to raise prices. We've already seen reports of price increases at some prominent consumer products firms. If these and future efforts are successful, inflation might well pick up pace.

Yield Curve

The final indicator I'm watching closely is the yield curve, which is the difference between short-term and long-term interest rates. When these rates are close together, it could suggest markets are losing confidence in the outlook. Currently, many people are concerned about the compression of the spread between 2-year and-10 year Treasuries. Their concern may well be warranted, since an inversion of this yield curve has predicted seven of the last six recessions.

I respect the 2-year/10-year spread as a signal. That said, I'm not inherently inclined to blindly follow the market's lead, so I've been digging into the research. The Board of Governors, for example, recently published an article suggesting that nearer-term spreads have a better forecasting record than the traditional 2-year/10-year measure. [5] These have remained more stable and don't show an elevated risk of recession at present.

Of course, these market reads are complicated by our own large holdings of Treasuries, the desire of foreign governments for safe assets and recent increases in Treasury purchases driven by our increasing deficit. Still, the yield curve is worth watching as well.

Conclusion

Net, I'm watching five signals: business investment, productivity, compensation for job stayers, consumer durables prices and the yield curve. While forecasting the future evolution of these signals is challenging, 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 is not so much today, but rather ensuring that growth continues. I hope you'll monitor these five metrics with me over the next year as the Fed tries to do its part to support the country's economic growth. 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] Based on real output per hour in the nonfarm business sector.
[3] For example, see Ryan A. Decker, John Haltiwanger, Ron S. Jarmin, and Javier Miranda, "Declining Dynamism, Allocative Efficiency, and the Productivity Slowdown," Federal Reserve Board *Finance and Economics Discussion Series* no. 2017-019, February 7, 2017.
[4] Thomas I. Barkin, "Closing the Gap," Speech at the Forum for Minorities in Banking, Charlotte, N.C., September 28, 2018; and "Crossing the Geographic Divide," Speech at the Reinventing Our Communities conference, Baltimore, Md., October 2, 2018.
[5] Eric Engstrom and Steven Sharpe, "(Don't Fear) the Yield Curve," Federal Reserve Board of Governors *FEDS Notes*, June 28, 2018.