

The Role of Human Capital in Shaping Economic Outcomes

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- Atlanta Fed President and CEO Dennis Lockhart, in a September 29, 2016, speech to the Future of Florida Forum in Orlando, presents his views on the economy and workforce development.
- Lockhart feels that a change in monetary policy could occur before long and that the FOMC is closing in on its statutory policy objectives despite a relatively weak pace of economic growth.
- Lockhart says that both labor force participation and the rate of growth of labor productivity have been constraining potential for a number of years.
- Lockhart believes workforce development programs have a place in the response to this challenge and can help improve the longer-run trend rate of growth.

Thank you for the opportunity to speak to this group of leaders of the very important state of Florida.

Florida is a bellwether state in the national economy. It's the third most populous state, so consumer activity here contributes significantly to trends in consumer activity nationwide. Tourism—so important to this state—tells us a lot about the state of mind of domestic consumers and their propensity to spend. Residential real estate development in Florida is a signal of national (and also international) demand conditions and consumer confidence.

I could go on, but the point is that Florida, with its diverse sub-economies and cultures, is an important window into the national

economic picture. Trends, both positive and negative, and economic challenges in Florida have national relevance.

Today I plan to do three things with my remarks. I will interpret the decision of the Federal Open Market Committee (FOMC) to leave policy unchanged at our recent meeting of September 20 and 21. I will offer my assessment of the current state of the national economy and the outlook. And I will discuss how human capital influences economic outcomes.

Growth is a central issue of our times. Growth results from rising numbers in the workforce, enhancement of their tools, and improvement of their skills.

At the national level, a central question today is, why is actual and potential growth restrained? Over the last several quarters, my FOMC colleagues and I have been progressively writing down our estimates of medium-term and long-run growth in official forecasts. There are a number of contributing factors. An important one is low growth of labor productivity. So another question is, why does the trend of productivity growth continue to run low? In my remarks I'll provide my personal views on these questions, and I'll offer some thoughts on state and local workforce development efforts as a way to improve labor productivity.

As always, **all** my remarks will be personal views. I'm not speaking for the Federal Reserve or the FOMC.

Stance of monetary policy

As I mentioned a moment ago, the FOMC left the policy interest rate—the federal funds rate—unchanged at our last meeting. The policy rate target range is set just $\frac{1}{4}$ of a percent above a setting of zero, for all practical purposes.

You may also be aware that on three occasions in recent years, the FOMC undertook bond-buying programs in an effort to keep longer-maturity interest rates low. These programs swelled the central bank's balance sheet to around \$4.5 trillion today. The FOMC is maintaining the status quo balance sheet as part of a quite accommodative stance of policy.

In the statement following last week's meeting, the Committee acknowledged that the national economy is improving and the case for a policy rate increase has strengthened. Nonetheless, the decision was to stand pat for the time being. That phrase—*for the time being*—appeared in the statement suggesting, as I see it, that a change in policy could occur before long. However, I did support the consensus view that, before taking the next move, it makes sense to see a little more evidence of progress toward our statutory policy objectives.

State of the economy and outlook

Those statutory policy objectives are full employment and low and stable inflation. They are the north stars of monetary policy. So, decisions of the Committee to adjust policy settings are highly influenced by our collective assessment of how far the economy is from the goals of full employment and a sustainable rate of inflation close to 2 percent. Think of full employment and 2 percent inflation as indications of an economy operating at steady state. When we've achieved those two objectives on a sustainable basis, policy should be set at neutral—neither intentionally stimulative nor intentionally restrictive.

In my opinion, the national economy remains short of these two steady-state conditions, but not by a lot. An evaluation of employment conditions ought to take into consideration a wide set of indicators, including conditions of various age cohorts and demographic groups. That said, the headline national unemployment rate is a useful gauge. Unemployment in August stood at 4.9 percent. This is within the range of last week's estimates from FOMC participants of the long-run sustainable unemployment rate.

Likewise, there are a variety of ways to assess inflation. The measure preferred by the FOMC stood at 0.8 percent for the year through July. Headline inflation is influenced by volatile elements like prices of gasoline and foodstuffs. If these categories of prices prone to ups and downs are excluded, core inflation over the last 12 months stands at 1.6 percent. There is some difference of opinion among economists and my colleagues whether or not the core inflation shortfall is all that material.

As a policymaker, I take both the current employment picture and recent inflation indicators as encouraging. We're closing in on our

objectives. We're nearing our objectives despite a relatively weak pace of growth.

The economy expanded slowly in the first half of the year at a rate closer to 1 percent. The Atlanta Fed's estimate of growth in the third quarter, the current quarter just about to end, is slightly below 3 percent. We believe this pickup in the pace of growth will continue through the fourth quarter such that growth for the year overall will likely end up just shy of 2 percent.

A 2 percent annual rate of growth has been the story of our economy's recovery since the recession ended in the summer of 2009. We've made substantial progress even with sluggish growth, particularly in broad measures of employment.

The reality of a solidly performing labor market suggests that even at 2 percent, the economy has been running above its long-run potential rate of growth. The thought is that idle or underutilized resources—including labor resources—are absorbed into the economy when it operates for a period above steady state.

Potential economic growth is limited by growth in the size of the labor force and how productive that labor force is. I'll repeat that in a slightly more complicated way. Population growth, adjusted for participation, times productivity yields economic growth.

Both labor force participation and the rate of growth of labor productivity have been constraining potential for a number of years.

Let me elaborate further on each factor. The explanation for declining participation is multifaceted, but a significant portion of the decline is explained by demographics. Baby boomers are reaching retirement age, and although some are extending their working lives, their participation overall is falling. Florida, of course, is the beneficiary of this phenomenon from the perspective of population growth.

There are other things affecting participation—for example, millennials staying in school longer and two-earner families reverting to one earner as the economy has improved.

Recently we have seen a slight uptick in participation. I attribute this to people who used to be out of the workforce rejoining the workforce, encouraged, in my view, by the continuing growth of jobs. Monthly payroll job growth has averaged 204,000 over the last year and 232,000 over the last three months. I expect we will continue to see job growth comfortably above the number needed to absorb population growth. So I expect we'll see either a further drop in the unemployment rate or a continuation for a while of the reversal of the participation trend. Possibly both. That said, my medium- to long-term assumption is a persistent decline in participation. Demography is destiny, you might say. It would require an implausible rise in the labor force participation rate to fully offset the predictable retirement numbers of baby boomers.

Labor productivity growth

Let me now comment on labor productivity growth. I believe a good deal of the explanation of weak productivity growth relates to weak spending on capital equipment. Investment in the structures, equipment, software, and other intellectual property products used by the labor force has been very soft since the early years following the end of the recession. When we at the Atlanta Fed ask business leaders across the Southeast about reticence to invest more, we hear a range of reasons. In Louisiana, we hear about the severe cutback in drilling structures investment because of the fall of oil prices. This is just part of the picture, however. A broader sample of businesspeople—representing both small businesses and larger enterprises—tells us that businesses are cautious about predicting future demand in a low-growth economic environment. And, very frequently, we hear references to greater perceived uncertainty—geopolitical, domestic politics, regulation, fiscal, financial stability.

In my latest forecast of economic performance through 2019, I assumed a modest pickup in capital spending just to sustain a 2 percent rate of growth over that timespan. Importantly, I am **not** assuming an increase of capital deepening across the economy of a magnitude that would rapidly and meaningfully boost productivity.

I'll repeat the simple growth equation from my introduction. Growth results from rising numbers participating in the workforce, enhancement of their tools, and improvement of their skills. With

declining participation—even while the population is growing—and weak investment in capital goods, the country has challenges achieving strong growth. How to respond? I believe workforce development programs have a place in the response to these challenges.

The role of workforce development

Over the last year or so, my community and economic development team at the Atlanta Fed has sharpened its focus on workforce development systems and policies. The Federal Reserve System overall has stepped up resources devoted to workforce development research and engagement of stakeholders.

We believe workforce development represents fertile ground. I'll point to five opportunities.

First, the workforce development landscape is fragmented and could be better coordinated as an industry. Our community and economic development team engaged with a group of 25 organizations across metro Atlanta engaged in workforce development. Atlanta is a representative large city. The group found a lot of duplication of services and limited communication between and among organizations. There is much scope for greater collaboration.

Second, too many providers of workforce development programs are not sufficiently aligned with employers. In a recent study of just over 200 providers in Atlanta's workforce development community, we found only 30 percent had a relationship with an employer.

I'll note that Florida has taken an important first step in broadening connections to the business community by rebranding all of its public workforce boards under the CareerSource banner. This common brand has helped to make resources more available and understandable to businesses and job seekers.

Third, programs do not operate at large enough scale to meet the needs of employers and workers. We see potential to expand programs that have a demonstrated record of success. We're also of the view that states in the forefront of workforce development efforts would be well advised to leverage the power of existing resources such as community and technical college systems.

Fourth, the funding situation of workforce development programs is complex. There has been significant reliance on federal and philanthropic grant funding. There are multiple federal programs that fund workforce development, but they have been in decline. Funding from state and local governments is uneven. Funding challenges make good programs hard to scale. My colleagues believe that new financial models are needed to attract funding to workforce development programs. We're working on this.

Finally, improved data collection and dissemination will help direct resources to programs that are effective. We recently invited state labor data directors in our region to a meeting to discuss their data systems—what they thought was working and where they were seeking improvement. Representatives from CareerSource Florida and the Florida Department of Economic Opportunity joined in the discussion. They pointed to improvement in the state's longitudinal data system. The intent is to evaluate the effectiveness of training programs for workers over the long term. We also heard about efforts to source local information across Florida on prevailing salaries in order to direct resources to programs that fill actual labor market gaps and deliver higher and more immediate returns on investment.

These are opportunities—opportunities to bring workforce development efforts to bear on labor productivity and, ultimately, growth of potential and realized economic growth. An important state like Florida ought to be a leader in this movement.

We all want to see stronger growth. As a policymaker, I would like to see growth modestly above potential for the immediate future to absorb remaining labor market slack. I would also like to improve potential—that is, I'd like to find ways to improve the longer-run trend rate of growth. I believe doing so involves strategies that address fundamentals like our economy's endowment of human capital.