An Economic Outlook

The Wharton School of the University of Pennsylvania

Philadelphia, PA

February 21, 2017

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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 FOMC.

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Good afternoon and thank you. It's always a pleasure to be back home at Wharton.

Today I'll give a brief overview of the economy, my outlook for the next year or so — including the path of monetary policy — and then talk a little bit about a subject that's probably near and dear to a lot of your hearts: student debt.

Before I begin, I'll start the way I always do with the standard proviso that my views today are mine alone and do not necessarily reflect those of others in the Federal Reserve System or my colleagues on the Federal Open Market Committee (FOMC).

Labor market

With that out of the way, things are looking pretty good.

We started off the year with a strong labor market. We added 227,000 jobs in January, and the unemployment rate stands at 4.8 percent, which is at or below my estimate of the natural rate of unemployment. That's a slight uptick from December, but it reflects more people coming off the sidelines and back into the labor force. So in this case, it's a positive outcome.

U6 unemployment is 9.4 percent. While that's still higher than I'd like, it's a far cry from the bad old days of the recession and its aftermath when U6 reached a peak of about 17 percent.

Quits are still high, layoffs remain low, and job postings are near historical peaks. My business contacts continue to tell me that finding workers, especially in certain occupations, is getting more and more difficult.

Taking that all into account, the labor market continues to tighten. And I see it as more or less back to full health.

Whenever I talk about the labor market, I'm always careful to point out that just because things are good — or even healthy — doesn't mean they're perfect. There continue to be pockets in the country — both geographically and demographically — that aren't feeling the relief. We have a lot of them in the Fed's Third District: post-industrial towns, rural areas, and the urban landscape. Philadelphia is the poorest of the 10 biggest cities in America, and Camden has, at various times, been called the poorest city in America period. Among different segments of the population, the unemployment rate for African American men remains at 8.0 percent, significantly higher than the national average.

We need to pay special attention to the regions and demographic groups that have been left behind. The Fed can help to some extent through our community development work, which focuses on strengthening local economies. But for the most part, monetary policy doesn't have the scope or tools to address these issues head on. That takes legislative action.

And while I'm relatively upbeat about employment, there's still room for wage growth to move up. While the continued improvement in the labor market has moved the needle on wage growth — as of January, the year-over-year growth was about 2.5 percent — previous expansions have seen sustained growth of above 3 percent. That's what we expect in a robust economy.

Inflation

Moving on to inflation, we're seeing positive upward movement, although PCE remains below our 2 percent target. Headline and core PCE closed out last year at 1.6 and 1.7 percent, respectively. That's a world of improvement over the end of 2015, when they were at 0.6 and 1.4 percent.

We do have January numbers for CPI inflation, with headline CPI rising a remarkable 0.6 percent, driven largely by an increase in gas prices. That brings the year-over-year change to 2.5 percent. Core CPI rose 0.3 percent, bringing that year-over-year change to above 2 percent.

I should note that inflation as measured by CPI is often higher than PCE. That said, it still indicates an overall upward movement, and I see us reaching our 2 percent target on PCE sometime this year or next.

Another positive indicator is that we're starting to see inflation expectations rally around the 2 percent goal.

Growth

Turning to growth, real GDP increased 1.9 percent in the fourth quarter of 2016. A substantial drag from net exports slowed growth there. While real GDP growth was stronger in the second half of 2016 — after it grew by 3.5 percent in the third quarter — we're really looking at moderate growth overall, averaging just under 2 percent. The Philadelphia Fed's *Survey of Professional Forecasters* points to 2.2 percent growth in the current quarter.

Retail sales have been strong, rising 0.4 percent in January. In fact, we've seen a rapid acceleration in retail sales since the middle of last year. And consumer confidence has continued the upward trend it started in 2016, carrying into this year.

Overall, I see strong consumer spending driving growth of about 2 percent over the course of the year. And that 2 percent growth is more or less what we should consider normal for the medium term.

Monetary policy

So, what does all this mean for monetary policy? Given the state of the economy — more or less back to normal — I continue to see three modest rate hikes of 25 basis points each as appropriate for 2017, assuming things stay on track.

I've said it before and I don't mind repeating myself: Monetary policy is a fairly limited tool that is fairly limited in its scope. A lot of people would like to see growth above our 2 percent projection, but that's not really up to Fed officials. That's the kind of policy that's outside our purview.

If we really want to move the needle, we need to invest in physical and human capital.

Student loans

And that's where I come to the subject of student loans.

I should mention that different Federal Reserve Banks have different areas of research focus. Dallas, as you might imagine, spends a lot of time looking at energy markets. In Philadelphia, we're the System leaders in research on consumer credit and finance. So, we have a lot of expertise in this area.

There's no question that investing in the education of our citizens is essential for growth and is the core of our economic future. We're talking about the engine of the American economy: The men and women who will be creating the next miracle drug, inventing the next radical technological innovation, writing the next wave of legislation.

But there's an all-too-familiar problem that can act as a barrier to people getting the education they need.

To steal a line from John Oliver, if you went to college in America, chances are you have two things: Bob Marley's greatest hits and student debt.

The headlines you've heard before, and they're fairly staggering:

The number of people with student debt doubled between 2000 and 2014, for a total of about 42 million. Aggregate student loan debt in the U.S. is currently nearly $1.3 trillion.[1]

The average student loan borrower has about $31,000 in outstanding balances, whereas the typical American borrower owes over $16,000.[2]

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[1] *FRBNY Quarterly Report on Household Debt and Credit*, November 2016. The actual number is $1.279 trillion as of September 30, 2016.

[2] The actual numbers are $31,308 (average) and $16,648 (median). The statistics are based on information contained in the New York Fed Consumer Credit Panel/Equifax data set.

And 11 percent of balances are past due, compared with 8 percent 10 years ago. It should be noted, however, that the delinquencies have been coming down since the peak of 12 percent in 2012.[3]

That's the data we're used to hearing, and that's what most of the conversation is about, for good reason.

But there are more data and some nuances to the numbers that bear investigating. Because if we're going to reach policy conclusions — and for the record, I'm not going to reach any policy conclusions because that's not my job — we should dig a little deeper.

First and foremost, defaults on smaller loans are actually more common than on big ones.

There are a number of factors that play into this, but there are some trends that emerge.

Larger loans tend be taken on by people attending four-year institutions, and those students tend to complete school at a higher rate. They may have more debt when they graduate, but graduating makes them more likely to find a job and a better paying one at that. So, those students tend to be in a better position to repay loans.

Students at for-profit colleges or two-year programs are generally in school for shorter periods of time, which is part of the reason the amounts are smaller. However, a significant portion of these students are unlikely to finish their degree or certificate. And people who don't complete their programs are more likely to default.

This is largely because they struggle to find jobs that pay enough to both repay loans and cover the general cost of living. That was made exponentially worse by the recession and the attendant weak labor market.

In 2013, for instance, the unemployment rate for borrowers who were recent graduates of four-year, public, and nonprofit institutions was 7.7 — only a little higher than the overall average unemployment rate for that year.

[3] *FRBNY Quarterly Report on Household Debt and Credit*, August 2016. The actual number is 11.0 for those who are 90 days' delinquent or in default at the end of 4Q2016. The statistics are based on information contained in the New York Fed Consumer Credit Panel/Equifax data set.

By contrast, recent graduates of two-year colleges had an unemployment rate of 16.9 percent. More alarmingly, those who went to for-profit schools had an unemployment rate of 20.6 percent.[4] To put that in perspective, we would literally have to go back to the Great Depression to get a national level of unemployment that high.

The recession was also marked by a dramatic increase in attendance at two-year and for-profit colleges. These schools accounted for roughly half of the increase in student debt between 2009 and 2011. This increase was part of a longer-term trend that highlights a lot of the data I've just talked about. From 2003 to 2013, over 30 percent of the increase in student debt was taken on by students from those institutions.[5]

What does this tell us, and why does this matter?

I'm not ignoring the issues facing students who graduated on time from four-year institutions and found good jobs when they left. Being in a better state than their counterparts doesn't lessen the blow of a few decades of paying off loans. And it still has implications for the broader economy: Millennials are now technically a larger generation than the baby boomers, and owing money affects the way they live and participate in the economy. There's a good amount of research that links student debt to younger adults being unable to move out on their own. Some of it finds a big enough effect to impact the housing market.

But we should also look at the way the segmentation of the student debt market impacts the way we view the issue, and, more broadly, how we approach policy.

Fundamentally, this is a question of how we look at skills, the labor force, and the ways in which we prepare people for professional success.

I'm always careful to avoid wading into debates about how elected officials should make policy. There are larger questions about the allocation of funds at the local, state, and federal levels that I'm going to sidestep.

What I can address is some of the data and research.

[4] Adam Looney and Constantine Yannelis, "A Crisis in Student Loans? How Changes in the Characteristics of Borrowers and in the Institutions They Attended Contributed to Rising Loan Defaults," Brookings Papers on Economic Activity (September 2015).

[5] See Looney and Yannelis.

I'm frequently amazed at the simplicity of programs that have demonstrable effects. Case in point, there is evidence to suggest that by simply offering high school students more intensive, personalized information about college options, they make better, more successful choices.[6]

Likewise, a more flexible approach to repayment can keep people from winding up in a debt cycle that can permanently affect their credit.

At the moment, student debt holders have the option of programs that protect them from spending more than 10 percent of their income on repayment. But they have to reapply annually, filling out the kind of complex sets of forms that bureaucracy is famous for. And eligibility is based on the previous year's income, which means if you lose your job, you won't be off the hook for payments for quite a while. The complexity — and probably the frustration — of the process keeps a lot of people out of the process who could use the help.[7]

One possible solution can be found in our counterparts overseas. Repayments are automatically linked to income through the tax systems in countries like Australia, the UK, New Zealand, and others. In addition to the relief it gives people paying off student loans, it reduces the dreaded reams of paperwork.

Another issue altogether is thinking about how we address tertiary education on a societal level. When my parents were growing up, all you needed for a good job was a high school diploma. That was still true for some of my generation, but that necessity quickly turned to being a college degree. I bet a lot of you and your friends feel that you won't be competitive in the marketplace without a master's.

The thing is we don't all need or want the same educational track. A traditional four-year degree is great for some people. Ditto a post-graduate degree.

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[6] Caroline Hoxby and Sarah Turner, "What High-Achieving Low-Income Students Know about College," *American Economic Review Papers & Proceedings*, 105 (May 2015), pp. 514–517.

[7] Eric P. Bettinger, Bridget Terry Long, Philip Oreopoulos, and Lisa Sanbonmatsu, "The Role of Application Assistance and Information in College Decisions: Results from the H&R Block FAFSA Experiment," *The Quarterly Journal of Economics*, 127 (August 2012), pp. 1204–1242.

For others, it’s not necessarily the right path. And we should stop making people feel as though they all need to fit into the same mold.

One of our research areas at the Philadelphia Fed is skills training and alternative routes to education and professional readiness.

The data show a skills gap. I hear it all the time from my business contacts: They have the jobs — they just don’t have the people to fill them because they don’t have the right training.

My staff recently conducted a study on what they call “opportunity occupations.” These are jobs that pay at or above the national median income but don’t require a traditional four-year degree. They make up close to 30 percent of the job market nationally.

If we reconsider the way we train people, especially for occupations that require special skills, we can start to maximize the potential of our workforce.

I saw this in action when I visited the Academies at Roxborough High School with my Community Development staff. This is a program that trains high school students to be career ready when they graduate, so they can make the move into jobs that will pay them a good wage. Some of them will go on to traditional four-year programs, some will get further technical or vocational training, some will start their career path right out of the gate. But they’ll all have the opportunity to make a living while they’re pursuing either more education or moving along their professional pathway or both.

If we approach education and the needs of the workforce from a different angle, we can save a lot of the heaviest-hit students a world of debt hurt.

Conclusion

I can’t formulate education policy, or allocate funds, or even make my own children study what I want them to — although, of course, I’m immensely proud of them and they’ve made excellent choices without listening to me.

But I can point to the research and what the data say. Changing our approach to how we invest in education and training won’t take care of the entire student debt issue, but it can help those who are disproportionately affected by it.