The Economic Club of New York

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Introduction

Chairman Marie-Josee Kravis

Good afternoon, and welcome to the 520th meeting of The Economic Club of New York. I'm Marie-Josee Kravis. I'm Chairman of the Club and a Senior Fellow at the Hudson Institute. And I hope you've all had a wonderful holiday season and I wish you a very healthy, happy, successful 2020, and I should say, extending that to the entire decade. Hopefully it will be the Roaring Twenties but without the same consequences as the last time around.

As you know, The Economic Club of New York is the nation's leading nonpartisan forum for discussions on economic and political issues. And we've had more than 1,000 prominent guests appear before the Club during the 113 years of our history, and we've established a very strong tradition of excellence. And I'd like to take a moment to recognize those of our 303 Centennial Society members who are attending today because it is their contributions that sustain the financial backbone of the Club. And I'd like to thank you very much for your steadfast support in allowing us to expand and diversify our programming.

I'd like to take a moment to recognize Harold Burson who was a longtime member of the Club, a former board member, and one of the founders of the Centennial Society.

He passed away last week and I'd like us to take just a moment of silence in his honor. And I'd like to welcome new members to the Club. Many of you are here for the first time today so I hope you'll be with us frequently during the course of the year.

As a reminder, applications for the 2020 Class of Fellows are available online and we hope that you'll consider nominating a next-gen participant that you know for this special year-long program. It is quite an extraordinary program and some of us are very envious. We'd like to participate ourselves. So please do send in your recommendations as soon as possible

And, on that note, I have to say that it's a real pleasure for me to introduce our special guest this afternoon, the President and Chief Executive Officer of the Federal Reserve Bank of Dallas, Rob Kaplan. Since 2015, Rob Kaplan has represented the 11th District, the 11th Federal Reserve District on the Federal Open Market Committee. And I should say that the 11th District encompasses Texas, Northern Louisiana, and Southern New Mexico. He oversees 1,200 employees and he's known as a great listener – someone who consults these employees on an almost daily basis, but also who reaches out to small, medium, and large companies on a regular basis to elicit their thoughts and perspectives on the economy and on their industries. And he's really made a point of integrating these views and these perspectives in his own work.

Previously, he was the Martin Marshall Professor of Management Practice and a Senior Associate Dean at Harvard Business School. He's the author of several books, including his most recent release, *What You Really Need to Lead: The Power of Thinking and Acting Like an Owner.*

Prior to joining Harvard in 2006, Rob Kaplan was Vice Chairman of The Goldman Sachs Group with global responsibility for the firm's Investment Banking and Investment Management Divisions. And throughout all of this, he's found time for philanthropic endeavors. Rob serves as the Chairman of Project ALS and as co-Chairman of the Draper Richards Kaplan Foundation, which is a global venture philanthropy firm that invests in developing non-profit enterprises dedicated to addressing social issues. He's also a board member of the Harvard Medical School.

Born and raised in Prairie Village, Kansas, Rob Kaplan received a Bachelor of Science degree in Business Administration from the University of Kansas and a master's degree in Business Administration from Harvard Business School.

The format today will begin with remarks from Mr. Kaplan followed by Q&A, which generously he's agreed to open up to the audience. So this is quite a treat for the Club, where members are not often allowed that privilege of participating in a Q&A. So I thank him very much. And as a reminder, the conversation is on the record. It's being carried

Live so I'd ask everyone to please silence your phones. On that note, the podium is yours. (Applause)

Robert S. Kaplan

The Federal Reserve Bank of Dallas

Thank you Marie-Josee. I really appreciate your introduction, and it's great to be here. And I'm glad to speak to you over lunch. I don't want to keep you from eating so you're not going to offend me if you start. What I was going to talk about today – there are a lot of things I could talk about, but I'm going to try, just in the prepared remarks, I'm going to talk about the outlook for the economy for 2020. And then I'm going to talk about some more fundamental issues about growth in the United States. In the Q&A I'm happy to talk about, in the Q&A I'm happy to talk about the path of monetary policy, what's going on in the repo market, the Fed balance sheet and all that. But in these initial remarks, I'm just going to talk about the outlook and some other issues.

So let me just start with 2020. Our forecast at the Dallas Fed is that the U.S. economy is going to grow about 2 - 2 1/4% in 2020, similar to what it grew in 2019. As part of that, we would continue to expect global growth is going to be somewhat better than last year, but still sluggish. It'll be helped by the recent Phase I trade deal and the fact we're not going to have, it appears we're not going to have more escalation. It'll also be

helped by the fact we're about to ratify USMCA, and I'll talk about that more in these comments. It's important that we get that arrangement ratified and settled down. It'll reduce uncertainty.

So global growth will still be sluggish but somewhat better. We think manufacturing in the United States will still be sluggish but again somewhat stabilized. And business fixed investment is going to be a little bit better, but still sluggish. And one of the things that's going to pull down business fixed investment is that the energy sector, which we cover closely at the Dallas Fed, we think energy Cap X in the United States could be down as much as 10 to 15%. So if you factor that in, we may see some improvement in other areas, but it's going to be hard for business fixed investment to be a very positive number.

When you wrap all that up together, that gets you to about 2, 2 1/4% GDP growth. And the reason it's that good is the consumer is strong in the United States. Household balance sheets are in much better shape than they were ten years ago. Not perfect, but the households have de-leveraged and the job market is historically tight. And so workers have a lot of confidence, either they're going to keep their job, or if they lose their job, they'll be able to find another one. And so in any given month, people may not spend but they've got the capacity to spend and we think that's the key underpinning of the economy in that the consumer is 70% of the U.S. economy. So if you've got a strong

consumer, you're going to likely have solid growth. And we think that's going to be the case in 2020.

With that, we think the unemployment rate, which right now is around 3 ½% could actually tick down a little bit. And the measure that we look at more closely than headline unemployment is referred to in the lingo as U6, which is unemployed plus discouraged workers plus workers who are working part-time who would like to work full-time. That percentage is now in the high 6s, 6.7%. That is not only well below its pre-recession low, it's getting near its lows for the last 20 years. And so that tells us that the job market is extremely tight. And we can talk about that more in the Q&A.

In terms of inflation, we still believe at the Dallas Fed that – and I'll talk about this in a bit – technology and technology-enabled disruption are continuing to mute inflation, but we still believe we're gradually, very gradually, drifting toward 2%. And the Dallas Trimmed Mean which is our preferred measure of inflation, which X's out extreme moves in the PPI numbers to the upside or the downside. That's running around 2% right now. And so that, to us, still is the best indicator that in the medium term we're drifting towards 2%.

Okay, so that's the outlook, and we can talk more about that when we open it up for questions. So the obvious question then that comes up is 2%, 2 1/4%, I thought we

grew at 2, 2 1/4% or in that neighborhood in 2014 and ‘15. Why aren’t we growing faster? And is it something the Fed is doing? Is it something else going on? And so let me talk about why GDP growth has been sluggish and I think is going to continue to remain sluggish unless we take certain actions.

So, just to frame things. Monetary policy is well equipped to get growth at or near or above potential. It is not well equipped or a very good tool to raise potential growth. And what you’re hearing from me today is we think, at the Dallas Fed, potential growth in the United States is in the neighborhood of 1 3/4 to 2%. It was much higher ten or fifteen years ago. And, oh, by the way, unless we take some action, it is our view that potential growth in the United States is going to drift lower and approach 1 ½% over the next ten years. And so let me just talk about why.

First, the first reason why potential growth is sliding is demographics. Workforce growth in the United States is slowing. It has been slowing for decades. And just to read you some numbers, workforce growth in the 70s was approximately 2.7% in the United States. In the 80s, it was approximately 2%. In the 90s, it was approximately 1-1/4%. In the 2000s to 2010, it was about .8 of a percent. And since 2010, it’s been about .4 of a percent and we believe, at the Dallas Fed, in the 2020s, it’ll be less than a quarter of one percent. Okay. GDP growth in a country or a state is made up of two things – growth in the workforce plus growth in productivity. And I’m telling you right now,

workforce growth in this country is slowing.

Now, over the years, there have been a number of things that have helped workforce growth in this country. Females entering the workforce, starting I think in the 50s, probably reaching its peak in the 90s, has been critical to workforce growth. Workers working later in their career, which is certainly going on, that has been critical to workforce growth.

But what's also been critical to workforce growth, based on our work at the Dallas Fed, has been immigration. It's a sensitive topic – I don't need to tell you. But the fact is our research at the Dallas Fed suggests over the last 20 years, over 50% of the growth in the workforce in this country has been immigrants and their children. It's our view that in the next 20 years, that number will be closer to 100%.

How do we know that? Because we know native-born workforce growth is going to be negative. And so we do a lot of work on immigration at the Dallas Fed and a researcher named Pia Orrenius leads our effort. And one of our findings is, and we've suggested this, is we think the United States would be very well served to restructure its immigration system to be more skills-based and employer-based, much more like Canada where you go out and interview companies and industries, find out what workers they're short of and then you backward integrate into the criteria for your

immigration system. And so this is a subject that elected and appointed officials will have to debate. But I have to tell you, if you think that you're going to cut the number of immigrants in the United States – which some people have suggested – and grow GDP, my purpose is to tell you those two things don't go together. GDP growth is critically fueled by workforce growth and workforce growth is declining.

Another statistic that indicates this is the participation rate in the United States right now, that is workers 16-year olds and older, is right now around 63%. For those who watch this, it's stayed pretty much constant around 63% for the last few years. That's been an enormous accomplishment. It was 66% in 2007. Okay. And we believe over the next ten years, that participation rate is likely to approach and slip to 61%, which will create a significant headwind for GDP growth in the United States.

Now we're not alone with this problem, by the way. Europe has got a challenging demographic issue. China has got a very challenging – it's not talked about a lot – it's got a very challenging issue with demographics and aging of their workforce. And this helps explain to us why global growth is relatively sluggish. Now, we can do something about this and we have in the past. But unless we change policies, it is our view that workforce growth is going to be sluggish.

Now, I mentioned there's a second part of GDP, which is growth in productivity. Maybe

we can make up for it in terms of productivity. And so far, we have not. Productivity, which is output per worker, has declined from about 1.9 in the 1990s to 1.4 to about 1.1% in the 2000s, or since 2010, excuse me. And here's what we think is going on at the Dallas Fed in terms of productivity, and we would relate it to the second big trend which we would call technology and technology-enabled disruption and how it relates to education.

So, first of all, many of you are sitting in the audience saying technology implementation is not new. Technology has been replacing people for most of our lives – technology replacing people. What is new, is dramatically new, is distributed computing power, i.e. the device that each of you have in your pocket, has changed the dynamics of the leverage between people who sell goods and services and people who buy goods and services in that it's shifting it.

And based on our work at the Dallas Fed, pricing power for most industries is challenged to the extent it's not been in our lifetimes. And if you go through each industry that we look at, there's a story – not only of technology replacing people, but of a disruptive competitor that may not make a profit, may not even make a gross margin, that is limiting the pricing power of most businesses.

Now, how are businesses dealing with this? They're dealing with it, I think, in a very

rational way. Most businesses are investing more in technology in order to compete and lower their costs. They have to because they don't have pricing power. And the other thing they're doing is merging. The need for scale has never been greater in order to afford the investment in technology. And when I have my calls with CEOs, which I do frequently, most CEOs will tell me a story how their workforce is here and over the next X number of years certain populations of the workforce are going to decline. Witness, people who run call centers, you know, those call center workers that make $55,000 a year are probably not going to have a job five to seven or eight years from now. And most companies are doing what they can to retrain workers to move to other parts of the business but they're admitting that a substantial percentage of workers are really not going to be able to be retrained and their workforce mix is going to change.

And so while businesses are finding ways to cope with this, my concern – from a productivity point of view related to GDP growth – is how technology and technology-enabled disruption is affecting the workforce.

And this is what we are finding at the Dallas Fed. If you've got a college education in this country, most of you probably know these statistics, your unemployment rate right now is about 2%. Okay. Much lower than the average. And your participation rate, i.e. whether you're in the workforce, it's about 74% for college graduates. If you've got a high school education, that unemployment rate jumps up to 3- 3/4% and your

participation rate dips down to in the 50s. And if you've got less than a high school education, your unemployment rate is over 5% and your participation rate is in the 40s. Much lower than the average.

We've got 46 million workers in this country who've got a high school education or lower. And what we're finding, and our working thesis at the Dallas Fed, is if you've got a college education, you will adapt to technology and technology-enabled disruption. Not without some pain and suffering and some trauma, but you've got the skills to adapt.

If, on the other hand, you're one of the 46 million workers that have a high school education or less, you are increasingly – unless you have a skill – you're increasingly finding that your job is either being restructured or eliminated. And unless you get retrained – which is a lot easier to say than to do, especially when you're in your 40s and you have a family to support – unless you get retrained, it's very likely that you'll find another job, that you may find your income go and your productivity go from here to here over the course of your career. So we measure productivity workforce-wide. Every industry I look at is dramatically more productive, okay, but we measure productivity as an economy workforce-wide. And what I'm saying is that we're seeing the impacts of technology and technology-enabled disruption are shaking out differently based on your level of education attainment, educational attainment.

Now, how do we address this? It strikes us that we need to make dramatic actions in the areas of education. And, in particular, I would highlight early childhood literacy, improved college readiness, but also skills training. If you look at surveys of approximately 36 OECD countries, the United States right now, among its most recently surveyed 15-year olds, ranks 20th in math, science, and reading, out of 36 industrialized nations. I mean, when did that happen? We are eroding and our research suggests, and the research of others suggests, if we could improve our math, science, and reading, we would have higher productivity.

A big part of the problem is our fastest growing demographic groups are entering first grade already behind grade level in terms of reading. And if they start at first grade behind grade level, all the research suggests it's very hard for them to ever catch up. And we have sizable percentages of our population who are not able to get to first grade at grade level. So we have been big advocates, and I've been a big advocate at the Dallas Fed for dramatically beefing up early childhood literacy, expanded Pre-K, improving literacy. This is not going to be a magic bullet that fixes things in a year or two, but that's the workforce of the future and we need to make a dramatic increase in investment in skills training.

Now many of you would rightly say I thought we were already making dramatic increases in skills training. We are. And I can say in Texas there are lots of great

examples – Dallas Community College, El Paso Community College, Greater Houston Partnership. We're making great progress. But I'm basically saying if technology-enabled disruption is intensifying and I think it is – it's going like this – our improvement in our educational training and skills training is improving like this and the gap is widening. And so we are not getting the benefits of all this technology investment that we might otherwise be getting.

Now some have argued, maybe there'll be a lag, there'll be a lag in adoption and we'll start to see the benefits. But our thesis and my thesis at the Dallas Fed is unless we dramatically elevate the priority of investing in the adaptability of our workforce, we are going to lag. If that is the case, we're going to have sluggish GDP growth. Because I've mentioned, GDP is made up of growth in the workforce and growth in productivity. We should be having initiatives to work on both of those.

Okay, so let me talk about two other big drivers. The third big driver I would talk about is globalization. But I will talk about globalization today as an opportunity. And the only concern, the main concern I have is we're less than 5% of the world's population and at the moment, globalization is being described as a threat in the United States. And what do I mean by that? If your job is being disrupted or eliminated in the United States, the narrative you're often being told today, it must be due to either a dumb trade deal, a poorly constructed trade deal, or an immigrant is either depressing your wages or taking

your jobs.

We've done a lot of work on this at the Dallas Fed and we have a big staff to do it. Our research suggests that analysis is true and was true 15 years ago. Today, no. If your job is being disrupted or eliminated, it's almost certainly due to technology and technology-enabled disruption probably happening within the United States. And we think globalization is, in fact, an opportunity for the U.S. to grow faster, given I've mentioned, workforce growth is slowing and we haven't gotten the benefits in terms of productivity.

And the issue in particular, we've been strong advocates of saying the U.S., and I think we're finally there, we should be segmenting our trade relationships. And, in particular, the trade relationship with Mexico and Canada to some extent is critical to U.S. competitiveness and job growth. And what do I mean by that? Forty percent of the imports from Mexico is U.S. content. Okay. So a substantial amount of our trade relationship with Mexico is integrated supply chains and logistical relationships which our research shows allow U.S. companies to domicile here, add jobs, and take share from Asia, be more globally competitive. It's not enough to add a job in the United States, you can add a job in the short run. But if you're not globally competitive, that job isn't going to be around five years from now.

We think the trade relationship with Mexico has been essential to that so I'm very glad

that that relationship is getting settled down. This is why the threat a few months ago against Mexico related to the border, if you can remember that far back as three months ago – it seems like a long time ago – where we were threatened in escalating tariffs, we found that that really had a pretty traumatic effect on a broad range of businesses that rely heavily on that relationship. And this was a big reason why many companies told us and told me we're not going to cancel projects, but we're going to put them on hold and we're just going to wait. And companies have not quite yet recovered from that threat. The good news is we hope that relationship with USMCA being ratified is going to be stabilized.

The trade relationship with China is a very different kind of relationship. It's a final goods trade relationship. And we think, our research suggests that the fact we have a trade deficit is not that significant, but the intellectual property and technology transfer issues are very significant. But we think if it was just that dispute alone, most businesses in the United States could manage that. But that dispute along with the issues in North America plus other trade issues globally with Europe have helped created uncertainty. And what I'm saying here is we think globalization and trade are opportunities. I mentioned our views on immigration, although it's this very controversial and sensitive subject, immigration probably is an opportunity – both of them are opportunities for the United States to grow faster.

And we're going to need to find ways to grow faster because of the fourth big driver that

I'm going to talk about and that is government debt to GDP. Okay, so I mentioned earlier, the consumer is in better shape because the household sector has been de-leveraging, okay, over the last ten years, that's positive. The corporate sector, the non-financial corporate sector is dramatically more leveraged. Triple B debt has tripled. Leveraged loans, high yield debt has grown dramatically and I've expressed concern about it. I don't think at this point it's a systemic risk because the financial sector has de-leveraged, at least as we sit here now, and we need to continue with tough capital requirements and stress testing. But it's likely to be an amplifier, that amount of corporate debt, in a downturn, i.e. if we start growing more slowly because businesses are so highly leveraged, they're going to allocate more of their cash flow to servicing the debt rather than investing in their businesses. But it's a situation we're watching and I think it's a problem, but it's, I think, manageable and not systemic.

When you go to the government, that sector has increased its leverage dramatically since the Great Recession. Debt held by the public is now 78% of GDP. And the present value of unfunded entitlements is now $59 trillion. When I started in this job four years ago, the number from the CBO was $46 trillion. So every time I get these new numbers, I figure it must be a mistake because I have $46 trillion in my mind. But the number is going north, and because of the demographic trends in the United States, where 30 years ago workers were here, dependents were here, shifting, where now workers are here, dependents are here, it's exacerbating this issue. And this is a big

problem for many states because the lack of workforce growth means there are 35, 40 states in this country whose population growth is flat to down. The most valuable thing a country, or a city, or a state can have is workforce growth and population growth.

Texas is bucking this trend because we've got an enormous amount of migration to the state. But 35 to 40 states, and I watch this monthly at the Dallas Fed, 35, 40 states in this country, their population trends are flat to down. So they don't have the money to spend on education and some of these key drivers of GDP growth. And so at a minimum, the high level of U.S. government debt to GDP means we don't have much capacity for fiscal policy, but the bigger issue is, the only reason we're able to manage this amount of debt and this debt growth is because the dollar is the world's reserve currency. And we think it's a mistake, and I think it's a mistake for us to rely too heavily that indefinitely the dollar is going to be the world's reserve currency. If that were to change so that global investors, they don't need to stop buying U.S. dollars, they just need to get down closer to market weight, and we would be paying more for our debt and we would have a substantial issue with over $20 trillion of government debt and this amount of unfunded entitlements.

And I'm sorry we're not serving alcohol at lunch, and I hope I'm not depressing you too much, but I'm mentioning these big trends mainly because they're opportunities. And you'll notice one of the things these big trends have in common, they don't have

anything to do with monetary policy. And the reason I talk about them is around the world, central banks are taking extraordinary steps to try to combat or make up for or compensate for these structural trends. And I believe strongly that while in the last ten years it seems like most of the economic policy in the United States has been monetary policy, through most of our lives we've had much broader economic policy. And going forward, if we're going to grow at higher rates, which we can, we're going to need structural reforms, infrastructure spending, and other actions beyond monetary policy if we're going to reach our full potential as a country. And I think, as a central banker, it's wise for me to continue to flag that and with some humility say, no, the Fed is not, or central banks around the world are not going to be able to solve these problems. We need broader economic policy.

Now, I'll just mention, and some of you will be sensitive to this, there's a fifth trend increasingly I'm talking about, which is becoming a driver, and that is climate change and sustainability. I come from a state, which, yes, we are the largest energy producer in the country and one of the largest in the world, but we've got issues with our Gulf, severe vulnerability to hurricanes, flooding, and other severe weather events. And if you even closely believe the National Climate Assessment, and I wrote a paper on this about three months ago, if that is close to being accurate, we are talking, in the state of Texas, about needing to make substantial investments along the Gulf, reinforcing the Gulf. We house some of the nation's most critical energy infrastructure, petrochemical

and refinery infrastructure. And it's going to affect migration patterns and increasingly when tail events start becoming regular occurrences, it's going to be affecting economic outcomes.

The good news, again, about climate change, it is an enormous economic opportunity for the United States. We have some of the leading companies in the world. There's going to be huge industries that are being developed and they already are, but will be increasingly, to deal with this issue. The United States can be a great beneficiary of it. It can even stimulate greater growth in the United States. And so I will just flag that and you will hear me increasingly talk about it.

So let me stop there. That's a little bit of the landscape that we see. And so while we are conducting monetary policy and have a big role to play, what you're going to hear me say probably in every place I talk as long as I'm in this job is we need broader economic policy, away from monetary policy, or we're going to have increasingly sluggish rates and disappointing rates of GDP growth in the United States. Thank you.
(Applause)

QUESTION AND ANSWER PERIOD

CHAIRMAN MARIE-JOSEE KRAVIS: Thank you so much for sharing all of this

information with us, but most importantly for your candor and for also putting monetary policy into context, in a broad context. So, very refreshing and enlightening. Thank you. We'll take questions. If you could, please identify yourselves. And I think we have...Bill Rose was the first one I saw with his hand up. You have a microphone.

BILL ROSE: Thank you very much, Rob, for your wide-ranging comments on productivity, immigration, technology, etc. One of the concerns I think the markets have, and you and I discussed this briefly before, is this tremendous reach and search for yield, tremendous buildup of debt, not just in the United States but even more so in countries like China, the emerging markets. And many central bank heads that I've talked to are concerned that the central banking community is running out of ammunition for the next problem whenever that comes. And on the fiscal side, really, they haven't taken this into account because it was the central banks that pulled us out of the last one. And maybe you can make a comment on that. Do you think that central banks really have run out of ammunition, I mean, other than going into negative interest rates?

ROBERT S. KAPLAN: We haven't run out of ammunition, but I do think, I'll give you an example. You mentioned negative interest rates. For me, negative interest rates is indicative of central bankers trying to do too much. And I think there's a point at which I think we would better serve the country by saying we will do our jobs but we need

broader economic policy. And so negative rates would be an example. I'm not convinced at all, having studied them outside the U.S., that they've helped growth at all. I think they've done damage to the financial sector. And we, in the United States, would be particularly vulnerable to that because we have a very large money market industry. Many of our companies rely on the healthy money market industry and the commercial paper market. And I don't know how we would be able to do negative rates here without real damage. And it won't solve the problem in that the problem, I think, is more structural. The reason rates are so low, what's the number one, there are a couple of key determinants of low rates. One is global liquidity. There's no question. And the central bank is a part of that and that's why I'm very sensitive, and I've said publicly, I'm very sensitive to growth from here in the Fed balance sheet, but the biggest driver, I believe, of lower rates globally is sluggish expectations for GDP growth. They track pretty closely. As GDP estimates have come down, rates have come down. And unless we find ways to grow faster, I think we're going to be living with low rates for an extended period of time. That would be my sense. And if we grow even slower, say 1 ½%, you could see rates even lower. This is a big challenge for central banks, but I don't think central banks can deal with it alone. We need broader economic policy.

SCOTT SHAY: Scott Shay, Chairman of Signature Bank. President Kaplan, my question has to do with the demise of LIBOR. The Fed, along with the Fed-organized committee that's led by the top ten banks has been urging that SOFR, a Secured

Overnight Funding Rate that is an index of U.S. Treasury repo transactions replace LIBOR. This is a market that's controlled 98% by the top ten banks. And my question is, and it's a concern of many, that in times of crisis, secured overnight rates tend to drop just at the very time that we need indices to go up, otherwise credit gets choked off. By the same token, people are also worried that there could be plumbing issues such as happened in September that cause SOFR to go to 9, 10% that would dramatically raise credit costs for companies in Texas and everywhere, middle market companies. And that the Fed might need to do something that it shouldn't be doing for other reasons, but because of that. A third concern is that there's no cash market in SOFR beyond overnight rates. The rest are mathematical constructs which the Fed is going to construct. So my question is why is the Fed encouraging the adoption of SOFR solely? And are alternatives being considered by the Fed or choices being considered by the Fed to give people access to other rates?

ROBERT S. KAPLAN: So this is a long discussion, but I'll just say that this is likely to be a process that evolves. We need to move beyond LIBOR. The first step has been proposed as SOFR, but we're also, yes, we're having discussions broadly about other alternative rates. There are other alternative platforms that are being proposed as alternatives to SOFR. And I think this will be a bit of an evolution moving away from LIBOR. And we can talk a lot more about this in a lot more detail, but yes, we're spending time on this and are aware of the pluses and minuses of these various

alternatives.

CHAIRMAN MARIE-JOSEE KRAVIS: Someone has a question at Table 10 and we'll come to Table 3.

Thank you. My question relates to the neutral rate and why it no longer follows GDP as you have suggested earlier. GDP is at 2% which means that the neutral real rate should be around 2% and obviously it is not. And then how do you resolve that conundrum regarding what you pointed out earlier, the net present value of the unfunded liabilities, which normally would suggest that interest rates should really go up.

ROBERT S. KAPLAN: So let me untangle a few of those points. So, for those who wonder, you're not going to find on your Bloomberg screen something that's called the neutral rate. The neutral rate is something we spend a lot of time thinking about, and I spend a lot of time thinking about at the Fed, but it's a theoretical rate. It's the rate, it's the fed funds rate at which we're neither accommodative or restrictive. And no one, including me, knows exactly what it is. It's one of these things you kind of feel your way. I've made public comments, and I probably still would, that I think probably the neutral rate is in the range of somewhere between 2 to 2 ½% right now. But I've been revising down my own estimates as have others around the FOMC table. Why? What's the primary driver of the neutral rate? Prospects for future GDP growth. It's the number one

issue. And if, again, future GDP growth is going to be more sluggish, it means the neutral rate is going to hover around 2%. So this helps explain, so when I'm thinking about monetary policy, first of all, I try to figure out how the economy is doing and what the prospects are. Then I figure out, based on that, should we be accommodative, in neutral, or restrictive. In order to make that judgment, I have to have in my mind some sense of what the neutral rate is. To me, looking at market determined rates is a reality check on the neutral rate, meaning if the ten-year Treasury is sitting, right now it's 1.79, 1.80, it's hard to believe that the neutral rate could be a lot above 2%. But again, the long and the short of it, this creates challenges for the central bank in that it limits our ability to raise rates because if you raise rates much above that level, you're going to be restrictive. And based on my outlook for the economy, I don't think it's appropriate to have a restrictive policy stance right now. I might have a different view on what we should be doing on the balance sheet. But in terms of rates, you know, we will continue to wrestle ad infinitum on what the neutral rate is and how we should be adjusting policy. But the punch line is again, you know, when people say, gee, I thought, you guys ought to be getting back to 4 or 5%, why can't you do that? It's because the economy has changed dramatically since the neutral rate was 4 or 5%. And we need to face, in this job I've learned, I learned as a business person, I learned in this, you've got to face reality, try to understand it, and we have to adapt to it. And the reality, with sluggish prospects for future growth, the neutral rate is historically low.

FATHER ANDREW: Hi. I'm Father Andrew from St. Paul's Foundation. Thank you very

much...

ROBERT S. KAPLAN: We need probably clergy here to have this conversation.

FATHER ANDREW: Well, monks do work and pray with an emphasis on the work. So with that in mind, I wanted to ask a question relative to prudential wisdom, labor, automation, immigration, small business effects, and venture philanthropy. And we'll make it concrete. We're building a small brewery north of Boston as part of a stadium to educate clergy to go back and develop capacity in the Middle East and Eastern Europe. However, because of the decline in vocations, we would need to hire people to run the brewery. Unfortunately, labor costs are so high and the market is so tight that we can't find qualified individuals. And if we do find qualified individuals, they're priced out of the market. And we can't hire people from the best brewery technology programs in Germany or elsewhere because of bad immigration policy. And, in addition...

ROBERT S. KAPLAN: And your situation is not, it's being repeated all through the country.

FATHER ANDREW: Absolutely. Not unique. And in order to build the monastery, we need stone masons, but no stone masons exist in America anymore. And if there are people who have sort of self-trained, they have educational debt from prior degrees

which prices them out of the market. So my question is would a guest worker program help? If the guest worker program helps, how does that relate to the tightening of the market because of the increase in automation?

ROBERT S. KAPLAN: Okay, so in this job, I've learned, I can flag the issue, what I've tried to stay away from. And I've talked to, remember, elected/appointed officials extensively on both sides of the aisle, but they listen to me and they do because I'm not advocating something away from monetary policy. I'm basically flagging the issue. Other than to say, we need to find ways to grow the workforce because I think we are at the point where the shortage of workers is negatively affecting GDP growth. And I see it all through the state, even of Texas. And, by the way, we have substantial migration in. So one of the things that opened people's eyes was Hurricane Harvey, which happened a couple of years ago in that as we bored into it, it's our best guess that there are 500,000 or 600,000 undocumented workers just in the Houston area. And, oh, by the way, half of the construction force, it's our estimate, half of the construction force in that city is undocumented workers. And so a lot of the construction and rebuilding and other things that need to get done, we are short. And I've talked to lots and lots of companies who just say we're slowing down a project or we're slowing down an initiative because we're not confident we can find workers. And so this is a big challenge in the United States.

CHAIRMAN MARIE-JOSEE KRAVIS: We're going to take two more questions and

then...

ROBERT S. KAPLAN: And if nobody asks about the repo thing, I'll volunteer it because I know you want to know about it.

KRISHNA GUHA: Thank you, Rob. I'm Krishna Guha from Evercore Partners. Rob, as you know much better than I do, the Fed's been engaged in a very extensive strategic review and the latest indications are that this will reach some conclusion around the middle of this year. Could you give us a personal perspective on what you would like to see come out of that review?

ROBERT S. KAPLAN: So here's two or three things that I would like to see and I'm on the Communication Committee and I'm right in the middle of this. Number one, I would like to see an explicit acknowledgment that financial stability should be a consideration in our deliberations. And right now our framework explicitly says full employment and price stability but I believe that a third consideration we've got to be weighing is what is the impact of our policies on financial stability. Second, on the inflation front, a lot has been made of the fact that we've been running behind our 2% target. And, as you've heard from me today, I think a lot of this muted inflation has to do with structural issues, lack of pricing power. And I think these issues are intensifying. And some of the issues are not very susceptible to monetary policy. So I would be open to debate about having

a range around the inflation rate, you know, say 1½ to 2½%. At least I would like to have that debate. I would be open to having a longer averaging period. But whatever we decide, those are analytics, they're not a substitute for our judgment and I would not want to be making – based on analytics – current commitments about what action we're going to take in the future because I worry about, in our efforts to reach that 2% inflation target, I want to think about the implications for financial stability. That has to be taken into account. So I guess those would be, there are other things we could do in the framework, but those would be two I'd mention.

CHAIRMAN MARIE-JOSEE KRAVIS: Last question.

KEVIN CHEN: Okay, thank you. Kevin Chen at Horizon Financial and also at New York University. So my question is I think you touched really a bit about the repo market. So last year the repo market had a lot of events and this year continues, we see more injection of capital. So what is the Fed's plan going forward? I mean is it, you know, going to be considered more like kind of new round of QE?

ROBERT S. KAPLAN: No. I hope not.

KEVIN CHEN: And also, I think a lot of people here think that, you know, if there's really a lot of need for repo finance, why not just let the rate kind of go up a bit further to let

people pay for the cost instead of the Fed to continue to feed...

ROBERT S. KAPLAN: So here's the issue. As we know, the Fed had been running up its balance sheet for a good part since the crisis. Then we stabilized it and then we tried to make efforts to gradually roll down our balance sheet. Not by selling securities but by not replacing maturities as they expired. While that was going on, government debt issuance continues to go this way. Deficit spending goes this way. And what we found in the month of September, and you could criticize this, maybe we should have done a better job anticipating it, the U.S. economy lost about $250 billion of reserves in the month of September because of tax payments and the more Treasury issuance, it basically takes reserves out of the system. And so we started to see spikes in the overnight lending market. The second problem, or second challenge, is because of new bank regulation, banks have to keep more capital, they have to keep more reserves, and they're not as willing to lend reserves to each other in the repo market. So what did we do? We stepped up and we said we're going to buy $60 billion of Treasury bills a month until say March or April. And then we also initiated these daily and term repo facilities so we became a part of the repo market to settle the rate down and particularly to get us through year end. My own view is this is going to be an ongoing challenge because we know government debt issuance is going to continue to climb. And so what I'd like to see us do is get through the $60 billion of Treasury purchases through March or April and then I believe very strongly we're going to need to find a way to curtail the

growth in the balance sheet and wind those down and find other tools, either regulatory or potentially other variations of repo, say a standing repo, it doesn't have to be a standing repo facility that provides, that is activated when there's a spike in the repo rate, okay. But I, for one, want to see us wind down this balance sheet growth to deal with this issue, but also, we're debating and will debate a structure – I think we should have a structure in place that allows us to have the smallest balance sheet possible in an ample reserves regime. Balance sheet growth is not free and I think we've done exactly what we had to do to get through year end, but from here, I plan, I'm part of, with the rest of the FOMC, debating options. But my own view would be we should find a way to limit and temper the growth in the balance sheet as much as possible while dealing with this repo issue. Because I am worried that growth in the balance sheet is fueling elevated levels of risk assets and other excesses in the balances that may be hard to deal with later. So this is a balancing act and we're going to have to work our way through it. Thank you Marie-Josee. Thank you very much.

(Applause)

CHAIRMAN MARIE-JOSEE KRAVIS: Again, thank you. And thank you for your generous commitment to taking questions and answering them, again as candidly as you presented. So thank you very much. I just want to remind the members. Our next event will be February 3 with Lee Ainslie, the Founder and Managing Partner of

Maverick Capital. And three days later, we'll be hosting Ken Griffin who is the Founder and CEO of Citadel. And then later that month, Heath Tarbert, the Chairman of the U.S. Commodity Futures Trading Commission. We have March 11, I hope you'll all mark your calendar, we'll have a day, or at least part of a day, Women in Business. It's our traditional discussion that we have. We've had International Women's Month. And so we've discussed women in venture capital at our last meeting last year, and we'll continue that discussion of women in business on March 11. In April, we'll receive David Solomon and then Paul Tudor Jones. And many more to come, but I just wanted to whet your appetite about the 2020 program. So thank you very much. Enjoy lunch. (Applause)