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"Assessing the Economy's Progress"

Eric S. Rosengren
President & Chief Executive Officer
Federal Reserve Bank of Boston

Presentation to the
Newport County Chamber of Commerce

Portsmouth, Rhode Island
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Good afternoon. Thank you for the invitation to speak with you today. It is a great pleasure to be in Newport County to talk about the economic outlook. In September, Rhode Island had an unemployment rate of 5.4 percent, only a bit above the national average. This represents a really remarkable improvement, given that the state was among the hardest hit during the Great Recession – unemployment peaked at 11.3 percent in Rhode Island in mid-2009. According to the Bureau of Labor Statistics, among the states, Rhode Island had the largest decline in the unemployment rate from September 2014, at 1.8 percentage points.[1]

Looking regionally, in September two New England states – New Hampshire and Vermont – had unemployment rates below 4 percent, and two other New England states – Massachusetts and Maine – had unemployment rates below 4.8 percent, which is my current estimate for the "full employment" level for the nation as a whole.

The employment report for October, released last Friday, held very good news. Nationally, the unemployment rate fell to 5 percent. In addition, payroll employment grew by 271,000 jobs in October, and over the past three months payroll employment growth has averaged 187,000 jobs per month. Clearly, we are seeing continued improvement in labor markets and a further reduction in the remaining labor market slack.

Given the positive labor-market news – in Rhode Island, in New England, and nationally – it is reasonable to ask whether the degree of monetary stimulus being provided by the Federal Reserve is still necessary. The question is especially relevant as many parts of the country return to pre-recession unemployment rates.

As I explore that question with you today, I would note as I always do that the views I will express are my own, not necessarily those of my colleagues at the Federal Reserve's Board of Governors or on the Federal Open Market Committee (FOMC).

At the September monetary policy meeting of the FOMC, the Committee chose not to raise short-term rates. In my view, that was a prudent decision, based on managing risks and concerns. In the second half of August, problems in some emerging-market countries were unsettling global financial markets – and it was unclear what the duration of those difficulties would be, and the likely extent of the spillover to more developed economies.

Fortunately, the worst of those concerns have not materialized. Many stock markets have improved from August, and more importantly, domestic spending in the U.S. does not seem to have slowed significantly as a result of those earlier concerns; and firms are continuing to hire additional workers.

After the October monetary policy meeting, the FOMC statement[2] noted that we are, of course, still monitoring global economic and financial developments. It went on to say that "it will be appropriate to raise the target range for the federal funds rate when [the Committee] has seen some further improvement in the labor market and is reasonably confident that inflation will move back to its 2 percent objective over the medium term." In more colloquial terms, I would say if we see continued gradual improvement in the U.S. economy, it will be appropriate to gradually increase short-term rates.

October's statement explicitly mentioned the possibility that the first move could occur as soon as the next meeting, in December, by saying: "In determining whether it will be appropriate to raise the target range at its next meeting, the Committee will assess progress – both realized and expected – toward its objectives of maximum employment and 2 percent inflation." I would highlight that the data received recently have been positive, reflecting real improvement for the economy.

Today, I would like to review some of the current economic data and in doing so, describe why I am quite supportive of the position taken by the FOMC at the last meeting.

Recent Economic Data

Many headlines have focused on real GDP growing at only 1.5 percent in the third quarter. However, I would like to share with you a measure that focuses on domestic demand – real final sales to domestic purchasers, which is shown in **Figure 1**. This statistic is similar to GDP, but excludes fluctuations in *inventories* and *net exports*. This leaves consumption, investment, and government spending – in sum, a measure that tries to capture the underlying strength in domestic demand. In the third quarter of this year, real final sales to domestic purchasers grew by 2.9 percent, following its second-quarter growth of 3.7 percent.

In part, this indicator of more robust growth reflects the strength of consumer spending, shown in **Figure 2.** Consumer spending has been boosted by the continued gradual improvement in labor markets, lower gasoline prices, and the relative strength in housing prices and stock prices, which have improved household net worth.

Importantly, the strength in the third quarter in this measure of domestic demand suggests that the U.S. was little affected by the problems in emerging markets, or by the resulting financial-market turbulence. With little collateral damage evident from external sources, I expect domestic demand to continue to support the economy. This should help to offset any potential weakness of some of our trading partners and the strength of the dollar, which of course makes it more difficult for U.S. exporters to compete internationally.

As long as domestic growth can offset any weakness in net exports, the economy should continue to grow somewhat above the level one would consider its "potential," a growth rate that I estimate to be somewhat below 2 percent today. Growth above that rate should place downward pressure on unemployment rates. Recent evidence confirms this assessment: despite real GDP growth averaging only 2.1 percent since the beginning of the recovery, both the widely reported U-3 measure of unemployment and the broader U-6 measure of unemployment have fallen quite quickly, as shown in **Figure 3** (the U-6 measure of unemployment adds persons marginally attached to the labor force, plus those part time for economic reasons).

How much *further* the unemployment rate can fall without risking a significant rise in inflation above the Federal Reserve's 2 percent target depends on one's estimate of the unemployment rate that is consistent with full employment. **Figure 4** shows the Federal Reserve policymakers' Summary of Economic Projections – the "SEP" – forecast for the unemployment rate through 2018.[3] The median among all policymakers' projections is shown as the solid line, starting at 5 percent and falling to 4.8 percent. In addition, the chart provides the estimates by FOMC participants of where *longer-run* unemployment is likely to be – which is a good proxy for their estimates of the unemployment rate consistent with full employment.

The area between the dashed lines contains the range of estimates, which is fairly wide – from a low of 4.7 percent to a high of 5.8 percent. The central tendency (which excludes the highest and lowest three estimates of longer-run unemployment) ranges from 4.9 to 5.2 percent, and is shaded. Given those numbers, the 5.0 percent unemployment rate for the U-3 measure is already squarely within the Fed policymakers' central tendency for longer-run unemployment. At the Boston Fed, our estimate of unemployment in the long run is 4.8 percent. While that is just below the SEP central tendency, it is only 0.2 percent below the current rate.

Once we have reached the 2 percent inflation target and the natural rate of unemployment, we should have normalized interest rates. So one way the unemployment rate stops declining and levels off is if the Federal Reserve begins normalizing interest rates during the recovery, as the current extent of monetary accommodation becomes no longer necessary to reach the long-term goals.

Figure 5 provides the *real* federal funds rate, measured as the federal funds rate minus the inflation rate (with inflation measured by core PCE).[4] The real rate is important for spending and investment decisions. The past three recessions are shaded.

Not surprisingly, the Federal Reserve generally reduces short-term interest rates during a recession and the early stages of a recovery. While the real federal funds rate did not become negative during the 1990 recession, it did become negative just after the close of the 2001 recession. What is more unusual is *how long* the real federal funds rate has remained negative in the aftermath of the most recent recession. After more than six years of recovery, the real federal funds rate still remains negative, to a greater extent than in either of the previous two recessions.

Figure 6 plots the real federal funds rate relative to the U-3 unemployment rate. The red dot highlights the October unemployment rate of 5.0 percent, and an October real federal funds rate of negative 1.2 percent. In addition, the chart separates – by color – observations from before monetary policy reached the zero lower bound (in December of 2008), and after. The bulk of negative real interest rate observations occur when the unemployment rate is quite high. More generally, when the unemployment rate is as low as it is now, you normally see positive rather than negative real federal funds rates.

Figure 7 shows the real federal funds rate relative to core PCE inflation. Again, the chart uses color to separate the observations from before and after monetary policy reached the zero lower bound. As the chart shows, the cluster of negative real interest rates reflects the period when monetary policy hit the zero lower bound. Since the nominal federal funds effective rate is near zero, the movement of the real interest rate once the zero lower bound was hit only reflects variation in the core PCE inflation rate. While there are limited observations of the core PCE inflation rate being this low, there are observations of a higher real federal funds rate when inflation is approximately as low as it is currently. This highlights that monetary policy remains quite accommodative by historical standards, even while the PCE inflation rate remains low, relative to our target.

To that end, **Figure 8** shows several possible paths for short-term interest rates. One path illustrates what might occur if we were to increase the funds rate by 25 basis points at each FOMC meeting (as we did in the recovery from the 2001 recession) until the rate reaches the SEP longer-run projection. Another path depicts the Fed policymakers' September SEP, and a third path represents market expectations, implied by federal funds rate futures. The latter two both would suggest that this is likely to be a much more gradual normalization process than the one that followed the 2001 recession. Given persistently low wage and price pressures, and the relatively slow real GDP growth forecast in the SEP shown in **Figure 9**, a more gradual path of normalization may be necessary to ensure reaching the 2 percent inflation target.

There are other potential advantages to a gradual removal of accommodation. First, a slower path will provide more time to analyze the effectiveness of monetary policy tightening tools. Were the Committee to wait longer to begin, and then need to potentially move rates more rapidly, we might have less flexibility to assess the effectiveness of some of our new tools.

A second benefit of a gradual removal of accommodation is that it would provide more time to analyze how the tightening is affecting the real economy. Given that there is significant uncertainty about the level of interest rates that would stabilize inflation or unemployment – and also uncertainty about the federal funds rate that would reflect fully normalized policy – a slower pace reduces the risk that the Committee takes more or less aggressive action than needed or intended.

Given the uncertainties surrounding the degree of accommodation that is necessary to achieve 2 percent inflation and full employment, I prefer a path that involves only gradual increases in interest rates and that essentially probes how tight labor markets can be, consistent with our 2 percent inflation target.

Financial Stability Considerations

When the U.S. economy was significantly missing on the Federal Reserve's employment and inflation goals, monetary policy was appropriately calibrated to provide considerable stimulus, so as to return the economy to its desired, normal state. However, as the economy attains a more desirable balance of full employment with 2 percent inflation, financial stability issues that imply risks to future economic balance should receive increased weight.

One potential cost of maintaining the federal funds rate at the zero lower bound for a long time is that it may incent behavior that would be discouraged in a more normalized interest rate environment. Looking forward, a potential risk of a low-interest rate environment is that investors seeking a higher return may take on too much risk in order to improve returns, perhaps not fully taking into account the higher risk that normally accompanies higher yields.

Early signs of this "search for yield" may be showing up in the commercial real estate market. **Figure 10** shows the path of commercial real estate prices, which have grown quite rapidly, despite the only modest growth in real GDP over the recovery.

While **Figure 10** reflects broad regional trends, in some more localized markets commercial real estate activity has been even more robust. A qualitative indicator in a major city is a simple crane count. When the number of cranes observed on a short walk in a city such as Boston reaches double digits, as is the case today, it is worth reflecting on the sustainability of such growth. Particularly given the role that commercial real estate played in the economic downturn in New England during the late 1980s, the trend in commercial real estate prices should be thoughtfully monitored.

Concluding Observations

In summary and conclusion, I would note that labor markets have improved over the past year, and we are at – or fast approaching – rates of unemployment that many economists estimate to be consistent with full employment. As long as the economy is growing somewhat above potential, I am reasonably confident we will return to our 2 percent inflation target and to my estimate of full employment.

As the October FOMC statement indicated, all future Committee meetings – including December's – could be an appropriate time for raising rates, as long as the economy continues to improve as expected. However, with inflation still below the target, I believe the path of increases should be gradual, once we do move off the zero lower bound.

Thank you for inviting me to speak with you today, and please accept my best wishes for continued growth and progress in the Rhode Island economy.

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[1] According to the Bureau of Labor Statistics: "Twenty-six states and the District of Columbia had statistically significant unemployment rate declines from September 2014, the largest of which occurred in Rhode Island (-1.8 percentage points) and Michigan (-1.7 points). The only significant over-the-year rate increase was in West Virginia (+1.0 percentage point). The remaining 23 states had rates that were not appreciably different from those of a year earlier." See: http://www.bls.gov/news.release/laus.nr0.htm

[2] See the October 28, 2015 FOMC statement: http://www.federalreserve.gov/newsevents/press/monetary/20151028a.htm

[3] See the September 17, 2015 Summary of Economic Projections (SEP): http://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20150917.pdf

[4] In order to calculate the real federal funds rate for October, we assume that the core PCE inflation rate remains unchanged in October at 1.3%, on a year-over-year basis.