Exploring the Economy’s Progress and Outlook

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May 12, 2016

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Gradual Improvement in the Economy

- Second-quarter indicators
  - Still quite early
  - Payroll employment – 160,000 jobs in April
    - Less than expected – 203,000 was the average monthly gain in Q1; but above “trend”
    - Enough to gradually tighten labor markets
    - Close to full employment
    - Higher wages and hours worked should be a positive driver for future consumption
Pick-up in Spending Expected

- Q1 real GDP growth only 0.5 percent
  - Weaker than projected earlier in the year
  - Weakness not expected to persist
    - U.S. and foreign stock markets rebounded from mid-February
    - Euro area grew faster than U.S. in the first quarter
    - Some evidence that spending is increasing
- Fewer headwinds from abroad and stronger consumption should improve spending for Q2
Implications for Policy

- Relatively little data for second quarter as yet
- Expect growth somewhat above my estimate of the “potential” rate of 1.75 percent
- Gradual improvement in labor markets and inflation
- The market remains too pessimistic about the fundamental strength in the US economy
- In my view, likelihood for removing monetary accommodation is higher than is currently priced into financial markets
Figure 1: Real GDP Growth

2014:Q1 - 2016:Q1

Quarterly Percent Change at Seasonally Adjusted Annual Rate

Source: BEA, Haver Analytics
Figure 2: Auto and Light Truck Sales
January 2014 - April 2016

Source: BEA, Haver Analytics
Figure 3: Change in Payroll Employment
January 2014 - April 2016

Source: BLS, Haver Analytics
Figure 4: Measures of Labor Underutilization
January 2014 - April 2016

Note: The U-6 measure is total unemployed, plus all persons marginally attached to the labor force, plus total employed part time for economic reasons, as a percent of the civilian labor force plus all persons marginally attached to the labor force.

Source: BLS, Haver Analytics
Figure 5: Average Hourly Earnings of Employees on Private Nonfarm Payrolls
January 2014 - April 2016

Source: BLS, Haver Analytics
Figure 6: U.S. Inflation Rate: Change in Core Personal Consumption Expenditures Price Index
January 2014 - March 2016

Source: BEA, Haver Analytics
Economy Continues to Improve

- It is early in the quarter, but data consistent with gradual improvement
- We are adding jobs faster than trend which should tighten labor market conditions
- Limited spending data consistent with growth above potential
Risks Associated with Leaving Rates Too Low for Too Long

- Benefits of accommodative policy
  - Probe on the natural rate of unemployment
  - Workers rejoin the labor force, many of them previously having given up looking for work
- Also potential costs of too much accommodation, for too long
  - Very low interest rates can encourage speculative behavior – I have some concerns about commercial real estate
  - It’s difficult to “fine tune” the economy – if we overshoot the natural rate of unemployment, *gradually* increasing is difficult
Figure 7: NCREIF Commercial Real Estate Transactions-Based Real Price Indices
1994:Q1 - 2016:Q1

Index, 2007:Q2 = 100

- Apartments
- Offices
- Retail Properties
- Industrial Properties

Note: Series are adjusted for inflation using the GDP Deflator.
Source: National Council of Real Estate Investment Fiduciaries (NCREIF), BEA, NBER, Haver Analytics
Figure 8: Real Multifamily Residential Mortgage Growth
1976:Q1 - 2015:Q4

Note: Series is adjusted for inflation using the GDP Deflator.
Source: Federal Reserve Board, Financial Accounts of the United States, BEA, NBER, Haver Analytics
Why are Potentially Inflated Commercial Real Estate Prices a Problem?

- Financial instability often tied to real estate
  - Debt contracts on volatile underlying assets are a problem when prices fall
  - Problem for owner, debtor, and potentially others if the debt is to financial institutions
  - Historical context: New England in the late 1980s and early 1990s
- Avoid problems of past cycles
Supervisory Responses

- **Interagency Statement on Prudential Risk Management for Commercial Real Estate Lending (SR 15-17)**
  - Prudential risk management
  - Reemphasized earlier guidance on the need for exposure thresholds and increased monitoring
- **Supervision can only apply to regulated banks**
  - Non-bank lenders
  - Foreign investors
Figure 9: Civilian Unemployment Rate
January 1960 - April 2016

Source: BLS, NBER, Haver Analytics
Concluding Observations

- Economy improving gradually – employment and inflation are getting closer to the Fed’s dual mandate
- My view is the Fed should be ready to gradually normalize rates, perhaps at a pace not currently anticipated by the federal funds futures market
- We must remain data dependent – domestic and international disruptions could change outlook
  - However – such disruptions would need to materially change the outlook
  - As we make progress on dual mandate, gradual removal of monetary policy should continue