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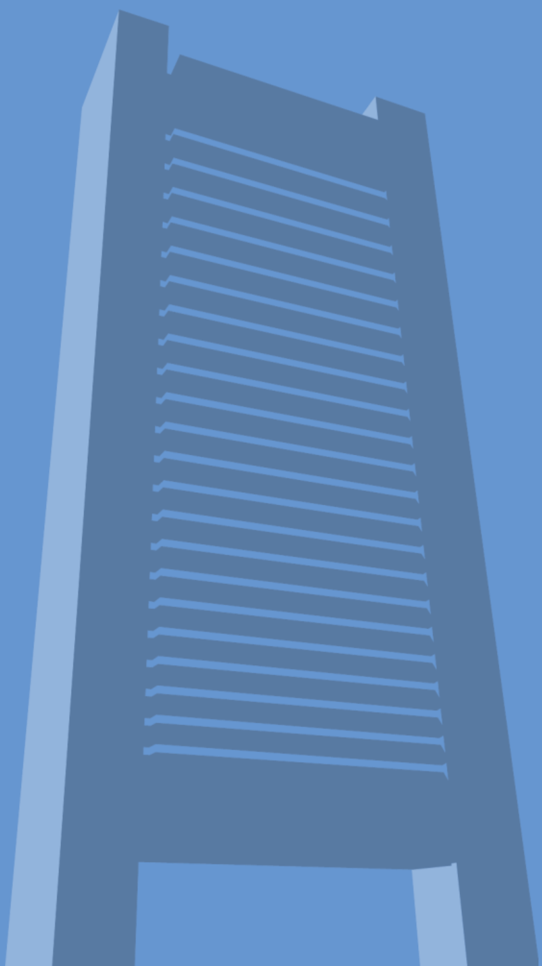

Economic Uncertainty – The Implications for Monetary Policy

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July 10, 2015

Global Interdependence Center
7th Annual Rocky Mountain Economic Summit
Victor, Idaho

bostonfed.org

Monetary Policy in Times of Economic Uncertainty

- Financial market participants prefer certainty
  - Simple statements of the direction of monetary policy
  - Unqualified statements are preferred
- Monetary policy depends on forecasts
  - Events this summer highlight the difficulty in making accurate forecasts
  - This uncertainty highlights the prudence of data dependent monetary policy

Uncertain Inflation Forecasts

- Why has core inflation remained persistently below 2 percent?
- Summary of Economic Projections had assumed we would be seeing more movement towards 2 percent target
- Recent international events make future path of energy prices and exchange rates more uncertain

Uncertainty Abroad

- Recent events in Greece highlight our interdependent world
- The emergence of questions about whether Greece and its creditors can reach a viable agreement complicates projections
- Not obvious that recent events will alter expected path of U.S. economy, but they have added to uncertainty around my forecast

Normalization and Uncertainty

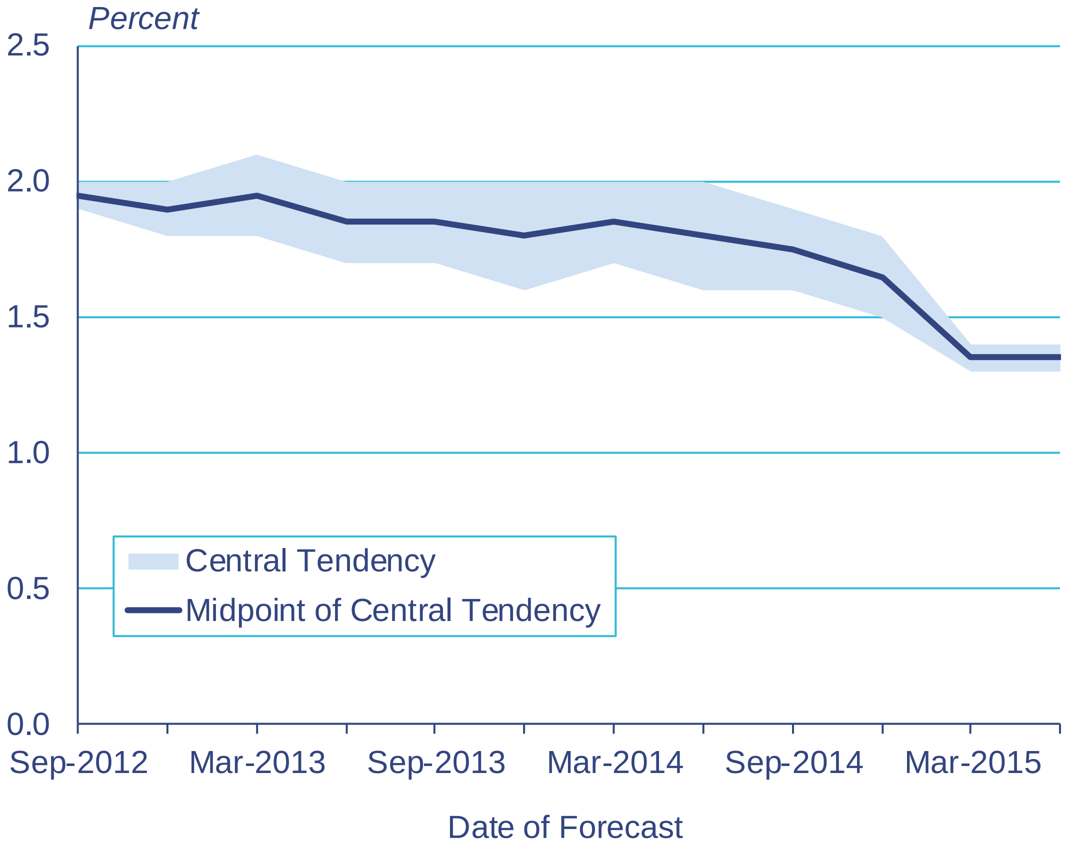
- Were the economy to unfold as I expect in my forecast
  - Normalization later this year might be appropriate
  - However, the forecast is subject to considerable uncertainty
- Today I will discuss some of the uncertainty that leads us to continue to focus on incoming data

Domestic Uncertainty

- Inflation remains well below our target
- Normalization condition – FOMC should be reasonably confident that inflation will move back to its 2 percent objective over the medium term
- Note that undershooting inflation targets has been a problem in many developed economies over recent years

Figure 1: Core PCE Inflation Projections for 2015 of Federal Reserve Governors and Federal Reserve Bank Presidents

September 2012 - June 2015

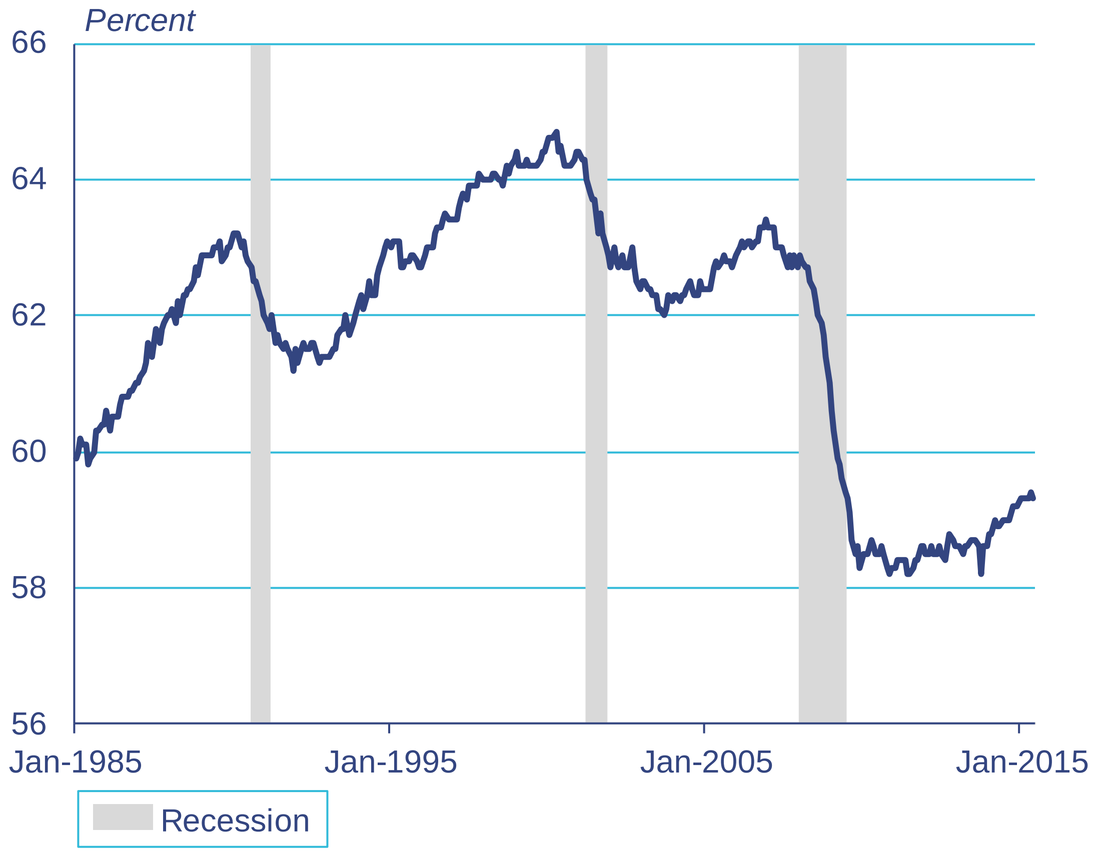


Note: The central tendency excludes the three highest and three lowest projections in each period. The inflation projections for 2015 are the percent changes from the fourth quarter of 2014 to the fourth quarter of 2015 reported in each SEP.

Source: FOMC, Summary of Economic Projections (SEP)

Figure 2: Employment-to-Population Ratio

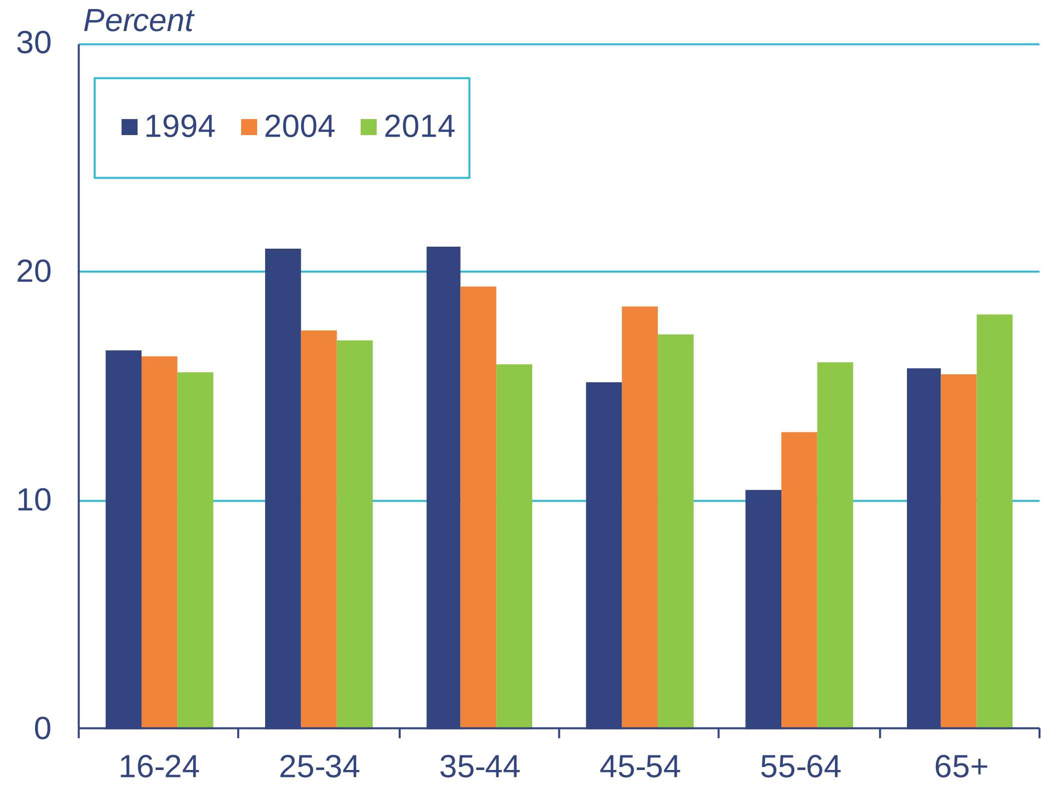
January 1985 - June 2015



Source: BLS, NBER, Haver Analytics

Figure 3: Age Distribution of the Civilian Noninstitutional Population, Age 16 Years and Older

1994, 2004, and 2014



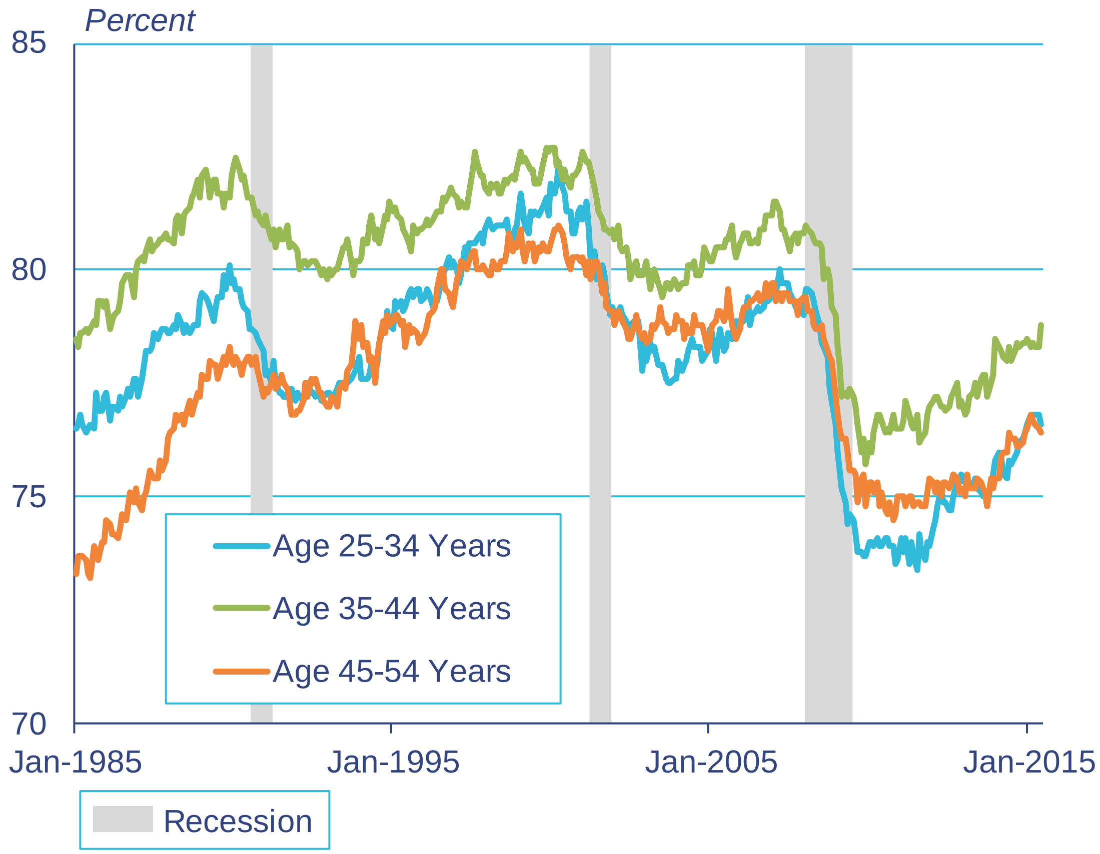
Source: BLS, Haver Analytics

Demographic Shift and Full Employment

- Young workers tend to have higher unemployment rates
- Older workers tend to have lower unemployment rates
- Estimates of full employment need to consider the impact of demographic changes
- While my estimate of full employment is now 5 percent, it may be lower if we continue to undershoot our inflation forecast

Figure 4: Employment-to-Population Ratio for Prime-Age Workers

January 1985 - June 2015



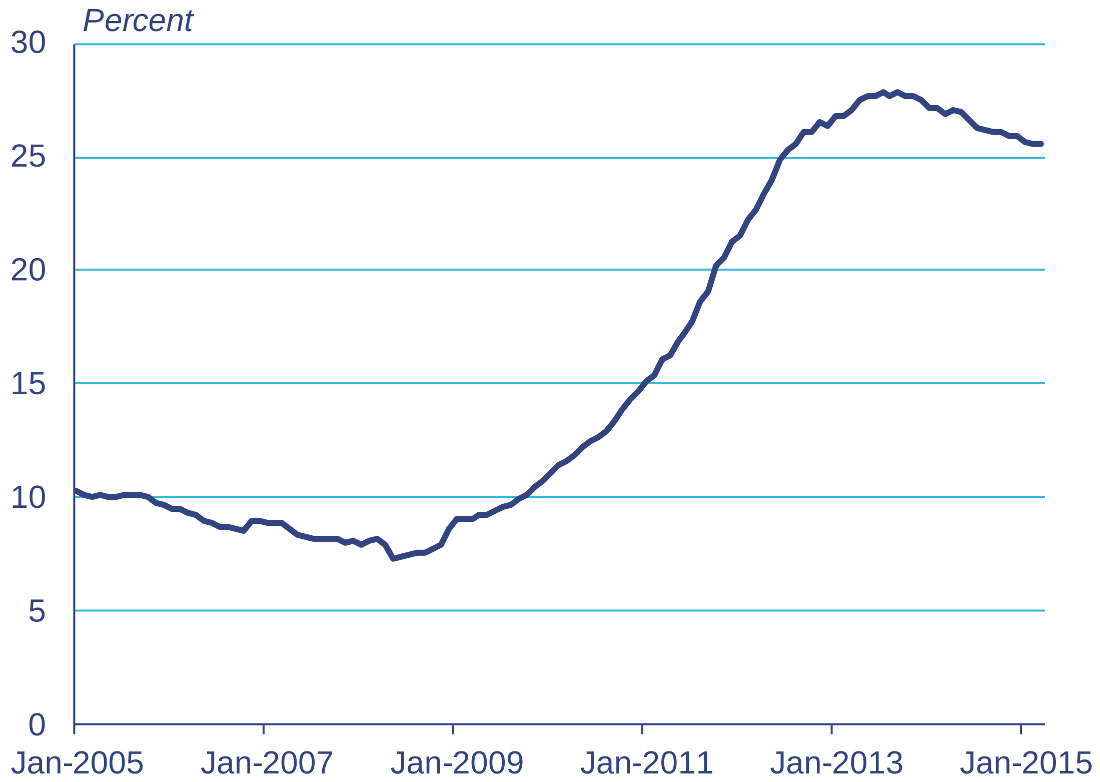
Source: BLS, NBER, Haver Analytics

Uncertainty and International Shocks

- Possible international shocks include:
  - Greece’s debt crisis
  - China’s slowing economy
  - Japan’s long-run economic challenges
- I am currently making the assumption that international matters will be resolved in a way that does not meaningfully alter the course of the U.S. economy
- Difficult-to-predict international events can make forecasting quite challenging

Figure 5: Unemployment Rate for Greece

January 2005 - March 2015



Source: Eurostat, Haver Analytics

Figure 6: Gross Domestic Product and Population of Greece Relative to that of the Euro Area, the European Union, and the United States

2014

Country/Region	Gross Domestic Product 2014		Population 2014		Per Capita GDP 2014	
	Billions of U.S. Dollars	Greece Relative to Country/ Region	Millions of People	Greece Relative to Country/ Region	U.S. Dollars Per Person	Greece Relative to Country/ Region
Greece	238.0	--	10.9	--	21,826.7	--
Euro Area	13,435.5	1.8%	334.5	3.3%	40,171.6	54.3%
European Union	18,505.9	1.3%	506.8	2.2%	36,513.5	59.8%
United States	17,419.0	1.4%	318.9	3.4%	54,629.5	40.0%

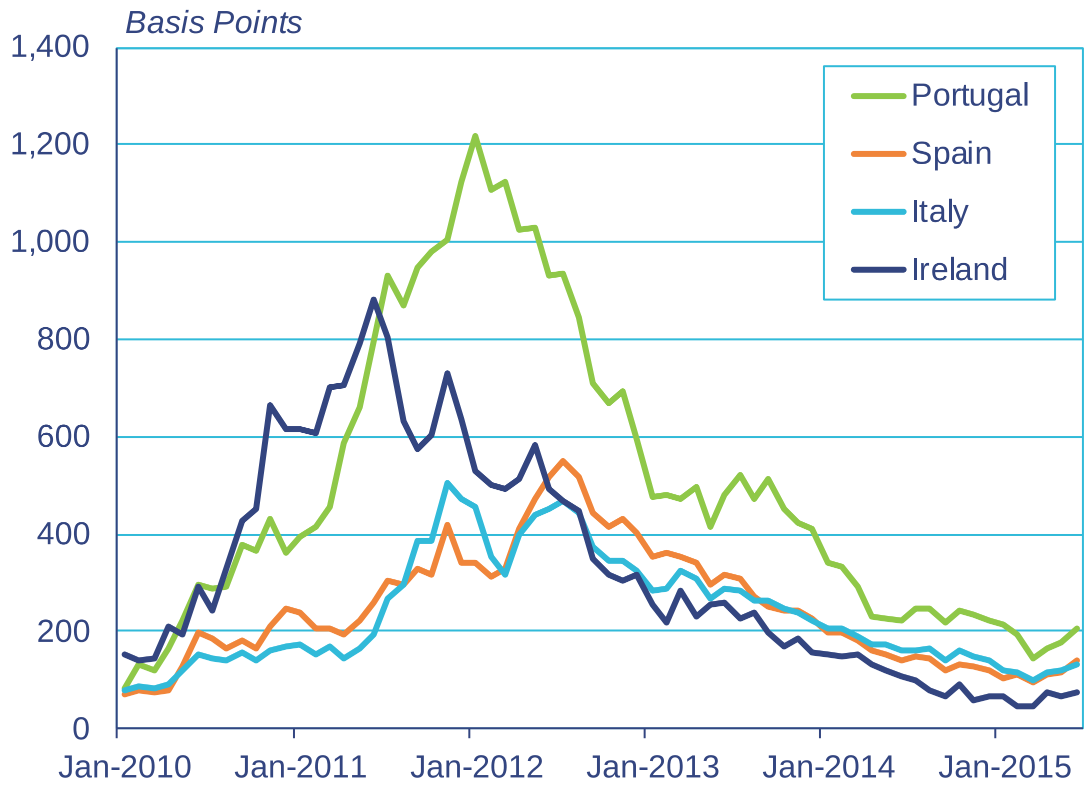
Source: BEA, Census Bureau, Eurostat, Haver Analytics

Calibrating Financial Stability Risks

- What is the concentration of exposures?
- Are the exposures held by highly leveraged investors?
- Do these investors play a critical role in financial markets functioning smoothly?
- In 2011, a key risk was commercial bank exposures to Greece
- With the earlier restructuring of Greek debt, much of this risk has been transferred, so losses would be borne diffusely by European taxpayers

Figure 7: Spread: Ten-Year European Government Bond Yields Minus Ten-Year German Government Bond Yield

January 2010 - June 2015



Source: Banca d'Italia, Banco de España, Central Bank of Ireland, Deutsche Bundesbank, Financial Times, Haver Analytics

Figure 8: Stock Market Index Fluctuations

June 26, 2015 - June 29, 2015

Country	Stock Price Index	Stock Price Index Close		Percent Change
		June 26, 2015	June 29, 2015	
Portugal	PSI-20	5,834.91	5,530.50	-5.2
Italy	FTSE MIB	23,800.47	22,569.95	-5.2
Spain	Ibex 35	11,372.30	10,853.90	-4.6
Germany	Frankfurt Xetra Dax	11,492.43	11,083.20	-3.6
Ireland	ISEQ Overall	6,367.67	6,209.14	-2.5
U.S.	S&P 500	2,101.49	2,057.64	-2.1

Source: Bolsa de Madrid, Borsa Italiana, Financial Times, S&P, Haver Analytics

Potential for Unintended Consequences

- Euro Area assumed to be a permanent currency union
- If that assumption eroded and it were to become understood, instead, that countries could leave the Euro Area, some of the advantages of the common currency would be diminished for all members
  - Exchange-rate risk
  - Inflation discipline
  - Capital flows

Conclusion

- U.S. economy has improved
- Still significantly undershooting inflation target
- Data dependence – need data that gives us greater confidence in our forecast, especially for inflation
- Need to carefully monitor potential impact of foreign shocks
- To date, foreign shocks have not significantly altered the outlook for an improving economy