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***“Monetary Policy as the Economy Approaches
the Fed’s Dual Mandate”***

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President & Chief Executive Officer
Federal Reserve Bank of Boston

New York Association for Business Economics

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Good afternoon. I would like to thank the New York Association for Business Economics for having me here today to share my views on the economy. At the outset, let me note as I always do that the views I express today are my own, not necessarily those of my colleagues at the Federal Reserve’s Board of Governors or on the Federal Open Market Committee (the FOMC).

The economy continues to grow moderately – at about the same 2 percent pace that it has for the past several years. This rate of expansion is slower than the historical average, but that appears to be largely due to declines in the rate of growth of productivity and the labor force.¹

Over the next year or two, I expect real GDP to grow somewhat faster than 2 percent, the unemployment rate to continue to gradually decline, and inflation to gradually return to the Federal Reserve's 2 percent target.

Recent data have been quite consistent with this outlook. Real GDP for the fourth quarter of 2016 grew at a 1.9 percent annual rate, with continued strength in consumer spending offset by an export slowdown. Weak exports were, in turn, the result of lethargic growth among many of our trading partners, as well as a relatively strong dollar. The labor market report for January showed that the economy added 227,000 new jobs, and an unemployment rate of 4.8 percent – a reading that is close to most economists' estimate of full employment. What's more, total and core PCE inflation measures are approaching the Federal Reserve's 2 percent inflation target, at 1.6 percent and 1.7 percent, respectively.²

While my forecast envisions a continuation of the economic growth we have seen over the past several years, it is important to note that the "starting point" is now quite different than it was a few years ago. The current 4.8 percent rate of unemployment is the same as the median forecast for unemployment in the long run by Federal Reserve policymakers (in the Federal Reserve's Summary of Economic Projections, or SEP)³ and only 0.1 percent above my own estimate of full employment. This would suggest that there is limited room for further tightening in labor markets before one might see more inflationary pressures. Also, inflation is now close enough to the Federal Reserve's 2 percent target that it is possible that we will reach the target as soon as the end of this year. However, inflation is not the only consequence of reaching or exceeding full employment: Another possibility is that imbalances will manifest themselves in asset prices, such as the price of commercial real estate.

As I will discuss today, with the economy at or approaching both elements of the Federal Reserve's dual mandate (price stability and maximum sustainable employment), it is my view that it will likely be appropriate to raise short-term interest rates at least as quickly as suggested by the Fed's current SEP median forecast, and possibly even a bit more rapidly than that forecast. Importantly, if GDP is growing faster than potential and we reach both elements of the dual mandate, the Federal Reserve risks "overshooting," potentially jeopardizing the very significant progress of the U.S. economy since the financial crisis.

Recent Trends in the Labor Market

I would like to walk you through the data that underpin my perspective. **Figure 1** shows initial claims for unemployment insurance. In 2005 and 2006, the years immediately preceding the financial crisis, initial claims for unemployment insurance were averaging a bit over 300,000. They rose sharply, more than doubling, during the worst of the financial crisis and recession, but have declined quite consistently over the past several years. The most recent weeks' data have seen initial claims hovering around 250,000 – below the level seen before the last recession.

As job prospects increase, workers become more confident that they will have the ability to improve their employment situation. As overall job prospects in the marketplace improve and workers' confidence rises, employers may well need to pay current employees higher wages to reduce the incentive for workers to quit in search of wages reflecting the rising market. As such, a rising "quits rate" is one gauge of how workers feel about the labor market's robustness and may also be a sign of emerging wage pressures.

Figure 2 shows the quits rate. Not surprisingly, the quits rate plunged during the financial crisis, as employees were primarily concerned with keeping their jobs in a significantly deteriorating labor market. As labor markets have improved, the quits rate has risen. The quits rate is still somewhat below the level prior to the recession – likely due to the aging of the workforce, and the lingering memory of recent concerns about employment security. But it shows a significant improvement in how employees are viewing the labor market.

Recent payroll employment, shown in **Figure 3**, has also been consistent with continued strength in the labor market. In January, the economy added 227,000 jobs. Over the past three months, the average has been 183,000 jobs – only slightly below the average for the last year. This growth rate will likely produce further declines in the unemployment rate, since employment is growing faster than the growth in the labor force that we expect over time.

The widely reported U-3 measure of civilian unemployment, shown in **Figure 4**, now stands at 4.8 percent, which coincides with the median long-run unemployment rate expected by FOMC participants in the Fed’s SEP. The chart also shows the Blue Chip consensus forecast (the green dots) for the next two years, as well as the SEP median forecast (the dark blue dot) of the path of the unemployment rate. The SEP median and the Blue Chip consensus forecasts expect the unemployment rate to end the year at 4.5 percent.

While the SEP assumes the unemployment rate will level off at that rate in 2018, the Blue Chip forecasters expect it to continue to fall somewhat below 4.5 percent. My own forecast is more consistent with the path of the Blue Chip consensus forecast, in that I expect real GDP to grow faster than potential, continuing to place downward pressure on the unemployment rate.

One feature of the recovery from the Great Recession has been the decline in the labor force participation rate, shown in **Figure 5**. The labor force participation rate is defined as the percentage of the working-age population (16 and older) that is either working or actively seeking work. Over most of the recovery, the labor force participation rate has declined. At first, the cyclical response of the participation rate had been reinforcing the trend associated with more people in the U.S. reaching retirement age. But as the recovery progressed, the trend decline due to an aging population has been offset by a positive cyclical response of increasing participation. Thus, the recent levelling off of participation, as seen in the chart, should be read as a sign of labor market strength.

Another feature of the labor market has been the median duration of unemployment, shown in **Figure 6**. The median duration of unemployment peaked after the Great Recession and has been steadily declining during the recovery. It is now only somewhat higher than it was prior to the last recession, although there remain an elevated number of people who have experienced a long duration of unemployment.⁴

In summary, the labor market has significantly improved during the recovery, and my own assessment is that there is very limited slack remaining. The unemployment rate is now at the SEP median forecast for unemployment in the longer run, and employees are becoming more comfortable switching jobs, and the duration of unemployment has normalized. Were the economy to grow much faster than potential, employers would likely encounter increasing difficulty in finding labor with the skills they need to grow. This potential labor shortage will place a premium on workforce development – which is consistent with comments I am

increasingly hearing from business and government contacts about the need for enhanced training for potential employees.

Economic Growth

Turning to growth, **Figure 7** shows the past two quarters of real GDP growth and the forecast of real GDP growth over the next four quarters from the Blue Chip consensus forecast.

While the 2016 fourth-quarter real GDP growth was only 1.9 percent, it followed a very strong 3.5 percent growth rate in the third quarter. As you can see, the Blue Chip forecast expects real GDP growth above 2 percent. Given my 1.75 percent estimate of the rate of potential growth, the Blue Chip growth forecast would yield a falling unemployment rate.

One source of the strength in the outlook is robust consumer spending, which accounts for roughly two-thirds of real GDP. Consumption was strong in the second half of 2016, as shown in **Figure 8**, and is likely to continue to be relatively robust, reflecting strong payroll employment, continued real income growth, and significant wealth gains over the past several years.

This growth in consumption is likely to offset areas of the economy that remain relatively weak. One important source of weakness has been exports, as shown in **Figure 9**. As monetary policy in the United States has become less accommodative, especially relative to our key trading partners, the exchange value of the dollar has risen. This appreciation, coupled with the general weakness of the economies of many U.S. trading partners, has caused real exports to slow.

Figure 10 shows the SEP median and Blue Chip consensus forecasts for real GDP growth over the next two years. The Blue Chip forecast is more optimistic than the SEP, with the median forecast of Federal Open Market Committee participants expecting only 2.1 and 2.0 percent real GDP growth in 2017 and 2018, respectively. My own forecast is more consistent with the Blue Chip consensus forecast, which is one reason why I am concerned about a potential overshoot of a sustainable full-employment outcome for the economy.

Figure 11 provides the SEP median forecast for the federal funds rate from the December FOMC meeting. The path of interest rates in the SEP median forecast may well be reasonable if the U.S. economy averages about 2 percent growth over the next two years. However, if real GDP grows faster than that – as I expect it may – it is reasonable to expect additional labor market tightening, gradual increases in inflation and, potentially, emerging imbalances in some asset markets. Should this forecast for somewhat faster growth than projected in the SEP materialize, my own view is that the U.S. economy may need somewhat less monetary policy accommodation.

Concluding Observations

The economy has continued to improve. Most forecasters are predicting above-potential growth and a gradual tightening in labor markets. In my view, such a path would justify a continued, gradual removal of monetary policy accommodation at least as quickly as suggested by the current SEP, and possibly even a bit more rapidly than that forecast.

However, as with any forecast, there remains great uncertainty. Significant risks to the U.S. economy still exist, particularly from conditions in overseas economies. Also, the future stance of fiscal policy in the United States is still unknown. These areas of uncertainty can materially impact the forecast, and by extension, the path of policymaking that would be consistent with those forecasts.

Thank you.

¹These have lowered my estimate of the so-called potential rate of GDP growth. The quite modest growth rate we have seen over the course of the recovery has been accompanied by a significant decline in unemployment. This confirms that even historically modest 2 percent growth has exceeded the potential growth rate, throughout the recovery.

²The target is defined in terms of total PCE inflation.

³See <https://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20161214.pdf>.

⁴In January, more than 24 percent of the unemployed had been out of work for 27 weeks or longer. While that is down from a peak of 45 percent following the recession, it is still elevated relative to a pre-recession average of 18 percent.