Exploring the Economy’s Recent Progress, and the Implications for Policy

Eric S. Rosengren
President & CEO
Federal Reserve Bank of Boston

May 10, 2017

Lake Champlain Regional Chamber of Commerce and the Central Vermont Chamber of Commerce
South Burlington, Vermont

bostonfed.org
Recent Economic Data

- First quarter data have been weaker than many expected – Q1 real GDP growth only 0.7 percent
- FOMC statement released last week – suggested that the slowing in growth during the first quarter is likely to be transitory
- My view: The weak Q1 is probably a temporary lull – and it is likely that the economy will grow at an average somewhat above 2 percent for the rest of this year
Labor Market Report

- Employment report last Friday
  - Payroll employment – 211,000 new jobs
  - Unemployment:
    - U-3 – 4.4 percent – below my estimate of full employment (4.7 percent)
    - U-6 – 8.6 percent – a new low for this recovery

- Strength of the labor market report on Friday provides some strong confirmation of a strong underlying economy
Concerns Raised about the Recovery

- Relatively slow loan growth
- Weakness in the economies of foreign trading partners
- My view: These are not compelling reasons to slow down the gradual normalization of monetary policy
- To keep the economy on a sustainable path
  - Beginning a very gradual reduction of securities held on the Federal Reserve’s balance sheet relatively soon
  - Continue to use short-term interest rates as the primary monetary policy tool for maintaining sustainable growth
Figure 1: CBO Estimates of Potential GDP Growth by Decade

Source: CBO, Census, Haver Analytics
Factors in the Downward Trend in Potential GDP

- Slowing population growth
- The labor force participation rate has fallen
- Most measures of productivity growth have been declining
- These factors are not determined by monetary policy
- Implication: My own estimate is that potential growth of GDP is only 1.75 percent
Figure 2: Blue Chip Forecast for Real GDP Growth
Forecast as of May 2017

Quarterly Percent Change at Annual Rate

- Average of 10 Highest
- Consensus Forecast (Average)
- Average of 10 Lowest

Source: Blue Chip Economic Indicators, May 10, 2017
Figure 3: Blue Chip Forecast for the Unemployment Rate
Forecast as of May 2017

Source: Blue Chip Economic Indicators, May 10, 2017
Implications of Growth Likely to Exceed Potential

- Private forecasters are expecting growth above potential and unemployment below the full-employment level.
- Represents an unsustainable, “overshooting” pace for the economy.
- Provides an important rationale for continuing the process of normalization of monetary policy that is currently underway.
Figure 4: Growth in Total Loans and Leases Outstanding at Commercial Banks from Trough of Last Four Recessions

Source: Quarterly Bank Call Reports, NBER
Figure 5: Growth in Total Loans and Leases and Commercial and Industrial Loans Outstanding at Banks

2011 - 2016

Note: Banks include commercial banks, savings banks, and savings and loan associations. Savings and loan associations are included beginning with the figure for growth from 2012:Q4 - 2013:Q4.

Source: Quarterly Bank Call Reports
Figure 6: Gross Issuance of Investment Grade Nonfinancial Corporate Bonds
2011 - 2017 Year-to-Date

Note: Domestic issuers only.
Source: J.P. Morgan, Credit Market Outlook and Strategy
Figure 7: Commercial Real Estate Loans Outstanding at Banks
2008:Q1 - 2016:Q4

Note: Banks include commercial banks, savings banks, and savings and loan associations. Savings and loan associations are included beginning in 2012.

Source: Quarterly Bank Call Reports
Implications of Bank Loan Growth

- Reflects the nature of the crisis, recession, and recovery

- Continued substitution of credit from capital markets and non-bank lenders for bank loans – rather than particular weakness in underlying economic conditions

- In some bank loan categories – such as commercial real estate – it is actually surprising how rapidly loans are growing, given the prevalence of high valuations
Figure 8: Global Stock Market Indices

December 30, 2016 - May 8, 2017

Index, December 30, 2016=100

- S&P 500
- MSCI Emerging Markets
- Euro STOXX 50

Source: Bloomberg Finance L.P.
Figure 9: International Monetary Fund Forecast for World Growth

2016 Actual and Projections for 2017 and 2018

Source: IMF World Economic Outlook, April 2017
Figure 10: Federal Funds Effective Rate
January 2006 - April 2017

Source: Federal Reserve Board, NBER, Haver Analytics
Figure 11: Federal Reserve System Assets
January 2006 - April 2017

Source: Federal Reserve Board, NBER, Haver Analytics
Figure 12: Federal Funds Target Rate Forecast from the Summary of Economic Projections

Year-end 2017 - Year-end 2019

Source: FOMC, Summary of Economic Projections (SEP), March 15, 2017
Concluding Observations

- The first quarter’s real GDP and inflation numbers proved to be somewhat weaker than many expected, but I do view these as a transitory phenomenon.

- My expectation is that the economy will remain on solid footing.
  - Unemployment rate likely to continue falling.
  - Unemployment is already likely below its sustainable level, and inflation fluctuating around 2 percent.
Concluding Observations (Continued)

- Such conditions justify continuing a gradual increase in the federal funds rate and also beginning to reduce gradually the level of the assets on the Federal Reserve’s balance sheet.

- As long as the balance sheet reduction is not steep, it should have only modest effects on credit markets – in other words it can be gradually reduced “in the background”.

- My view: The federal funds rate should be the primary vehicle for attaining sustainable growth, full employment, and price stability at 2 percent inflation.