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FEDERAL RESERVE BANK OF BOSTON™

"Exploring the Economy's Recent Progress, and the Implications for Policy"

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

Lake Champlain Regional Chamber of Commerce and the Central Vermont Chamber of Commerce

South Burlington, Vermont
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Good afternoon. It is a pleasure to be back in Vermont, and to be able to provide an update on the economic outlook. 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).

I increasingly hear from business leaders about a shortage of qualified workers – particularly here in northern New England, where unemployment rates are now at or below 3 percent. This is, of course, a welcome change from 2008 and the years that followed, when far too many workers experienced great difficulty finding jobs. But my primary message today is about the importance of achieving positive, but *long-run sustainable,* economic conditions – full employment and stable prices (which the Federal Reserve defines as 2 percent inflation) – and, by extension, that monetary policy supports such an outcome.

Before I turn to these issues, I would highlight that economic data for the first quarter have been weaker than many expected. As the FOMC statement released last week[1] suggested, and in my own view as well, this 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.

One reason is that much of the weakness in the first quarter was related to consumption, yet personal income and wealth have continued to rise, and consumer confidence indices remain quite positive. So my expectation is that consumption will re-emerge in the second quarter and we will continue to have a consumption-led recovery.

The employment report for April was also published last Friday. Payroll employment bounced back from March, with 211,000 new jobs – and the unemployment rate was reported as 4.4 percent nationally, which is below my estimate of full employment in the longer run (4.7 percent). In addition, the broader U-6 measure of unemployment (which takes into account marginal attachment to the labor force and employment that is part time for economic reasons), declined to 8.6 percent – a new low for this recovery.

All in all, I do not regard the weakness in first quarter data as a harbinger of softness in the underlying economy, and the strength of the labor market report on Friday provides some strong confirmation of that view. With real GDP growth in the remainder of the year likely to exceed 2 percent, and robust labor markets, and measures of inflation near 2 percent, I think it is important that the Federal Reserve continue to gradually normalize interest rates, and also to begin to normalize the central bank's balance sheet. Doing so, I believe, is the best way to help the economy remain on a sustainable path.

Some of the downside risks that observers have cited – such as relatively slow loan growth, and weakness in the economies of foreign trading partners – do not seem to me compelling reasons to slow down the gradual normalization of monetary policy. I will return to these topics in a moment, but let me share my overall view that it is important to avoid creating an over-hot economy (one that could require a less gradual monetary policy adjustment). And in order to avoid doing so, the Federal Reserve should continue gradually normalizing monetary policy. This would imply beginning a very gradual reduction of securities held on the Federal Reserve's balance sheet relatively soon, while continuing to use short-term interest rates as the primary monetary policy tool for maintaining sustainable growth – growth that is consistent with the Fed's dual mandate of maximum sustainable employment and stable prices.

Growth Likely to Exceed Potential

With real GDP growth averaging just over 2 percent during the recovery – which is modest by historical standards – labor markets have nonetheless become tight. For the unemployment rate to steadily fall even with such restrained growth rates implies that the so-called potential growth rate for the economy is now below 2 percent (given that the unemployment rate falls when actual economic growth exceeds potential).[2]

Figure 1 provides a chart showing Congressional Budget Office (CBO) estimates of potential growth, as well as population growth, by decade. In the 1980s and 1990s, the CBO estimated that potential growth was over 3 percent, while their estimate for this decade is well below 2 percent.

A number of factors explain the downward trend in potential GDP, which is determined by the number of available workers and the amount of output that each worker produces. Slowing population growth accounts for some of the decline, as does slowing labor force growth, which has been affected by the baby boomers retiring and leaving the labor force. Another factor behind the slowdown in potential GDP growth has been productivity. Most measures of productivity growth have been declining, so that there is less growth in goods and services per unit of labor. Given these developments in population growth, labor force, and productivity, my own estimate of potential growth is 1.75 percent.

Figure 2 shows the Blue Chip consensus forecast for real GDP through 2018, as of May. Blue Chip provides forecasts based on a survey of roughly 50 private-sector forecasters. Their consensus projection has growth more than half a percentage point higher than my estimate of the potential rate. As I suggested a moment ago, growth in excess of potential would likely have the effect of further tightening labor markets. The green dotted border indicates the average of the 10 highest and 10 lowest estimates for real GDP. Note that nearly all of the shaded region exceeds the 1.75 percent estimate of the potential growth rate.

Figure 3 shows the Blue Chip consensus forecast for the unemployment rate. Consistent with their real GDP forecast, most Blue Chip forecasters expect the unemployment rate to continue to trend down. It is worth noting that the average of the 10 highest forecasts is only 4.7 percent unemployment, which is also my estimate of the full employment level, at the outset of the forecast period. For most of the forecast period, the average of the 10 highest forecasts is just 4.6 percent. The shaded region between the 10 highest and 10 lowest forecasts lies entirely below my estimate of full employment. The average of the 10 lowest forecasts for unemployment falls to 4 percent by the end of 2017 and falls below 4 percent in 2018. Such low unemployment rates would likely cause increased pressure on wages and prices, and signal an economy on a pace exceeding its sustainable level.

In sum, most forecasters are expecting growth above potential and unemployment below the full-employment level. This would represent an unsustainable, "overshooting" pace – and provides an important rationale for continuing the process of normalization of monetary policy that is currently underway.

Potential Risks to the Forecast

One concern that has been raised about the robustness of the recovery involves the growth rate of bank loans, shown in **Figure 4**. The growth in bank loans has been less rapid than in earlier recoveries, and one can look at both demand and supply issues for explanations. One reason for the relatively slow growth is that, in the wake of the Great Recession, many firms and households sought to decrease their debt burden – which resulted in a depressed demand for loans. In addition, many firms – if they survived the recession – found themselves with impaired balance sheets that made them less able or qualified to borrow. Turning to issues with the supply of loans, I would note that historically, recoveries characterized by weak initial lending also were periods where a large number of financial institutions became troubled. To maintain capital-to-assets ratios after losses – say in commercial real estate – financial intermediaries have pared back lending (because loans are assets for banks).

While loan growth has been slower than in other recoveries, **Figure 5** provides some context for the recent growth in total and commercial and industrial (C&I) loans held by banks. Loan growth for 2016 exceeded 5 percent, a pace faster than the growth in nominal GDP.

In addition, it is important to note that bank loan growth can understate overall credit growth, because many firms with access to capital markets satisfied their borrowing needs through bond issuance, taking advantage of the historically low interest rates and locking in low, long-term rates. **Figure 6** shows the gross issuance of investment grade nonfinancial corporate bonds. Issuance has grown and remains robust. I would also note that increasingly, smaller firms have alternatives to banks to meet their financial needs. Many smaller firms are turning to non-bank lenders and "fintech" companies or are able to access capital markets directly. This greater access to capital markets is very likely substituting for what otherwise might have been bank loans.

Many firms seeking bank loans use real estate as collateral. **Figure 7** shows the growth of commercial real estate loans. Banks are rapidly expanding lending in the multifamily and construction and land-development sectors, despite the relatively high valuations for commercial real estate in many markets.

In sum, while bank loan growth has not been as robust as in previous cycles, this likely reflects the nature of the crisis, recession, and recovery – and the 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.

Risks from Overseas

Another source of concern over the past several years has involved weak economic performance in countries that are trading partners with the U.S. Indeed, geopolitical concerns are likely to pose some potential risk to the U.S. forecast for the foreseeable future. However, on balance, the risks from abroad seemed to have abated somewhat.

Figure 8 shows the increases in stock prices in emerging markets, Europe, and the United States since the beginning of this year. While U.S. stock prices have advanced, European stocks have seen similar improvements – and emerging markets have increased more than the U.S. or European indices. All this likely reflects increased investor optimism that the economic recovery in many countries is beginning to take hold, and the data for economic activity in the Euro Area and many other developed and emerging economies supports that assessment.

Figure 9 shows the International Monetary Fund (IMF) forecast for real GDP growth this year compared to last year – for the U.S., the Euro area, and emerging markets. In the United States and in emerging markets, the IMF is expecting stronger growth over the next two years, which is consistent with the improvements in stock markets that we see. The IMF outlook for Europe is essentially unchanged, but given the recent turmoil generated by elections in several European countries, continued positive growth is better than some had been expecting.

While the risks of a slowdown from abroad will probably always be present in some degree, this risk does seem to be abating of late. Economic forecasts for growth are increasing and investor sentiment has improved.

The Stance of Monetary Policy

Figure 10 shows the federal funds rate targeted by the Federal Reserve. The Fed began the normalization process in December 2015 by raising the federal funds target range to 25 to 50 basis points. Since that initial hike, the FOMC has increased the rates two additional times, in

December 2016 and March 2017. The target range for the federal funds rate is currently between 75 and 100 basis points.

Despite the three 25-basis point increases in the federal funds rate target range, U.S. monetary policy remains quite accommodative. Short-term nominal interest rates are below the inflation rate, so the *real* interest rate remains negative (the real rate is simply the nominal rate minus inflation). In addition, as mentioned earlier, most forecasters expect growth to exceed potential. With conditions now consistent with full employment and the Fed's inflation target, in my view, monetary policymakers should certainly continue on the path of gradual normalization, and continue to explore its pace.

The Federal Reserve has another monetary policy tool, as depicted in **Figure 11**. During the financial crisis and its aftermath, when short-term interest rates approached zero the central bank needed to find other ways to return the economy to full employment and the 2 percent inflation target associated with price stability. Since short-term rates were essentially at zero, the Fed lowered long-term interest rates by buying long-term Treasury securities and agency mortgage-backed securities (MBS). The result was an expanded central bank balance sheet that reached roughly $4.5 trillion in assets.

Looking ahead, the federal funds rate would obviously exceed 1 percent after one more 25 basis-point increase. In my view, that seems an appropriate point to consider beginning a very gradual normalization of the Federal Reserve's balance sheet. I believe the Fed should do so gradually, so that the reduction in the balance sheet is not disruptive, and so that it can occur largely in the background. This would maintain the Federal Reserve's focus on the federal funds rate as the primary instrument of monetary policy.

Figure 12 provides the most recent forecast for the federal funds rate from Fed policymakers, based on the most recent Summary of Economic Projections (SEP). The dark line, the median forecast for the federal funds rate, increases gradually over the next two and a half years, peaking at 3 percent. The median forecast among policymakers is for two more increases for this year. My own view remains that along with a gradual reduction in the level of the balance sheet, it would still be reasonable to have three rate increases over the remainder of this year, assuming the economy evolves like my forecast envisions.

Concluding Observations

In summary and conclusion, I would point out that 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, with the unemployment rate likely to continue falling and already likely below its sustainable level, and inflation fluctuating around 2 percent.

My view is that 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." That will allow Fed policymakers to focus primarily on gradual normalization of the federal funds rate, using it as the primary vehicle for attaining sustainable growth, full employment, and price stability at 2 percent inflation.

Thank you.

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[1] See https://www.federalreserve.gov/newsevents/pressreleases/monetary20170503a.htm.

[2] An economy growing at potential is one that keeps the degree of resource utilization stable over time. In particular, a stable unemployment rate is an indication that the economy is growing at potential. Periods of declining unemployment rate signal that GDP is growing above potential, and vice versa when the unemployment rate is increasing. In the earlier stages of the recovery, it was important for the economy to grow faster than potential in order to raise the degree of resource utilization and bring the unemployment rate down. At the current stage of the recovery, however, continued growth above potential runs the risk of overheating the economy. The potential growth rate of the economy needs to be inferred from the data, and it depends on the long-run growth rate of the labor force and productivity. While in the short run labor force and productivity can be affected by cyclical factors, in the longer run labor supply is largely driven by demographic trends and productivity by technological progress. There is uncertainty associated with the rate of growth of potential, despite the fact that some demographic developments are relatively easy to predict. This uncertainty notwithstanding, the average pace of GDP growth during the recovery has been enough to bring the unemployment rate down. As a result, over this period the potential growth rate of the U.S. economy has been less than 2 percent.