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***“One Policymaker’s Wait for Better  
Economic Data”***

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President & Chief Executive Officer  
Federal Reserve Bank of Boston

*Capital Workforce Partners  
“Workforce Stars” Event*

Hartford, Connecticut  
June 1, 2015



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Good morning. It is a pleasure to be invited to address you today, and to take part in this event honoring individuals and organizations that contribute to the health of the regional workforce.

As I begin, I would note as I always do that the views I will 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).

With the wonderful New England summer weather now upon us, it may seem unnecessary – and perhaps a bit cruel – to dredge up memories of the brutal winter we experienced here in the Northeast. However, economics *has* been called the dismal science.

But I have a substantive reason for pondering the winter we just endured. Because economic data emerge with lags, recent disappointing numbers have generated a spirited debate about whether the weak performance can be explained by temporary factors, such as the brutal weather we experienced during the first quarter. In many parts of New England, record snowfall prevented people from getting to work, shoppers from getting to stores, and customers from going out to eat. So clearly, bad weather did deter some economic activity.

However, the data were not just weak during the worst of winter; they were also weak before the storms and have been weaker than expected ever since. So economic growth for the first half of this year looks to be well below what was expected, even correcting for some temporary disruptions.

Of course, this weaker growth has implications for monetary policy. In the last two monetary policy statements issued by the FOMC, the Committee’s criteria for raising short-term rates were twofold – first, further improvement in the labor market, and second, being reasonably confident that inflation will move back to our 2 percent target. Such conditions are likely to be met in the near term only if the economy grows above the rate economists refer to as its “potential.” Given the data that we have seen so far, economic growth above potential seems unlikely for the first half of this year.

Despite a disappointing first half, most forecasters expect a stronger second half of the year. Among the factors supporting this optimism are growth in personal income, the positive impact of lower gas prices, and household net worth that continues to grow. However, so far this improvement is only in the forecast, and not in the data. The data have disappointed before, and an appropriately data-dependent monetary policy requires confirmation in the numbers, not just in forecasts of better times.

Today I would like to provide an overview of recent data, which in my view demonstrate why the conditions for beginning the tightening of monetary policy have not yet been met.

This view is heightened, I would argue, by global political, security, and financial conditions that suggest the risks of a negative shock from abroad remain elevated, as has been the case over the last several years. With short-term interest rates near zero, monetary policy would have limited ability to offset such a shock. If we were fortunate enough to see the economy grow much more quickly, we would have the ability to raise rates more quickly. But the near-term constraint on offsetting a shock amounts to an “asymmetric” situation that, in my view, needs to be taken into account in formulating an appropriate policy stance.

### **Recent Economic Growth**

**Figure 1** shows the private-sector forecasts for real GDP growth as of last November. It provides the median forecast of quarterly real GDP growth in the Survey of Professional Forecasters conducted by the Philadelphia Federal Reserve Bank, and the average forecast of quarterly real GDP growth from the Blue Chip survey. While there is

some overlap among the participants in the two surveys, both surveys forecast relatively strong real GDP growth from the fourth quarter of 2014 through 2015.

However, the figure shows that actual growth has been well below forecasted growth. Real GDP in the fourth quarter of 2014 grew at 2.2 percent, and declined 0.7 percent in the first quarter of 2015. My expectation is that second quarter growth is likely to be only 2 percent. Taken together, this means that over the past three quarters, real GDP growth has been disappointing. If such a pace of growth persists, it is unlikely to be associated with further significant declines in the unemployment rate.

**Figure 2** shows the probability assessments for different real GDP growth rates for 2015 submitted by forecasters participating in the Survey of Professional Forecasters in February and in May. The distributions show forecasters were more confident about the probability of stronger 2015 real GDP growth in 2015 in February than in May. Thus, based on the weaker incoming economic data, a noticeable leftward shift in the probability distribution occurred between February and May.

Together, Figures 1 and 2 show that forecasts have tended to be too optimistic about growth in 2015, and that their assessment of the likelihood of strong growth over the year has declined significantly as the year has progressed.

**Figure 3** shows that there was indeed unusual weather in many parts of the country in the first quarter. In the East, the weather was unusually cold. This would presumably discourage shopping, housing starts, and other types of economic activity where adverse weather could deter outdoor activity. However, the chart also shows that while the East had record cold, the West had record warmth. Warmer than normal winters in the West might not be much of a deterrent to economic activity in the short

term<sup>1</sup> unless you were hoping to ski (although New England provided ample opportunities for that).

Even though most of the unusual weather occurred in February, the higher-frequency economic data suggest slowness both before and after February. While it is difficult to assess the exact effect of weather on first-quarter data, if there was a temporary deferral of economic activity due to bad weather, one should expect a snapback as the weather improves. But there has not been much evidence of such a snapback in the numbers.

**Figure 4** provides the quarterly pattern of real GDP growth over the previous five years. The dotted lines pinpoint the growth rate that occurred in the first quarter of each of these years. Some economists have questioned whether the normal seasonal adjustments are appropriately capturing seasonal variations in economic activity, since first-quarter growth has tended to be lower than other quarters recently. If inappropriate seasonal adjustment accounts for a significant portion of weak measured growth in the first quarter, this too would suggest a snapback in the subsequent quarter (and reasonable growth on average across the two quarters). But the data for the second quarter do not yet indicate much of a snapback, with many current-quarter forecasts of GDP close to 2 percent growth.

**Figure 5** provides the growth rate of real GDP leading up to the first tightening of monetary policy in previous cycles. The table shows that in each of the previous tightening cycles, real GDP growth in the two years preceding the tightening was above 3 percent. It should not be surprising that the first tightening of policy occurred during periods of relatively strong growth. However, today we are faced with a growth rate of

2.3 percent over the past two years, and the strong possibility that growth in the first half of this year will average much less than 2 percent. In my view, such a pace of GDP growth does not meet some of the economic preconditions we look for when we begin a tightening cycle, even if one takes into account that potential GDP growth is now lower than in previous cycles.

### **The Role of Consumption**

Most forecasters have expected relatively robust growth in consumption. Because consumption is such a large component of GDP, stronger growth in consumption can offset weaker growth in many of the smaller components of GDP.

**Figure 6** shows that seasonally adjusted consumption at the end of last year was quite strong, while in the first quarter of this year it was disappointing. If first-quarter weakness was really due to temporary factors, we would expect a rebound in the second quarter as these factors waned. The weak retail sales numbers for April, however, signal that we need to see more data before dismissing the slower first-quarter consumption as only a result of temporary factors.

**Figure 7** provides an estimate of retail sales based on a survey that breaks out results by geographic region of the country. Given the weather map shown in Figure 3, one might expect sharp variations across regions of the country. However, the regional patterns are quite similar, making the weather a less plausible explanation for most of the weakness in the first quarter.

An alternative explanation – versus temporary factors such as severe weather impacting recent data – could be simply that many consumers remain reluctant to spend

despite the time that has passed since the Great Recession. **Figure 8** shows that the personal saving rate has remained well above where it was prior to the Great Recession.<sup>2</sup>

If consumer behavior is still being impacted by the experience of the financial crisis, the Great Recession, and the painfully slow recovery, then it is possible that the economy will not be as robust as many economic models would suggest, because the models do not take into account this behavioral change. As **Figure 9** illustrates, many of the factors that drive consumption in most economic models have been increasingly favorable. The strength of these consumption fundamentals likely explains why many forecasters continue to expect reasonably strong consumption and growth in the second half of this year.

### **Achieving the Fed's Mandate**

The Federal Reserve has a dual mandate from Congress that is focused on stable prices and maximum sustainable employment. Let me now turn to inflation and employment in more detail.

**Figure 10** illustrates that neither the “total” nor the “core” measures of PCE inflation are yet showing much evidence of returning to the 2 percent inflation target that the Fed considers ideal. If the economy were growing quickly, there might be greater confidence that the resulting tightening of labor markets would boost wages, and ultimately prices, such that the 2 percent target level of inflation would be reached over the next two years. However, if growth remains slow, confidence in the likelihood of achieving the 2 percent inflation target in the next two years would be diminished.

**Figure 11** shows longer-run forecasts of the unemployment rate from the Summary of Economic Projections made by Federal Reserve policymakers over the past year, including the most recent as of the March FOMC meeting.<sup>3</sup> At 5.4 percent, unemployment is currently below some FOMC participants' estimate of "full" employment. However, in the absence of inflationary pressures, estimates of full employment among many FOMC participants have been trending down. At this point, the median estimate of full employment among FOMC participants – as reflected in their longer-run unemployment rate projections – is 5.05 percent.<sup>4</sup> Still, a declining unemployment rate coupled with weak GDP growth could signal that the level of the unemployment rate consistent with full employment is drifting even lower.

**Figure 12** provides the range and median of inflation forecasts for the next three years as of the March FOMC meeting. Many FOMC participants forecast that inflation will only gradually reach the 2 percent inflation target.

**Figure 13** shows that at the March FOMC meeting, many participants viewed the most likely path of the federal funds rate to be a tightening that is gradual by historical standards.<sup>5</sup> Obviously, the data coming in since that meeting may result in revisions to that path after the June FOMC meeting.

As the federal funds rate target is raised, it is likely to also be reflected in longer-term rates, such as the 10-year rate. But as **Figure 14** shows, the historical relationship between the 10-year Treasury rate and the effective federal funds rate has been quite variable. On average, the spread has been roughly 150 basis points. But the figure highlights that it is certainly possible that the spread between the funds rate and longer-term rates could be much larger than it has been of late.

## **Concluding Observations**

In summary and conclusion, the economy has been softer in the first half of this year than many forecasters expected. It is too soon to know whether this is driven primarily by temporary factors like the severe winter, or is a reflection of broader changes in the economy.

For monetary policy to begin the normalization process, I believe we need to be confident that we will return to full employment and 2 percent inflation over the next couple of years. If the economy continues to grow at the same pace as we witnessed on average in the current and the past two quarters, I do not expect to see timely improvements in the unemployment rate and sufficient progress towards the 2 percent inflation target. This, in my view, makes a compelling argument for continued patience in monetary policy.

Thank you.

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<sup>1</sup> Obviously, warmer winters can have longer-run negative impacts on economic activity, given that they may exacerbate drought conditions.

<sup>2</sup> Prior to the financial crisis, the saving rate may have been unusually low and has now perhaps returned to a more normal level.

<sup>3</sup> Economic Projections of Federal Reserve Board Members and Federal Reserve Bank Presidents, March 2015: <http://www.federalreserve.gov/monetarypolicy/files/fomcproptabl20150318.pdf>

<sup>4</sup> In Figures 11 and 12, what is referred to as the median is the midpoint of the median range reported in the minutes for the FOMC meetings. For example, in Figure 11, for March 2015, 5.05% is the midpoint of the median range of 5.0% and 5.1% reported for the longer-run unemployment rate.

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<sup>5</sup> Despite the slow path shown in the figure, many private-sector forecasts have assumed an even slower path for interest rates.