EMBARGOED UNTIL
11:20 A.M. U.S. Standard Time on Friday, September 20, 2019
OR UPON DELIVERY

Federal Reserve Bank of Boston®

"Assessing Economic Conditions and Risks to Financial Stability"

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

Stern School of Business, Salomon Center for the Study of Financial Institutions, New York University

New York, New York
September 20, 2019

The views expressed today are my own, not necessarily those of my colleagues on the Federal Reserve Board of Governors or the Federal Open Market Committee.

Good Morning, it is a pleasure to be here at NYU's Stern School of Business to participate in this conference on credit markets. I want to thank the Salomon Center for the Study of Financial Institutions for inviting me to share my views of the economy.

I'd like to begin with a few remarks about monetary policy which I believe are relevant to the discussions taking place here today. At the Federal Open Market Committee (FOMC) meeting earlier this week, the Committee voted to reduce the federal funds rate by 25 basis points. I dissented, and in my remarks today I will explain my views on the appropriate degree of monetary accommodation at this time. I will also share my perspectives on the potential buildup of some financial-stability concerns.

I will take a few minutes to summarize my argument as I begin, and then delve into a little more detail to show you the data which inform my views.

First, the stance of policy is already accommodative.

The latest policy action of the Committee reduces the short-term interest rates the Federal Reserve controls to a range from 1.75 to 2 percent. This rate on unsecured overnight credit is very close to current readings on inflation, and thus holders of federal funds will earn a nominal return that does little more than compensate them for the prevailing rate of inflation. The Committee also provides information on what they expect the federal funds rate to be in the longer run, and that estimate is 2.5 percent. These two factors suggest that the stance of monetary policy is currently accommodative. Yet, it is notable that the federal funds futures market is pricing in a significant probability of another decrease by year end. The market apparently believes the economy needs added stimulus to continue the expansion. My own view is different.[1]

Second, the economic data suggest continued expansion.

It is not unusual to have a sequence of decreases in the federal funds rate when the economy is in an economic downturn, often when interest rates have become too contractionary and there is concern that the economy is slowing too much. The data we have in hand suggest instead that the recovery would continue apace even with little monetary policy accommodation. Consider, as we always do, the Federal Reserve's dual mandate from Congress – maximum sustainable employment, and price stability.[2] With respect to those goals, the national unemployment rate is currently 3.7 percent, a rate that is very low by historical standards and likely well below the natural rate of unemployment. Regarding price stability, which we define as 2 percent inflation, it is true that earlier in the year inflation was running below target. But as the Consumer Price Index (CPI) release last week indicated, those low readings seem to have been temporary. The 12-month change in the core CPI reported last week rose to 2.4 percent, reflecting the more rapid price increases of the past three months.

Third, risks to the economic outlook are of concern, to be sure.

Given economic results that seem broadly in line with the Fed's dual mandate, why the concern? Well clearly, there are elevated risks. The trade dispute with China is having an impact on both the United States and global economies. While manufacturing is a relatively small sector in the U.S. economy, it is a cyclically sensitive sector, and tariffs and slower global growth are stressing it. Related to the trade disputes, business fixed investment has been affected, as firms are uncertain about which tariffs will be imposed – and the potential retaliation by countries impacted by the tariffs.

But even with these trade-related impediments, real GDP grew 2 percent in the second quarter, a bit above my estimate of its sustainable rate. And economic forecasts, which incorporate the effects of tariffs and slower global growth on the U.S. economy, expect growth to continue in real terms at close to 2 percent. So the risks, while of concern, have not slowed the economy below its sustainable rate of growth.

Fourth, responding to risks to the economic outlook with too much monetary accommodation entails costs, and thus introduces risks of its own – one such risk is the potential buildup of financial instability.

It is appropriate for policymakers to respond to risks in the outlook. The response should depend, of course, on how likely one thinks the outlook is to deteriorate, and by how much, and also what you believe are the likely costs of reducing rates. As I suggested a moment ago, so far the economy seems to have weathered the impact of trade disruptions and slowing foreign growth.

One potential cost of increased accommodation is that very low rates can encourage households and firms to take excessive risks. This could show up in the form of increased household and firm leverage, with prices for risky assets reaching levels that may not be sustainable over time.

Assessing those risks and costs is challenging, to be sure, and a matter of judgment on which people may disagree. Still, I would argue that having such an accommodative stance of monetary policy is unusual in what appears to be a fairly robust economy. Typically, the federal funds rate is pushed below the level policymakers expect it to be in the long run only during economic downturns. During a downturn, the costs of lowering rates are relatively modest, as fears of rising inflation are low and the concern is usually that too little credit is being extended. However, the current situation involves pushing rates lower when asset prices, and in particular some risky asset prices, already seem inflated. I don't see current financial risks as causing a downturn, but such conditions have the potential to amplify a downturn, should it occur.

Current Economic Conditions

Having laid out the outlines of my argument, let me walk you through some of the key data on the current economic situation and private-sector forecasts.

Figure 1 provides recent economic data for employment, inflation, and stock prices, as well as the consensus Blue Chip forecast for economic variables for 2019 as of June and September. The table shows that from May through August, the fundamentals remained quite strong and have shown very little variation. The unemployment rate is currently at 3.7 percent, where it has been all summer, and private forecasters expect we will end the year slightly lower, at 3.6 percent. While the core PCE measure of inflation (which removes the often-volatile food and energy prices) has been a bit below the Fed's 2 percent target, core CPI has been firmer over the summer, consistent with the interpretation that the softer readings on inflation that we saw in the spring will likely be temporary. Finally, the most recent consensus forecast for real GDP for the year is 2.3 percent, which is above the estimate of its sustainable rate, and thus consistent with somewhat tighter labor markets (as reflected in the Blue Chip's small decline in the forecasted unemployment rate).[3] In sum, current economic conditions are quite favorable, and stable, and private forecasters expect those conditions to remain quite similar through the end of the year.

Figure 2 shows the target federal funds rate in the second half of this year relative to the Fed's inflation target of 2 percent. We began the year with the federal funds rate somewhat above the inflation target. With this most recent reduction in the federal funds rate, it is now below where we expect the inflation rate will converge to over time.

Figure 3 shows the target federal funds rate since June, along with a projection of its path (the forecast is calculated using the CME Group probability for the most likely outcome for the target range), and the median of the FOMC participants' federal funds rate expectation over the long run, currently 2.5 percent. With this week's reduction, the federal funds rate is trading in the target range of 1.75 to 2.0, notably below its long-run "neutral" level. In sum, whether judged relative to inflation or relative to its long-run neutral level, monetary policy is currently accommodative.

Monetary Policy and Economic Conditions

Now I would like to explore how unusual it is to have such accommodative monetary conditions while the economic outcomes suggest continued above-trend expansion.

The top panel in **Figure 4** shows the unemployment rate and the Congressional Budget Office's (CBO's) estimate of the natural rate of unemployment. When a recession occurs, shown as shading, the unemployment rate rises above the natural rate – and during the recovery the unemployment rate eventually tends to fall below the natural rate. The figure shows that at present, the unemployment rate is below the CBO's estimate of the natural rate.

The bottom panel in Figure 4 provides a gauge of where the federal funds rate is relative to what we call "r star" (r*), the real short-term interest rate that is neither contractionary nor stimulative when the economy faces no headwinds or tailwinds. That interest rate is consistent with an economy that is at full employment with stable inflation.[4] The previous chart showed that the nominal federal funds rate expected by the Committee in the long run is 2.5 percent. With an inflation target of 2 percent, this implies that the Committee sees an r* in the long-run of 0.5 percent.

By comparing the top and bottom panels of Figure 4, we see that over time when the actual unemployment rate is high relative to the natural rate of unemployment, the real federal funds rate tends to be low relative to r*; in the chart, the real federal funds rate minus r* tends to be low, reflecting the fact that monetary policy needs to be accommodative to help the economy recover from the headwinds it is facing during recessions. When the unemployment rate is quite low, the real federal funds rate tends to be above the long run real rate; the real federal funds rate minus r* tends to be high. While this relationship is only shown through the second quarter, with the last two reductions in the federal funds rate, we are below the 0.5 percent r* we expect in the long run. Simply put, we normally do not have monetary policy this accommodative when the unemployment rate is this low.

Figure 5 has the same bottom panel, but a top panel that shows two measures of inflation – the core PCE inflation rate and the Dallas Trimmed Mean PCE inflation rate (which removes outlier observations, regardless of the category) – and the Federal Reserve's 2 percent inflation target. As in Figure 4, the bottom panel shows the real federal funds rate minus r*.

Comparing the top and bottom panels, we see that when inflation is high relative to the target, monetary conditions are tightened – the real federal funds rate minus r* tends to be high. Similarly, when inflation is quite low, monetary policy tends to be accommodative and the real federal funds rate minus r* tends to be low. Currently, the Dallas Trimmed Mean PCE is at 2 percent. In my view, with inflation near target, this level of accommodation is not needed.

Of course, there are risks to the current favorable conditions and forecasts, including the risks brought on by current trade policy – and those risks might make one more concerned about a possible downturn. However, I take some solace in a few facts. Most of the U.S. trade dispute is currently with one country. And while the trade dispute has the potential for painful impacts on some industries in the U.S., in total the estimated direct impacts for the U.S. macroeconomy to date are not particularly large—perhaps several 10ths of a percentage point on GDP (in part because exports are only 12 percent of U.S. GDP and tariffs are not on all goods from all countries).

But the potential for trade disputes to undermine confidence in the economy for businesses and households is a concern. One warning signal would be if economic data that tend to be leading indicators of recession showed signs of stress.

To that end, **Figure 6** shows building permits. Before the 1990 and 2007 recessions (and many other recessions, not shown in the figure), building permits plummeted. Currently, while building permits have leveled off, they have not shown significant declines.

Figure 7 shows initial claims for unemployment insurance. As firms become worried about a recession, they slow down hiring – and some firms need to lay off workers. As a result, initial claims for unemployment insurance were on the rise before previous recessions. Today, initial claims are still falling and are near the low for the period shown.

Of course, many observers are concerned about the inverted yield curve, which is a topic I explored in a speech earlier this month. My own view is the inverted yield curve may be driven by different forces this time.[5]

In sum, it is fairly unusual to have monetary policy this accommodative at a time when the economy still appears to be expanding fairly robustly. While risks are elevated, many of the non-manufacturing indicators of recession are not showing magnified concern.

Financial Stability Concerns

Now, I will turn to addressing some of the financial stability-related risks and costs that can result from monetary policy being too accommodative. **Figure 8** shows the average debt multiples of highly leveraged loans. It's important to note that high leverage does not generally *cause* recessions, but high leverage can be an amplifier that makes recessions more severe. Going into the 2007 recession, highly leveraged loans had increased significantly to a multiple of a bit below five. Once the recession occurred, borrowers and lenders pulled back, and debt multiples decreased significantly.

The decade-long period of very low interest rates has led highly leveraged firms to gradually increase their debt multiples to very high levels. Importantly, the low interest cost of leverage today masks the true costs of leverage that only become visible once the economy deteriorates. During good times, higher leverage increases returns; it is not until the downturn that the problem becomes apparent, and then the costs are borne not only by the shareholders, but also by the employees of firms and the communities in which the affected firms operate.

Lowering interest rates not only decreases the cost of credit, it also encourages a greater quantity of credit. Households and firms are incented by the lower rates to take on more leverage, and this can be to their detriment when the next downturn occurs.

Furthermore, the costs of credit conditions that are too-accommodative can sometimes appear in unexpected places. **Figure 9** shows the capitalization rates for different types of property. The capitalization, or "cap," rate is the ratio of net operating income produced by a property to the price paid for the property, calculated at the time of a transaction. So falling capitalization rates imply lower expected returns on the property, or equivalently a high multiple of a property's valuation relative to its expected income stream. Part of these low cap rates can be explained by low interest rates generally, but very low cap rates can indicate an overly optimistic valuation of real estate assets that makes these investments vulnerable in a downturn.

I will also point out that evolving market models, along with low interest rates, are creating a new type of potential financial stability risk in commercial real estate. One such market model is the development of co-working spaces in many major urban office markets.

A stylized model of co-working office space arrangements appears in **Figure 10**.[6] What makes this form of development a potential financial stability risk is two-fold.

First, co-working companies – which enter into long-term leases with the property owners – have tended to re-lease to smaller-sized and less mature companies on a shorter-term basis. This segment of the economy is likely to be particularly susceptible to an economic downturn, potentially resulting in office vacancies rising more quickly than they have historically. Thus, in a downturn the co-working company would be exposed to the loss of tenant income, which puts both them and the property owner at risk if they cannot make lease payments to the owner of the building.

A second reason for concern is that some companies may utilize bankruptcy-remote special purpose entities, or SPEs, for leases. This structure may allow the co-working company to potentially walk away from unprofitable lease arrangements in an economic downturn without the property owner having recourse to the ultimate parent, the co-working company. Simply put, I am concerned that commercial real estate losses will be larger in the next downturn because of this growing feature of the real estate market, which could ultimately make runs and vacancies more likely due to this new leasing model.

The fact that the shared office model relies on small-company tenants with short-term leases, combined with the potential lack of recourse for the property owner, is potentially problematic in a recession. This also raises the issue of whether bank loans to property owners in cities with major penetration by co-working models could experience a higher incidence of default and greater loss-given-defaults than we have seen historically.

The potential for increased losses accruing to property owners comes not just from the limited liability arising from the SPE structure, but also from the change in the composition of tenants. The owner of the building may be willing to take on this added risk because shared office space often pays higher rent, which is particularly attractive in a low-interest-rate environment. Thus, this new model for offices has the potential for a run on commercial real estate as revenues decline (small lessees not renewing) combined with reaching-for-yield behavior (owners willing to lease to an SPE to get higher rents). It will not be until a recession that this evolving model will be truly tested.

These are just two examples of the potential costs of very low interest rates in a relatively stable economic environment. The incentive to take on more leverage and to reach for yield can be costly – but the costs are apparent only when a downturn occurs.

In sum, this is an important time in the cycle to be thinking about structures and situations that could challenge financial stability in a downturn. The combination of reaching for yield with runnable liabilities is a common problem in financial stability situations. It's important to think about the potential for runs on commercial real estate stemming from a situation where short-term leases might not be renewed in recession, and long-term leases are no longer economically viable. Interest rates play into the situation, as low rates potentially lead to a reach for yield, and building owners are more willing to lease to SPEs to get higher returns (rents) at a time when capitalization rates are quite low.

Concluding Observations

I voted against the reduction in interest rates at the most recent FOMC meeting. The economic data that we have seen so far suggest that the economy remains healthy and robust to a number of shocks and uncertainties. While risks clearly exist related to trade and geopolitical concerns, lowering rates to address uncertainty is not costless. In my view, there are clearly risks of headwinds hitting the economy, but the stance of monetary policy is already accommodative. There are also risks of tailwinds and costs to monetary policy being too accommodative. Additional accommodation is not needed for an economy where labor markets are already tight – and risks further inflating the prices of riskier assets, and encouraging households and firms to take on what may be too much leverage.

Thank you.

---

[1] For additional discussion, see https://www.bostonfed.org/news-and-events/speeches/2019/weighing-the-risks-to-the-economic-outlook.aspx.

[2] The Federal Reserve Act provides the following monetary policy goals, "promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates." The first two are the dual mandate. Moderate long-term interest rates are generally viewed as a product of the first two, provided that the maximum employment is a sustainable maximum employment.

[3] My own forecast is quite similar, anticipating growth in the second half of this year of 2 percent – which is somewhat above my estimate of the potential growth rate in the economy.

[4] For more on the Laubach-Williams model, see: https://www.newyorkfed.org/research/policy/rstar.

[5] For additional discussion, see https://www.bostonfed.org/news-and-events/speeches/2019/weighing-the-risks-to-the-economic-outlook.aspx.

[6] This figure reflects information gathered from CB Insights, Colliers, CreditSights, Cushman & Wakefield, JLL, RCA, SEC filings, and major media coverage.