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Federal Reserve Bank of Boston®

"Exploring Current Economic Conditions and the Implications for Monetary Policy"

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President & Chief Executive Officer
Federal Reserve Bank of Boston

National Association for Business Economics
(NABE) 60th Annual Meeting

Boston, Massachusetts
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Good afternoon. It is a pleasure to be speaking with you today at the 60th annual meeting of the National Association for Business Economics. Let me also welcome you to our wonderful city of Boston.

Before I begin my remarks, let me note that the views I express are my own, not necessarily those of my colleagues on the Federal Reserve Board of Governors or the Federal Open Market Committee (FOMC).

Last week the FOMC raised the federal funds rate by 25 basis points, a move consistent with the very strong economic performance seen over the last two quarters. With this latest monetary policy action, the federal funds rate has now been increased three times this year – and at 2 to 2-1/4 percent, it is now above the Federal Reserve's inflation target of 2 percent for the first time since the financial crisis and Great Recession.

Today, U.S. monetary conditions remain mildly accommodative, with short-term market rates barely higher than the inflation rate (thus barely positive in real terms). And given tax cuts and spending realities, fiscal policy remains quite accommodative.

Given the accommodative stance of monetary and fiscal policy, it is not surprising that most private forecasters, as well as most members of the FOMC, expect the economy to grow strongly for the second half of this year. Many economists expect real growth for the second half of this year to be approximately 3 percent. That is strong enough to further tighten labor markets and further push down the unemployment rate, currently at 3.9 percent. Consistent with this expectation, the Blue Chip forecasters anticipate the unemployment rate falling to 3.5 percent by the end of next year.

This strong U.S. economic growth is occurring despite some clear risks to the global economy, which I'll touch on today. The announcement of increased tariffs by both the U.S. and China last Monday heightened concerns that trade disruptions could become a significant headwind over time. In addition, several emerging market economies are now more stressed – particularly those such as Turkey, whose corporations' U.S. dollar-denominated debts have become costlier as their currency has depreciated against the dollar. And while Europe has shown some signs of improving, there is still the possibility of more significant disruptions emerging from a potentially disruptive Brexit, or from the exposure of many European banks to some of the troubled emerging market economies.

How should U.S. monetary policymakers respond to these conditions – a strong U.S. economy, but clear signs of rising risks emanating from other economies? I am carefully watching factors that could pose risks to the continued U.S. economic expansion. But my own assessment is that the most likely outcome will be a U.S. labor market that continues to tighten and the likely buildup of economic imbalances, including, but not limited to, inflationary pressures.

While inflation remains well contained to date, pushing the economy too hard risks inflationary concerns or financial-stability risks. Either of these outcomes might necessitate a more forceful monetary policy response. While a more forceful policy might be appropriate under such conditions, it is not a risk-free strategy and could put at risk the continued expansion. The history of rapid rate increases in the U.S. suggests that such a risk is real, and as a result my preference for a strategy that allows a continued, but gradual, pace of monetary tightening.

Assuming the potential global risks I mentioned do not materialize and disrupt strong U.S. GDP growth, I believe that continuing to raise short-term rates gradually, until monetary policy becomes mildly restrictive, is likely to be appropriate and beneficial over the long term.

Labor Markets

Conditions in labor markets are, of course, foundational to my analysis. In every discussion I have with businesspeople in New England, a theme that continually comes up is the tightness of the labor market. Turning to the data, **Figure 1** shows that the number of initial claims for unemployment insurance is now near a series low and much lower than it has been during all but one of the previous recoveries since 1967. It is not surprising that firms are not laying people off, because the economy continues to be quite strong, but another factor is the difficulty finding someone to replace a worker who is laid off or leaves. So layoffs may remain uncommon even if firms experience some slowdown in their business.

Figure 2 shows the so-called "quits rate," the number of people who voluntarily leave their job as a share of total employment, since 2003. Keep in mind that if you quit your job, you do not qualify for unemployment insurance. So, essentially, the quits rate provides an indication of workers' confidence in their ability to find a new job.

Figure 3 shows the job openings rate – which is the number of job openings at the end of the month, relative to total employment plus job openings, monthly since 2003. The job openings rate is now significantly higher than at the peak before the crisis and recession. This measure of firms' demand for labor is at its highest level since the series was first reported in late 2000.

Figure 4 shows the unemployment rate, which has fallen to 3.9 percent. The Blue Chip consensus forecast expects it to fall to 3.5 percent by the end of next year. Such an outcome would be well below most estimates of the natural, or long-run, rate of unemployment. At present, the FOMC's Summary of Economic Projections (SEP) suggests that no FOMC participant estimates the long-run unemployment rate to be lower than 4 percent. The median longer-run unemployment rate projected by FOMC participants is 4.5 percent. I would suggest that a forecast where the unemployment rate falls well below its estimated long-run sustainable level for a significant period of time is a sign of macroeconomic imbalance, which poses a risk of rising inflation or increasing financial stability concerns – or both.

Wages and Prices

Turning to wages and prices, **Figure 5** provides the average hourly earnings of production and nonsupervisory private-industry employees from January 2003 to August 2018. Over the past five years, earnings have gradually risen, and are currently roughly consistent with the sum of 2 percent inflation, plus the somewhat subdued productivity gains of roughly 1 percent.

Interestingly, if you examine service-providing industries and goods-producing industries, you see that earnings in both have been increasing. The service-providing industries' earnings closely match those of the total, while goods-producing industries (which include those that are more export-intensive and thus more likely to be directly impacted by tariffs) have seen earnings increase more quickly of late – although I should note that the volatility of these earnings is always higher than that of services. Should the upward trend in wages continue, one would expect firms to either shrink their profit margins or begin to pass on some of the costs as price increases.

Figure 6 shows total and core PCE measures of inflation. The inflation measures have fluctuated recently around the Federal Reserve's 2 percent inflation target, although there is a modest upward trend over the past three years. Private forecasters in the Survey of Professional Forecasters now expect PCE inflation to be just above 2 percent both this year and next. Consistent with my earlier comments on tight labor markets, I personally believe there are some upside risks to this outlook.

Figure 7 shows PCE inflation separately for goods and services from 2003 through the second quarter of 2018. While services PCE inflation has been a bit above 2 percent over the past two years, the more volatile goods PCE inflation has, for the most part, been below 2 percent – although it has been rising recently.

As we study price movements, we need to consider trade and tariffs. Tariffs may be passed through, at least in part, to prices in goods-producing industries over time. But tariffs may also be used as "cover" for passing through the rising cost of labor[1] as labor markets tighten further. Indeed, many of our business contacts in New England have highlighted that they now receive little resistance to passing on price increases. These anecdotes may reflect an unintended consequence of the tariffs: suppliers may now feel they have more pricing flexibility, posing an upside risk to measured inflation.

Real GDP Growth

Figure 8 shows the pattern of real GDP growth. At 4.2 percent growth, the second quarter of 2018 was quite strong. However, some of this growth likely reflects shifts in the timing of spending in expectation of the imposition of tariffs on some goods. For example, soybean shipments increased in the second quarter, apparently to beat the imposition of tariffs; shipments are likely to fall now that the tariffs are in place.

Over the second half of this year, private forecasters are expecting that real GDP growth will average around 3 percent, with growth next year ranging from 2 to 2.5 percent. Since that exceeds what economists call the economy's potential rate of growth (somewhat below 2 percent), I would expect to see further declines in the unemployment rate over this horizon.

Figure 9 provides the pattern of consumption. While consumption growth slowed unexpectedly in the first quarter, it rebounded in the second quarter. Most forecasters expect consumer spending to be a key driver of the economy, reflecting high consumer confidence, rising stock and housing prices, and continued growth in personal income.

Given the uncertainty surrounding tariffs and foreign growth, the trajectory for exports of goods and services remains uncertain. Exports represent a sizable share of GDP, as shown in **Figure 10**. If retaliatory tariffs roughly match the tariffs imposed by the United States, the result could be a roughly equal reduction in exports and imports, leaving the trade deficit approximately the same.

However, tariffs increase the uncertainty around the path of net exports. Trade disruptions could cause countries to source their purchases from new countries, for instance – but in many cases this is not a change that could happen easily or quickly. Moreover, uncertainty about how long the tariffs might be in place makes the decision about whether to relocate production or to find new supply sources or markets even more difficult.

Over the past 20 years, supply chains have become increasingly interconnected across many countries for any one good. As suggested above, the threat of tariffs may disrupt the global supply chains, causing firms to source from more costly (without tariffs) – but potentially more dependable – suppliers. These complex supply adjustments are likely to play out over an extended period. This implies a modest upward bias to the inflation forecast over the next several years. In an environment of strong growth and tight labor markets, these staggered one-time price changes run a greater risk of becoming more solidly incorporated into inflation expectations.

An added concern for exporters is the higher value of the dollar, which makes it more difficult for our goods and services to remain competitive, as shown in **Figure 11**.

Risks

There are certainly significant risks to the forecast. I will mention three here. First, the strength of the U.S. dollar has generated complications for some emerging market economies. **Figure 12** shows the significant currency devaluations for two emerging economies, Argentina and Turkey. Businesses in these countries that have borrowed in dollars will of course find it more difficult to pay their debts as the value of their own currency falls relative to the dollar.

A second challenge for emerging markets is the increase in oil prices. Many of the emerging economies are importers of oil that is priced in dollars (**Figure 13**), so rising oil prices only complicate matters, as both higher dollar prices and a rising value of the dollar act as a tax on these countries' incomes. To the extent that emerging market growth is slowed by rising oil prices, this in turn will pose a challenge to U.S. growth.

There have also been increased concerns over a potential slowdown in China. Perhaps reflecting such unease, Chinese stock prices have declined recently (**Figure 14**). As a highly leveraged economy faced with significant tariffs, the risk of a more significant slowdown in the world's second largest economy should be considered.

Concluding Observations

I will conclude with a few final observations on policy. **Figure 15** shows the median path of interest rate projections through 2021from the SEP. The median forecast in the SEP has the federal funds rate rising to 3.4 percent. The median estimate for longer-run or equilibrium interest rates in the SEP is 3 percent, so this implies interest rates gradually rising to become mildly restrictive.

My own view is generally consistent with the SEP forecasts. I believe that Federal Reserve policymakers will likely need to move interest rates gradually from a mildly accommodative stance to a mildly restrictive stance in order to best fulfil our mandate – stable prices and maximum sustainable growth.

While this amounts to one person's forecast, it is important to note that it is fully consistent with a forecast of GDP growth above potential that leads to further tightening of labor markets, and inflation mildly overshooting the Federal Reserve's 2 percent target. Of course, if some of the risks that I have highlighted today become more germane to the outlook, a different policy path would be warranted.

Thank you.

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[1]Adjusted for productivity.