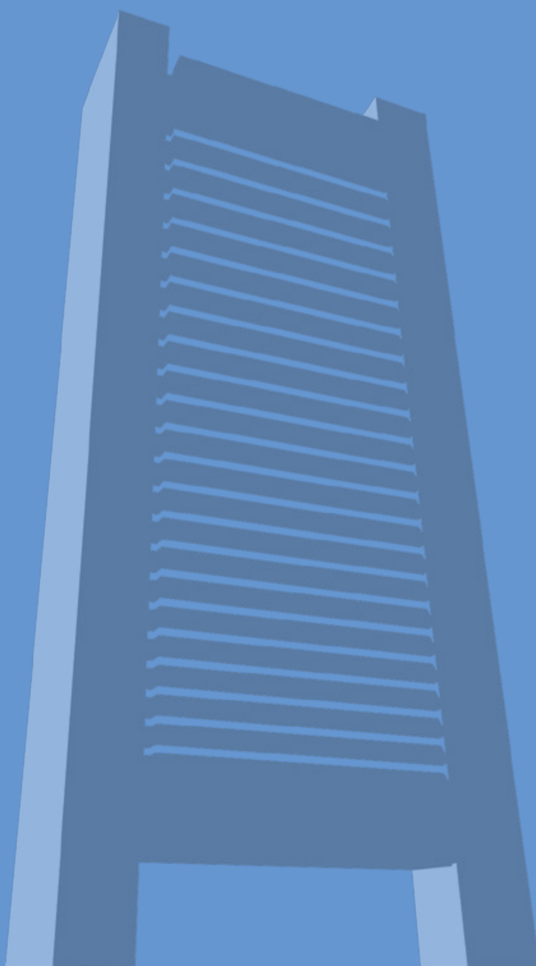
FEDERAL RESERVE BANK OF BOSTON™

EMBARGOED UNTIL WEDNESDAY, MAY 10 AT 12:45 P.M.; OR UPON DELIVERY



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

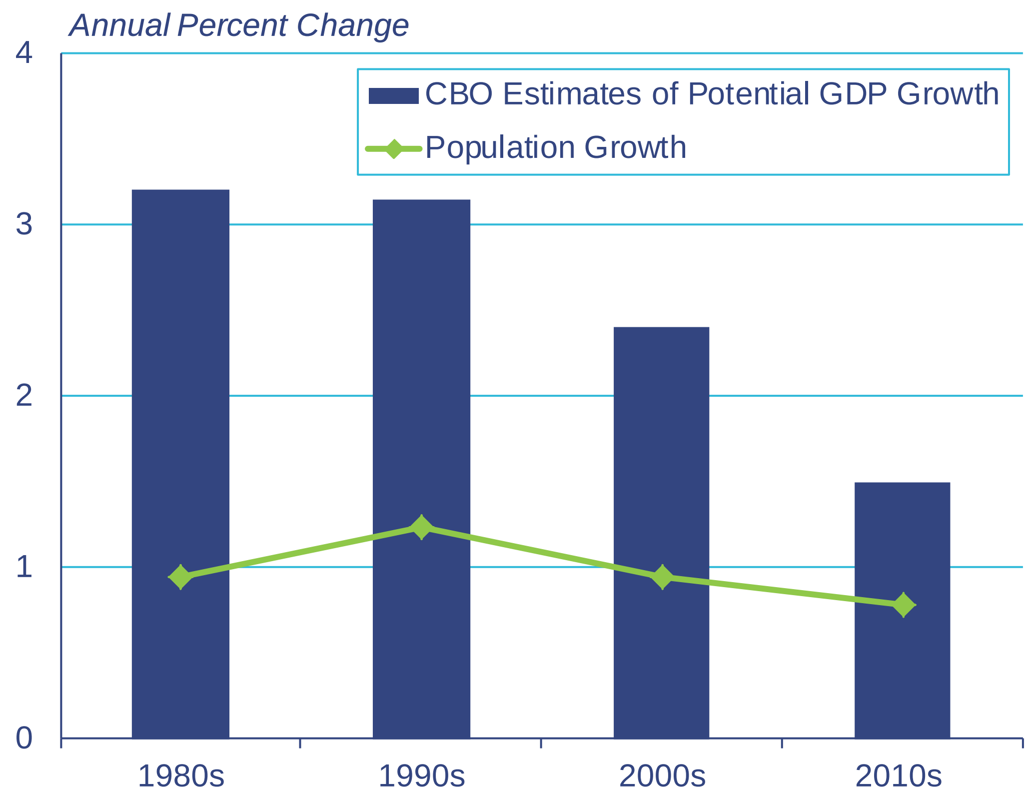
Labor Market Report

- 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



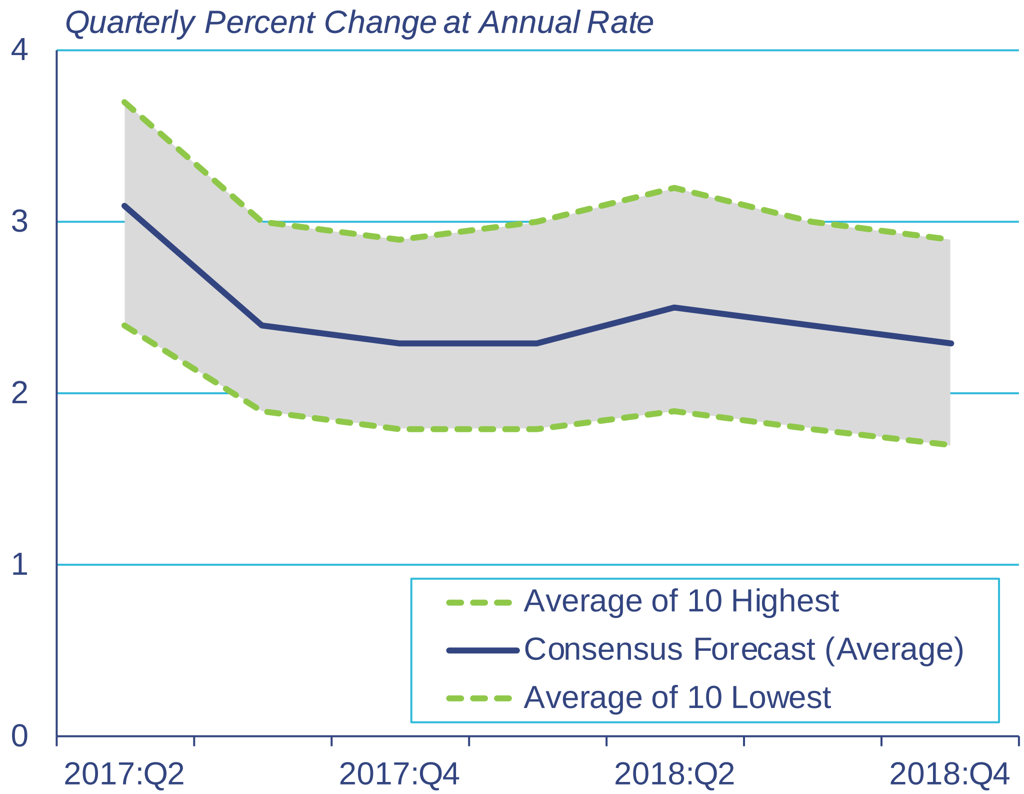
Source: CBO, Census, Haver Analytics

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

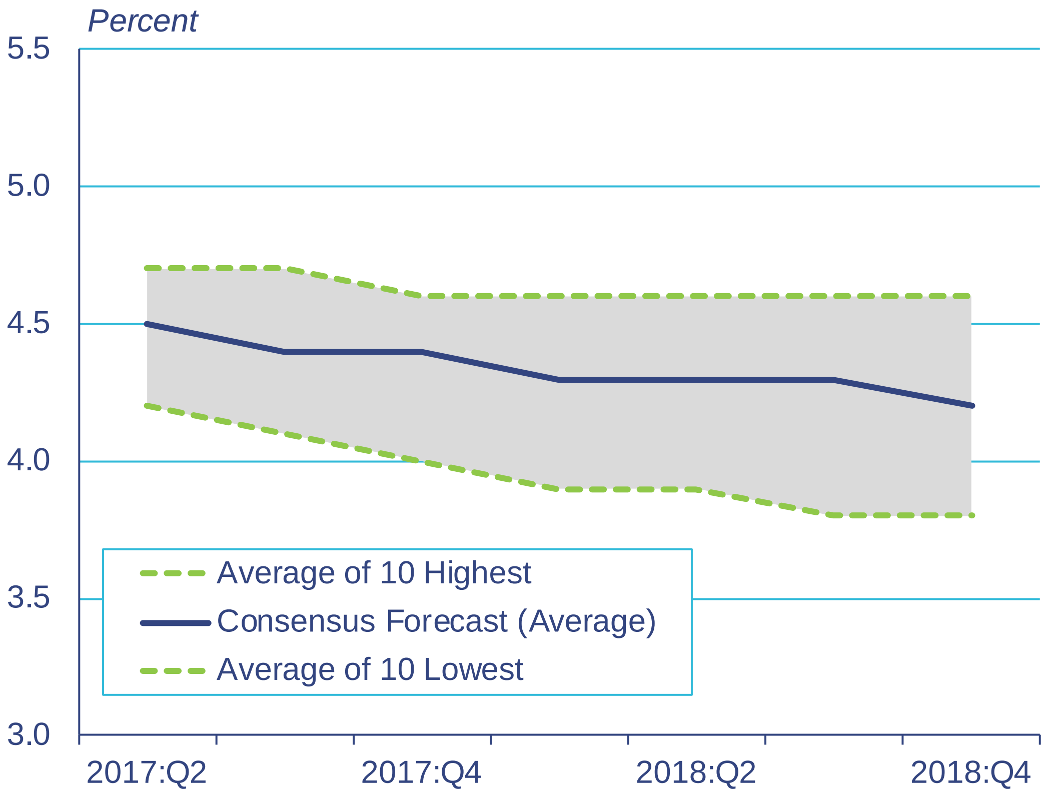
Forecast as of May 2017



Source: Blue Chip Economic Indicators, May 10, 2017

Figure 3: Blue Chip Forecast for the Unemployment Rate

Forecast as of May 2017

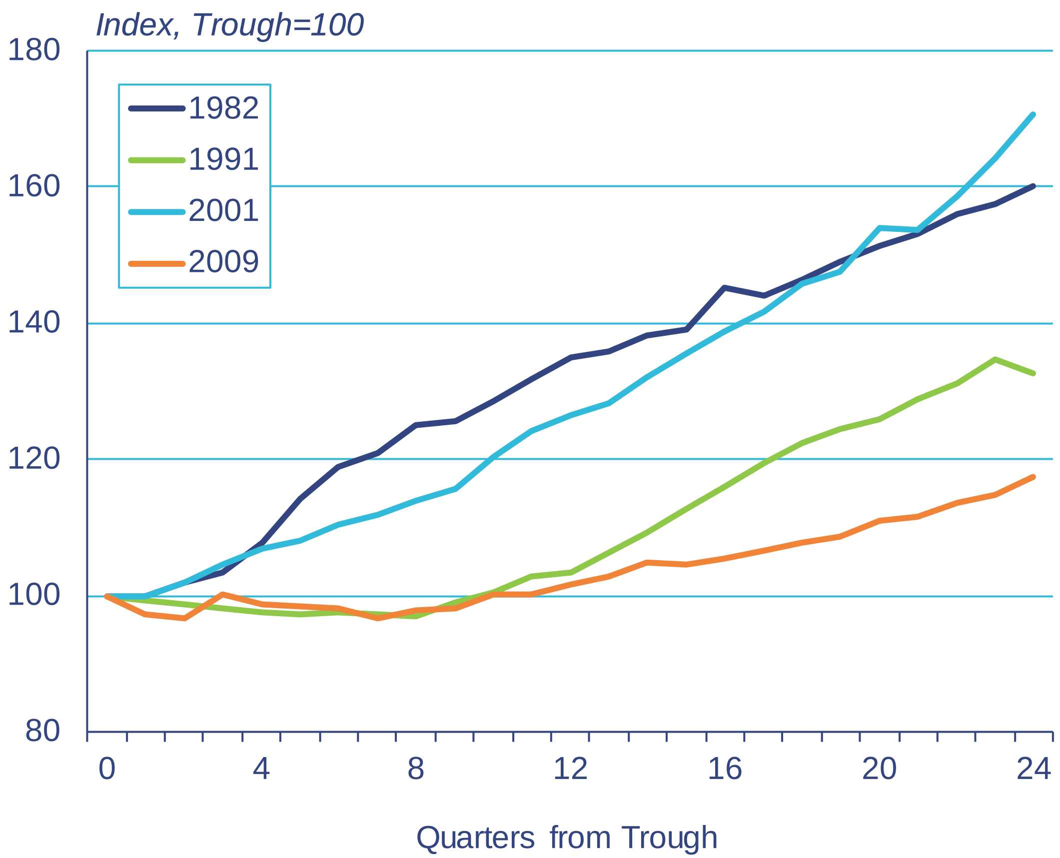


Source: Blue Chip Economic Indicators, May 10, 2017

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

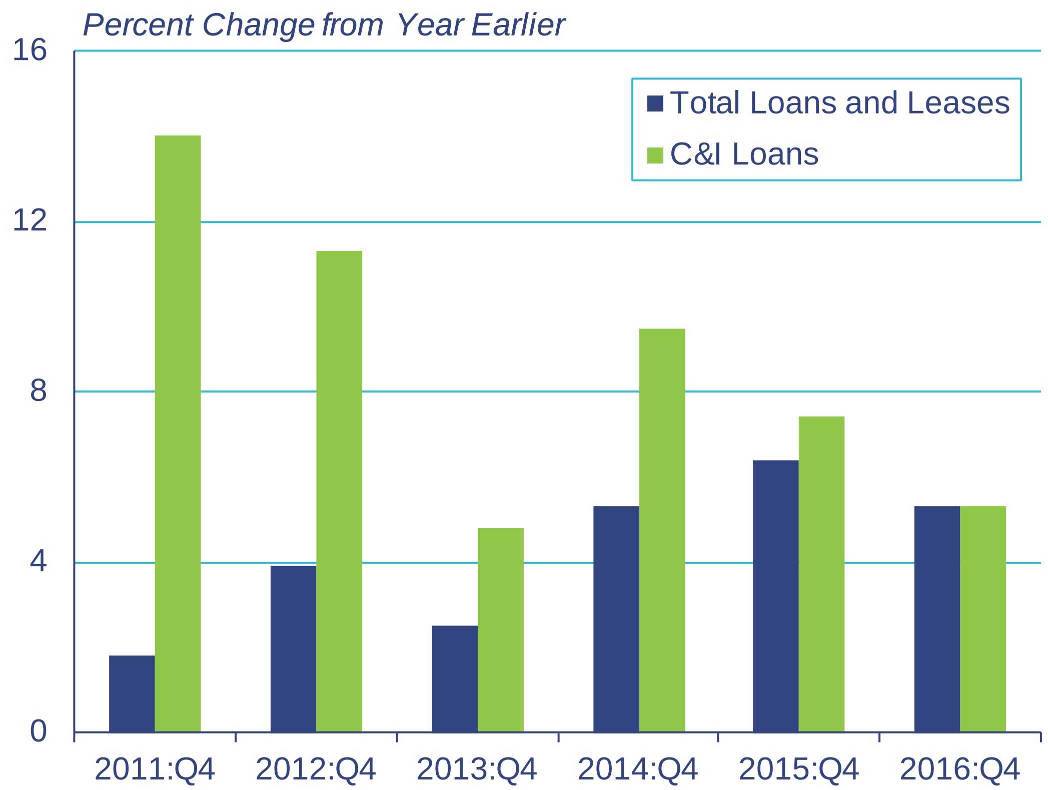
Figure 4: Growth in Total Loans and Leases Outstanding at Commercial Banks from Trough of Last Four Recessions



Source: Quarterly Bank Call Reports, NBER

Figure 5: Growth in Total Loans and Leases and Commercial and Industrial Loans Outstanding at Banks

2011 - 2016

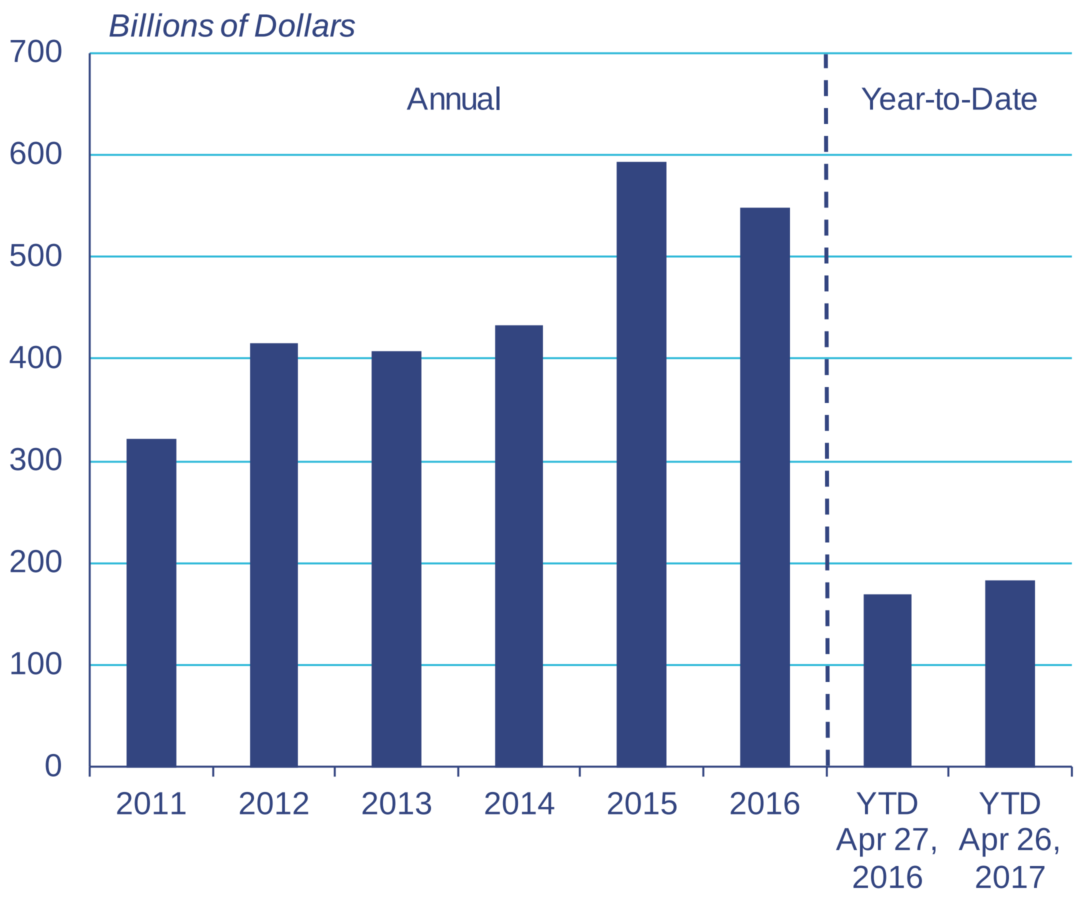


Note: Banks include commercial banks, savings banks, and savings and loan associations. Savings and loan associations are included beginning with the figure for growth from 2012:Q4 - 2013:Q4.

Source: Quarterly Bank Call Reports

Figure 6: Gross Issuance of Investment Grade Nonfinancial Corporate Bonds

2011 - 2017 Year-to-Date

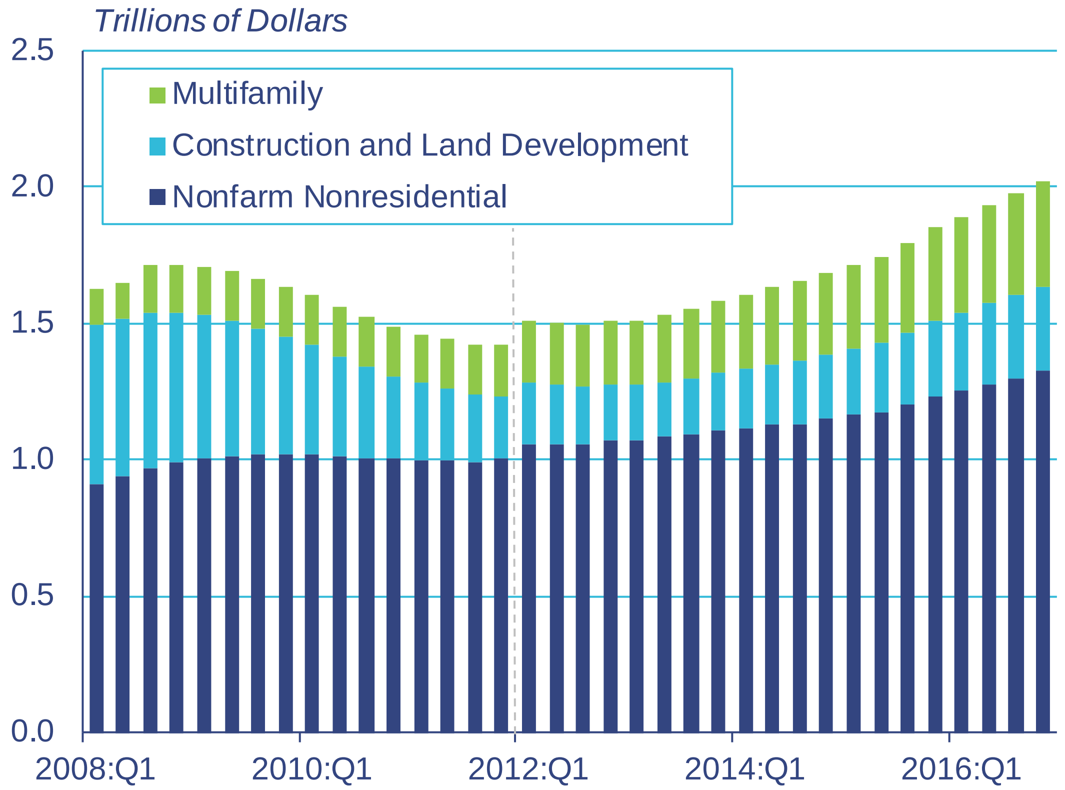


Note: Domestic issuers only.

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.

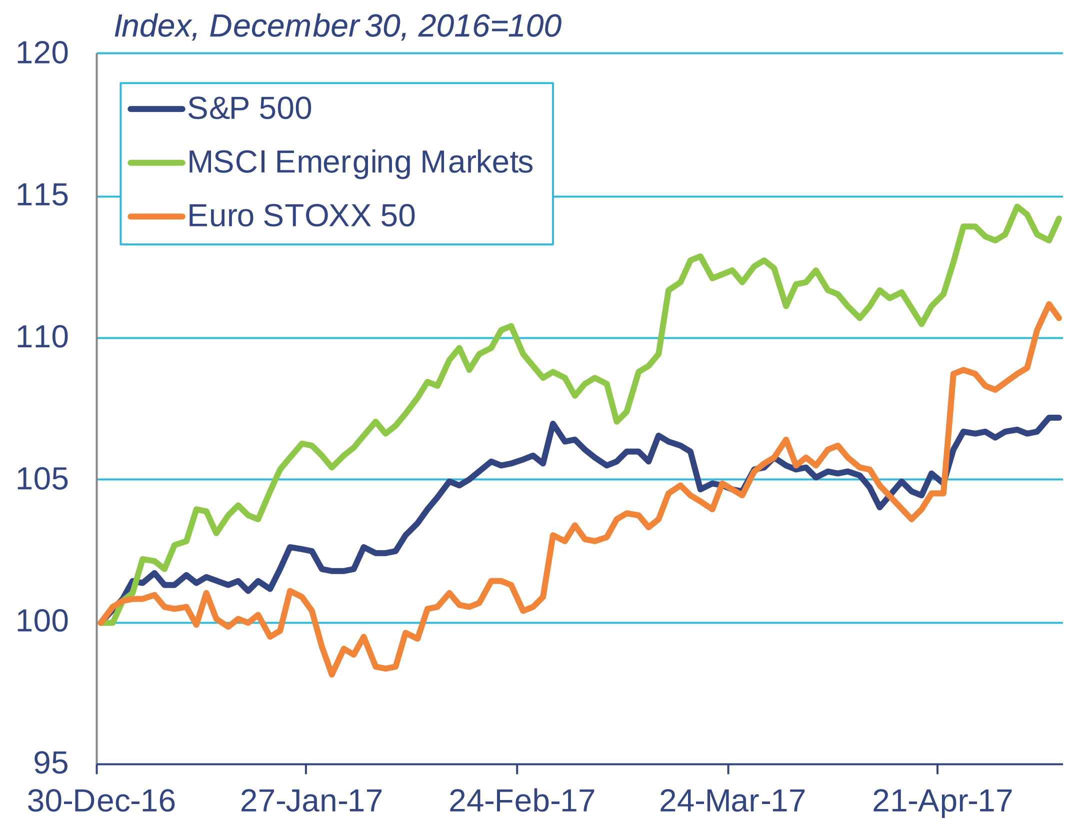
Source: Quarterly Bank Call Reports

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

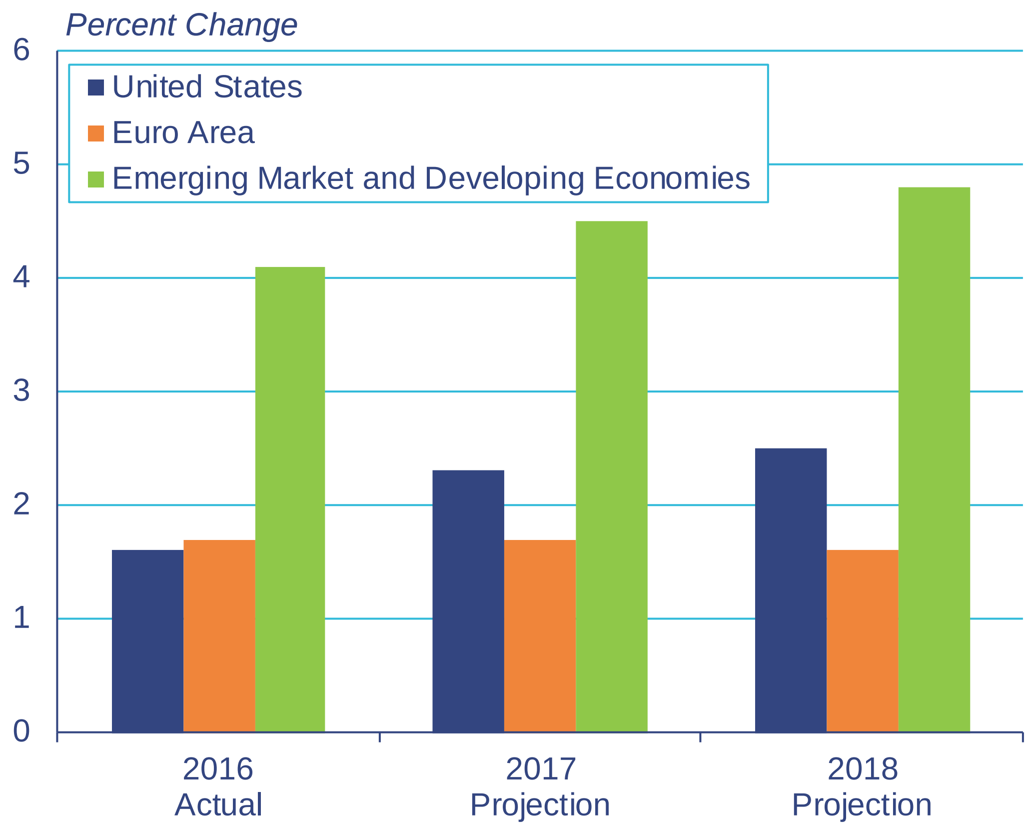
December 30, 2016 - May 8, 2017



Source: Bloomberg Finance L.P.

Figure 9: International Monetary Fund Forecast for World Growth

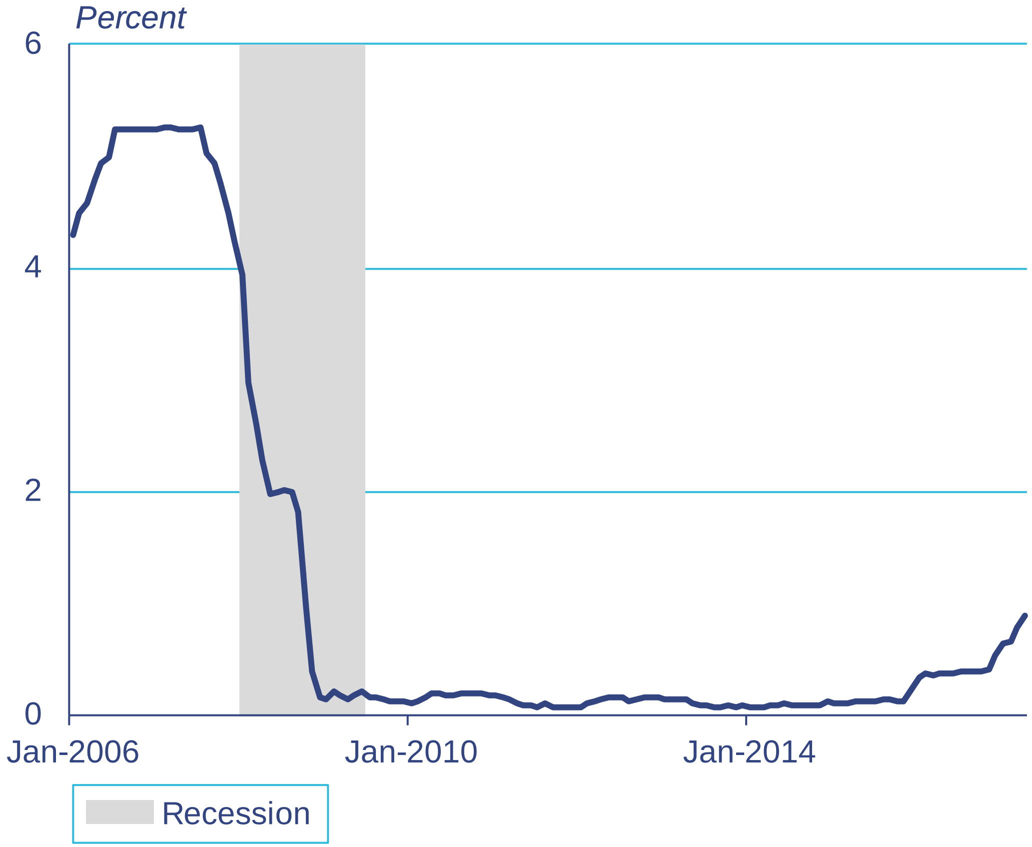
2016 Actual and Projections for 2017 and 2018



Source: IMF World Economic Outlook, April 2017

Figure 10: Federal Funds Effective Rate

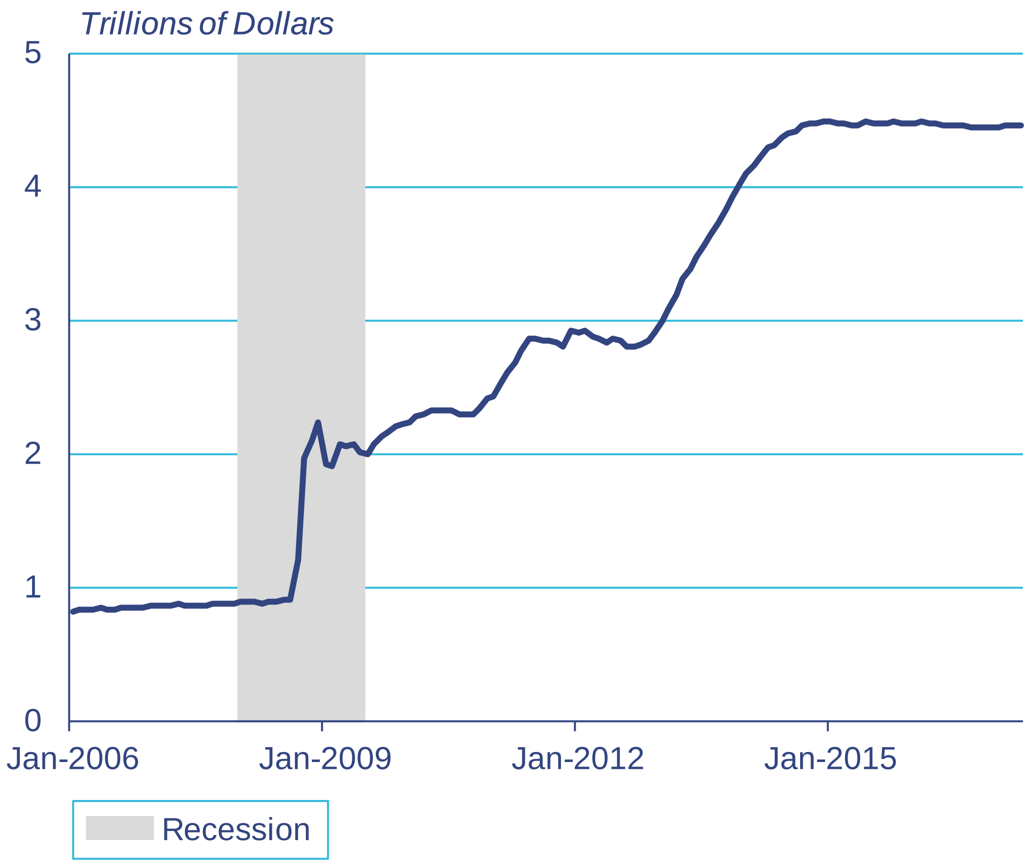
January 2006 - April 2017



Source: Federal Reserve Board, NBER, Haver Analytics

Figure 11: Federal Reserve System Assets

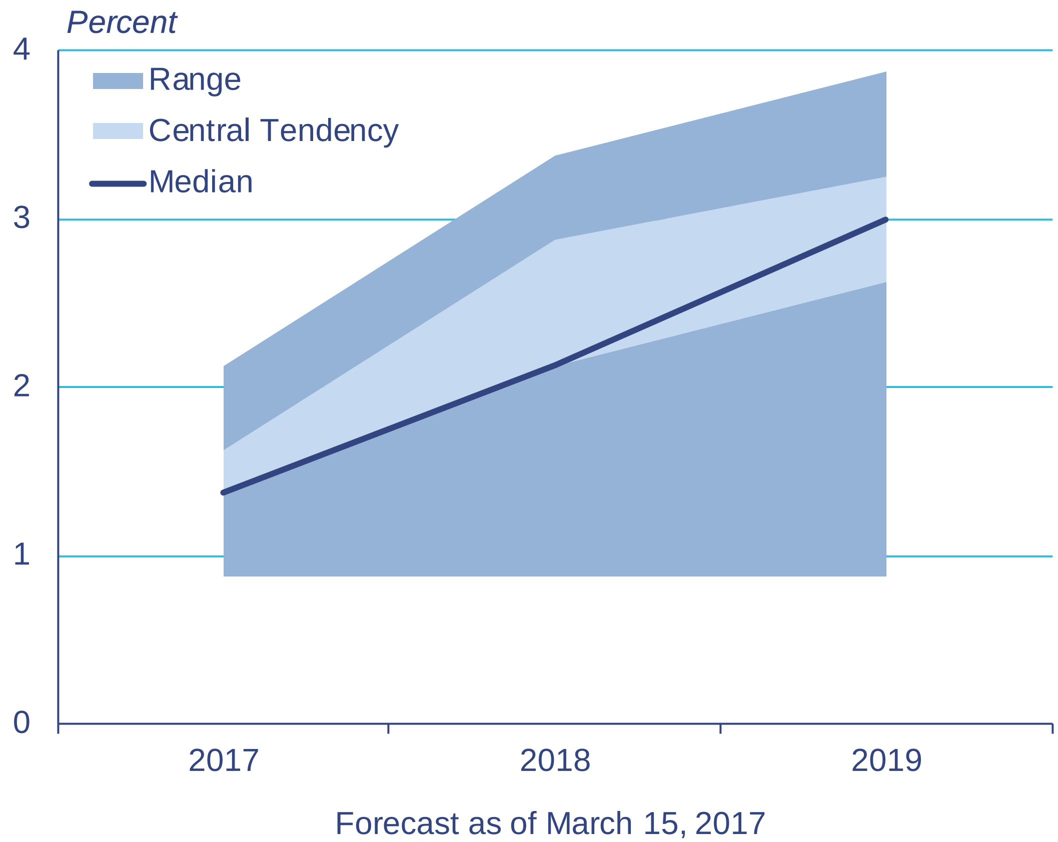
January 2006 - April 2017



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