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"Exploring Economic Conditions and the Implications for Monetary Policy"

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

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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 Afternoon. It is wonderful to be back on campus at the University of Wisconsin-Madison. I appreciate the opportunity to take part in today's American Economic Challenges Symposium, and congratulate the Department of Economics and the Juli Plant Grainger Institute for Economic Research on putting together such a terrific program. I am pleased to be able to speak with you today about the current state of the economy, and the implications for monetary policy and interest rates.

Last Friday, we all noted with interest the publication of the September employment report from the U.S. Department of Labor.[1] Interpretation of the report seems to have varied, depending on the observer. To those concerned with and focused on risks to the economic outlook, the payroll-employment number of 136,000 – which is slower growth than earlier this year – as well as the weakness in the manufacturing sector, supported the narrative that tariffs and weakness globally are slowing down the domestic economy. However, others noted that the preceding months were revised a bit higher, the unemployment rate had declined to 3.5 percent – a nearly 50-year low – and that slower employment growth may instead reflect an economy growing beyond capacity and facing hiring constraints associated with a very tight labor market.

My own view is that the September employment report highlights trends we have been seeing since the spring: the presence of elevated downside risks, but actual economic outcomes that are not much different than what most forecasters expected six months ago or longer.

To be sure, the economy faces a number of downside risks. In an already slowing global economy, the imposition of tariffs and the prospect of additional tariffs are together resulting in slower exports and weakness in the manufacturing and agricultural sectors. Indeed, the high-frequency incoming economic data have been consistent with a slowdown that is largely concentrated in manufacturing – which has reduced business fixed investment, as firms wrestle with the implications of higher trade barriers. In addition, geopolitical concerns remain elevated. The recent attack on Saudi oil production and the potential for a difficult Brexit, in a Europe that is already growing slowly, highlight that the global recovery faces risks that make it somewhat fragile.

Despite these clear risks, second-quarter U.S. economic growth was above the estimated "potential" rate (that is, an estimate of the economy's maximum sustainable output over the long term).[2] Looking forward, Fed policymakers' September *Summary of Economic Projections* (SEP) and the consensus of private forecasters both anticipate growth around potential.

How can the economy continue to expand at potential with the sort of weakening in exports and investment that we are seeing? To date, the answer has been strong consumer spending. The U.S. consumer has been bolstered by plentiful jobs in tight labor markets, strong growth in personal income, and increases in household wealth due to rising prices of assets like stocks and homes. An important question remains whether consumption can continue to offset the negative effects of trade problems and slower foreign growth.

While U.S. consumers have been resilient to date, continued resilience is not guaranteed. So it is important to consider whether the economy can continue on its quite favorable path – with growth around potential, tight labor markets, and inflation near the Fed's target of 2 percent. The stance of monetary policy is already accommodative, so my view is that policymakers can be patient and continue to evaluate incoming data before taking additional action. My forecast for the economy does not envision additional easing being necessary. However, should risks materialize and economic growth slow materially, to below the potential rate, I would be prepared to support aggressive easing.

Current Economic Conditions

Figure 1 provides the median forecast of Fed policymakers for key economic variables from the SEPs from March and September 2019. How different are the forecasts of economic outcomes in September, compared with what we anticipated before the recent increase in tariffs and the cuts in the federal funds rate? What is striking to me is how little the forecasts for 2019 have changed.

Of course, this is due in part to the significant easing actions that the Federal Open Market Committee (FOMC) has already put in place, which will continue to stimulate the economy this year and next. More recently, Fed policymakers have added a couple of interest rate cuts to the mix. These actions, to some extent, help to keep the forecast in the healthy zone.

Interestingly, the forecast for real GDP growth for 2019 has actually increased over this period, though only by 0.1 percentage point. In March and September, the median forecast for the unemployment rate at the end of this year was 3.7 percent, an unemployment rate that looks too pessimistic now, given the September employment report's reading of 3.5 percent. While total and core PCE inflation are lower than had been expected, core PCE inflation (which removes the often-volatile food and energy prices) has risen 0.3 percentage points from its lows earlier this year.

Overall, then, the economy has evolved about as expected, despite the unanticipated increase in tariffs and the slower growth of exports and business fixed investment. Moreover, recent monetary policy easing is likely to provide some stimulus over the next several quarters.

Not only has the economy evolved about as expected, but it is currently close to where policymakers had hoped it would be at this time. **Figure 2** shows the recent paths for some alternative measures of inflation. The dashed line indicates the Fed's 2 percent inflation target. Three different measures of inflation are shown on the chart. On a 12-month basis, core CPI is currently at 2.4 percent. Core CPI has risen over the past several months, settling at 2.4 percent for August and September. The Dallas Trimmed Mean, which removes extreme observations, rounds to 2 percent. Core PCE is at 1.8 percent, slightly below the Fed's target – but has also trended up recently. With tight labor markets and an already accommodative stance of policy, it seems likely that inflation will remain close to target as long as the economy does not unexpectedly slow down.

Figure 3 provides the Committee's most recent estimate of full employment (the dashed line) at 4.2 percent. While the level of unemployment associated with full employment is difficult to estimate, and the FOMC has lowered its median estimate of full employment over the past several years, we see that the September unemployment rate of 3.5 percent is well below policymakers' best current estimate of full employment.

In sum, the U.S. economy is now very close to meeting the Fed's Congressional mandate of full employment and stable prices (which we define as 2 percent inflation). In addition, I would note that the Committee's September median forecast for 2019 real GDP growth was 2.2 percent, consistent with no significant slowdown in the second half of this year. So as we look at economic performance, forecasts, and risks to the forecasts, the overriding policy question is whether the risks are so elevated that further easing is required, despite already accommodative policy.

Financial Considerations

Certainly, one reason for concern about the economic outlook is the movement of the 10-year U.S. Treasury yield. The yield on 10-year Treasury bonds has declined significantly, leading many financial market participants to express concern that this signals a more significant impending slowdown. An alternative explanation that I have discussed in recent talks is that very low (and in some cases negative) long-term foreign rates are playing a role in pushing down U.S. long rates, as foreign investors move money from low-rate economies into the (relatively) high-rate U.S. markets, pushing down U.S. yields.[3] Also, it seems like global investors are using U.S. Treasuries to partially hedge against the possibility of an economic downturn in their country or region, since the prices of long-duration U.S. Treasury securities normally rise during economic downturns. I see both of these as more likely explanations of the recent movements than an impending U.S. slowdown.

Other financial indicators do not portend a significant slowdown. Despite high leverage in the corporate sector and more issuance at the bottom end of investment-grade ratings, the spread between yields on corporate bonds and Treasury bonds, shown in **Figure 5**, remains below the average spread of the past 25 years. Similarly, the stock market, shown in **Figure 6**, remains close to all-time highs.

Recent developments in oil markets are more consistent with apparent risks to the global economy. As shown in **Figure 7,** oil prices have fallen – usually a sign that investors see additional weakness developing in the global economy – despite the supply disruption caused by the attack on Saudi oil production. The dollar has continued to appreciate against various currencies, and relative to the pound – as Brexit concerns remain elevated – which is shown in **Figure 8**. And **Figure 9** shows the continued impact of the trade war with China, as both exports to and imports from China have declined significantly.

Implications of the Risks

Given that the economy is close to achieving the Fed's dual mandate, should the risks that are clearly present cause policymakers at the Fed to alter monetary policy? At this point in the cycle, should risks be addressed preemptively, or should FOMC participants wait until they materialize?

Despite the clear risks to the economic outlook, most professional private forecasters expect the economy to continue to grow around its potential. **Figure 10** provides the most recent Blue Chip forecast – a summary of the views of approximately 50 private forecasters -- for real GDP over the next several years on the left, as well as a comparison to the earlier March forecast on the right. In the chart on the left, the solid line shows the average forecast for real GDP, which at about 1.7 percent is the same as my estimate of the potential growth of the economy. The dashed lines reflect the average of the 10 lowest and 10 highest forecasts for real GDP. Even the lowest 10 forecasts still expect positive economic growth, though slower than my estimate of potential. The chart on the right compares the average of the 10 lowest from the current forecast (the dark blue dashed line on both charts), with the average of the 10 lowest from the March forecast. The lowest forecasts have not become more pessimistic.

With both the Fed's forecast and private forecasts expecting the economy to grow at close to potential, the decision to ease further or keep rates as they are rests on how much insurance to take out against the risks that I have outlined. To answer that question, one should take into account how much insurance is already in place – that is, what is the current stance of monetary policy? **Figure 11** shows the federal funds rate relative to the SEP estimate of what the federal funds rate will be in the long run – roughly speaking, the interest rate that FOMC members believe is neither stimulative nor contractionary, other things equal. The median estimate of the long-run federal funds rate is 2.5 percent. The target for the federal funds rate was set by the FOMC at a range of 1.75 to 2.0 percent at its most recent meeting, after two one-quarter-percentage point reductions in the rate in July and September of this year. In short, the current level of the federal funds rate is already below the FOMC's estimate of the long-run rate.

In sum, monetary policy is already accommodative. This is especially notable given that the average forecaster expects growth close to potential, with already-tight labor markets. But note, too, that Figure 11 shows the funds rate is not that far from zero, which suggests the Fed, at current rates, has limited scope to lower rates in the event of a downturn. That limited policy space – which some see as reason to "keep powder dry," and others as reason to act early – should also figure into the Fed's determination of appropriate policy today.

Concluding Observations

In summary and conclusion, I would note that after two recent rate easings of 25 basis points each, monetary policy is already accommodative. Sustaining growth at potential depends on the U.S. consumer continuing to offset the weakness we are seeing in exports and business fixed investment. To me, it seems appropriate to continue to closely monitor incoming data to determine if the forecast of growth around potential is likely to be achieved, or if the risks I have outlined are indeed materializing.

While the risks to the global and U.S. economies remain, there are also risks to easing too aggressively, as I've highlighted in previous speeches. Ever-lower interest rates could encourage reaching-for-yield behavior at exactly the wrong stage of the economic cycle. This remains an important consideration factoring into my views on the elements policymakers must weigh and balance at this complex time for our economy.

Thank you for having me back to Madison.

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[1] For more, see Employment Situation Summary, released Oct. 4, 2019.

[2] For context on the estimate of the economy's potential growth rate, see the Congressional Budget Office, for example https://www.cbo.gov/publication/53558.

[3] For additional discussion, see: Rosengren, Eric: "Weighing the Risks to the Economic Outlook," Sept. 3, 2019, and "Assessing Economic Conditions and Risks to Financial Stability," Sept. 20, 2019.