

## The Labor Market, Monetary Policy, and Risks to the Economic Outlook

**Dennis Lockhart**  
President and Chief Executive Officer  
Federal Reserve Bank of Atlanta

**Kiwanis Club of Birmingham**  
**Harbert Center**  
**Birmingham, Alabama**  
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### Key points

- Atlanta Fed President and CEO Dennis Lockhart talks to the Kiwanis Club of Birmingham about the labor market, monetary policy, and risks to the economic outlook.
- Lockhart's outlook for the economy calls for continued moderate growth, with GDP for 2013 likely to be a little over 2 percent and inflation expectations well anchored.
- Lockhart says that the recent drop in the national unemployment rate to 7.7 percent is encouraging. However, broad labor market conditions remain mixed, with some indicators showing progress and others revealing little or no improvement.
- Lockhart contends that the most worrisome downside risks to the economy, both at home and abroad, have diminished since last year at this time.
- Lockhart sees encouraging developments in the economy, but says that several more months of improving economic data, especially employment data, would give him the confidence that the economy is experiencing sustainable momentum. Meanwhile, he believes the Federal Open Market Committee's large-scale asset-purchase program continues to be justified.



Good afternoon, and thank you for the invitation to speak with you today. I'd like to take a moment to recognize Drew Langloh, a member of the Federal Reserve Bank of Atlanta's Birmingham Branch, and Don Boomershine, a former chairman of the branch. I greatly appreciate their commitment to the Fed and to this region.

One of the most enjoyable aspects of my job as the Atlanta Fed president is to speak to businesspeople and visit communities across the Sixth Federal Reserve District, and it's a privilege to address the Birmingham Kiwanis Club.

Today I'm not going to stray much from the topics you would expect someone from the Federal Reserve to address. I'll begin with a brief review of the current national economic environment as I see it. In that review, I will emphasize labor market conditions, a focal point of policy. I'll then describe the posture of monetary policy opposite this picture and conclude with some thoughts on policy-related issues.

My remarks today represent my own personal views and do not necessarily reflect the views of my colleagues on the Federal Open Market Committee or the Federal Reserve System.

### Economic outlook

From 2010 to 2012, economic growth averaged about 2 percent a year, a pace far below what was expected for the aftermath of a deep recession.

As we move into the second quarter of 2013, the national economy is expanding at a moderate pace. Although admittedly choppy from quarter to quarter, economic activity is gradually but steadily improving.

However, tighter fiscal policy is likely to take some near-term strength from GDP growth. I am referring to the end of temporary payroll tax cuts for workers, the increase in income tax rates on higher-income individuals, and expenditure cuts prompted by sequestration. While we face uncertainties stemming from contentious fiscal issues, I do see some upside potential for better growth and more robust job creation this year.

There are some encouraging signs in the overall economic picture. Recent survey data suggest that businesses are looking more favorably at capital spending decisions over the next six months. In addition, new orders for capital equipment have been growing in recent months.

The housing sector, after several years of exerting a drag on economic growth, has begun to contribute positively again in a variety of ways. For instance, home price appreciation, on a year-over-year basis, is now approaching 10 percent—the largest annual gain since 2006.

Consumer spending has also picked up in the past few months. Rising equity markets and higher housing prices may have created an increased sense of economic well-being among many households. Sales of domestically produced autos are running more than 10 percent higher than a year earlier.

On the inflation front, despite volatile fuel and food prices, overall inflation as measured by the Consumer Price Index continues to be tracking the 2 percent objective set by the Federal Open Market Committee, or FOMC. Other inflation measures are running below the 2 percent objective.

My outlook for the economy calls for continued moderate growth. I now expect GDP to come in a bit north of 2 percent for 2013 as a whole, with inflation expectations remaining well anchored.

As we look at the Alabama economy, we expect to see economic growth mirror that of the nation.

Positive news coming from the automotive industry should bode well for this region. This sector should continue to strengthen as housing recovers and consumer confidence grows, providing an additional boost to the local economy.

## Employment

The national employment situation continues to be a central focus of policymakers. The Federal Reserve has a dual mandate from Congress—to foster both price stability and maximum employment. We have seen some progress on employment, but that progress has been relatively slow and remains short of commonly cited definitions of maximum employment.

Encouragingly, we did see a drop in the national unemployment rate to 7.7 percent in February from 7.9 percent in January—and that brought unemployment to its lowest level in four years. Nonfarm payrolls are also estimated to have advanced at a better-than-expected pace of 236,000 jobs in February. We will get a reading for March on Friday.

The February employment data contributed to an improving recent trend in job creation. Over the past three months, employment has risen by an average of 191,000 per month, compared with an average monthly gain of 183,000 in 2012.

While these recent employment trends are encouraging, I am also reminded of what happened last year. We saw strong data in the early months of 2012, followed by a mid-year swoon. So I think it is appropriate to be a bit cautious in extrapolating these recent employment trends. More evidence is needed.

The fact is that conditions in the broad labor market are quite mixed. While some indicators of labor market health have improved a lot since the recession, others have not improved much at all or have even worsened. As I said, net job creation is picking up. Initial claims for unemployment insurance have fallen. But the official rate of unemployment remains high, many discouraged workers have left the labor force, and there are many people working part-time jobs who want to work full time.

At the Atlanta Fed, we have created a tool called the Jobs Calculator to compute employment paths under different scenarios. Assuming that labor market participation remains stable, the Jobs Calculator shows the economy would need to add at least 180,000 new jobs each month to get the unemployment rate down to 6 percent within three years.

But it is also possible that labor force participation could pick up somewhat if job prospects improve. In this case, more jobs would be needed for people returning to the labor market. For example, a 0.5 percentage point rise in labor force participation would mean that about 210,000 jobs a month would be needed to achieve an unemployment rate of 6 percent within three years. I think this example illustrates the challenge that lies ahead on the employment front.

## Stance of monetary policy

Let me now address the current stance of monetary policy and some policy-related issues.

The Federal Reserve's policy posture remains very accommodative to support continued economic growth and job creation.

The federal funds rate target remains effectively at zero, where it has been for more than four years now. The FOMC has indicated that this ultra-low interest rate policy will stay in effect at least until the unemployment rate reaches a threshold of 6 1/2 percent.

To support the housing market recovery, the Fed began purchasing agency mortgage-backed securities last September at a pace of \$40 billion per month. We have also been purchasing longer-term Treasury securities since that time at a pace of \$45 billion per month. We refer to these policy actions as large-scale asset purchases. You may know this program by the commonly used term "quantitative easing," or QE. The QE program is open-ended. The FOMC has conditioned ending these bond purchases on "substantial improvement in the outlook for the labor market."

If the current pace of asset purchases continues to year's end, these programs will have added about \$1 trillion to the Fed's balance sheet compared with its scale before last September. There are quite valid concerns about the longer-term consequences of continuing to expand the central bank's balance sheet.

In brief, here are those concerns: First, there is concern about the potential for a rise in inflation expectations and resulting inflation if the balance sheet remains too large for too long. Second, concerns have been raised about the possible effects of further asset purchases on the functioning of financial markets and on financial stability more generally. And third, there is concern about losses the Fed might incur as it sells assets in the process of shrinking the balance sheet.

As I weigh these concerns against the need for policy to buttress economic momentum, I conclude that these asset purchases continue to be justified.

There are encouraging developments in the economy, to be sure, but the evidence of sustainable momentum that will deliver "substantial improvement in the outlook for the labor market" is not yet conclusive. I favor a "wait and watch" mode for the time being. Several more months of positive data—especially in a range of employment data—would give me confidence that the economy has real traction and is unlikely to backslide.

How will I, as one policymaker, determine that the balance has shifted and the time for a policy change has come? Well, one key consideration is the array of risks to the economic outlook and my degree of confidence in the outlook.

Given the inherent inaccuracy of economic forecasts, I give particular attention to the most serious downside scenarios—what economists often call "tail risks."

In 2012, I perceived significant negative tail risks. They included the possibility of a financial spillover from financial instability and a recession in Europe and a congressional impasse that would have driven us over the so-called fiscal cliff.

Today, I think those tail risks have diminished. Notwithstanding the recent alarm over banks in Cyprus, I think the potential for a shock coming from Europe is smaller today than it was a year ago. Overall, it seems to me the economy has moved beyond the most worrisome downside possibilities that concerned so many of us last year at this time.

Today, business optimism is on the rise, and I think there is potential for a step-up in business investment and hiring activity as the year progresses. I hear anecdotal comments to this effect from contacts across the Southeast. This is something I could not have reported to you a year ago.

The key word in the phrase “substantial improvement in the outlook for the labor market” is **outlook**. For my part, a critical consideration in judging how much longer asset purchases should continue will be confidence in the positive outlook. Confidence that is solidly grounded in improving economic data, accumulated over a sufficient span of time, will help me conclude that the work of the large-scale asset purchase program, as a temporary supplement to conventional interest-rate policy, is complete.

The decision to curtail asset purchases ought to be forward-looking, and in my judgment, that point could come later this year or early next year without harm to the momentum of the economy.

Now I'll be happy to take some of your questions.

**Contact:** [Jean Tate](#) 404-498-8035

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