SPEECHES

Monetary Policy in Light of the Economic Outlook

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Key points

- Atlanta Fed President and CEO Dennis Lockhart, in a June 27 speech to the Kiwanis Club of Marietta, Georgia, says that despite some mixed signals, he currently expects continued moderate growth in the economy, with gross domestic product for 2013 in the range of 2–2.5 percent, slightly more for 2014.
- Lockhart says that the policy position of the Federal Open Market Committee (FOMC) has not changed regarding the fed funds rate. The policy interest rate is as low as it can go, and the FOMC has stated it will remain there at least until the unemployment rate approaches a threshold of 6 1/2 percent.
- Lockhart estimates that this unemployment rate threshold, and lifting of the fed funds rate, will come sometime in 2015.
- Lockhart points out that, as the Chairman made clear, there is no "predetermined" pace of reductions in the asset purchases, nor is the stopping point fixed.
- The pace of purchases, the composition of purchases, and the ultimate size of the Fed's balance sheet still depend on how economic conditions evolve, Lockhart stresses. All elements of the asset purchase program will be considered on a meeting-by-meeting basis in light of the incoming data and economic outlook.

Introduction

I want to thank the Marietta Kiwanis for inviting me to speak here today. I have held Kiwanis in high esteem for a long time. In high school in California, I was a member of the Key Club. My father was a Kiwanian. He would take me to Kiwanis meetings from time to time. I remember that his club had the tradition of imposing fines of a dollar on any members whose name had been in the newspaper or had gotten community recognition in some way. I remember thinking I was watching my allowance evaporate when my father put money in the pot.

I am sure many of you have been closely watching the Federal Reserve's recent moves and the financial markets' reactions to those moves. Maybe you've felt emotions similar to those I had 50 years ago when I thought I was seeing my allowance dissipate.

This afternoon, I will share my views on state and national economic conditions and the outlook. I will also discuss the Fed's recent communication about the direction of monetary policy and comment on its interplay with recent market turbulence.

As you listen, please keep in mind that my comments are my personal views and may not reflect those of my colleagues in the Federal Reserve System or on the Federal Open Market Committee (FOMC).

Georgia and the national economy

Let me begin with some thoughts on economic conditions here in Georgia. We at the Federal Reserve Bank of Atlanta spend a lot of time monitoring the economy in our district, which includes not only Georgia but also Alabama and Florida and portions of Louisiana, Mississippi, and Tennessee. Through what we call our Regional Economic Information Network, we gather grassroots information about conditions across the Southeast, which helps us contribute to national monetary policymaking. Because we're headquartered here in Atlanta and so many of our contacts are nearby, we feel we have pretty good grassroots intelligence on Georgia's economy.

Our state's economic performance has steadily improved since the recession ended and particularly over the past year. Since January 2012, jobs growth has averaged a little more than 5,700 per month. This is much improved from the previous two-year average of only 3,000 per month. It's important to note that we are climbing out of a pretty deep hole. Given the current pace of job creation, we are still about two years away from our previous employment peak.

Georgia's current unemployment rate stands at 8.3 percent—still high by historical standards but down from its peak of more than 10 percent. The state's unemployment rate ticked up in May, but this was largely the result of more people entering the labor force and actively looking for work, a positive sign.

Employment continues on a positive trend in most sectors in our state. The monthly labor market data for the state are quite volatile, but looking through the noise, we can see that the fundamental signals suggest the state is gaining momentum even though we have not yet returned to our prerecession pace of growth.

Georgia's economy during the recovery has mostly tracked national trends. I think that will continue. So let me now turn to the national picture.

Setting the scene

I'll start with some scene setting. The recession that began in late 2007 and ran to the summer of 2009 was the deepest since the Great Depression. The national economy has been in recovery—that is, expanding—for almost four years now.

If you look through month-to-month and quarter-to-quarter fluctuations, the annual growth rate of gross domestic production (GDP) over the recovery period to date has been around 2 percent. This very modest pace of growth has brought gradual progress in reducing unemployment. Unemployment peaked nationally at 10 percent and now stands at 7.6 percent. Over this period, inflation has been moderate. And inflation expectations of the public have remained well anchored.

Current state of the national economy—vital signs

GDP growth has not been uniform quarter to quarter. Recently, the numbers have jumped around somewhat. The final reading for the fourth quarter of 2012 was an annualized 0.4 percent, quite weak. The first quarter of this year came in at 1.8 percent after a pretty sizeable downward revision from 2.4 percent. The second quarter number is expected to be in roughly the same neighborhood—an annualized rate between 1.5 percent and 2 percent. So if the second quarter numbers come in as economists currently expect, the past three quarters will post a pace of growth a shade under 1.5 percent, below the recovery-average pace of about 2 percent. These incoming data readings leave some question about what to expect going forward.

The vital signs of the economy are mixed. I'll comment on some of these vital signs under three headings. I'll use the familiar dashboard device of green, amber, and red.

Green news first. The housing sector is clearly rebounding. Residential construction is increasing. Auto sales are holding at a very healthy annual level, just above 15 million units. Retail sales are holding up rather well in spite of the tax changes at the beginning of the year. The energy sector is very active as measured by both exploration and production. Confidence levels—both business and consumer—are rising.

In the more neutral, amber category, exports are contributing little to growth nationally. Weakness in Europe and slowing in Asia have softened U.S. export performance. Business investment has slowed recently. Businesses still seem to be hesitant to invest or hire for expansion.

In the red category, some amount of fiscal drag from the sequester appears to be holding back the economy. Manufacturing and industrial production have slowed considerably. And growth of household income in the early months of the year had been weak and trailing the rate of consumption growth. This morning's numbers showed some reversal of that picture. Still, any gap between income growth and consumption growth bears watching.

Also, there is the curious matter of inflation. Inflation—as indicated by a composite of indices and analytical cuts—is low. It's arguable that inflation is running *too* low. In January of 2012, the FOMC set an official inflation target of 2 percent to be achieved over the long run. Key measures of inflation have recently been tracking below 2 percent. It's possible these low inflation readings indicate an economy that is weaker than I, for one, believe it is.

The Atlanta Fed regularly surveys a sizeable sample of businesses across the Southeast. In our recent surveys, very few businesses claim to have much pricing power. In our most recent survey of business inflation expectations, a significant number of respondents said they expect input costs to remain flat or to decline over the next 12 months.

It's my view that the inflation situation calls for close monitoring. If inflation expectations of the public and those indicated by financial markets soften appreciably, we policymakers would have to reevaluate the appropriateness of policy for the situation.

The outlook

This scenario is not my base-case outlook for inflation. I expect the rate of inflation to rise gradually toward the target of 2 percent.

Monetary policy is set based on the outlook for the economy. It is in this context of weak inflation readings, mixed vital signs, and choppy quarter-to-quarter growth statistics that each participant in the Federal Open Market Committee, myself included, recently updated the forecast.

Here in a few words is my growth forecast: I expect the moderate pace of growth we have been experiencing to continue, resulting in a GDP number for the year as a whole in the range of 2 to 2.5 percent. To achieve that, the second half will have to be a little stronger than the first half, and I expect 2014 to improve slightly on the pace of the second half of 2013.

With moderate growth and low inflation, I think it is appropriate to put emphasis on growing employment and improving labor market conditions. The official rate of unemployment that is calculated by the Bureau of Labor Statistics stands at 7.6 percent. The rate of unemployment has declined 0.6 percentage point over the last year and about 2.5 percentage points over the last three years. Clearly, this is progress.

Like the larger story of slow growth and gradual recovery, employment conditions have improved only gradually. Payroll employment increased an estimated 175,000 in May, similar to the average over the past 12 months. I am forecasting a continuation of this trend. If we get month-to-month job growth of this magnitude or a little better and if labor force participation remains stable, we should see an unemployment rate of around 7 percent by the middle of next year. Such progress will be pivotal for the management of monetary policy over the next year.

It's important to remember, however, that the official unemployment rate and the monthly payroll jobs growth number don't represent a complete picture of labor market conditions.

For example, the movement of the unemployment rate is influenced not just by the flow of workers from unemployment to employment, but also by the flow of workers in and out of the labor market. Before the recession, about 1.6 million unemployed workers dropped out of the labor market each month. Today, the flow from unemployed-but-looking to out-of-the-labor-force is 2.5 million a month.

The official unemployment number, therefore, swings on participation in the labor force. As confidence in economic prospects improves, we would expect this to result in the return of people who are currently out of the workforce, potentially causing the unemployment rate to rise, as we saw in last month's data. So drawing conclusions strictly from the unemployment rate is not straightforward.

The (appropriate) stance of policy

To sum up the outlook, as I see it, growth will accelerate slightly from its current moderate pace, inflation will rise gradually toward 2 percent, and unemployment will decline steadily at a modest pace. To realize this forecast or something close to it, monetary policy, which is "highly accommodative" (in central banker speak), will have to remain so for quite some time. The Fed's policy interest rate—the federal funds rate—is as low as it can go. The FOMC has stated the policy rate will remain there at least until the unemployment rate approaches a threshold of 6 1/2 percent. Nothing has changed as regards that policy position. The timing of the first move to raise the policy rate will depend on overall economic conditions, but I would estimate "liftoff," as it is called, to come sometime in 2015.

At the most recent FOMC meeting last week, the Committee decided to continue for the time being to apply additional monetary stimulus in the form of asset purchases at the pace of $85 billion per month. The public knows this supplemental stimulus as "quantitative easing," or QE. The purchases are split pretty evenly between agency mortgage-backed securities (MBS) and Treasury securities. I supported this decision.

In his press conference following last week's FOMC meeting, Chairman Bernanke stated that if the unemployment situation continues to improve, the QE program could slow down starting later this year. This process of reducing asset purchases could continue in measured steps through the first half of next year, with purchases ending when and if sufficient progress has been made in employment conditions. At midyear, the composite forecast of the committee would have the rate of unemployment around 7 percent.

As the Chairman made clear, there is no "predetermined" pace of reductions in the asset purchases, nor is the stopping point fixed.

The pace of purchases, the composition of purchases, and the ultimate size of the Fed's balance sheet still depend on how economic conditions evolve. All elements of the asset purchase program will be considered on a meeting-by-meeting basis in light of the incoming data and economic outlook.

In my view, the comments by the Chairman do not constitute an enormous shift in policy. The asset purchase program is best thought of as a supplement to the FOMC's interest rate policy, designed to add a little more heft to efforts in support of ongoing recovery. As I said a moment ago, I still anticipate that the very low interest rate policy will remain in place for a considerable time after the end of asset purchases, and thus policy will remain highly accommodative.

This policy course will not be particularly difficult if the signals are clear that the economy is evolving as envisioned. But the world is rarely so cooperative. I would argue that uncertainty is lower today than a year or two ago, and consequently confidence in the outlook is justifiably higher. But stuff happens. I don't think we can completely rule out greater fiscal drag than anticipated, or intensified effects of global economic weakness, or structural challenges becoming more apparent, or shocks that move the economy off course. We know from the events of 2008 that financial markets can shake and sometimes shock the overall economy.

Financial markets have been volatile recently. They may be reacting to a number of things. Certainly among these is Fed communication. It could be argued that financial markets are reflecting a different interpretation of Chairman Bernanke's commentary. I don't want to be too cute about a serious matter, but to make an analogy, it seems to me the Chairman said we'll use the patch (and use it flexibly), and some in the markets reacted as if he said "cold turkey." In any event, the upshot has been a rise of market volatility, higher long-term interest rates, and a decline in bond and equity prices.

The financial markets are in constant interplay with the real economy. As a policymaker, I'm watching closely to see if there is negative spillover into the real economy—Main Street. That, I think, is the key consideration.

If the broad economy evolves close to the outlook I laid out—which itself is close to the composite forecast of the 19 FOMC participants—then the economy will be on track to a better place. In that circumstance, I think the position that the economy does not need quite as much stimulus is fully supportable.

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