SPEECHES

Monetary Policy and the Economic Outlook

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

Annual Business and Economic Summit
Montgomery, Alabama
November 12, 2013

Key points

- Atlanta Fed President and CEO Dennis Lockhart, in a November 12 speech at the Annual Business and Economic Summit in Montgomery, Alabama, reviews current economic conditions and the Fed's highly accommodative monetary policy actions to support economic recovery.
- Lockhart says that in an effort to orient the public's expectations regarding policy actions, the Fed employs several communication methods, including a formal statement after each meeting of the Federal Open Market Committee, press conferences, and meeting minutes.
- Lockhart says the Fed is pursuing two objectives—full employment and low and stable inflation.
- The economy is growing at a slow pace, Lockhart says. Substantial progress has been made on employment, but there is more to be done. At the same time, inflation is too low, which carries some risk of a weakening economy.
- Lockhart's baseline outlook for next year is for stronger economic activity—a growth rate in the range of 2 1/2 to 3 percent. But he is concerned about the possibility that the economy will stay on its current track and we'll see no acceleration.
- Lockhart stresses that the right monetary policy for these circumstances is continued strong stimulus, but that is not to say that the mix of policy tools needs to or will stay the same.

Thank you for that kind introduction.

One of the ways the Federal Reserve's monetary policy shapes economic outcomes is through its influence on the expectations of the public about the policy environment. The Fed and particularly the financial markets are engaged in a continuous minuet of policy action and communication and asset pricing. The market's pricing of various interest-paying instruments—from overnight repurchase agreements to long-term bonds—sets the rate or yield curve. The price of credit affects decisions of consumers and businesses here in Montgomery and across the country on matters such as buying or refinancing a home, buying a car, and making a capital investment.

In an effort to orient the public's expectations, the Federal Reserve—specifically, the Federal Open Market Committee, or FOMC—employs a number of communications methods. A formal statement follows each FOMC meeting. Three weeks later, minutes of the meeting are published. The Chairman conducts a press conference after some FOMC meetings. The Chairman testifies at least semiannually before Congress. The FOMC publishes quarterly compilations of the economic forecasts of individual FOMC participants—Fed governors and Reserve Bank presidents. And Fed officials make speeches and do interviews. Many of these communications are reported and interpreted in the media.

The content of our public communication includes assessments of economic conditions, the outlook for the economy, risks to the outlook, and, importantly, the framework for making a future policy decision. Since policy must respond to evolving conditions and developments, the public and the markets are understandably interested in what is often called the "reaction function" of the Committee.

The Committee's reaction function is a matter of great interest at the moment because of anticipation of a decision about tapering. Tapering as commonly understood refers to the winding down of the Fed's program of asset purchases, or QE. Clarity regarding how a consensus-driven policymaking committee will react to a range of possible economic scenarios is a real test. It's especially challenging when the degree of economic uncertainty seems to be high.

The policymaking context today is murkier than I would like. Because of the federal government shutdown, some of the data we follow are likely to be less reliable than usual through December at least. Earlier in the year, uncertainty seemed to be dissipating. But in my recent soundings of business contacts across the Southeast, I hear sentiments that uncertainty is back and visibility is shortening.

Today I'll do my best to be as clear as I can. I must emphasize that the views you'll hear are mine alone. They may not be shared by my colleagues on the FOMC and in the Federal Reserve System.

For the sake of clarity, I'm going to lay out my arguments right up front. Here are my key arguments: the Fed is pursuing two objectives—full employment and low and stable inflation. Currently, the economy is growing slowly. A lot of progress has been made since the end of the recession on employment, but there is a way to go before we should be satisfied. Inflation is too low. It is well below the FOMC's goal of 2 percent.

My baseline outlook calls for an improved economy in 2014—growing a bit faster than it has been. But that may not happen. There is a nontrivial chance that 2014 will look like 2013. Next year's economic outcomes will swing importantly on fiscal drag and consumer spending. Even with better growth, in all likelihood, at year-end 2014, inflation will still be too low and employment levels will be well short of the goal. Therefore, monetary policy overall should remain very accommodative for quite some time. The mix of tools we use to provide ongoing monetary stimulus may change, but any changes will not represent a fundamental shift of policy.

At the FOMC meeting two weeks ago, the Committee chose to hold to an accommodative monetary stance to support ongoing recovery. As most of you are aware, the FOMC is using two principal tools to provide this policy accommodation. The first is a near-zero level of the federal funds rate target along with communication of how long

and under what conditions we will maintain that level. The second is bond purchases, so-called QE3. The Fed is buying $85 billion per month of longer-term Treasury securities and government-guaranteed mortgage-backed securities. In late October, the Committee decided to keep both of those policy tools in force.

Current state of the economy
As context for that decision, let me elaborate on the condition of the economy. As I said, the economy is growing slowly—averaging around 2 percent. At the same time, consumer inflation is low. Consumer activity is expanding modestly. The consumer remains cautious. Manufacturing activity is continuing to gain strength, but not by leaps and bounds. Business investment is restrained. To generalize, businesses are not placing big bets on the future—they seem to be expecting more of the same in terms of demand.

Employment is growing at a pretty steady, if unspectacular, pace. Monthly job gains over the last six months have averaged 174,000. It's fair to say employment conditions are improving. The official rate of unemployment calculated by the Bureau of Labor Statistics was 7.3 percent in October, down from 7.9 percent a year ago. Over the last year, the economy has created 2.3 million payroll jobs on net.

This is a good story, and an important story. When the current asset purchase program was announced in September 2012, private forecasters expected that the unemployment rate at the end of this year would be about 1/2 percentage point higher than it is today. In that sense, there has been substantial improvement in labor markets over the past year.

On the other hand, several measures of labor market health are less satisfactory. Long-term unemployment is at historically high levels. And the number of people working part time while looking for full-time work remains elevated. There are about 4 million more people unemployed today than before the recession. And there are significant numbers of discouraged workers who are not counted in the labor force who would return if conditions were more encouraging.

Even though the economy is growing, and we're making progress on unemployment, there are real concerns about whether the recent modest pace of GDP growth is enough to maintain employment momentum.

Inflation trend
Finally, I'll comment on inflation. People generally tend to worry about the upside risk of inflation. But as I said at the outset, inflation is too low. A persistent low rate of inflation raises concerns about a stalling out of economic expansion.

In January 2012, the FOMC established an official inflation target of 2 percent as measured by the personal consumption expenditures, or PCE, price index. By that measure, the trailing 12-month rate of inflation was 0.9 percent in September. The recent three-month trend is only marginally stronger at 1.2 percent.

My interpretation is that inflation has been reasonably stable, but at a low level—well below the desired level of 2 percent. It's not falling, but it's also not showing much tendency to move toward our targeted goal.

I don't think the inflation situation is that alarming yet. There are few signs of disinflation (the slowing of the rise of prices), let alone outright deflation (that is, broadly based falling prices). And inflation expectations of the public remain stable. But I would like to see the inflation rate rise to around 2 percent and stay there.

The outlook
Now let's look ahead to 2014. I'm assuming stronger economic activity next year—a growth rate in the range of 2 1/2 to 3 percent. Even with the preliminary third-quarter GDP estimate of 2.8 percent, full-year 2013 is likely to come in closer to 2 percent. To achieve a faster pace of growth, it's my opinion that we'll need to see two developments. First, we'll need a pickup in consumer activity and, second, we'll need a fall-off of intensity of fiscal drag.

The fiscal drag weighing on the economy has a number of elements. They include the ongoing effects of the tax increases at the beginning of this year, the effects of the sequester, any lingering effects of the recent government shutdown, and the effects of fiscal policy uncertainty on business investment and consumer spending.

As regards the shutdown, we at the Atlanta Fed expect the direct impact of the shutdown to be relatively small and temporary. We expect to lose half a percent of GDP growth in the fourth quarter, with a similar amount added back, in all probability, in the first quarter of 2014.

My greater concern relates to fiscal policy uncertainty because it can affect consumer and business confidence. I've recently heard opinions among contacts in the region to the effect that consumer confidence took a hit with the debt ceiling drama and the shutdown. In fact, consumer confidence did fall sharply between August and October this year. Whether these effects are long-lasting remains to be seen.

To sum up, I remain cautiously optimistic that growth will pick up next year. This is my baseline outlook. But, at this juncture, I can't fully discount the possibility that the expected economic improvement won't materialize and that we'll see a replay of the weak growth of the past three years. This possibility is an influence on my thinking about the appropriate direction of monetary policy, the topic I'll turn to now.

Stance of policy
Monetary policy is highly accommodative—as central bankers say. The FOMC is currently using two tools to maintain the desired degree of monetary accommodation—the policy interest rate and bond purchases. Importantly, the FOMC has stated that it intends to keep the short-term policy rate low at least until the unemployment rate falls below 6 1/2 percent. This "forward guidance" is meant to convey a sense of how long short-term interest rates will stay near current levels.

There is some confusion about how the Fed's forward guidance and asset purchase program relate to each other. I will give you my view.

In the toolkit the FOMC has at its disposal, there is a sense in which asset purchases and low policy rates are complementary. Asset purchases and forward guidance on interest rates are complements in the sense that they are both designed to put downward pressure on longer-term interest rates. Asset purchases obviously exert downward pressure through the act of buying in specific maturity sectors of the Treasury and mortgage-backed securities market. Forward guidance on the short-term policy rate (the fed funds rate) influences market beliefs about the path of policy, and that too influences longer rates. Lower long-term rates encourage spending on business investment and consumer activity in interest-rate-sensitive sectors like autos and housing.

But there is also a sense in which these tools are substitutes. By substitutes I mean that guidance pointing to a sustained low policy rate and asset purchases are discrete tools that can be deployed independently or in varying combinations. They can be thought of as a particular policy tool mix chosen to fit the circumstances at this particular phase of the recovery. In my view, the use of these two tools has been effective in combination over the last many months. Both have provided stimulus. I think of asset purchases as supplemental stimulus on top of low short-term interest rates—current and prospective.

Going forward, it may be appropriate to adjust the policy tool mix. That will depend on circumstances and the economic diagnosis of the moment.

I want to close where I began and repeat the basic points of my remarks today. The economy is growing at a slow pace. Even with that slow growth, substantial progress has been made on the employment front, but there is more to be done. At the same time, inflation is too low, and that carries some risk of a weakening economy.

I expect things to pick up in 2014, but it's possible the economy will stay on its current track and we'll see no acceleration. The right monetary policy for these circumstances is continued strong stimulus. That is **not** to say, however, that the mix of policy tools needs to or will stay the same.

Contact: Jean Tate 404-498-8035

RELATED LINKS: PDF version • Dennis Lockhart's biography • Speaker's Bureau • Atlanta Fed speeches