

2014: A Transitional Year

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

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Key points

- Atlanta Fed President and CEO Dennis Lockhart, in a February 5 speech at the Rotary Club of Birmingham, discusses the economic outlook for 2014 and Fed policy.
- Lockhart says the last two quarters of economic expansion were rather strong, and this year is beginning with some carryover of momentum.
- He expects 2014 to be a transitional year in terms of both economic performance and the mix of Fed policy tools. Absent a marked adverse change in the economic outlook, he expects the Fed's asset purchase program to be completely wound down by the fourth quarter of this year.
- Lockhart notes that the FOMC expects to keep the federal funds rate at its current level until well past the 6.5 percent unemployment rate marker, especially if inflation remains low.
- Lockhart believes that appropriate monetary policy and the self-reinforcing pull of inflation expectations should bring inflation back in line with the FOMC's longer-term target of 2 percent.
- Lockhart states that monetary policy is positioned correctly and that policymakers should be patient and not quick to respond to zigs and zags in the data.



Good afternoon and thank you to Philip Jackson, a former member of the Federal Reserve Board of Governors, for that kind introduction. I'd like to take a moment to recognize a few of our directors in attendance. I appreciate your dedication and service.

I'm pleased to be with you today and happy to be back in Birmingham.

My overall message today will be optimistic. We are coming off two rather strong quarters of economic expansion. I think the year began with some carryover of momentum, and even with the recent decline in equity markets, I sense in my conversations with business contacts across the Southeast rather solid, well-grounded confidence about the year ahead.

In my remarks today I will offer an outlook for the year, but I will also give some time to a discussion of the tug and pull of mixed economic data. There always seems to be some ambiguity around the true state of the economy. I hope you will find it interesting to hear about some of the questions policymakers grapple with.

I will close with comments on Fed policy. I'll share with you my mind-set on the appropriate positioning of monetary policy over the coming months. My colleagues in the Federal Reserve and on the Federal Open Market Committee (FOMC) may not have the same mind-set and underlying views. I am speaking, therefore, only for myself, not the Federal Reserve or the FOMC.

Transitional year

From my perch at the Atlanta Fed, 2014 looks to be a transitional year. The Federal Reserve has a new leader. Janet Yellen was sworn in as the new Federal Reserve chair on Monday and will preside over her first FOMC meeting as chair in March. If you follow the public communication and policy decisions of the FOMC, you've seen an emphasis under Ben Bernanke on transparency in communication and assertive action in support of the recovery. I expect continuity under Chair Yellen.

This year is also transitional in terms of the mix of Fed policy tools used to move the economy ahead. In December, the Committee made the decision to begin tapering asset purchases. The first reduction brought purchases down from \$85 billion per month to \$75 billion per month. At the last meeting a week ago, the Committee decided to bring purchases down by another \$10 billion per month. Absent a marked adverse change in the outlook for the economy, I think it is reasonable to expect a progression of similar moves, with the asset purchase program completely wound down by the fourth quarter of the year.

An orderly wind-down of asset purchases is contingent, as I suggested, on the economy staying substantially on track. It's hard to discern with absolute precision the track the economy is on. Incoming data are rarely unambiguously positive or negative. Data are always messy. Policymakers are challenged to separate true signal from noise and to decide how much weight to put on the arrival of disappointing data reports.

We had such a situation with the arrival of the December payroll jobs number. It came in at a 74,000 net gain. A number closer to 190,000 was expected. My reaction—and that of many of my colleagues—was to "look through" the December jobs report and assume the economy remains on the higher growth track enjoyed in the second half of 2013.

There was a notable difference between performance in the first half and performance in the second half of 2013. In the first half of the year, real gross domestic product grew at a rate of 1.8 percent annualized. This was a bit slower than the recovery average up to that point. In the second half of the year, growth picked up sharply, to an estimated annual pace of 3.7 percent.

Some of the strength in the second half resulted from a buildup of inventory (which, of course, can't go on indefinitely), but we also saw strength in consumer spending, business spending on equipment, and exports. The pickup in consumer activity and business investment hints at rising confidence about future prospects for the economy.

We may get some not-so-great numbers in the first quarter of this year. First-quarter GDP growth may be affected by weather events as well as the inventory cycle. Employment numbers may also reflect these influences.

Still, I think the fundamentals have improved, and the economy is likely to continue to perform in a higher gear over the full-year 2014. So, I will argue that 2014 may also turn out to be a transitional year in terms of economic performance.

Sustained higher growth ought to carry with it real progress on two key dimensions of economic performance—prices and employment. Both are explicitly set out as formal objectives of the Fed as determined by Congress. The Fed's dual mandate calls for stable prices along with full employment.

To give you a fix on how we are starting the year relative to these goals, inflation is currently running around 1 percent per annum.

Given my current baseline outlook for the economy, I project inflation to gradually rise to around 2 percent, reaching that rate toward the end of 2015.

Two percent is the FOMC's longer-term target for inflation. This rate is low enough that it does not materially distort the economic decisions of households and businesses. At the same time, it is just high enough to provide a safety margin against a debilitating cycle of *deflation*.

Judging from a variety of indicators, it appears that expectations for future inflation are pretty well-anchored around 2 percent.

Unfortunately, inflation is currently running well below this target. A persistent undershoot of inflation would likely be symptomatic of weakness in our labor and product markets, and reflective of risk to the economy going forward.

I believe that a combination of appropriate monetary policy and the self-reinforcing pull of inflation expectations should bring inflation back in line with the FOMC's target, other things equal. That is my base-case forecast. But I am monitoring wage and price developments carefully for evidence that inflation will move back toward 2 percent.

As regards employment, my forecast calls for continuing steady improvement in labor market conditions, consistent with my growth outlook. The unemployment rate is not the sole indicator of labor market health, but it is an important benchmark. Unemployment—as measured by the Bureau of Labor Statistics in its December monthly survey of households—is at 6.7 percent. We will get a new number on Friday.

The FOMC earlier set down a marker of 6.5 percent unemployment as a threshold for considering a change of interest-rate policy. We could cross that threshold before long. Recently, the Committee communicated that it expects to keep the federal funds rate at current levels well past 6.5 percent unemployment, especially if inflation is projected to stay below target. As I said earlier, absent a material change in the trajectory of the economy, the key policy question, as I see it, is how long to keep the federal funds rate target at zero.

Gaps/slack

In that regard, a question weighing on my mind as a policymaker is, how close or far are we from fulfillment of our mandated objectives—or, put differently, what is the extent of the current and near-term gaps we're dealing with?

The "output gap" is the distance between the economy's current performance and its potential. The "employment gap" is the distance between the current level of employment—often expressed in terms of the rate of unemployment—and an estimate of full employment. And the "inflation or price stability gap," if you will, is the difference between current readings of inflation and the FOMC's official inflation target, 2 percent. The inflation gap can be on either side of this target. Today, as I have mentioned, it is to the downside of 2 percent.

I believe we're still dealing with sizeable gaps in terms of overall output, inflation, and employment. If inflation were running *above* 2 percent, my diagnosis might have to be more nuanced, but today, the three gaps taken together suggest there remains a fair amount of slack in the economy. In the current context, the objectives are complementary.

The employment gap presents some analytical challenges. Much progress has been achieved in lowering the unemployment rate since the end of the recession. In fact, the unemployment rate has fallen faster than many forecasters expected.

But, as you have probably heard, this decline in unemployment has been accompanied by a sizeable drop in labor force participation—that is, the share of the working-age population in the labor market.

Since the beginning of the recession at the end of 2007, the rate of labor force participation has declined by close to 3 percentage points—a very large and rapid decline by historical standards. In terms of today's population, that amounts to about 7 million people who are no longer part of the unemployment rate calculation. This development has led some to wonder whether a falling unemployment rate may have lost some of its value as an indicator of improving labor market conditions.

This is where the analytical challenges come in. If the decline in labor force participation is due to structural changes—such as population aging—that is one thing. Monetary policy cannot do much about the fact that we are getting older as a nation. But it is an entirely different matter if people are not participating in the labor market due to cyclical conditions. That would indicate the economy is not strong enough to create jobs and people are discouraged from looking for work. Monetary policy *can* do something to combat weak spending conditions that could be holding back economic recovery.

So, which is it? Has the labor force participation rate fallen because of structural changes or cyclical conditions? It's not entirely clear, but the answer seems to be "both." The point is that even if we attribute much of the decline in labor force participation to structural developments, a significant part of the decline still seems to be a result of weak spending and the sluggish economic expansion.

In these circumstances, with indicators like the unemployment rate particularly difficult to read, readings of inflation can be especially informative. In general, we expect weak demand to be associated with weak prices. Therefore, watching inflation and wage growth closely will help us gauge whether we're getting the basic economic strength needed to improve the more complicated employment situation.

Appropriate monetary policy

In closing, let me touch briefly on policy—the monetary policy of the FOMC. Notwithstanding the decision to taper asset purchases, the stance of policy remains very accommodative. Translation: short-term interest rates are quite low—and in my own outlook, they will remain low for quite some time. I expect the Fed's policy rate to stay put until well into 2015.

That assessment could be adjusted, of course, if economic conditions change a whole lot. But given my current views on the economy, I like the current positioning of policy.

It's in the right place for now, in my opinion. I think we policymakers should be patient—not too quick to respond to zigs and zags in the data.

In my view, the Committee should stay the course and let more clarity emerge on the sustainability of the recent pickup in growth, the path of inflation relative to the 2 percent target, and the nature of the employment situation.

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

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