SPEECHES

One Policymaker's Approach to Evaluating Economic Progress

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Miami, Florida
April 2, 2014

Key points

- Atlanta Fed President and CEO Dennis Lockhart, in an April 2 speech at the Greater Miami Chamber of Commerce, talks about his approach to evaluating economic progress.
- Lockhart continues to support the phase-out of the asset purchase program, known as quantitative easing, which at its current pace will end in October or December of this year.
- Lockhart says with the asset purchases tapering predictably, the focus has jumped to the question of when the FOMC begins the process of "liftoff" of the federal funds rate.
- Lockhart emphasizes that the main instrument of monetary policy is forward guidance about the path of interest-rate policy and the conditions that will justify liftoff.
- Lockhart says he is looking to a "dashboard" of labor market indicators to gauge economic growth.
- Lockhart feels that sustained GDP growth in the neighborhood of 3 percent will generate sufficient movement toward the FOMC's objectives to justify a gradual liftoff in policy rates sometime in the latter half of 2015.

Thank you for having me back here at Jungle Island. Miami has made quite a comeback from the recession's depths in 2008 and 2009. It's nice to visit a city that's enjoying such a strong rebound.

I attribute that to Miami's unique position as a true international city and, of course, to collaborative leadership. I have some firsthand knowledge. Your chamber president, Al Dosal, also serves on our Miami Branch board. Thank you, Al, for your enthusiastic service.

There is an expression that seems especially apt as we watch events in the Ukraine. It is "geography is destiny." In a quarter that's seen hard-hitting weather events across most of the country, South Florida was spared.

I believe weather effects have been meaningful in the national economy in the quarter just ended. I'll elaborate on that point in my remarks today.

Here's what I plan to cover today: I'll give you my sense of where the economy stands at this juncture and where it's headed. I'll argue that there remains a considerable amount of economic slack, especially in the utilization of labor resources.

Given my view on how economic conditions are likely to evolve, I will argue that monetary policy should remain quite accommodative for some time. To be even more precise, any uptick in the policy rate is unlikely to be warranted until at least the last half of next year. I will provide a sense of how I am assessing economic progress toward the Federal Open Market Committee's (FOMC) goals and provide my view on developments that could lead to a revision of that general timeline.

I have to emphasize that what follows are my personal opinions. My colleagues on the FOMC and in the Federal Reserve System may not agree.

The economy's current position and outlook
First-quarter growth of gross domestic product (GDP) was weak on a number of counts following two quarters of relative strength. It will be many weeks before we have a final and conclusive number, but tracking estimates indicate that overall growth in the first three months of this year was below 2 percent on an annualized basis.

Weather seems to have been a significant factor in the disappointing first-quarter growth. In our contacts with business people across the Southeast, we heard accounts of weather-related losses in production, retail sales, shipment time, work days on construction sites, and visits to hotels and restaurants.

Depending on industry, some of our contacts expect the lost activity to be made up in coming weeks while others expect activity to resume only to normal levels.

As convincing as these anecdotal accounts of weather effects may be, the softness of the first quarter naturally raises concerns that the economy has lost momentum here in the early part of the year. Forecasters, including Federal Reserve forecasters, have to decide if the economy is likely to continue on this weak growth path or if the first quarter will turn out to be just a one-off spell of weaker performance.

I am in the latter camp. My key working assumption is that growth will accelerate in the second quarter and repeat in subsequent quarters. I expect stronger growth will help to absorb underutilized resources in the economy, especially labor resources.

Monetary policy objectives
My baseline forecast—just explained—is central to my view on the appropriateness of current monetary policy.

As many of you know, the Federal Reserve through the FOMC runs monetary policy with two primary objectives in mind. One objective is to support full utilization of labor resources, or full employment. The other objective is to maintain price stability, or low (but not too low) inflation. The FOMC has chosen to define price stability in terms of a targeted rate of inflation of 2 percent over the longer term.

Consistent with my belief that the economic growth rate will rise, unemployment will decline, and resource slack in the economy will shrink, I expect inflation to firm to a healthier rate over the medium term on a track to the FOMC's 2 percent target.

I want to spend some time describing how I think about monetary policy decision making in light of the ambiguity caused by first-quarter weakness. But before laying out my own framework for assessing the economy's true trend in coming months, let me refresh your understanding of the current state of the Fed's monetary policy.

The FOMC is currently using two instruments to implement its policy. One instrument is the program we refer to as large-scale asset purchases—what is often called "quantitative easing," or QE. The other is communication about how long the Committee intends to maintain the key federal funds rate target at its present near-zero level. We refer to this policy tool as "forward guidance."

As you know, quantitative easing is being wound down. Through all of 2013, the Fed used its power of money creation to fund the purchase of mortgage-backed securities and Treasury securities in the amount of $85 billion per month.

In December, the FOMC took the first step to phase out this program. At the past three meetings, the monthly pace of purchases was reduced by $10 billion. Today, the level of monthly purchases stands at $55 billion. At this pace, purchases will drop to zero in October or December.

I support the continued phase-out of the asset purchase program. Growth has improved and the unemployment rate has fallen since the start of the latest round of QE. My assessment of the underlying momentum of the economy leads me to the view that the FOMC's forward guidance will adequately support ongoing progress toward the Committee's objectives.

Through forward guidance, the FOMC has indicated its intention to keep policy rates low for some time to come. I think this accommodative policy is right for the current circumstances. My forecast of continued improvement in GDP growth, labor market conditions, and inflation is predicated on the continued support of accommodative monetary policy. Furthermore, I think we are still some distance from full employment and a comfortable zone of inflation.

With our asset purchases tapering on a pretty predictable course, it is understandable that the focus has jumped ahead to the question of when the FOMC begins the process of "liftoff" of the federal funds target from the zero floor. Anticipation is a feature of monetary policy, not a bug. The essence of forward guidance is communication about the conditions that would make policymakers change course.

It is very difficult, and ultimately undesirable, to link such conditions with a precise date. The use of forward guidance does require that policymakers articulate as clearly as they can about how they are assessing economic conditions in formulating their views on appropriate monetary policy. In that way, the public can align their expectations with policy intentions.

My approach for assessing progress

So let me lay out my approach for assessing progress as the economy moves along in the coming months. Understand that this is just one policymaker's thinking, not the Committee's.

First, my view is that sustained GDP growth in the neighborhood of 3 percent will generate sufficient movement toward the FOMC's objectives to justify a gradual liftoff in policy rates sometime in the latter half of 2015.

But, if that progress fails to materialize, a later liftoff date than I am assuming will likely be appropriate.

It is important to note that pickup in GDP growth is not a goal in and of itself. As I have indicated, I am looking to this pickup because I believe it will be sufficient to produce labor market and inflation outcomes that align with the FOMC's mandated objectives. So direct assessment of labor market and inflation developments is also critical.

Under ideal circumstances, we might be able to gauge the momentum of the economy using just a couple of economic statistics. For example, we might look mostly at the official civilian unemployment rate and the most recent 12-month trend growth rate of the price index of personal consumption expenditures (PCE). These indicators normally work pretty well. But in the complicated environment that emerged in the wake of the financial crisis and the Great Recession, a more comprehensive approach to assessing economic conditions is warranted.

Indeed, I like to think in terms of a dashboard of indicators to help me gauge how close we are to full employment and price stability.

My staff at the Atlanta Fed has developed a labor conditions tracking tool based on a broad set of labor market indicators. Taken as a package, these indicators will help me assess progress toward full utilization of labor resources over coming quarters.

For example, in addition to the standard unemployment rate, I look at broader measures of unemployment that factor in marginally attached workers—people available and wanting a job but not currently looking for a job. Their numbers are about 1 million more today than before the Great Recession.

Another underutilized group are those working part-time but who claim they want full-time employment. They currently represent about 5 percent of the labor force, and that's an unusually high number relative to the official unemployment rate. We would clearly like to see an increase in the flow of these workers from part-time to full-time work.

The headline unemployment rate we are all familiar with is the U-3 statistic generated by the government. It currently stands at 6.7 percent. A more inclusive measure of unemployment that factors in the marginally attached and those who are involuntarily working part-time is called U-6. This measure is currently calculated as 12.6 percent.

I'll be looking for two developments: an absolute drop in both the official and broader U-6 measures of unemployment over the coming months, but also a tightening of the gap between them. The good news is that over the past six months the difference between these two measures of unemployment has in fact been narrowing.

Measures of labor market turnover also help me gauge improving conditions. These give me indications of increased hiring by firms, and also of increased confidence of workers willing to move on to better jobs. Progress along these dimensions has been very slow, and the rate of hires and quits remains well below prerecession levels.

One other important indicator is wages. Wage growth by most measures has been very low. I take this as a signal of labor market weakness, and in turn a signal of a lack of significant upward unit cost pressure on inflation.

Labor compensation growth is at the heart of the connection between labor market conditions and inflation, so wage growth would also be a key indicator on my inflation dashboard.

In fact, the Federal Reserve Bank of Atlanta maintains an "inflation dashboard" of 30 monthly indicators of inflation that I find useful in summarizing broad inflationary developments.

With this dashboard as general guide, I will be watching for gradually stronger pricing power by firms as evidenced in a number of retail price measures.

I would also hope to see a modest firming in commodity prices as global industrial activity improves.

And I will be checking to make sure that the key measures of inflation expectations remain steady.

Conclusion

Although my labor conditions dashboard shows signs of improvement, progress toward full employment has been very gradual and uneven when viewed from a broad perspective. With respect to inflation, the broad view has yet to suggest a clear movement back in the direction of the FOMC's 2 percent goal. So I believe the FOMC is still significantly short of achieving its two mandated objectives.

Let me sum up. At the Atlanta Fed, my staff and I are in a period of collecting data in support of our baseline assumptions. We are assuming a resumption of growth approaching 3 percent in the second quarter and beyond. We assume the first quarter was weak mostly because of weather. We will know if our assumptions on that score are wrong relatively soon. Validation of our medium-term outlook, including progress on employment and inflation, may take a little longer.

The main instrument of monetary policy is forward guidance about the path of interest-rate policy and the conditions that will justify liftoff. If our assumptions are invalidated by incoming data, I think we will have to alter guidance. But based on my working medium-term outlook, I see the latter half of 2015 as the likely time frame for the first move to higher rates.

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