

## To Liftoff and Beyond

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- Atlanta Fed President and CEO Dennis Lockhart, in an April 16, 2015, speech to the Palm Beach County Business Leaders in Florida, shares his view on what the economic picture suggests as the appropriate path for monetary policy.
- Lockhart says the Federal Open Market Committee's (FOMC) decision to raise interest rates will depend on further progress in labor markets and reasonable confidence that inflation will rise to the FOMC's longer-run target of 2 percent.
- Lockhart says that the economy has made considerable progress since mid-2009, and the pace of improvement has picked up steam over the past couple of years.
- Assuming some recent economic weakness is passing, Lockhart's outlook for the remainder of the year is for a run rate of annual GDP growth resuming a pace between 2 1/2 and 3 percent.
- Lockhart says he'd like to see evidence in the data that the desired outcomes are materializing. But his support for a monetary policy liftoff decision will inevitably be a judgment call. Strength in one aspect of the overall economic picture may offset ambiguity in another.
- Lockhart stresses that the process leading to a normalized structure of interest rates will just begin with the liftoff decision.



Thank you. It's a pleasure to be back in Palm Beach. I'd like to thank the Palm Beach Chamber and the Economic Council for hosting me at this event.

As a Fed policymaker, I consider it essential to get out and talk to people in my Federal Reserve region to hear how they are currently experiencing the economy.

At the same time, when I weigh options for optimal monetary policy and go to Washington to participate in meetings of the Federal Open Market Committee (FOMC), I consider policy from a national perspective only. I don't base my position on policy matters on what is best for the regional economy. However, what I learn about economic developments in the Southeast helps me build my national view.

The Sixth Federal Reserve District comprises six states in whole or in part. They are Florida, Georgia, Alabama, Louisiana, Mississippi, and Tennessee. Florida is the largest state economy among these. The Southeast is expansive geographically and is a large chunk of the U.S. economy. It's over 40 million people and about 13 percent of the country's gross domestic product. If the region were a separate country, its economy would rank as number 9 in the world. It helps our work of gauging national trends that the Southeast economy is sizeable and resembles the national economy in industrial composition and employment distribution.

The Atlanta Fed operates from six offices across the region. Our Miami office is one of our largest. The Miami office focuses on South Florida and, particularly, Southeast Florida.

To ensure we are gathering information about the performance of the economy as systematically as possible, we have organized something we call our Regional Economic Information Network, or REIN. REIN is made up of business and community contacts in a variety of fields and includes firms and institutions of all sizes.

Our economic information network in this part of Florida is overseen by our regional executive in Miami, Karen Gilmore. Karen, like me, is not a Fed career employee. She was a banker in South Florida for many years and brings valuable Main Street experience and knowledge to the Fed. We are teaching her how to talk like a central banker in Fed speak. *She's making appreciable progress commensurate with the extent of her temporal commitment thus far in her new capacity.*

As someone who sits at the FOMC table, I can assure you that real-time economic intelligence about what's happening on Main Street is a big part of our discussions. I would like to thank those of you here who have shared your insights on business conditions with Karen. For potential new partners in this audience, if she calls, I'd be very grateful if you'd take the call.

Today, I'll give you the opportunity to stand in my shoes as a Fed policymaker. I'll try to give you a good feel for a policymaker's considerations and thought processes as the FOMC approaches an important decision. The decision, of course, is whether and when to raise interest rates. I'm going to share my assessment of current national economic conditions. I will provide my views on the outlook for the economy and what the economic picture suggests as the appropriate path for monetary policy.

The Federal Open Market Committee has laid down two criteria to be met before we begin to raise interest rates. They are further progress in labor markets and reasonable confidence that inflation will rise to the longer-run target of 2 percent. The FOMC has also emphasized that the decision will be data-dependent. I consider this an essential discipline around our decision making on this matter. To me, data dependency means there is no preconceived plan. Data dependency means the decision will be based on the best evidence we have of the reality and trajectory of the economy.

I always must begin with a disclaimer. I will be presenting my personal views. I am not speaking for the FOMC or the Federal Reserve. My Federal Reserve colleagues may not agree with my views.

### State of the economy

I'll start by presenting the economic picture as I see it. Assessment of the performance of the economy requires at least three lens apertures to capture relevant timeframes.

The economy, in real terms, has made considerable progress over the past five years. Since mid-2009, real gross domestic product, or GDP, has grown by more than 13 percent. The unemployment rate has fallen from its peak of 10 percent to 5.5 percent in the latest reading.

The pace of improvement picked up steam over the past couple of years. The official unemployment rate, for example, is now only ½ percent above my estimate of the longer-run natural rate of unemployment—in concept, the lowest level of unemployment before job market slack is absorbed and inflation pressures begin to emerge.

Substantial progress has been achieved, and I believe the economy now has sustainable momentum, yet data available for the first quarter of this year have been notably weak. Most current tracking estimates of real GDP growth in the first quarter are in the neighborhood of an annual rate of only 1 percent. The Atlanta Fed's tracking estimate is considerably below 1 percent. A tracking estimate updates a key economic measure as each new data element arrives. A tracking estimate is a preliminary number. We are still receiving data on the first quarter, so we're still computing first-quarter tracking estimates.

I'm sure many of you took note of the falloff in March payroll job growth reported early this month. The payroll jobs number came in at 126,000, well below the previous month. Importantly, there were downward revisions to the previous two months' numbers. The report for March brought the employment picture down to earth. Whether temporary or persistent, the pace of decline in the rate of unemployment, and the pace of growth of payroll employment, slowed somewhat. The apparent weakness of the first quarter can be partially explained, I believe, by transitory factors. Bad weather in February was a drag on economic activity. There was some inventory drawdown following inventory accumulation in earlier periods.

Consumer spending in the first quarter was not as strong as expected. We did not see an expected boost to consumer spending coming from lower gasoline prices at the pump. At the same time, drilling activity in the energy sector predictably fell off in reaction to the drop in crude oil prices. As the year proceeds, I see consumer activity offsetting lower investment and employment in oil exploration and development.

One other unexpected factor appears to have weighed on activity in the first quarter, and that is the effect of the higher dollar on exports. Net exports—that is, the contribution to economic growth after imports are netted against exports—has fallen apparently as a result of the stronger dollar. Manufacturing activity has felt the pressure. Manufacturing growth numbers have softened considerably relative to a year ago.

To summarize, some factors at work in recent months were clearly transitory in nature, and some other factors have triggered rapid adjustment in certain sectors of the economy. Together, they are giving rise to heightened uncertainty about the track the economy is on.

### **Inflation**

In addition, the ongoing picture for inflation adds to uncertainty about the path of the economy. You can think of inflation pressures as symptomatic of demand conditions across the economy. Or, saying the same thing in a different way, inflation pressures or the lack thereof may reflect the degree of slack remaining in product, service, and employment markets.

In January 2012, the FOMC set an inflation target of 2 percent over the longer run. There are many measures of inflation. Technically, the FOMC defined its target using a particular index—the personal consumption expenditures (PCE) price index—and chose the so-called headline version of the PCE index. In headline inflation statistics, the relatively volatile food and energy components are included.

By this measure and others, the inflation trends over the last few years have been disappointingly sluggish. The problem we face as policymakers is getting inflation **up** to target, and for quite some time this has been difficult. Annual inflation numbers have come in below 2 percent for each of the past two years. This has been the case in spite of some quarters of growth well above the estimated longer-run trend rate of growth. And this has been the case in spite of what I believe to be an acceleration in growth since mid-year 2013. It's a bit of a puzzle.

Recent inflation readings continue to be soft, and the price data for the first quarter were especially weak. On a 12-month basis, headline inflation in February was up a meager 0.3 percent. Core inflation—which excludes the recently falling gasoline component—was up 1.4 percent for the 12 months through February.

I also look at shorter-term measures of inflation to get a sense of the current run rate. For the three months ending in February, core inflation was up only 0.9 percent.

Even factoring out the effects of lower gasoline prices on consumer price inflation and the appreciation of the dollar on import prices, the behavior of inflation poses an issue. To repeat, the FOMC has stated that to get comfortable about making the first move to raise interest rates, the Committee participants collectively need to be reasonably confident that inflation will trend higher.

### **My economic outlook**

It is axiomatic that monetary policy has its effect with long and variable lags. Monetary policy is therefore forward-looking. For that reason, my colleagues and I always have a working forecast in place on which to make judgments about appropriate policy.

In spite of the recent weakness, I do not believe the economy in some fundamental way is faltering, stalling, slowing—pick your description. I expect something of a replay of 2014—a weak first quarter due to transitory causes followed by a pickup in growth in later quarters. My outlook for the remainder of the year is for further progress toward full employment with inflation gradually firming. I have the run rate of GDP growth resuming a pace between 2 1/2 and 3 percent per annum. But this forecast leans heavily on the assumption that recent weakness is a passing phenomenon. The evidence on which to make this forecast is not yet "in the numbers."

Over the coming weeks and months, I will be monitoring the incoming data closely and carefully for validation of my outlook assumptions. A murky economic picture is not an ideal circumstance for making a major policy decision. The decision to begin raising rates will be a Committee decision, of course. The decision will represent the consensus that emerges from a wide-ranging discussion that I know will include a range of interpretations of the picture presented by the data as well as different weightings of risks and priorities.

By laying down the marker of data dependency, the Committee has set limits regarding what is relevant. The state of and outlook for the broad economy will be central.

As I see it, data-derived judgments on the timing of the liftoff decision can be based on tests of increasing stringency. I think the bar can be set at three levels.

### **Three tests or bars**

The lowest bar is that key indicators of labor market progress and, especially, the inflation trend are at least stable—that is to say, not moving in the wrong direction. To explain, this test would be satisfied, in my opinion, if unemployment and underemployment numbers are not backing up. Core inflation measures would not be softening. This

level of evaluation might call for evidence that core inflation measures are headed back to levels that prevailed before the oil price and dollar exchange-rate shocks. This requirement might also look for evidence confirming that the first-quarter weakness was an aberration. Some of the current uncertainty ought to have been dispelled.

The second bar would be set a little higher. The second test is that indirect evidence supports a favorable outlook for both continuing employment progress and especially the firming of price data. To explain, I think some amount of comfort about prospects for rising inflation can be based on the strength of GDP growth indicators, the trend in payroll job creation, and the acceleration of wage pressures.

The highest bar would be, as you would expect, the most exacting. It is direct, affirmative evidence in the data that the desired outcomes are in fact materializing. This test would call for a falling unemployment rate and rising inflation.

In a timeframe of a few months, I don't place equal probability on satisfying all three tests. I expect it will take longer for direct, affirmative evidence to appear that would validate a decision to begin raising rates. Falling unemployment and rising inflation may be unlikely in the very near term. In my working forecast, inflation does not pick up until the second half of the year.

I'll state my preferences or leanings. Ideally, I'd like to see direct, affirmative evidence in the data that the desired outcomes are in fact materializing. But I can get comfortable with less. I prefer at least some indirect evidence that progress toward our objectives is likely to continue. To get to "reasonable confidence" about inflation, sufficient evidence could show up in growth numbers, employment numbers, and rising wages as an indication of tightening conditions.

My support for a liftoff decision will inevitably be a judgment call. I don't think it is advisable to approach such a decision with rigid quantitative triggers in mind. Strength in one aspect of the overall economic picture may offset ambiguity in another.

#### **The post-liftoff path of policy**

Once the initial decision to raise rates is made, attention will shift to the subsequent path of policy. The process leading to a normalized structure of interest rates will just begin with the liftoff decision. This is a crucial point. Our policymaking is oriented to achieving the best outcomes in the broad economy. I see the interests of the Main Street economy as more aligned with an approach that thinks of liftoff and subsequent rate moves as a package.

To my way of thinking, the data-dependency basis for a decision to lift off and anticipation of follow-on increases of the policy rate are connected. The less an initial decision to raise rates is based on concrete, unambiguous evidence of labor market progress and inflation convergence to target, the less that first move should bring an expectation of a rapid-fire string of subsequent increases. The more solid the data evidence underpinning liftoff, the more predictable the subsequent rate path can be, in my opinion.

I think waiting a while longer improves the chances of seeing confirmation from incoming data that the economy is on the desired path. I think it is highly desirable that the public sees an economic picture at the time of the liftoff decision that is consistent with the decision criteria the FOMC has set out. Ideally, coherence between data and decision would be clear to all.

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