Assessing Economic Conditions for Liftoff

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- Atlanta Fed President and CEO Dennis Lockhart, in a December 2, 2015, speech to the Broward Workshop in Fort Lauderdale, discusses his views on the economy in advance of the December Federal Open Market Committee meeting.
- Lockhart says the FOMC has emphasized that a liftoff of the federal funds rate will be "data dependent," with the central consideration being what the economic data say about the state, momentum, and outlook for the national economy, as well as employment and inflation.
- Lockhart says real gross domestic product is estimated to have grown at a 2.1 percent annual pace in the third quarter and that a moderate pace of growth should be sustainable.
- Lockhart believes the Committee's criterion of "further improvement in labor markets" has been met. Inflation has been below target, but Lockhart believes that much of what's suppressing inflation is transitory in nature.
- Lockhart says that, absent information that drastically changes the economic picture and outlook, the case for liftoff is compelling.

Thanks for having me back at the Broward Workshop.

The next meeting of the Federal Open Market Committee, or FOMC, the body that sets monetary policy for the country, is two weeks away. It is a much-anticipated meeting, and there is a chance it will be historic in character. I say "historic" because I expect the Committee to consider, as it has in recent meetings, the first increase in the policy interest rate in nearly 10 years. And it's been seven years since the federal funds rate was first set at effectively zero. The public has come to know the potential first rate rise as "liftoff."

I won't predict what the Committee will do. But I can give you my personal views on the considerations involved in such a decision. I have to emphasize that you'll hear my personal views. I am not speaking for the FOMC or the Federal Reserve.

My views on what's important in a decision to raise rates for the first time in almost a decade parallel the criteria the Committee set out back in March of this year.

By way of background, Congress has directed the Federal Reserve and the FOMC to pursue two principal objectives in formulating monetary policy. They are price stability and maximum (or full) employment. This is the so-called "dual mandate" under which the FOMC operates.

Back in March, we established two conditions for a decision to lift off. They are consistent with the dual mandate. We said we want to see "further improvement" in labor market conditions. And we said we want to achieve "reasonable confidence" that inflation will firm up and converge to our target of 2 percent in the medium term.

The Committee has also emphasized, and has repeated often, that a liftoff decision will be "data dependent." This simply means that we'll be guided by the numbers. That is to say, the central consideration will be what the economic data tell us about the state, momentum, and outlook for the national economy, as well as particulars regarding employment conditions and inflation.

Since I am just two weeks away from having to weigh in and ultimately vote on this important decision, my staff and I are getting close to a last review of the overall picture suggested by the data. I'm approaching this exercise in the spirit of a final accounting. I'm going to walk you through its highlights. As I move through the key data elements, I'll provide some commentary on how reliable—in a final accounting sense—I consider the information we have. I judge reliability in terms of how noisy the monthly and even quarterly data can be, how subject they are to material revision, and how significant is the standard error around an economic statistic. These tests help me judge how much confidence we can have in the signal quality of incoming data.

I'll start with the economic top line, so to speak. That is **growth of gross domestic product**, or **GDP.**

Real GDP is estimated to have grown at a 2.1 percent annual pace in the third quarter. Excluding weakness in the export sector as well as inventory reductions, the component of GDP called real final domestic demand rose at an annual rate of 2.9 percent. This demand growth was largely due to strong consumer spending. I currently expect some slowing in the pace of consumer spending in the fourth quarter, which will dampen overall domestic demand a bit. I base this assessment on the Atlanta Fed's real-time GDP tracking tool, called GDPNow, which processes incoming data on economic activity into an estimate of GDP and its components.

I would characterize quarterly GDP growth estimates as being of medium reliability. They are subject to frequent, and sometimes sizable, revisions. As another check on the GDP growth numbers I just cited, we can look at a second method that calculates gross domestic income, or GDI. In theory, GDI should equal GDP, but that's rarely the case in practice. In the third quarter, GDI rose at an annual rate of just over 3 percent. This statistic seems to support the conclusion that the economy is growing at a solid pace in spite of ongoing headwinds coming from global conditions and the strong dollar. All things considered, I think a moderate pace of growth should be sustainable.

Let me turn now to **employment**. We have in hand data through October. The October monthly nonfarm payroll growth calculation came in at 271,000. We'll get the November numbers this coming Friday. Monthly employment data are not terribly reliable. But a run of strong numbers for an extended period of time—like the average gain of 234,000 jobs per month we've experienced the past two years—gives me substantial confidence that the employment growth trend is for real.

The unemployment rate is perhaps the most important employment statistic in the mind of the public. It improved to 5 percent in October. A broader measure of unemployment and underemployment, known as U-6, tracks involuntary part-time workers and potential workers available for work but not currently looking for a job. This measure hit 9.8 percent in October, more than 7 percentage points lower than its peak in early 2010, and it has fallen a full percentage point since March.

In my opinion, the Committee's criterion of "further improvement in labor markets" has been met. And further "further improvement" is certainly attainable.

I think the economy is closing in on full employment. As we approach that condition, I would expect to see confirming evidence that labor markets have tightened up. Such evidence might come in the form of wage growth. The trend in wage growth has been weak for some time, but it may be picking up. In October, average hourly earnings increased at a 4.4 percent annual rate, well above the postrecession trend of just over 2 percent. But, as I said, a month does not a trend make.

To circle back to growth drivers, solid job gains and rising household incomes should contribute to a favorable spending outlook. Growing demand should encourage further hiring. I think this dynamic is at work and will continue into 2016.

I'll complete this high-level review of the data picture with comments on **inflation**.

Inflation has been below target for much of the recovery, and continues so. A little background: In January 2012, the FOMC set the formal inflation target at 2 percent over the longer run as indicated by the index of personal consumption expenditures (or PCE). In defining price stability, the Committee chose to rely on the overall, or "headline," readings of the index, inclusive of volatile energy and food prices.

The price data themselves are fairly reliable. However, the underlying inflation signal can be swamped by a variety of transitory relative price movements. This has been the case recently. Transitory effects of declining oil and gasoline prices and the stronger dollar, along with the weight of remaining slack in the economy, have pushed headline PCE inflation close to zero.

One way to "see through" transitory factors is to use so-called trimmed-mean inflation estimations. These price statistics eliminate the largest monthly price swings—those that often produce noise in the numbers. Trimmed-mean measures have been running much closer to the 2 percent target. The Federal Reserve Bank of Dallas's trimmed-mean index, for example, is up 1.7 percent over the past year. Comparing this and like calculations to headline numbers suggests to me that much of what's suppressing inflation is transitory in nature. I have bought into that view.

To wrap up, I've given you just the highlights of what I can assure you is a comprehensive review of the economic data that my staff and I perform before any FOMC meeting. Policy considerations at the upcoming meeting call for an especially deliberate process. There are two weeks to go, with additional data still to arrive. That said, absent information that drastically changes the economic picture and outlook, I feel the case for liftoff is compelling.

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