SPEECHES

A Kaleidoscopic Context for Monetary Policy

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- Atlanta Fed President and CEO Dennis Lockhart, in a March 21, 2016, speech to the Rotary Club of Savannah, discusses the Federal Open Market Committee's recent policy decision and his outlook for 2016.
- Lockhart supported the FOMC's March 16 decision to hold rates steady and believes there is sufficient economic momentum to justify a further rate hike at one of the coming meetings.
- Lockhart says the U.S. economy is on a track that should produce moderate growth this year, between 2 and 2.5 percent, and the FOMC's inflation objective of 2 percent is achievable in the medium term.
- In Lockhart's opinion, the outlook for 2016 and 2017 swings on the question of whether domestic demand will hold up.
- Lockhart adds that a longer-term structural factor to consider is the aging population distribution, which will present challenges to achieving vigorous growth in future years. He says the just-released Atlanta Fed's annual report discusses this phenomenon.
- Lockhart says that monetary policy remains on a gradual path of rate increases, and decisions will be data-dependent.

Last week, the Federal Open Market Committee, the Federal Reserve's group responsible for setting monetary policy, met and decided to keep unchanged the benchmark policy interest rate that influences the rates that businesses and households pay and earn.

The statement issued at the conclusion of the meeting characterized an economy that continues to grow at a moderate pace supported to a significant extent by growth of consumer spending.

The statement noted that progress continues on both monetary policy objectives—employment and inflation. Job gains continue to accumulate quite satisfactorily, and some inflation indicators show movement higher in the direction of a healthier rate of inflation.

Despite continuing economic progress, the Committee cited recent global economic and financial developments as a reason for its decision.

I supported the Committee's decision. Although I believe further normalization of interest rates will likely be justified by economic performance this year—and possibly relatively soon—I felt a patient approach made sense at this meeting.

Today I will elaborate on the factors I considered most important in the recent policy decision. Looking ahead, I'll lay out my near-term economic outlook, and I'll comment on how the context of risks and uncertainties around the outlook can affect decision making on policy.

I will be sharing my personal views, as always. I'm not speaking for the Federal Reserve or the Federal Open Market Committee.

I'll start with my current assessment of economic momentum. I see the economy on a growth track that should produce moderate growth this year—between 2 percent and 2 1/2 percent.

This outcome could be in question if you simply extrapolate from growth in the fourth quarter of 2015. The fourth quarter was relatively weak—currently estimated at 1 percent. Consumer activity eased off considerably in the fourth quarter. The higher dollar continued to exert a drag on exports. This was felt especially in the manufacturing sector.

An important question is whether to view the fourth quarter as a one-off aberration or a sign of slowing growth. Since we're still in the first quarter of 2016, it's a little early to come to a definitive conclusion. But we **are** able to gauge the strength of economic momentum in real time using a method we call a *nowcast* (as opposed to a forecast). A nowcast takes each data point as it comes in and adds it to a model-based computation of the growth rate of gross domestic product (GDP) on an annual basis. Such a computation is sometimes called a tracking estimate. The data we have in hand as input to this estimate run through January, with a few data points for February. Our tracking estimate for the first quarter is currently 1.9 percent.

So I am reasonably confident the first quarter will represent something of a bounceback from the fourth quarter of last year. Consumer activity has picked up sufficiently since the fourth quarter to support the view that overall domestic demand—the lead driver of the economy—is expanding at a healthy enough pace.

With a moderate pace of macroeconomic expansion in 2016 should come continued improvement in employment conditions. The headline rate of unemployment stands at 4.9 percent as of the last report. The employment report for February showed another small uptick of labor force participation, following earlier similar moves beginning last fall. I take this as an encouraging sign that potential workers previously out of the labor market are being enticed back into the labor force. Their return suggests that slack remains in our economy's utilization of all potential labor resources, but we're getting closer and closer to the objective of full employment.

The FOMC's other policy objective is low and stable inflation. The rate of inflation has been too low for a long time, and the current run rate continues to be measured below the Fed's target of 2 percent. Depending on the measure you use, inflation is running between two-tenths and eight-tenths of a percent below the desirable rate.

There have been encouraging aspects of recent inflation reports that suggest inflation may firm as we get to the back half of the year. Measures of inflation that **exclude** the direct price effects of energy prices and other relatively volatile consumer prices are not far below 2 percent. These data—taken with my assessment that the economy's growth is still a bit above the longer-run potential rate—make me optimistic that the Committee's inflation objective is achievable in the medium term.

In my opinion, the outlook for 2016 and into 2017 swings on the question of whether domestic demand will in fact hold up.

Arrows on the dashboard of domestic demand point in various directions. Business investment remains soft. Investment in inventories rose last year and remains somewhat elevated. The need to work off inventories could constrain expansion in the near term. As you know, investment in structures related to oil and gas exploration and production has fallen dramatically. Other forms of business investment reflect a cautious mentality.

The economy has drawn its strength instead from domestic consumer activity. A number of factors seem to be underpinning household and consumer spending. Employment gains have bolstered confidence in job security, job availability, and prospects for future income. The recovery of house prices has increased household wealth. Household balance sheets are much improved compared to those a few years ago. Low interest rates and available credit continue to enable spending on durable goods.

Short of some big shock that turns consumer psychology on its head, I see no reason why consumer spending growth should not continue. I think the conditions supporting this engine of economic momentum are likely to hold steady. I should add to the list the so-called "gasoline dividend." Although slower than expected to show through in consumption patterns, lower oil prices and lower gasoline prices should bolster the economy through the consumer channel.

The incoming economic data have been, admittedly, mixed since the momentous December meeting of the FOMC (the meeting at which the Committee raised its policy rate for the first time in almost a decade). We policymakers face some ambiguity. In my experience, this is almost always the case. But overall, I see the recent data as positive. I believe a forecast of sustained moderate growth momentum is realistic and remains the likely scenario. In my opinion, there is sufficient momentum evidenced by the economic data to justify a further step at one of the coming meetings, possibly as early as the meeting scheduled for end of April.

I have been closely following the commentary in reaction to the Committee's decision and subsequent communication last Wednesday. The decision to keep rates unchanged did not surprise financial markets. Financial market participants apparently had concluded that the tone of the incoming economic data, combined with the recent financial market volatility and signs of global weakness, was enough to dissuade the Committee from following up its December liftoff decision with another rate hike.

In contrast, much has been made of the implications of the 17 independent forecasts submitted by Committee participants, taken together. The number of interest-rate increases in 2016 implied by the median forecast drawn from participants' submissions was reduced from the December projection. In past communications, we emphasized that rates would likely rise gradually and, consequently, monetary policy would likely remain quite accommodative for some time. Now it appears the Committee has signaled an even more cautious and deliberate approach than that implied in December.

So what gives? Well, first, let me reemphasize a message frequently repeated in communications of the Committee. There is no pre-set path of policy decisions. There is no date-specific plan that the public could take as a committed course of action. Decisions to raise rates will be data-dependent. To my way of thinking, this means that at each decision point (each meeting), the Committee will reevaluate whether the real economy—the Main Street economy—remains on the assumed path to full employment and price stability. The Committee will consider information received since the last meeting and what that information implies for the outlook. And, importantly, the Committee will take account of the context of risks and uncertainties surrounding the outlook.

I would argue that the real economy—the Main Street economy—remains substantially on the path envisioned by Committee participants at the time of the liftoff decision in December. However, the context of risks and uncertainties has shifted somewhat. In my view, this explains the Committee's changed sentiment regarding the speed of normalization, the pace of rate increases.

What do we know today that we did not and could not take into account in December?

We know that in January and early February, the world's financial markets, including our own, went through an episode of significant volatility. From the first trading day of January, investors appeared to go "risk off" and headed for safety. A number of concerns seemed to gang up on investors: the weak fourth quarter here in the United States, economic weakness globally in advanced economies and emerging markets, the apparent economic slowdown in China, Chinese currency depreciation, and the falling oil price and what that could mean for global demand.

We know that an important index that measures financial volatility—the VIX—rose to a level above 28 (a very high reading) on February 11 and has since settled back to a much calmer reading around 15. We know that financial markets here have substantially recovered lost value, but we do **not** know if the volatility investors experienced and the public observed in January and early February will have any extended impact on the broad economy.

We know that on March 5, the government of China stated its GDP growth target for the next measurement period at a range of 6.5 to 7.0 percent. The introduction of a range was interpreted as allowing for lower growth than recorded in the past, reinforcing the sense that China's economy is slowing.

We know that the Bank of Japan—Japan's central bank—unveiled a negative rate policy on January 29. Japan joined the eurozone in using negative official rates to spur inflation and growth.

We know that on March 10, the European Central Bank deployed Mario Draghi's "bazooka." The ECB pushed its policy rate more into negative territory and took other strong measures in an attempt to pull the eurozone out of its persistent weak state evidenced by very low inflation.

These are some highlights of a rough start to the year. As I said, the context has mutated somewhat since December, even if, all things considered, the economy remains on a positive trajectory.

A kaleidoscopic context for policymaking is a fact of life in today's world. Over the past seven years of economic recovery, there have been various points along the way at which I predicted an acceleration of growth. Too often a headwind or other complicating factor materialized to hold back the economy and undermine my prediction. There

was the European debt crisis that shook confidence. There were intermittent fiscal crises in this country. (Remember the "fiscal cliff"?) There were bouts of financial market volatility, and there were weather events.

Headwinds pass. They are temporary factors that constrain growth, and in that sense they are part of the medium-term, cyclical story of the economy.

There are also longer-term structural factors to consider in forecasting growth. My team of economists at the Atlanta Fed is trying to gain a better understanding of these factors. One such factor is demographics.

Today we are publishing our 2015 annual report. It will include an essay entitled "The Graying of the American Economy." It explores the economic consequences of an aging population distribution.

As the number of retired seniors expands over the next few decades, the growth rate of the labor force will slow, and the requirements of supporting the non-working population will accelerate. Other things being equal, slower workforce growth will restrain economic growth. Clearly, the nation faces challenges in achieving vigorous growth in the years ahead.

But returning to the near-term narrative, let me summarize my main points. The FOMC decided last Wednesday to keep the policy rate unchanged. The economy is trending positively, overall. Growth continues at a moderate pace. However, the environment for policy setting has changed enough since mid-December to justify exercising some patience as regards the next rate increase. The Committee will be monitoring global and financial developments along with evaluating incoming data. Policy remains on a gradual path of rate increases, and decisions will be made based on what the economic data tell us about the likely direction of the economy while taking account of the risk and uncertainty context.

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