SPEECHES

Four-and-a-Half Current Questions for Policymakers

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- Atlanta Fed President and CEO Dennis Lockhart, in a May 3, 2016, speech to the World Affairs Council in Jacksonville, discusses the Federal Open Market Committee's recent policy decision and questions he will be considering as the June meeting approaches.
- In spite of a weak first-quarter U.S. economic growth estimate, Lockhart continues to expect stronger growth over the rest of the year.
- Lockhart believes the FOMC is closing in on its full employment objective and sees indications that broad-based inflation is firming.
- In Lockhart's view, the downside risks from abroad appear to have subsided somewhat.
- Lockhart says there is growing concern that the potential rate of economic growth is lower today than it was in the past, which would have implications for the path of monetary policy. He adds that the low rate of labor productivity growth is puzzling.

Thank you for that introduction.

I once read a dictionary cover to cover. I was in a situation of mandatory attendance of classroom lectures on some dull subjects. So I brought a dictionary to class and worked my way through it. The instructors—when seeing me peering into my Webster's—thought I was looking up one of the words they'd just used. This was an acceptable lapse of attention, I guess.

One of my favorite sections of the dictionary is the A-M-B words—words like *ambiguous*, *ambivalent, ambidextrous,* and *amblyopic.* Amblyopic refers to dim vision without obvious visual impairment. An apt word, perhaps. I'm from the Federal Reserve and I'm going to talk tonight about the economy.

A meeting of the Federal Open Market Committee, or FOMC, concluded a week ago. The Committee decided not to increase interest rates.

The statement that followed the meeting said that economic activity appears to have slowed even while labor markets continue to improve. The Committee cited slowdowns in consumer spending, business fixed investment, and net exports. The housing sector was mentioned as a positive element along with consumer sentiment and growth of household real income. The statement noted that inflation continues to run below our 2 percent target for the longer run, and inflation expectations remain stable. Finally, the Committee repeated that it is closely monitoring global economic and financial developments.

At the time of the meeting, we did not have in hand the first estimate of first-quarter gross domestic product (GDP) growth; that reading of the economy was received last Thursday morning.

In the days running up to the initial GDP growth reading, the Atlanta Fed's GDPNow tracking estimate predicted an annual rate of growth for the quarter in the neighborhood of half a percent. That turned out to be pretty close to the Bureau of Economic Analysis's first estimate of 0.5 percent. That's weak growth.

The economy is throwing off mixed signals. The data have an ambiguous quality. We have weak first-quarter growth and at the same time strong labor market data and indications that inflation is firming. Firming is desirable. We want to see the inflation rate move up toward, and ultimately to, 2 percent.

The FOMC's next meeting is in mid-June. For the next few weeks, you can expect to hear lots of discussion and speculation about whether the FOMC will make a second increase in its policy rate. I'm not going to take a position tonight on that question. The policy path will depend on how conditions evolve between now and mid-June.

Rather, I'd like to provide you some insight into how I—one policymaker—am organizing my thinking on the economy and policy considerations at this juncture.

There are always many considerations, but I am especially attuned to four—actually four-and-a-half—questions that I feel I must think about as the June meeting approaches.

Here are the four-and-a-half questions in shorthand:

- First, domestic economic growth—what's happening? What's the outlook?
- Second, the FOMC's monetary policy objectives of full employment and stable prices—how close are we to achieving these objectives?
- Third, risks to the baseline outlook—what are the key risks and especially, how much weight to put on global risks?
- Fourth, our economy's longer-run potential rate of growth—is it lower than before? Should we lower our expectations for future growth, in part because productivity growth is low?
- Finally, the half question: labor productivity growth—what should we make of the low trend numbers?

I need to stress that my remarks this evening are my personal views. I am not speaking for any other Federal Reserve official or for members of the FOMC.

Growth
As already mentioned, first-quarter growth appears to have been weak. The disappointing first quarter follows a better, but less-than-stellar, fourth quarter.

When, at the beginning of the year, my team at the Atlanta Fed set our expectations for the first quarter, we knew that some components of economic momentum that underperformed in the second half of last year would likely remain soft. For example, we expected net exports to lag due to the dollar's strength, and we expected business investment in structures to stay depressed due to the fall in oil prices. It's worth noting that both the dollar and oil prices have reversed somewhat their strong moves over the last two years.

Household spending—also called personal consumption—was soft in the second half of 2015, but we were counting on a rebound of sorts in the new year. The underlying fundamentals then appeared and still appear solid. These consumer fundamentals include household balance sheets, house prices, income growth, and low interest rates to finance purchases of homes, cars, and other durable goods.

To sum up, we were expecting solid growth of domestic demand fueled by strengthening consumer spending. So far this year, we've been disappointed. Although not a bad thing in the end, the savings rate has edged higher. Consumers appear to have banked some of the gasoline dividend. The consumer seems to be behaving cautiously.

What to make of these conditions? Is slow domestic demand likely to be persistent or transient? And are the readings even fully reliable?

Doubts are legitimate. The first quarter has been anomalous in recent years. In 2010, 2014, and 2015, the first quarter was substantially weaker than the remaining three quarters of the year. From 2010 through 2015, the first quarter averaged less than a percent.

We could be picking up statistical noise in first-quarter numbers. Some economists believe "residual seasonality" could be distorting the numbers. Rough estimates by my staff put the impact of residual seasonality on first-quarter growth anywhere between 1/2 and 1 1/2 percentage points.

An alternative interpretation of the data sees first-quarter weakness as just a lull. In other words, normal quarter-to-quarter ups and downs are at work.

In spite of the first-quarter estimate, I haven't revised my view that the economy is growing at a moderate pace. For now, I'm sticking with my forecast that growth will be stronger over the rest of the year. The fundamentals look solid for consumer activity.

How close to objectives?
As you may be aware, the FOMC sets monetary policy to achieve two objectives—the so-called dual mandate established by Congress. The two objectives are full employment and low and stable prices.

The exact measure of full or maximum employment is debatable. And it's widely accepted that full employment varies from year to year and period to period. Using the conventional unemployment number calculated by the Bureau of Labor Statistics, most of my Fed and FOMC colleagues estimate today's full employment at a bit below 5 percent unemployment. The current rate is fairly close to that.

I believe we are closing in on our full employment objective, but there is some evidence that unused or underused labor resources remain.

Data on involuntary part-time workers, for example, are a bit elevated compared with pre-recession levels. Perhaps more striking is the recent reversal in labor force participation. More than 2 million workers have joined the labor force over the past six months. The number of people coming off the sidelines tells me there's a shadow labor force, and it's now feeding employment gains. Monthly payroll jobs growth has averaged 234,000 over the last year and 209,000 over the last three months.

As for the inflation objective, the Committee has set the target at 2 percent over the longer run. Inflation readings remain below our target. Some of those readings show a gap to target that is not trivial. That said, there are indications that broad-based inflation is firming. This gives me some confidence that the run rate of inflation will rise to 2 percent over the medium term.

Here's a key point in assessing the current situation: the tone of reports on our two objectives—the encouraging employment and even inflation data—isn't easily reconciled with the current growth picture. As a policymaker, I've got to form an opinion on which data element is the most reliable signal of economic reality. For the time being, I'm favoring the encouraging employment data over the growth data. Our soundings of business leaders across the Southeast (a process led by our Jacksonville regional executive, Chris Oakley) are more upbeat than the recent GDP number.

Risks—domestic and global
There are always risks—both downside and upside—around a baseline outlook for the economy.

It's an old joke that economists are ambidextrous—"on the one hand, on the other hand"—and that only a one-armed economist will give you a straight opinion.

As suggested by my earlier commentary on growth, my biggest worry is that a lull turns out, in fact, to be persistent. The motor of the economy is household spending and business investment. We could be seeing a downshifting in consumer activity along with continuing and persistent wariness on the part of business as regards capital expenditures.

Furthermore, in its last three statements following FOMC meetings, the Committee has made a point of acknowledging concern about global financial and economic developments. As you will recall, the year began with a period of heightened volatility in financial markets that seemed to be triggered by factors such as the slowing of the Chinese economy, a sell-off in the Shanghai equities market, stress on commodity-exporting emerging markets, and concerns about diverging monetary policies around the world.

In my view, the downside risks from abroad appear to have subsided since January and February. Things have calmed down somewhat.

Last week's FOMC statement reiterated that the Committee continues to monitor global economic and financial developments. The global watch list includes a number of concerns. I will mention one concern that has some potential to loom large as we approach the June meeting. That is Brexit, as it is called—the referendum in the U.K. on whether to remain in the European Union. Brexit could be a source of heightened global uncertainty.

I want to make another important point. As we monitor global factors, what concerns me is the potential effect on our domestic dual-mandate objectives (employment and inflation), not the drama of the developments per se.

Potential

Now I'd like to shift from relatively short-term economic considerations to a longer-term frame of reference. The last question—or question-and-a half—deals with what may be structural aspects of our country's economic performance. The first question is about the trend rate of potential economic growth—that is, how fast can our economy grow over time on average?

There is growing concern that this number is simply lower today than it was in the past. Lower potential would have implications for the path of monetary policy. To explain, if the potential rate of growth is lower, it is likely the neutral interest rate is also lower. The neutral rate is the rate at which policy must neither add stimulus nor remove stimulus to keep inflation low and employment at maximum. In this state of the world, interest rates would remain low for a long while. Put differently, even as the FOMC normalizes the settings of interest rates, rates would be low by historical standards.

Productivity

There are a number of reasons potential growth could be lower than in the past. I won't go into all the possible causes, but one in particular has become a matter of considerable concern and puzzlement. That is the low rate of labor productivity growth in recent years. Productivity, or output per hour worked, has averaged a mere 1/2 percent per year over the past five years.

To put that number in perspective, over the 20 years leading up to the Great Recession, U.S. productivity growth averaged 2.2 percent per year. At that rate of productivity growth, the American standard of living was doubling roughly every 32 years. If the recent trend is the new normal, our standard of living would double in about 140 years.

We don't have compelling explanations for the cause of slower productivity growth, but we do have some clues. If we look at what is different these days as compared to the pre-recession period, a factor that gets one's attention is the decline of what's called "capital deepening."

Put simply, U.S. firms are deploying net new capital at an unusually slow pace.

An implication of the recent trend in productivity is that the U.S. economy is growing almost entirely by pulling more workers into jobs. That's a good thing when the U.S. labor force is underemployed.

But if, as I asserted earlier, the economy is nearing full employment, at some point we should begin to see mounting pressure in the labor market. One sign of mounting pressure would be accelerated wage growth.

We have not yet reached that point. Generally speaking, wage growth remains tepid. Broadly based wage growth would be the clearest indication that the ability of the economy to grow by adding workers is reaching its limit.

Close

I'll sum up. As the next policy decision point in June approaches, I will be probing three immediate questions while considering one and a half other questions. Are data relative to growth improving, rebounding? How close are we to full employment and 2 percent inflation? What is the risk context? I will weigh answers to these questions keeping in mind the longer-run concerns of slow labor productivity growth and its contribution to what may be lower potential growth. At the moment, the data, overall, are ambiguous. As a policymaker considering whether to hike interest rates, I'm ambivalent at this point. But I continue to be ambitious for the performance of the U.S. economy for the remainder of the year.

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