Key Questions for Monetary Policy

Dennis Lockhart
President and Chief Executive Officer
Federal Reserve Bank of Atlanta

Mississippi Council on Economic Education
2014 U.S. Senator Thad Cochran Forum on American Enterprise
Jackson, Mississippi
September 25, 2014

Thank you for honoring me with the invitation to be your keynote speaker today. As you may know, the Federal Reserve Bank of Atlanta shares your goal to increase economic and financial literacy among our citizens. In fact, our New Orleans Branch staff has worked closely with the Mississippi Council on Economic Education for the past decade. Together, they produce "Focus on the Economy," an annual conference that attracts teachers from throughout Mississippi for sessions about the Fed, the economy, personal finance, and related topics. I am pleased to continue that tradition of partnership here this afternoon.

Today I want to share my views on current and prospective monetary policy with a medium-term horizon. I'll start by describing the context in which the most recent decisions on monetary policy were made. I will round out my remarks with commentary on five front-and-center questions. They are questions my colleagues and I are having to engage as we shape monetary policy and public expectations.

I must emphasize that the views you'll hear are my personal views. I am not speaking for the Federal Reserve or the Federal Open Market Committee (the FOMC). There is a healthy spread of opinion on the FOMC. I can assure you I have colleagues in the Federal Reserve System who will not entirely agree with my views.

Before laying out the five questions, let me provide some background.

FOMC decisions change little

Last week, I participated in a two-day meeting of the FOMC. The Committee's decisions involved very little change. The policy interest rate—the target range for the federal funds rate—was kept at zero to 25 basis points. This decision continues the policy of keeping the bellwether Fed policy rate effectively as low as it can go. The policy of a rock-bottom policy rate has been in effect since the fourth quarter of 2008.

The statement that followed the meeting was updated in small ways from the July statement but conveyed little change in the outlook for the economy and the outlook for policy. Importantly, there was no substantive change in our forward guidance about how long the policy rate will be held at an effective rate of zero. The Committee reiterated the view that "liftoff" (the timing of the first move to raise rates) will likely occur a "considerable time" after the end of asset purchases (or QE, short for "quantitative easing") in October. The end of QE next month is now virtually certain. The statement also repeated the expectation of the Committee that once liftoff occurs, rates will rise at a gradual pace.

I supported the Committee's decision to stay the course in both substance and language. For my part, I continue to expect conditions for liftoff to ripen by the middle of 2015 or a bit later.

There are two more FOMC meetings this year and eight next year. As each meeting approaches, speculation will intensify that the Committee will signal in some way when the tightening cycle will begin. The timing isn't foreordained. The performance of the economy in the coming quarters should and will dictate the timing of liftoff. This conditionality has been expressed by stressing that the decision will be data-dependent. The phrase "data-dependent" is a kind of shorthand, as I see it. It's shorthand for a process of assessing, based on the best and most recent evidence we have, whether the economy is on the track we assume it's on. The data should tell us whether the outlook has worsened materially and give some hint as to whether downside risks around the outlook have intensified.

Let me lay out in broad strokes my sense of the outlook. I expect GDP (gross domestic product) to grow at an average annual rate of 3 percent this quarter and next and through next year. Inflation, by most measures, is running below the FOMC's longer-run target of 2 percent. I expect inflation to firm up gradually as the economy continues on a 3 percent growth track. And I expect unemployment and underemployment to continue to decline at a steady pace. I think the country will approach a condition near full employment by late 2016 or early 2017. I'll ask you to keep this forecast in mind as I walk you through five questions confronting policymakers.

Question 1: Is the 3 percent growth story holding up?

Yes, it appears so. The first half of the year 2014 had some wild swings from contraction in the first quarter to growth over 4 percent in the second. The second quarter had nonrecurring elements of a rebound from the drop-off in the first quarter. At this date, we have only tracking estimates for the third quarter. Tracking estimates gauge apparent growth in real time and make adjustments with each incoming piece of data. Most tracking estimates for the third quarter—including our own at the Atlanta Fed—gauge growth this quarter at around 3 percent.

The recent run of data has been encouraging in many respects. Manufacturing data have shown improvement. The services sector has also seen improving activity. Consumer and business confidence indicators are rising.

However, consumer activity per se has been growing only at a tepid pace, especially if you exclude auto sales. To be confident in an outlook of 3 percent or greater growth, we need to see consistency in consumer spending. The housing sector also raises some concern, and the recent appreciation of the dollar may dampen export activity in coming months.

In some respects, I view GDP growth as a means to an end. A chief end is full employment. The question is whether the pace of growth is enough to sustain progress in reducing underutilization of labor resources in the economy. Will we get enough growth to continue to shrink labor market slack? That sets up the second question.

Question 2: How much labor market slack remains?

Federal Reserve policy makers face the question of how much labor market slack remains. In its post-meeting communication last week, the Committee repeated the claim that significant underutilization of labor resources persists. I agree with this view.

As you no doubt have heard or read, the recent national monthly payroll jobs report for August was disappointing relative to the average rate of jobs growth for the prior seven months. At the same time, the official unemployment rate—which stands at 6.1 percent—has been stuck around that level for a few months. I wouldn't read too much into short-term movements in the data. I think steady progress is still the right characterization of employment markets.

No one measure of employment conditions tells the full story, in my view. I pay attention to a wide variety of indicators. In computing the unemployment rate, for example, if you worked an hour for pay in the last month, you're employed. A broader measure treats some part-time workers—namely those working part-time involuntarily—as not fully employed.

The same broader measure includes the so-called marginally attached in the workforce and in the ranks of unemployed. Marginally attached workers are available for work but, for whatever reasons, have not looked for work in the last month. It's worrisome that the proportion of prime-working age men has grown among the marginally attached.

The current level of headline unemployment is still some distance from my notion of full employment. And the gap between headline unemployment and broader measures suggests there is more work to do before we should be satisfied with employment conditions in the country.

Question 3: What is the risk of inflation?

One way to assess the extent of labor slack is by observing wage pressures. Wage growth for the most part has been quite slow. We are not yet seeing much indication of broad-based wage or compensation pressure. Rising wages can be viewed as a link between employment conditions and broad price pressures, or inflation. Inflation is always a central banker's concern. I frequently hear a question about what inflation risk might be associated with keeping interest rates so low for longer. That's question three.

As I said earlier, inflation is running below the 2 percent target the FOMC established in January of 2012. Inflation ran considerably below target for most of 2013 and early in this year. We saw some encouraging firming of prices in the spring, but recently measures of inflation have backed up a little. Separating short-term and transient effects from the underlying trend is always challenging. In its fundamentals, inflation is reflecting what are still, in my view, lukewarm demand conditions. I expect the inflation rate to rise only gradually to a sustainable 2 percent.

There are two legitimate inflation worries. One is persistent undershooting, with all this would imply for the strength of economic activity. The other is an overshoot that gets out of hand. At this juncture, I'm more concerned about a persistent undershoot. I am relatively sanguine about the risk of a strong and undesired upside surge in inflation. Inflation expectations, which are very influential in shaping real outcomes, continue to be firmly anchored. Also, in talking to business contacts, I hear almost no claims of pricing power.

Question 4: What about financial stability?

Another important question about the risk associated with keeping rates so low for longer is this: What risk of financial system instability might the Fed be feeding? Are we inviting another financial crisis?

It's clear that U.S. equity market indexes are hitting historic highs. It's clear that buoyant bond markets are pricing in some continuation of ultra-low interest rate policy. And it's clear that investors have been searching for yield for quite some time.

As a policymaker, I have to think about two scenarios. The first is that bond markets are somehow surprised in the coming months and that the transition to a period of tightening is disruptively and destructively volatile. Last year's so-called "taper tantrum" in the bond markets is something to avoid. The second scenario would resemble the recent financial crisis, not perhaps in its particulars, but in the sense that it was a systemic event.

To my mind, the key filter in assessing risk levels in this regard is the word "systemic." I am comfortable that being patient regarding liftoff until the middle of next year or perhaps a little later will not bring on a systemic financial event. I take comfort in the much-strengthened defenses of the banking system, financial institutions in general, and financial regulators. I take comfort in the enhanced capital levels of the most systemically important institutions. I think defenses are dramatically improved, and the resilience of the financial system is measurably stronger than in 2007.

Question 5: What about geopolitical risks?

My fifth and final question relates to the global context. With developments in the Middle East, tensions between the West and Russia over Ukraine, quite soft economic conditions in Europe, and challenges associated with a transitioning economy in China, it's fair to ask: how does a policymaker factor geopolitical risks into policy thinking?

All these developments and others are monitored carefully, I can assure you. All these sources of potential geopolitical or global economic risk have been in our consciousness for a while.

In my assessment, this concern is appropriately about an escalation of trouble that comes on suddenly and with great force. Such a shock could spill over through financial or commodity markets to the broad economy. It would be foolish to dismiss this risk entirely, but our financial markets seem to reflect a view that the U.S. real economy enjoys some insulation from severe spillover risk. I think that's a realistic assessment.

Conclusion

I'll close with this thought: there are always risks around a projection of any path forward. There is always considerable uncertainty. Given what I see today, I'm pretty confident in a medium-term outlook of continued moderate growth around 3 percent per annum accompanied by a substantial closing of the employment and inflation gaps. In general, I'm more confident today than a year ago. I see the balance of risk around this outlook as reasonably balanced. No one has a perfect crystal ball, but I am rather confident that we'll get to economic conditions between mid- and late next year that would justify initiating a period of normalization of the interest rate environment.