Comments on the Recent Monetary Policy Decision

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

Buckhead Rotary Club
Atlanta, Georgia
September 21, 2015

- Atlanta Fed President and CEO Dennis Lockhart, in a September 21, 2015, speech to the Buckhead Rotary Club in Atlanta, Georgia, discusses current economic conditions and the recent Federal Open Market Committee (FOMC) decision to hold off on raising its policy rate.

- Lockhart maintains that the sources of uncertainty that fueled recent financial market volatility represent a modest risk, but that the Main Street economy is his essential concern. He describes the U.S. economy as performing solidly.

- The FOMC set out two principal decision criteria for a fed funds rate liftoff: "further improvement in labor markets" and achievement of "reasonable confidence" that inflation will rise to the targeted rate of 2 percent in the medium term.

- Lockhart states that labor markets have improved, but that inflation has not yet achieved the FOMC's target. The inflation rate has hewed closer to 1 1/2 percent over the economic expansion, and has been essentially zero over the past 12 months.

- Lockhart believes that the inflation expectations of businesses and consumers remain anchored around 2 percent and that the continuing expansion of the broad economy will play through to the inflation numbers once transitory influences have subsided.

- Lockhart is ready for the first policy move on the path to a more normal interest-rate environment and is confident that the phrase "later this year" is still operative. He anticipates a gradual pace of rate increases.

It's good to be back at the Buckhead Rotary. I see a number of friends in the audience. That's always a good thing when one's task is to explain the Fed's monetary policy decisions, particularly just a couple of days after a policy meeting while debate still rages about whether or not we did the right thing.

I'm sure almost everyone in the room is aware of what I'm talking about. The Federal Reserve's vehicle for making monetary policy—the Federal Open Market Committee (FOMC or the Committee)—met last Wednesday and Thursday. The Committee decided to keep the policy rate—the federal funds rate—where it has been for almost seven years. That is, at just above zero, effectively as low as possible. The Committee held off a decision to lift off.

Said differently, the Committee held off on a decision to begin a process of normalization of the policy rate. Changes in the Fed's policy rate affect many other short-term interest rates and, in turn, longer maturity rates in the economy.

The Committee issued a statement just after the meeting ended Thursday. The statement described a domestic economy that is expanding at a moderate pace and making steady progress by most measures. The statement mentioned that underutilization of labor resources is declining. At the same time, the statement noted that inflation continues to run below our longer-run objective of 2 percent. Importantly, the statement acknowledged recent economic developments abroad and recent volatility in financial markets. It pointed out the possibility—but not certainty—that these developments could spill over to have some effect on the trajectory of our domestic economy, including realized inflation.

Along with this statement, the Committee also issued its quarterly *Summary of Economic Projections.* Each FOMC participant submits a forecast of key variables—growth, unemployment, inflation, the fed funds rate—four times a year. As a group, the five Fed governors and 12 Reserve Bank presidents who make up the FOMC continue to project growth in the range of 2 to 2 1/2 percent annualized over the next two to three years. This is very similar to the pace of growth seen on average over the now six years of economic recovery. The group sees inflation moving in the direction of 2 percent in 2016, arriving reasonably close to target by the end of 2017. The group expects some continuing decline in unemployment. But it's fair to say the current rate of 5.1 percent is close to what many participants would consider full employment, at least by the headline unemployment measure.

Last week's meeting was clearly an important one, even if the much-discussed liftoff decision did not arrive. Today I want to walk you through my take on the various considerations that influenced the decision to hold off raising rates. In so doing, I'll share my sense of the current condition of the economy and what to expect going forward. I said "my take" because, as is always the case, you will hear my personal views. I am not speaking for my colleagues in the Federal Reserve or on the FOMC.

Global economic and financial developments

Let me start by talking about recent global economic and financial developments, acknowledged in the FOMC's statement as "on our screen" as we approached decision time.

Starting in mid-August, financial markets here and abroad experienced markedly higher volatility. There are a lot of indicators of volatility. A useful one is the VIX, an index that measures implied volatility of traded option contracts on S&P 500 stocks. The VIX measures the U.S. market's expectation of volatility over the next month. It is sometimes called the fear index.

Fears of financial market participants apparently rose in mid-August. Although volatility is lower today, as of Friday it had not completely subsided. In my estimation, the spike in volatility was in reaction to the confluence of several factors. I will just list them in no particular order. Contributing factors were the drop in Chinese equity share prices and the devaluation of the Chinese currency. We also heard concerns about the apparent slowing of China's economy. And there was the weakness of emerging markets' economic conditions resulting from declining commodity prices and the knock-on effects of a slowing China. Also on the list was the appreciation of the U.S. dollar and its assumed downward pressure on U.S. exports as well as inflation. Additional factors were the renewed decline of oil prices and uncertainty about the Fed's near-term policy intentions.

As I said, about a month ago, uncertainties loomed larger, market volatility rose, and, from a policymaker's perspective, risks to the domestic economy ratcheted up a little. It's too early to know whether this episode amounts to a bona fide shock to the economy or just a nervous spasm in the markets.

Taking the China considerations in isolation, I don't anticipate large first-order impacts on U.S. growth. First among first-order impacts would be effects on exports. I don't think weaker demand from China will greatly reduce our export performance. It's possible there will be indirect impacts, perhaps by way of demand for our exports from emerging markets or Europe.

It's widely expected that lower-cost imports from China and elsewhere will soften inflation. Because of ordering cycles and lags in import cost adjustments, the disinflationary effect of cheaper goods from China is hard to know in a specific time frame.

At this point, my summary assessment is that the sources of uncertainty that fueled financial market volatility represent a modest risk to our economy, but a risk factor nonetheless.

I want to stress a basic point. Financial market swings per se are not my central concern. The broad Main Street economy is my essential concern. Market volatility can be a symptom of more fundamental ills. And market volatility, if protracted, can be a channel for damping forces on economic activity. It's too early to detect any significant impact on the real economy, to know whether any or all of the factors I cited will evolve into a significant headwind. For that reason, I thought it prudent to wait to evaluate whether recent developments change the outlook. I supported the Committee's decision last week to hold off, and the altered risk picture relative to the economic outlook was decisive in my thinking.

Current state of the economy

Since, as I stressed, the impact of unexpected developments on the course of the Main Street economy is my central focus as a policymaker, let me now comment on the state of the economy. The data indicate the economy is expanding at a moderate pace. The economy is performing solidly. This view is supported by feedback from our contacts across the Southeast.

The weak first quarter was followed by a quite strong second quarter. Our tracking of real-time incoming data in the current quarter suggests a slower third quarter. One cause is slower inventory stocking. Looking at final sales—a measure that removes the influence of inventory swings—the underlying demand picture looks much firmer. This picture of solid continuing overall demand growth is underpinned by consumption growth, strengthening business investment, and steady growth of residential investment.

I've been describing GDP (gross domestic product) growth trends at a national economy level. Let me come closer to home with a few comments on the economy here in Atlanta.

The economy in our metro area has been tracking progress in the national economy with a slight lag. We see this in the data. Employment is growing. Trends in sectors important to the region are positive—for example, transportation and logistics, tourism and lodging, residential construction, commercial real estate, and business services. The business services sector is a mainstay of the Buckhead community. Atlanta is a recognized center of sophisticated business services with global reach. I consider Atlanta's economy to be better balanced, with a more diversified employment base, than before the recession. I'm bullish on Atlanta's economic prospects. Atlanta should grow along with the national economy.

The FOMC's decision criteria

I have a little more to say about the national economy. So, back to 40,000 feet.

As many of you are aware, the FOMC has a dual mandate and is required by statute to pursue two objectives in making monetary policy. They are maximum employment and price stability.

As a decision to lift off—to begin normalizing interest rates—became a more immediate consideration, the Committee set out two principal decision criteria. They were "further improvement in labor markets" and achievement of "reasonable confidence" that inflation will rise to the targeted rate of 2 percent in the medium term. Obviously, both of these requirements derive directly from the FOMC's dual mandate objectives.

Let me provide my assessment of conditions associated with these two decision criteria.

First, employment: Over the past year, the economy has been adding jobs at a pace averaging 243,000 per month. This is a strong pace of job growth. In August, the unemployment rate ticked down 0.2 percentage points to 5.1 percent. This rate of unemployment is now quite close to the level many economists believe to be full employment. That includes Fed economists and my colleagues on the FOMC.

An important question for policymaking is how much slack remains in labor markets. I have long held that the most familiar measure of unemployment—what the Bureau of Labor Statistics calls U-3—is not a sufficient indicator of the degree of labor resource underutilization in our economy. Broader measures present a more complete picture. That picture incorporates measures of involuntary part-time workers and people who are only marginally attached to the formal labor force. This latter group is made up of people who are not actively looking for work but are available and might go back to work if economic conditions were creating more demand for their labor.

While the growth in jobs and the decline in joblessness have been impressive, I'm not yet convinced we're at full employment. I think some slack remains. At the same time, I continue to maintain that achieving full employment is not a prerequisite for a liftoff decision. By most measures, we have seen substantial improvement in employment conditions, and we can expect that improvement to continue.

One way to size up the degree of remaining labor slack is to look at wage growth. Wage growth across the country remains subdued. Admittedly, wage growth is a lagging indicator and may be slow to reflect labor market tightness. Nevertheless, the lack of significant wage growth can be taken as a cautionary sign.

That said, I think it's worth taking a minute or two to compare what the data are telling us about wage pressures with what my staff and I hear from contacts among major employers in the Southeast. We hear of growing wage pressures for selected job categories. We get the clear impression that hiring challenges are intensifying. Very recently, our sense of rising wage pressures has become more generalized.

There are a number of ways employers might experience tightening labor markets before they resort to wholesale wage increases. (Perhaps here you can nod if you're experiencing some of my examples.) They might experience accelerating attrition broadly or in the category of higher-paying jobs. They might have more offers turned down because of pay. They might have to match outside offers to retain some of their current employees. And they might have to increase hours of part-time workers, triggering benefits, or increase hours of full-time employees, triggering overtime. If we put our minds to work, we could come up with a litany of things that could be classified as wage pressures. These are just a few examples of evidence that employment conditions may be tightening and wage pressures may be about to accelerate.

As one participant in the Committee's process, I am satisfied I can check off the requirement of "further improvement in labor markets" as having been adequately met. I am not so comfortable about inflation.

In January 2012, the FOMC set an explicit inflation target of 2 percent per annum over the longer run. Before 2012, individual Fed officials often referred to a target of 2 percent in their speeches and put it in their longer-run projections.

Over much of the past six years and more of economic expansion, our policies have failed to deliver on the inflation goal of 2 percent annualized. Using our preferred inflation index, the rate of inflation has hewed closer to 1 1/2 percent, and, over the past 12 months, inflation has been essentially zero.

A material share of the recent shortfall has been tied to falling oil prices. If we remove energy prices, inflation has been around 1 1/4 percent over the past year—still well short of goal.

I think the recent numbers largely reflect transitory factors—oil, the rising dollar, falling commodity prices. These factors produce relative price changes, and relative price changes occur all the time. Relative price changes are not necessarily symptomatic of broad, fundamental inflation forces, but they do affect the numbers. Gauging the underlying reality of trend inflation has been and continues to be challenging. The inflation picture is likely to remain murky into next year.

I think the case for checking off the criterion of "reasonable confidence" that inflation will converge to the 2 percent target is harder to make than employment. Even so, I have gotten comfortable enough on the inflation question to take a first step in one of the coming FOMC meetings in what will likely be an extended process of normalization of the interest-rate environment. My comfort is based on the belief that there are two forces at work that will shape the inflation outcome in the medium term.

The first is inflation expectations. I believe inflation expectations of U.S. households and businesses remain anchored around 2 percent. I base this on survey data of consumers and business leaders. This evidence conflicts with recent financial market-based trends in inflation compensation. In the current volatile circumstances in financial markets, these data are hard to interpret. I am willing to look past these measures for now.

The second force is the continuing expansion of the broad economy. I assume that continued absorption of resources associated with ongoing expansion will result in tighter labor and product markets. I expect such fundamentals will play through to the inflation numbers once transitory influences have subsided.

The way forward

In my vote at the recent FOMC meeting, I put most of the decision weight on prudent risk management around recent and current market volatility. As things settle down, I will be ready for the first policy move on the path to a more normal interest-rate environment. I am confident the much-used phrase “later this year” is still operative.

Once normalization is under way, I anticipate a gradual pace of rate increases. This stance of policy will be appropriate, in my view, for an economy operating in a weak global environment, an economy with some amount of slack remaining in labor markets, and an economy trying to shake off disinflationary influences and sustain enough momentum to achieve a healthy rate of inflation over the longer run.