Dennis Lockhart: A potentially momentous year for policy

Speech by Mr Dennis Lockhart, President and Chief Executive Officer of the Federal Reserve Bank of Atlanta, to the Rotary Club of Atlanta, Atlanta, Georgia, 12 January 2015.

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Key points

- Atlanta Fed President and CEO Dennis Lockhart, in a January 12 speech at the Rotary Club of Atlanta, reviews the growing strength of the economy, the economic outlook for the year ahead, and the monetary policy outlook.
- Lockhart stresses that the policy "liftoff" decision will be data-dependent.
- Lockhart expects the annual rate of GDP growth for the second half of the year to be around 4 percent, which is strong growth.
- Another reason for optimism, says Lockhart, is that there was more improvement in labor markets in 2014 than in any other year of the recovery. He thinks the momentum evident in the second half of 2014 will carry over into 2015, and the ongoing outlook will remain solid.
- Lockhart feels the Fed is nearing the end of its job as defined by the extraordinary circumstances of the financial crisis and deep recession. He is looking for a new phase of policy to commence in 2015.

As I look back on 2014 and look ahead to 2015, I can comfortably assert that, more and more, the U.S. economy is hitting on all cylinders. The recovery that began in 2009 is well-advanced, and we are getting closer to a point where the Fed's Federal Open Market Committee (FOMC), the body that formulates monetary policy, can begin a process of normalizing the interest-rate environment. That process will begin with so-called "liftoff" – that is, the first increase in the policy rate.

Chair Yellen, speaking for the Committee, has stressed that the liftoff decision will be data-dependent. That means we will be closely monitoring evidence of the performance of the economy as the year proceeds, and we will be assessing what the stream of economic data seem to indicate regarding the outlook.

So, today I want to present my forecast of how this potentially momentous year is likely to play out. I'll do this in terms of both the vital economic signs and policy. I want to give you a sense of what factors could materially change – even derail – that scenario. And I want to convey a sense of the basis on which important policy decisions ahead will be made.

This is my eighth annual address to this club. As always, you will be hearing my personal views. I am not speaking for the Federal Reserve System or the FOMC. My colleagues may not agree with what I have to say.

Current state of economy and outlook

So let's start with the current economic situation. I'll do a short-form version of this focused on three key elements of economic performance – growth, employment, and inflation.

After negative growth (contraction) in the first quarter of 2014 that was largely explained by bad weather, the economy experienced strong and accelerating growth through the third quarter.

Growth in the fourth quarter is likely to be slower than the very strong third quarter. We are still working with very preliminary measures of fourth-quarter performance. At the Atlanta Fed, we expect the fourth-quarter gross domestic product (GDP) growth rate to come in around 3 percent (annualized). That would produce an annual rate of growth in the second half around 4 percent. This is strong growth, and we believe there is solid momentum carrying over into 2015. Notwithstanding the equity market volatility of last week, we're starting the year on an optimistic note in terms of real economic activity.

Growth of consumer spending appeared to accelerate toward the close of 2014. Personal consumption expenditures rose at an annual rate of 9.2 percent in November, raising the year-over-year rate to 2.8 percent growth. Roughly half of the strong November growth of consumption was auto purchases, but other categories of spending accelerated as well. People seem to be more prepared to open their pocketbooks. The University of Michigan consumer sentiment index for December reached its highest reading since January 2007.

Another reason for optimism is that 2014 was a year of significantly improved employment conditions. Payrolls increased by almost 3 million, the strongest reading since 2000, and the gains were spread across a wide range of industries. The headline unemployment rate fell by more than a percent over the year. The long-term unemployment rate, defined as 27 weeks or more, also declined meaningfully.

Also, we saw the smallest decline in five years in the participation in the labor market of working-age people. We believe this indicates increasing confidence in labor market prospects.

Over the last year as the labor market has improved, we've paid special attention to trends in wages. Growing wages would validate tightening employment conditions and would also support growth of consumer activity and prices. Both are highly desirable in current circumstances.

The recent evidence on wages has been mixed. A number of measures of wage growth remained well below historical norms throughout most of last year, while others did tick up slightly in the second and third quarters.

Based on research, my team has advanced the thesis that the elevated number of people working part-time involuntarily is restraining wage growth. There are about 6.8 million such workers as of December. It's encouraging that the number of involuntary part-time workers declined by almost a million over the past year, four times the decrease in 2013.

Overall, there was more improvement in labor markets in 2014 than in any other year of the recovery. Employment conditions are improving, and improving faster, and prospects of continued progress are encouraging moving into the new year.

The behavior of wages and prices, in contrast, remains less encouraging, and, frankly, somewhat puzzling in light of recent growth and jobs numbers.

Most recent readings of inflation remain considerably below the Fed's notion of a healthy rate, that is, 2 percent. In spite of extremely accommodative interest-rate conditions, inflation readings have tracked well short of the 2 percent target for the past two years.

At the Atlanta Fed, we don't rely totally on any single measure of inflation. We use a dashboard approach to tracking and assessing the broad inflation picture. The components that typically make up a traditional inflation forecast (including, for example, producer prices and commodity prices) are showing readings toward the lower end of their longer-term ranges.

Let me summarize in captions. Solid growth. Improving employment conditions. Stronger consumer activity. But mixed wage growth and weak inflation readings.

Taking account of all this, I see a positive outlook for 2015. I expect GDP growth to be around 3 percent for the year. I expect continued robust job creation accompanied by growing wages. And, while acknowledging some room for skepticism about the inflation picture, I'm looking for inflation to rise gradually through year-end. There will almost certainly be weak inflation readings early in the year influenced by energy prices. But once that influence has passed, I expect inflation to move toward the Fed's targeted longer-term run rate.

Potential headwinds and downside risks

What could derail or materially undermine this scenario? There are certainly risk concerns, whether we characterize them as potential headwinds or more serious downside risks. The most concerning is a soft global growth outlook. We're observing a rather sharp contrast between U.S. economic prospects and those of much of the rest of the world. The jittery financial markets last week probably can be explained, at least in part, by an interpretation of falling oil prices as reflecting weak global demand, deflation data in Europe, and a resulting flight of capital to safety.

I'm sure the question of the broad economic effects of falling oil prices is on your mind. I am of the view, based on a preliminary assessment by Atlanta Fed economists, that lower oil prices will be a net benefit to the U.S. economy. I expect a decline in energy-sector new investment and some falloff in employment to be more than offset by a boost to consumer activity. Also, the lower cost of oil imports should positively affect the net exports component of the GDP growth calculation.

The appreciation of the dollar since last summer will likely affect the export sector, to some extent. My view is that the impact of the dollar's more expensive exchange value and, for that matter, the direct impact of lower oil prices on the energy sector are not severe for the national economy as a whole. But whenever two major world "prices" adjust so markedly, unanticipated second- and third-order effects could result. Geopolitical event risk connected to the rapid adjustment of these globally high-impact prices cannot be dismissed. Analytical humility is a sensible posture.

Policy outlook

These are concerns, not my base-case scenario. As I said earlier, I think the momentum evident in the second half of 2014 will carry over into 2015, and the ongoing outlook will remain solid.

If that is indeed the case, I believe the first action to raise interest rates will in all likelihood be justified by the middle of the year.

The phrase "middle of the year" is admittedly not very precise. That's purposeful on my part. Understandably, some financial market participants are fixated on what exact month the first move will occur. Perhaps it's easy for me to say, but I don't think the exact timing of liftoff is the most important concern. A couple of years hence, whether the first rate increase came at a particular meeting or another – whether a bit earlier or later than expected – isn't going to make a great deal of difference for the real, Main Street economy.

The key liftoff decision criteria ought to be closely linked to the FOMC's two principal policy objectives – maximum employment and low and stable inflation. In my view, the biggest factor influencing the actual timing of a liftoff decision should be the Committee's ***confidence*** that these objectives will be achieved in an acceptable timeframe and, especially, that inflation will move at deliberate speed toward the target of 2 percent per annum.

Inflation readings and forecasts may be pivotal in deciding when to begin adjusting policy. As already explained, we are, at present, experiencing inflationary trends well below target, and our readings are complicated by more-than-normal noise associated with the drop in oil and gasoline prices, falling import prices, and softening of some measures of inflation expectations.

It's quite possible there will be considerable ambiguity in the picture presented by data in the first half of the year. Beyond the noise in inflation numbers, it's obvious there is simply a lot moving around at this time – oil prices, the dollar, even quarterly growth numbers, in all likelihood.

Noisy, jumpy data affect my confidence in the outlook. I'm likely to decide what policy decision to support based on where I think things are headed. When the numbers come in noisy, it's just harder.

If the early months of this year bring mixed news on the economy, the risk manager in me will lean to preferring a later date for the first policy move to an earlier one. That said, after six years of recovery and considering all that that has both transpired and been accomplished, I don't think we policymakers should get too rigid about liftoff a little earlier or later. My preferred timing may not be the Committee's consensus decision.

Just as I think it's appropriate to downplay the exact timing of liftoff, I think it's important to understand that a decision to raise rates will not constitute the throwing of a switch from easy money conditions to tight. The rate environment will remain stimulative, even as the policy rate gradually rises, as I expect. The pace of rate increases will not be preordained. The path of policy will depend on the ongoing performance of the economy.

At the recent meeting of the FOMC in December, the Committee made an adjustment of its forward guidance by introducing the theme of ***patience*** in beginning to normalize the stance of policy. I supported and expect to continue to support a patient approach, one that is relatively cautious and conservative as regards the pace of normalization of rates.

Conclusion

Now let me offer a few closing thoughts. I hope you will take away from this talk a distinct sense of satisfaction and optimism regarding the recent and prospective performance of the American economy.

The financial crisis of 2007 and 2008, the deep recession that followed, and the sluggish recovery after that presented extraordinary challenges, and the response involved the use of extraordinary policy measures. I feel the Fed is coming nearer to the end of our job as defined by those extraordinary circumstances, and anticipation of the normalization of monetary policy – interest rate policy – is appropriate. In that sense, I look for a new phase of policy to commence in 2015.

Leaders of the Federal Reserve – both Ben Bernanke and Janet Yellen – have repeatedly emphasized that the Fed's monetary policy is not a panacea, not a cure-all for all the nation's economic challenges. In my opinion, many underlying fundamentals of the economy remain to be adequately addressed. When I use the word "fundamentals," I have in mind concerns such as the long-term fiscal balance; the strength and prospects of the middle class; the skills, capacity, and health of the workforce; the quality of infrastructure; and funding and incentives for continuing innovation. Addressing these really big challenges is not the work of monetary policy, but monetary policy can be a facilitator and shape a supportive environment for other actors – in the public sector, the private sector, and civil society – to tackle the hard work of strengthening these fundamentals. There's still work to be done.

I will end with that thought – a call to action for everyone in the room.