The Economic Outlook and Future Policy Directions

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Key points

- Atlanta Fed President and CEO Dennis Lockhart, in a December 5 speech at the Broward Workshop in Fort Lauderdale, Florida, reviews current economic conditions and the Fed's eventual winding down of quantitative easing.
- Lockhart says the economy has grown steadily, if slowly, since the recession ended four-and-a-half years ago, with annualized GDP growth averaging a little over 2 percent, 7 million new jobs, and low inflation.
- Lockhart's outlook for 2014 calls for some firming in economic activity, a gradual improvement in labor markets, and an inflation trend moving toward 2 percent.
- Lockhart expects that a decision to begin tapering asset purchases will be considered in the coming meetings of the FOMC.
- Lockhart feels that the financial markets have substantially internalized key points of the FOMC's direction with policy: the low-interest-rate environment will be maintained for some time, a reduction of asset purchases is not tightening, and the Fed can change the mix of policy tools while preserving an environment of continuing economic progress.
- Lockhart says he would support a transition process of winding down asset purchases that would provide as much certainty as possible about how it will be done.

Good morning and thank you for inviting me to speak to this prestigious group, the Broward Workshop. I'd like to take a moment to thank Tom Shea, a former director of our Miami Branch, and Al Dosal, who currently serves as a director. I would also like to acknowledge Mike Jackson, one of your members, who has been serving as chair of our Miami board.

Our directors serve principally as economic advisers and play a vital role in supplementing economic data with useful regional and sectoral information. Let me publicly thank them all for their service.

Today I plan to provide my take on the current state of the economy and the outlook for 2014. I will also share my personal views on the current stance of the Federal Reserve's monetary policy. More specifically, I'll comment on the alignment of market expectations with the conditional framework for tapering bond purchases that Chairman Bernanke laid out on behalf of the Federal Open Market Committee, or FOMC, in June.

The essence of the decision the Committee faces is whether to begin the process of winding down the use of an extraordinary monetary policy tool known to the public as quantitative easing, or QE. The current program has been operating since September 2012 and is the third episode of the use of this tool. The financial markets are exceedingly interested in the prospect of reducing, over the coming months, bond purchases that are currently running at $85 billion per month. These asset purchases are made up of a roughly equal mix of longer-term Treasury securities and agency mortgage-backed securities.

The expectation of a decision to start tapering has been a factor in the pricing of bonds across the maturity and issuer spectrum and, therefore, the market's determination of long-term interest rates. The prospects for sectors like housing and autos are highly influenced by interest rates. It's fair to say that the near-term actions of the Fed are a front-and-center concern of the financial community, business community, and the general public.

As a preface to my remarks today, it's important that I emphasize I'm speaking for myself, not for the Federal Reserve, and my views are not necessarily shared by my colleagues on the FOMC or others in the Federal Reserve System.

Review of progress and economic outlook

Let me start by attempting to define the context of upcoming policy deliberations. In the four and a half years since the recession ended, the country's economic conditions have improved a lot, yet are short of what you'd call victory.

The economy has grown steadily, if slowly. Annualized GDP growth has averaged a little over 2 percent over this period. The level of real economic activity is about 5 percent higher than the pre-recession peak. And with that expansion, the economy has netted more than 7 million new jobs. Inflation has been low—averaging 1.7 percent measured on an annual basis over the postrecession period.

A number of industries or industry sectors that contribute significantly to the overall economy have recovered a lot of ground. Improvement in the housing sector, for example, has been a positive factor, especially in the more recent stage of the recovery. Housing starts have almost doubled from their low point in 2009. The Case-Shiller house price index for the third quarter was up 11 percent from a year earlier and reached the highest level for the index since the third quarter of 2008. Other housing data tell a similar story of recovery. Existing home sales were up 13 percent last quarter from a year earlier and were at their highest level since early 2007. One of the concerns earlier this fall was the potential effect of higher long-term rates on the housing sector. Momentum in the housing sector has softened somewhat, but hasn't deteriorated markedly.

Still, as I said, the recovery has been slow, and the acceleration of growth that many economists—including Fed economists—predicted has not really materialized.

Positive developments that suggest the glass is half full are offset by areas of persistent weakness that bias some observers to the view that the economic glass is half empty.

To cite a couple of half-full/half-empty phenomena, unemployment has dropped from 10 percent to 7.3 percent today, but participation in the workforce has also fallen. And inflation, as I said, has remained low on average, but is actually too low to totally dismiss the concern that the economy is weaker than measured and vulnerable to a reversal.

We track a lot of data at the Atlanta Fed to consolidate a view of the trajectory of the economy. Recent evidence of forward momentum coming from the data has been mixed.

As a further example of mixed signals, let me relate a report on October construction spending received Monday of this week:

> Total construction spending…rose in October, well above the consensus expectation.
>
> Private residential construction spending declined in October following an increase in September. Private nonresidential construction fell...following a decline in September. And public construction spending rose in October.

You can't help but think "on the one hand" and then "on the other hand."

At a higher level, looking at the overall growth picture, the economy grew at a respectable annual rate of 2.8 percent in the third quarter, according to current estimates, which will be revised later this morning. That sounds like a pretty good number, but about one-third of that growth was greater inventory accumulation. The pace of spending (what economists call "final sales," which eliminates inventory swings) rose just a shade above 2 percent last quarter, virtually right on its trend for the last three-and-a-half years.

Changes in inventory investment are often followed by their opposite—in this case, the working off of inventories. As a consequence, growth this quarter is very likely to be only half that seen in the third quarter as those inventories are drawn down. Recent tracking estimates of fourth-quarter GDP growth are substantially below 2 percent.

In an economy as large, complex, and diversified as ours, the data are almost always going to be somewhat noisy. That said, it's my judgment that the recent incoming data are, on net, positive.

Tapering decision considerations

I expect that a decision to begin tapering asset purchases will be considered in the coming meetings of the FOMC. In my assessment, the trajectory of recovery—the outlook for the economy—justifies consideration of such a move.

My outlook for 2014 calls for some firming in economic activity. Along with that expectation for stronger output growth, I am expecting labor markets to continue their gradual improvement and inflation to move in the direction of the FOMC's 2 percent target.

My Atlanta Fed colleagues and I will be monitoring the incoming data and taking stock of information gathered from business contacts—our directors being prominent among them. In this process, I'll be looking for positive evidence of momentum as well as the absence or retreat of factors that could restrain or even torpedo progress.

Let me lay out my current thought process for coming to a decision to support or not support, as the case may be, tapering asset purchases.

I'm looking for continuing positive evidence that employment is growing at a sufficient pace to sustain a steady, if gradual, march toward the Fed's objective of full employment. Job growth came in at 204,000 in October. Over the last 12 months (October to October), monthly jobs gains have averaged 194,000. The rate of unemployment has fallen to 7.3 percent from 7.9 percent a year ago.

I'm also looking for evidence of important elements of growth—important components of GDP—acting as drivers. One such driver is the growth of consumer spending. I think there are reasons to be optimistic that consumer spending will strengthen. Real personal income growth has been firming.

Household balance sheets are improving—in part because of rising home values and the rise of the stock market. Credit delinquencies are now below their pre-crisis lows.

In the category of what I'm hoping will be absent or shrink, I'm expecting a fall-off of fiscal drag in the coming year. Cuts in government spending have taken more than half a percentage point off GDP growth over the past year. The net drag of a downsizing government sector is projected to lessen, but not entirely dissipate, in 2014.

I am also watching for any signs of disinflation. So, to turn that around, I'm looking for the absence of consistent disinflationary price trends. Inflation has, by a variety of measures, averaged about 1 percent over the past year, well under the FOMC's longer-term objective of 2 percent. Some of that shortfall has come from falling energy prices. But even if we look through the behavior of energy prices, inflation readings have been exceptionally soft. While I don't yet see convincing evidence that a disinflationary trend is under way, inflation trends bear careful watching.

Finally, my thought process includes a scan of the horizon for potential sources of economic shocks of the kind that could precipitate a reversal, shocks that could throw the economy completely off track. There are always risks, but over the past year, I believe many of the most worrisome sources of risk have retreated.

The risk of severe financial instability coming from Europe has been managed down.

We've gotten past the fiscal cliff, and in October, the serious consequences associated with a fiscal default were avoided. The same fiscal matters come to a head again in January, of course, so we can't yet breathe easy. There is still significant risk—that has to be acknowledged.

Some recessions in the past have been precipitated by sustained oil price spikes. The Middle East remains fairly unsettled, and there are a number of factors at play, but I think the risk of an oil or energy price shock affecting the United States is relatively low.

As I think through the various factors to take into account—the data evidence, the outlook, the balance of risks—I am pretty confident in the sustainability of the economy's progress. The recent flow of data is not pushing me off the outlook I espoused a few moments ago. Again, I am forecasting a firming in economic activity, a gradual improvement in labor markets, and an inflation trend moving in the direction of 2 percent.

I didn't have such confidence in the fall of 2012, when the current program of asset purchases began. At that time, employment growth was slowing, and we were seeing continued weakness in housing, household deleveraging, and a much higher degree of uncertainty about the fiscal and banking situation in Europe.

I also was not comfortable in September of this year with what appeared to be lagging job gains (they were later revised higher) and the fiscal negotiations coming in October.

And I agreed with the decision at the October FOMC meeting to wait a while longer given the uncertain effect of the fiscal drama on consumer and business confidence and the complications the shutdown caused in tracking the economy through vital data.

I now think it is appropriate in coming meetings to put a tapering decision on the table as long as the resulting overall posture of policy preserves a high degree of accommodation.

Key points in Committee communications

Even though communication of the Committee's direction with policy has been complicated and challenging over the last months, I think many in the financial markets have substantially internalized certain key points. They are:

- The low-interest-rate environment will be maintained for quite some time.
- A reduction of asset purchases is not intended to be tightening.
- And, the Fed can change the mix of tools we use to implement policy while preserving an environment supportive of continuing economic progress.

If market expectations are that the asset purchase program will wind down over the coming year, I think that is reasonable.

If and when the FOMC arrives at a decision to wind down asset purchases, it's my view that it will be helpful to the transition process to provide as much certainty as possible about how this will be done. The minutes of the October FOMC meeting noted that

> [S]ome participants mentioned that it might be preferable to…announce a total size of remaining purchases or a timetable for winding down the program. A calendar-based step-down…would be easier to communicate and might help the public separate the Committee's purchase program from its policy for the federal funds rate and the overall stance of policy.

I am among those who see merit in this approach as long as the economy follows roughly the path we expect. Once the decision is made, I favor providing the public as much clarity and certainty as possible about how the change will be executed.