

# The Economic Outlook and Forward Guidance

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## Key points

- Atlanta Fed President and CEO Dennis Lockhart, in a February 19 speech at Mercer University in Macon, Georgia, talks about the Federal Open Market Committee's (FOMC) monetary policy in relation to current economic conditions and the outlook for the year ahead.
- Lockhart's outlook for 2014 remains optimistic, and he expects the tapering of Fed asset purchases to be completely wound down by the fourth quarter.
- Despite improving conditions, substantial gaps exist between where the economy is and where it ought to be. The FOMC would like the ongoing rate of inflation to move closer to 2 percent.
- Also, labor market indicators show a qualitative weakness underlying the quantitative progress associated with the drop in the unemployment rate.
- Lockhart stresses that the basic stance of Fed policy will remain highly accommodative until well past the 6.5 percent unemployment rate threshold. In other words, the FOMC will not raise the federal funds rate for some time.
- Lockhart says that the FOMC's focus on "forward guidance" about the direction of rate policy reflects its increasing importance as a policy tool.
- The Atlanta Fed's official forecast expects the liftoff of the policy rate in the second half of 2015, and Lockhart remains comfortable with that forecast.

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## Introduction

I've been worrying about speaking in Macon for several weeks now. A few weeks ago, I was witness to a most amazing concert in Atlanta that involved musicians with Macon connections. Chuck Leavell was the organizer and lead performer of a night of rip-roaring southern rock that included Robert McDuffie, the superb concert violinist whose conservatory is here at Mercer University; Gregg Allman of the Allman Brothers; and the Atlanta Symphony Orchestra. One of the most-appreciated numbers was Chuck Leavell's rendition of "Low Down Dirty Dog." You should've been there. Since then, I've been worrying about my gig here—a central banker talking about the economy and monetary policy. Will you tell your friends "you should've been there"? Or, maybe, "you should've been there to hear that low down dirty dog from the Federal Reserve."

Well, the pressure's on, I guess. Here's my playlist for this afternoon: I plan to talk about the country's current economic situation and the outlook for 2014. I'll describe the positioning of the

Federal Open Market Committee's (FOMC's) current monetary policy in relation to the outlook. And I will spend quite a bit of my time discussing the FOMC's "forward guidance" about interest rate policy. My focus on forward guidance reflects its growing importance as a policy tool of the Fed. Indeed, we're now in a period in which effective communication between your central bank and the public, including participants in financial markets, presents heightened challenges for us policymakers. I'll elaborate on that point in my remarks.

As always, my comments are my personal views and may not reflect those of my colleagues in the Federal Reserve System or on the FOMC.

### **The economic situation and outlook**

Let me begin with my views on the current state of the economy and the outlook. The economy seemed to move to a higher growth track in the second half of 2013. As the data now stand (we do not yet have the final number for the fourth quarter), the economy expanded in the second half at an annual rate of 3.6 percent. This is the current estimate of real GDP (gross domestic product) growth—that is, growth net of inflation. That is about 1 ½ percentage points above the economy's average growth since the end of the recession.

Mixed incoming data on economic activity in December and January have raised concerns about whether the economy has traction at this faster growth pace. There appears to have been a slowdown. Weather effects may very well have dampened retail sales, auto sales, housing starts, manufacturing activity, and of course transportation, among others. Weather is also likely to affect the February unemployment report, which we'll receive on March 7.

As a result, the current quarter is difficult to read as an indication of the most likely story for the full year 2014 and first part of 2015. The recent mixed data could be just a temporary thing—as the weather explanation suggests—or something more fundamental going on. While I am tracking the numbers carefully, at the moment I think it's too early to draw a conclusion. Even though the first quarter this year may turn out to be soft, I am "looking through" the recent information to a full year of sustained higher growth. In that sense, my outlook remains optimistic for the full year. I expect real GDP growth to be between 2 ½ and 3 percent.

I remain hopeful for the full year because I think the fundamentals underpinning economic performance are notably improved compared to a year ago and earlier. Factors that earlier impeded consumer spending and business investment have relented. Uncertainty about fiscal arrangements controlled by Congress is reduced. Business and consumer confidence is higher. Risks of financial instability associated with problems in Europe have abated. The recent spell of emerging market turbulence has quieted, and U.S. equity markets seem to have firmed.

While conditions have improved, substantial gaps exist between where we are and where we want or ought to be economically. Inflation is currently running around 1 percent, depending on the measure used. The FOMC would like the ongoing rate of inflation to be closer to 2 percent. This is considered a healthier rate of inflation for the longer term. At 2 percent, there is less risk of slipping

into a cycle of economic contraction, and at the same time, price changes over time are not significant enough to distort the planning of households and businesses.

There is also a sizeable employment gap between today's 6.6 percent rate of unemployment and estimates of full employment. We rely on a quantitative measure of unemployment to convey both quantitative and qualitative dimensions of the country's work picture. The FOMC's most recent estimates of full employment, using the official unemployment rate as a gauge, range from 5.2 percent to 5.8 percent. In my view, that difference of about 1 percent between today's rate and the Committee's estimate of full employment may understate the distance still to be travelled.

Even with these caveats, my bottom line is that the economy is in a better place today than a year ago and before. I maintain that the outlook is positive and, in terms of its basics, much improved.

### **Policy stance today**

I'd like now to turn to an explanation of where the Fed's monetary policy stands. For all of last year, and since September 2012, the Fed pursued a program of large-scale asset purchases, or quantitative easing. Last December, the FOMC decided to reduce those purchases from \$85 billion per month to \$75 billion per month. In January, the Committee brought those purchases down by another \$10 billion per month. These decisions were based on the economic progress achieved since the recovery began in June 2009, an improvement in employment conditions, and, importantly, the positive outlook for continued progress.

As long as the outlook remains solid and does not deviate dramatically from the path we believe it's on, I would expect the tapering of asset purchases to continue over the balance of the year. I expect the asset purchase program to be completely wound down by the fourth quarter of this year.

In our public remarks over much of last year, my colleagues and I stressed a couple of very important messages. First, even with the phase-out of asset purchases, the basic stance of policy remains highly accommodative. To translate, the Committee intends to keep interest rates very low. The second message was that the QE program and the Fed's policy interest-rate target are two separate tools of policy. Consequently, we can wind down the asset purchases—a program that was meant to provide temporary, supplemental “oomph” to the low interest-rate policy—and preserve the accommodative positioning of policy appropriate for the reality of our economic situation.

The financial markets—particularly participants in the bond markets—seem to have heard these messages. In the aftermath of the tapering decision in early December, longer-term interest rates did not rise and have not risen since then to any great extent. I think the transition currently underway has gone pretty well, and communication with the public and markets on this aspect of policy was rather effective.

### **Guidance as lead policy tool**

That claim sets up my next topic—the role of forward guidance about interest-rate policy as an actual policy tool.

As most of you know, the FOMC sets a target for the federal funds rate. This is the rate at which banks with surplus reserves at the central bank lend to banks short of reserves on an overnight basis. This one interest rate—which the Fed can more or less control—serves as the foundation of the whole maturity spectrum of interest rates and interest yields that matter to Main Street America. In that sense, the Fed’s policy interest-rate decisions set the tone for broader financial conditions—tight or easy, as they say. And, importantly, participants in longer-term bond markets anticipate the future path of the Fed’s policy rate in determining the rates charged for car loans and home mortgages, for instance.

The federal funds rate target—the FOMC’s policy rate—has been set at effectively zero for more than five years. It would not be possible to push it lower even if economic conditions called for lower rates. Quantitative easing was a way to exert further downward pressure on rates in the absence of the ability, in practical terms, to set the policy rate below zero. These have been unusual times since 2008, requiring unusual measures.

Now that the program of asset purchases is being wound down—to repeat, appropriately, in my view—more of the work of maintaining an accommodative environment falls to Fed communication in general and forward rate guidance in particular.

To put emphasis on that point, let me quote from a speech last spring by Janet Yellen, the Fed’s new chair. She said, “[T]he Federal Reserve’s ability to influence economic conditions today depends crucially on its ability to shape expectations of the future, specifically by helping the public understand how it intends to conduct policy over time, and what the likely implications of those actions will be for economic conditions.”

Indeed, modern monetary policy is aimed at influencing economic outcomes through the “expectations channel.” Expectations drive decisions by consumers, households, businesses, and investors throughout the economy. These decisions, taken together, have a big influence on the trajectory of the economy.

So what we at the Fed say we intend to do as regards interest-rate policy should have a big impact on what happens. I would argue that under the current circumstances, forward guidance about the direction of rate policy is more than just added commentary; it is a policy tool itself. And for the period ahead—the next couple of years at least—forward guidance may be the lead policy tool, arguably the most potent method we have for influencing financial conditions and economic results.

Let me repeat that point using different words. Getting the economy we want depends increasingly on the ability of the public and participants in financial markets to hear, understand, and believe FOMC communication about the direction of monetary policy and the intended financial conditions tied to policy decisions.

### **The state of play of guidance**

Today, the central question that forward guidance addresses, and the predominant focus of financial market participants, is the timing of liftoff. Liftoff is code for the date of the first increase of the policy interest rate.

I'll lay out what the FOMC has said recently on this subject. A little over a year ago, in December 2012, the FOMC set an unemployment rate of 6.5 percent as a threshold for consideration of liftoff. The unemployment rate has been falling rapidly toward that 6.5 percent threshold, and today stands at 6.6 percent. Its decline has been faster than many expected, and the reasons have been more complicated than just unemployed people finding jobs.

Labor economists follow the intensity of "flows" underlying employment statistics such as unemployment and labor force participation. At any given time, there are flows of employed and unemployed people into and out of the labor force.

You may be aware that some of the decline in unemployment has coincided with falling labor force participation. About half of the fall in participation can be explained by demographic trends— that is, baby boomers choosing to retire. At the same time, a nontrivial portion of the decline seems to be associated with a rising share of prime-age workers who are not in the labor force. Some of these individuals are categorized as "marginally attached" to the workforce—they are available for work but have not actively looked for a job in the last month. They represent what you might call a shadow workforce of people not actually counted among the unemployed. A subset of the marginally attached population is classified as "discouraged workers." These people are not looking for a job because, for any number of reasons, they do not think there is work for them out there.

I should also mention the people who have a job—and so are officially employed—but are working part time and say they would like more hours.

All of these categories of underutilized labor resources—underutilized human capital, if you will—grew during the recession and have stayed elevated through the recovery. As a result, I often point to what might be called qualitative weakness underlying the quantitative progress associated with the drop in unemployment to 6.6 percent.

I would argue the official unemployment rate overstates progress to date. At the same time, the low readings of inflation are hard to square with stronger growth. I had these concerns in mind when I supported the FOMC's decision to adjust its guidance in December of last year. The Committee said it anticipates that the policy rate will remain at zero **well past** the 6.5 percent threshold. Further, in its official statement following the January FOMC meeting, the Committee said that the "highly accommodative stance of monetary policy will remain appropriate for a **considerable time** after the asset purchase program ends..."

There are two reasons for this guidance. One is the weakness in employment data that underlies the improving unemployment rate. The other is the weakness of inflation readings. I think that both

factors should be equally important considerations in determining how long to keep the policy rate at its current level.

**My current thinking on liftoff**

In my Reserve Bank's most recent official forecast, we predicted liftoff of the policy rate in the second half of 2015. I remain comfortable with that forecast.

Even with the intense interest in the date of liftoff, I expect that the work of forward guidance will not be finished just with the first increase of the fed funds rate. I expect communication and forward guidance to be especially demanding requirements for the FOMC, and for that matter other central banks, going forward.

To summarize my main points today, I see forward guidance on the Fed's policy rate as the lead monetary policy tool currently and for the foreseeable future. It is a challenge for policymakers.

The central policy question is the timing of liftoff.

The key criteria for a liftoff decision are a firming of inflation to near the FOMC's target of 2 percent and both a quantitative and qualitative closing of the employment gap.

So, that's the "lowdown" on monetary policy as I see it at this juncture. I don't know how to use the rest of the song's title. It would just get me in trouble. I'll now try to answer your questions.