

The Global Economy, the U.S. Economy, and the Federal Reserve's Monetary Policy

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Key points

- In Dubai on May 11, 2014, Atlanta Fed President Dennis Lockhart shares his views on the state of and outlook for the global and U.S. economies.
- Lockhart notes that the global economy has been gradually recovering with moderate rates of growth and low inflation, but also with significant resource slack in advanced economies.
- Lockhart's U.S. forecast calls for growth accelerating to an annualized rate of around 3 percent. He will be watching for a stronger rate of industrial production growth, improved demand for capital goods, and a step-up in consumer spending.
- Lockhart expects the Fed's asset purchase program to be completely phased out by later this year, and says economic conditions will justify beginning to raise interest rates in the latter half of 2015.
- Lockhart believes that changes in U.S. financial conditions affect interest rates and asset prices in other countries through various channels, but feels that overall emerging market vulnerability to external causes is considerably lower than it has been in the past.
- Lockhart notes risks to his outlook in terms of U.S. economic growth momentum, geopolitical events, and financial instability, but is not overly concerned that markets or institutions pose broad systemic risks at this time.

It's a pleasure to return to this part of the world. I'm on a bit of a nostalgia tour. I began my career 42 years ago in the Middle East and spent a total of seven years here. I have very fond memories of my experience in the region.

Today, I will offer my views on the state of and outlook for both the global economy and the U.S. economy, and will explain the current position of the Federal Reserve's monetary policy. And, given the weight of the U.S. economy and the importance of the dollar in global economic affairs, I will comment on how Fed policy affects the rest of the world, particularly emerging markets. I will also comment on the future risks and explain how financial stability concerns factor into my thinking on policy.

Please note that I am speaking only for myself. My views may not be shared by my colleagues in the Federal Reserve System. I am here at the invitation of the U.S. Department of Treasury and Department of State. However, I am not speaking for these arms of the U.S. government, and they, too, may not agree with the views I will express today.

Global economy

Let me start with a look at the global economy. The financial crisis of 2007 to 2008 affected the entire globe, and the ensuing recession in the United States was mirrored by weak or stagnant conditions in most of the advanced economies. Many of the major emerging-market economies performed relatively well in the years immediately following the recession—2009 to 2011—before slowing more recently. Overall, it's been a slow process of recovery for much of the world.

The slow recovery has been supported by very accommodative monetary policies in the United States, Europe, and Japan. Interest rates remain quite low. Said differently, the global cost of credit has remained unusually low. Monetary policy decisions are rarely coordinated among the major central banks today, but widespread weak economic conditions have dictated similar policies in the advanced countries, to be sure. Some aspects of monetary policy have been quite unconventional. I'm referring, of course, to the measures taken in the United States and Japan when short-term interest rates could not be pushed any lower. The world knows these policies as "quantitative easing."

I believe that highly accommodative monetary policies have met with some success. However, the advanced economies still face large shortfalls in economic performance, as evidenced by still unsatisfactory levels of underemployment. Inflation in advanced economies has firmed a little lately, but remains low and below the targeted run rates of many central banks. Persistent low inflation has raised concerns of tipping into deflationary conditions, but at a global level, this outcome has not materialized, in part due to the extraordinary policies of the world's central banks.

Recently, the circumstances of some emerging markets have become less settled. Some emerging markets have experienced capital outflows, triggered in part by the winding down of extraordinary policy accommodation in the United States. A number of countries have had spells of volatility in their financial and currency markets. There are persistent concerns about emerging-market fundamentals, especially in countries dealing with high inflation and wide current-account deficits.

To generalize, however, the global economy has been enjoying a gradual recovery with moderate rates of growth and low inflation, but also significant resource slack in advanced economies.

U.S. economy

The U.S. economy is my primary focus as a central banker, and the condition of the U.S. economy is very important in a global context, so let me spend a few minutes talking about how I see economic developments there. Since the middle of last year, the U.S. economy appears to have entered a higher growth path, although the preliminary data for the first quarter were much weaker than expected. After two quarters of growth above 3 percent (annualized), the quarter ended March 31 showed practically no growth at all.

The Bureau of Economic Analysis released an advance estimate of only 0.1 percent growth of real gross domestic product (GDP) for the first quarter of 2014.

Unusually harsh winter weather seems to have been a significant factor in the disappointing first-quarter growth. Businesspeople have noted, for example,

weather-related losses in production, retail sales, shipment time, workdays on construction sites, and visits to hotels and restaurants.

Statistically, the drop-off in real GDP growth in the first quarter mostly reflected downturns in exports and capital spending, a decline in private inventory investment, and slower government spending.

The softness of the first quarter naturally raises concerns that the economy has lost momentum. Many forecasters, including Federal Reserve forecasters, are treating the first quarter as a temporary phenomenon with few, if any, longer-term implications. To generalize, forecasters and businesspeople alike are expecting a rebound in the second quarter and beyond. Most observers of the U.S. economy are optimistic that real growth will snap back to a pace of around 3 percent per annum.

I share that outlook. My official forecast calls for growth accelerating starting this quarter to an annualized run rate around 3 percent. I expect stronger growth will help absorb underutilized resources in the economy, especially labor resources.

A week ago Friday, we got the latest employment report from the U.S. Bureau of Labor Statistics. The trend in payroll jobs creation was quite encouraging. Also, the official unemployment rate fell by a surprising four-tenths of a percent to 6.3 percent, but with the April number, the labor force participation rate fell again to almost a 30-year low. In simple terms, last month, the United States apparently added jobs but lost workers. So I am hesitant to take on board this decline in the unemployment rate as indisputable evidence of progress toward full employment.

As many of you know, the Federal Reserve, through the Federal Open Market Committee, or FOMC, conducts monetary policy with two primary objectives in mind. One objective is to support full utilization of labor resources, or full employment. The other objective is to maintain price stability, or low (but not dangerously low) inflation. The FOMC has chosen to define price stability in terms of a targeted rate of inflation of 2 percent over the longer term.

Consistent with my view that the economic growth rate will improve, I expect inflation to firm to a healthier rate over the medium term on a track to the FOMC's 2 percent target. There are some signs of firming in recent data.

However, it may not be clear for several months, or even quarters, whether the U.S. economy is undeniably on a stronger and sustained growth path around a run rate of 3 percent. To gauge the true extent of economic expansion, I will be watching for a stronger rate of industrial production growth, improved demand for capital goods, and a step-up in consumer spending.

U.S. monetary policy

Let me now take a few minutes to discuss the Federal Reserve's policy stance in light of the outlook I've laid out (which, I might add, is pretty mainstream among Federal Reserve and private forecasters).

As you know, the Fed is winding down its asset purchase program, commonly known as "quantitative easing," or QE. Starting last December, the Fed reduced its monthly purchases from \$85 billion a month to the current level of \$45 billion. I expect this program to be completely phased out by October or December this year.

In my view, this is a first step in the gradual normalization of monetary policy. Assuming continued recovery of the U.S. economy and the closing of employment and inflation gaps, the Fed's policy interest rate would begin to rise at some point next year.

For now, the policy rate remains near zero, and the FOMC has indicated through its published statements its intention to keep policy rates low for a while longer.

Based on my outlook, I think that conditions in the U.S. economy will justify beginning the process of raising rates in the latter half of 2015. Once rates begin to rise, I expect the process to normalization of interest rates to be gradual.

Effects of U.S. monetary policy worldwide

The world watches U.S. monetary policy closely, and global capital flows are influenced by expectations of Federal Reserve policy. Recent turbulence in certain

emerging markets led to substantial controversy over the effect of U.S. policy on the rest of the world.

Questions were raised about the wisdom and timing of the Fed's decision to start withdrawing the extraordinary support provided by quantitative easing and the decision to do so seemingly without regard to the effect on other countries.

I'll give you my perspective as one U.S. policymaker. Changes in U.S. financial conditions **do** affect interest rates and asset prices in other countries through various channels. U.S. central-bank policy influences capital flows and their effects, in turn, on the foreign exchange rate, equity markets and debt markets, both external and domestic.

As a result, some emerging economies may face pressures when U.S. monetary accommodation is reduced. They may have to make policy and business adjustments. This was the situation earlier this year, but since then conditions in most affected countries have stabilized or at least calmed.

Stepping back, my sense is that overall emerging market vulnerability to external causes is considerably lower than it has been in the past. Many emerging-market policymakers responded to the financial crises in Asia and Latin America in the late 1990s and early 2000s by moving to flexible currencies, building official reserves, and cutting their dependence on foreign currency borrowing.

The Fed has tried to be transparent about the direction of its monetary policy. In my view, we have communicated clearly our intention to wind down asset purchases and eventually begin to raise rates as the U.S. recovery advances and our policy objectives look more attainable. These contingencies should have been clear even before last summer when the subject of phasing out the asset purchase program was broached in a Fed press conference.

I believe it is in the world's interest that the U.S. economy strengthens and that the Federal Reserve pursues policies appropriate for, and supportive of, improving conditions. Also, with my expectation that the United States will experience better economic growth over the medium term, I believe the outlook for emerging economies is also improved.

Risks

I have presented a rather upbeat outlook for the U.S. economy. I have to acknowledge some risks to my outlook. Risks can express themselves in a number of ways, but at present I see the risks falling under three headings. First, as I said, it may be a while before we know if the intrinsic growth momentum of the U.S. economy is indeed as strong as I'm projecting.

Second, there is the risk of financial instability. In a highly integrated global financial system, events almost anywhere can have an impact on financial stability in the United States, here in the Middle East, and elsewhere. To take a U.S.-centric view, given how long a low-interest-rate environment has been in place, it's wise to keep a close watch on asset markets for signs of "irrational exuberance," a phrase coined by former Fed Chairman Alan Greenspan. I can assure you Fed policymakers are monitoring developments carefully. As one policymaker, I am not overly concerned that markets or institutions pose broad systemic risks at this time.

The third area of concern is geopolitical in nature. Tensions between Russia and the West over Ukraine have an economic dimension, both in the interplay between the parties and the potential for destabilization of markets and economies. Even in the absence of significant direct exposure (which is the case for the United States), I think there is risk that heightened conflict could produce volatility in global financial and commodity markets that, if prolonged, could spill over to the U.S. and global economies. The recent lessening of tensions is a welcome development.

Conclusion

In my comments today, I've tried to provide a summary perspective on the economic circumstances of the day that I think affect us all. I learned early in my career that geographic location influences a person's perspective—where you sit often determines where you stand. I'm pretty certain the world looks somewhat different to you from here, and that what you think is important may not have been covered in my remarks. So, I welcome now your comments and questions.