Thoughts on Liftoff

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Key points

- Atlanta Fed President and CEO Dennis Lockhart, in a July 11 speech in Jackson Hole, Wyoming, discusses the timing of liftoff, or the raising of the federal funds rate.
- Lockhart ties a liftoff decision to the economy's proximity to achieving the FOMC's two monetary policy objectives, price stability and maximum employment.
- Lockhart says inflation has been running below 2 percent, the FOMC's target rate, for quite a while, but very recently inflation numbers have been firming.
- Lockhart believes the recent firming of price data removes some downside risk, but we should be seeing other indicators of the absorption of economic slack, especially wage growth.
- Lockhart feels a number of troubling employment phenomena have been at work, including the drop in prime-age participation in the labor force and the number of people working part-time for economic reasons.
- Lockhart cites two risk considerations. He feels we have to contemplate the risk of a prolonged overshoot of 2 percent inflation and is also looking at financial system stability as a potential risk. But he is not overly concerned.
- With all factors considered, Lockhart maintains the view that economic conditions that would justify a liftoff decision will arrive in the second half of next year.

Introduction

I plan to focus my prepared remarks before the conversation with John Silvia and my colleague, Charlie Evans, on the question that is increasingly commanding the attention of Fed watchers, financial markets, and Fed policymakers. In its most succinct form that question is, "When is liftoff?" I will share how I, as one policymaker, am approaching that policy question.

As always, I must emphasize that I'm presenting my individual views. My colleagues on the Federal Open Market Committee (FOMC) and in the Federal Reserve System may not see things the same way.

Current stance of policy

A useful place to start, I think, is a quick review of the current stance of monetary policy here at the beginning of the third quarter.

Completion of the tapering of asset purchases—which began last December—is now virtually a foregone conclusion. The minutes of the June FOMC meeting indicate the asset purchase program will end in October, leaving just ongoing reinvestment of maturing securities.

The majority of FOMC participants through their individual quarterly projections have indicated that the first move to raise short-term interest rates will likely come in 2015 or 2016. Opinions vary among FOMC participants on whether the first policy action ought to come earlier or later. Chair Yellen—speaking for the Committee, in my view—has emphasized that the timing of the decision will depend on the evolution of the economy over coming quarters and will, therefore, be substantially data-driven.

Finally, the Committee has stated that once a tightening process begins, it is likely to proceed at a gradual pace.

That's where policy stands at the moment.

So the question Charlie Evans and I are confronted with as policymakers is under what circumstances will it be appropriate to start raising the policy rate (the federal funds rate)?

A framework for contemplating liftoff

Let me lay out my current framework for thinking about that question.

First, I tie a liftoff decision to achievement of the FOMC's two monetary policy objectives—price stability and maximum employment. This is not to say the Committee must or should wait until those objectives have been fully and unarguably achieved. Rather, I think we will be in the zone of liftoff decision making when the outlook for accomplishment of the two objectives suggests they are in sight. By "in sight" I mean that given the trajectory of the economy, they are highly likely to be achieved in a reasonable timeframe. You might call this a "whites of their eyes" approach to pulling the trigger on raising rates.

Determining that the economy is near achieving price stability and full employment is not entirely straightforward. I'll explain why.

The FOMC has defined price stability as a 2 percent rate of inflation over the long run as gauged by the overall (or headline) price index of personal consumption expenditures (PCE).

I define price stability operationally to be, therefore, at or near 2 percent on a sustained basis. Speaking for myself, I can tolerate some deviation above or below the 2 percent target providing inflation does not drift too far away from target for too long.

Reading the true course of inflation can be challenging because of normal month-to-month, quarter-to-quarter fluctuations in the data as well as occasional shocks that cause episodes of transient changes in the numbers.

Inflation has been running below 2 percent for quite a while, a fact that has not gone unnoticed by the FOMC in devising its policy stance. Very recently the PCE inflation numbers have been firming along with other measures of price trends. Over the first five months of the year, the year-over-year inflation rate according to the PCE index has risen from 1.2 percent to 1.8 percent. The three-month inflation rate, which is presented as an annualized rate, of course, rose from 1.4 percent in January to 2.5 percent in May.

The higher recent inflation numbers are welcome, in my view, and I do not see this development as cause for alarm. At the same time, I don't feel enough evidence has arrived to be sure price stability is here or near. Inflation does not typically come forth in isolation. We should be seeing other indicators of the absorption of economic slack. We should see accompanying wage growth especially. So far, such affirmation of the sustainability of recent firming has been meager. The recent firming of price data removes some downside risk, in my opinion. But a test of time hasn't been met.

It's a challenge also to arrive at an agreed-on definition of maximum employment.

The conventional approach is to define maximum employment in terms of the Bureau of Labor Statistics' official unemployment rate (U-3 on their scale). Today, U-3 is at 6.1 percent. My working estimate for full employment on this basis is, say, 5 ¼ percent.

But a number of troubling employment phenomena have been at work that make me less confident in the exclusive use of the unemployment rate. Two such phenomena are the drop in prime-age participation in the labor force and the rise during the recession and subsequent slow reduction over the course of the recovery of people working *part-time for economic reasons* (PTER).

In current circumstances, a single measure of employment or unemployment does not provide a complete enough picture of what I care about in labor markets. I care about the full utilization, both quantitatively and qualitatively, of available labor resources.

My assessment is that the gap to be closed on the employment objective is bigger than estimated by a simple comparison of today's U-3 unemployment rate and a projection of the equivalent unemployment rate at full employment.

That said, the report that came out on July 3 was certainly encouraging. As you know, the payroll survey showed the addition of 288,000 jobs and the unemployment rate fell to 6.1 percent. The trends and momentum are undeniably positive. We've seen four months in a row of quite healthy jobs reports, suggesting more is going on than just a rebound from the weather-affected first quarter. My caution in declaring that I see the whites of full employment's eyes is closely linked to the still-elevated level of involuntary part-time employment. That measure of labor utilization has been stubborn when compared to the decline of headline unemployment. The number of people working part-time for economic reasons increased in June. This series has been declining over the year, but over the last few months, it has toggled back and forth.

Also, as mentioned earlier, we have been seeing very little upward wage pressure, and this tells me there remains considerable actual slack in employment markets. I want to emphasize the important role of wage pressures as evidence that the employment gap is in fact closing and, for that matter, that the inflation numbers are for real. Slow wage growth seems to be connected to the PTER story. Studies have identified an empirical connection between slow wage growth and the elevated level of part-time employment.

To cut to *my* bottom line, the FOMC is still somewhat short of the point where achievement of the two objectives is confidently "in sight," in my opinion.

Importantly, the two objectives remain complementary. The same basic policy posture can promote accomplishment of both objectives, in my view. At the moment, there is little or no tradeoff between the two objectives. That could change, but that's how I see the situation for the foreseeable future.

Risk considerations

There is another aspect of my framework for thinking about the circumstances that should accompany a decision to begin raising rates. I am also considering the risk picture.

Specifically, there are two risk concerns on my screen.

First, given that the Committee is seeking to approach a 2 percent run rate of inflation from *below*, I think we have to contemplate the risk of a prolonged overshoot of 2 percent.

I don't believe the recent broad-based uptick of inflation measures necessarily portends that inflation is going to get out of hand. Inflation expectations remain well-anchored. There is no sign that price makers, or the general public, anticipate a break with the experience of price stability the country has enjoyed for more than two decades.

I am also monitoring the risk situation as regards financial system stability. With equity indexes at or near historic highs, financial market volatility very low, and evidence of "reach for yield" behavior, concern about financial system and market instability has been building. In the thinking of some observers, the potential for a rash of damaging financial system instability can be associated with a continued low-rate environment.

Again, while remaining watchful, I'm not overly concerned that financial market conditions today map to *systemic* risk concerns with high potential for *spillover* to the real economy, the Main Street economy, if you will. My emphasis on "systemic" and "spillover" is intentional. I see a difference between some degree of fragility in financial markets due to investors widely carrying "risk-on" positions and the realistic chances of a broad, systemic meltdown that engulfs the broad economy. I think the latter should be the Fed's and FOMC's greater concern.

Conclusion

A policy position always involves a tradeoff of real or potential costs versus benefits. In my view, the potential and achievable benefits of sustaining very accommodative monetary stimulus, based on a policy rate in its current range of 0 to 25 basis points, beyond year-end 2014 and into next year continue to outweigh the possible costs.

My outlook for the economy in the coming quarters underpins my judgment on the cost/benefit tradeoff of current policy. The key element of my outlook is a run rate of GDP growth at or better than 3 percent through the next several quarters.

I am focusing on the *run rate* as opposed to a projected full-year 2014 GDP growth rate because the weak first quarter will push down the full-year arithmetic. I think the run rate from the second quarter onward is more relevant to policy decisions ahead. On balance, recent data have supported a 3 percent GDP growth run rate assumption.

I am still prepared to believe that the first-quarter contraction was an anomaly attributable substantially to weather, an inventory adjustment, health care spending, and exports. However, if there were temporary or unusual factors at work depressing the first quarter, then it is reasonable to expect that the lifting of those factors provided a bump in the numbers in the second quarter that may also have been transitory.

There is quite a divergence between what we thought was happening in the first quarter based on tracking estimates, for example, during the quarter and the ultimate verdict on first-quarter growth (contraction). Tracking the economy in real time is very hard. The Bureau of Economic Analysis first told us first-quarter growth was 0.1 percent. This first estimate of first-quarter growth was almost three percentage points off their most recent and final reading. My point is it will likely be hard to confirm a shift to a persistent above-trend pace of GDP growth even if the second-quarter numbers look relatively good.

This experience suggests to me that we can misread the vital signs of the economy in real time. Notwithstanding the mostly positive and encouraging character of recent data, we policymakers need to be circumspect when tempted to drop the gavel and declare the case closed. In the current situation, I feel it's advisable to accrue evidence and gain perspective. It will take some time to validate an outlook that assumes above-trend growth and associated solid gains in employment and price stability. I'm sticking to the view that conditions that would justify a liftoff decision will arrive in the second half of next year.