

## More than a Few Good Data

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### Key points

- Atlanta Fed President and CEO Dennis Lockhart, in a December 8 speech to the Council for Quality Growth in Atlanta, shares his thoughts on current economic conditions and appropriate timing of a decision by the Federal Open Market Committee (FOMC) to begin raising interest rates.
- Lockhart emphasizes that the FOMC decision to begin raising the Fed's policy rate, which has been set at effectively zero since December 2008, will be data-driven.
- Lockhart: There has been broad-based evidence of steadily improving employment conditions, with net payroll jobs being added at a monthly rate averaging 241,000 jobs so far this year.
- Lockhart says that the current U.S. inflation picture is not so encouraging. Inflation for the past two-and-a-half years has been stuck below the 2 percent target.
- Lockhart foresees sustained GDP growth at an annualized rate around 3 percent and the jobless rate falling to between 5¼ percent and 5½ percent by year-end 2015 amid firming inflation measures.
- Lockhart cautions that challenging conditions in Japan and Europe present potential spillover risks to the U.S. economy.
- Current momentum in the U.S. economy, says Lockhart, makes interest rate liftoff likely in mid-year 2015 or later.

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One of my favorite movies is *A Few Good Men* starring Jack Nicholson and Tom Cruise. I've seen it five or six times. It's about the murder of a Marine private

down at Guantanamo Bay Naval Base and the trial of two young Marines who thought they were roughing up a slacker under orders.

At bottom, it's about a narrative that does not hold up and hang together.

The Tom Cruise character, Lieutenant Daniel Kaffee, a Navy JAG officer who has been assigned to defend the two Marines, puts the Jack Nicholson character—Colonel Nathan Jessup—on the stand. Colonel Jessup is a hardened Marine commander of Gitmo. He can barely contain his resentment of the young Navy lawyer and his disgust at being called to testify.

The scene builds to a climax when Lieutenant Kaffee confronts Colonel Jessup:

*Private Santiago was begging for a transfer. But when he finally got it, how many people did he call? Not one call to his parents or a friend saying he was coming. He was asleep at midnight and you say he had a flight out in six hours. Yet everything he owned was in his closet or his foot locker. Santiago was leaving for the rest of his life and he hadn't called a soul or packed a thing. Can you explain that?*

Today I'm going to review with you another narrative and ask the questions: Is it holding up? Does it hang together? I'm going to present my narrative of the path of the country's economy. This is the basic narrative on which I'm basing my thinking on the appropriate timing of a decision by the Federal Open Market Committee (FOMC) to begin raising interest rates.

Considering that the Fed's policy rate has been set at effectively zero since December 2008, the decision, when it comes, will be historic. As you might expect, my colleagues and I feel a great responsibility to get it right.

As members of the development community, I know you are quite interested in when and how this decision will be made. I know your business interests are highly attuned to the evolving interest-rate environment, the capitalization rates associated with the cost of money, and general demand conditions in the economy.

Since we are nearing year-end and will soon enter what could very well be a transitional year in terms of monetary policy, this is a good time to review the economic story line of 2014 as prologue to laying out the outlook for 2015.

As I do all this, please keep in mind that I'm presenting my personal views. My colleagues on the FOMC and in the Federal Reserve System may not agree.

### **Devising a narrative**

Before I get to a summary of 2014 and my outlook for 2015, let me explain how my staff at the Atlanta Fed and I do our work of economic forecasting and then fitting my policy positions to the state of the economy. We construct a narrative of the path of the economy and the risks, both downside and upside, to that narrative. We continuously assess the validity of our narrative in light of incoming data. If the data are, on balance, consistent with our basic narrative, we stick with it. But when enough evidence has accumulated to seriously challenge the key assumptions in our narrative, we change our assumptions and adjust our narrative.

*Colonel Jessup: "You want answers?"*

*Lieutenant Kaffee: "I think I'm entitled to them."*

*Colonel Jessup: "You want answers?"*

*Lieutenant Kaffee: "I want the truth!"*

*Colonel Jessup: "You can't handle the truth!"*

Great scene!

In economics, absolute truth is elusive, but here's what I'm thinking. Here's my economic narrative: For about a year now, I've put forth the view that the economy has shifted to a higher growth gear compared to the sluggish pace of growth over the first four years of recovery from recession. From the summer of 2009, when the recovery began, to mid-year 2013, growth averaged 2.2 percent. It has been my belief that, starting mid-year 2013, the pace of growth accelerated

to around 3 percent, and that this growth rate will be sustained at least through 2015.

If that story holds up, the economy should continue to make substantial progress in terms of the two statutory objectives that make up the FOMC's dual mandate. Those objectives are maximum employment and low and stable inflation.

Let's take a closer look at how 2014 has unfolded. I should mention that given the lag in receiving data and the likelihood of revisions, it will be well into 2015 before we can close the book on 2014. But based on what we know now, full-year 2014 GDP growth should come in a little above 2 percent.

On the face of it, that number seems at odds with my 3 percent growth narrative. But when the tale of 2014 is told, I think it will be about one crazy, anomalous quarter and three quarters of solid growth.

The first quarter of this year actually saw contraction of the economy approaching 2 percent. You will remember that much of that weakness was explained by unusual weather. My staff and I believed at the time, and with benefit of perspective we still hold, that the weak first quarter was a one-off event, not indicative of a trend. The strength of GDP growth in the second and third quarters seems to vindicate this view. With more than 4 percent annualized GDP growth in the second quarter and 3.9 percent growth estimated for the third quarter, our narrative seems to have remained intact.

We are well into the fourth quarter now, of course, and we expect this quarter to show a slowing of growth compared to the third. Our most recent estimate points to 2.1 percent annualized growth in the fourth quarter. We are prepared to interpret this slower growth as normal and predictable quarter-to-quarter fluctuations, not the start of a more persistent slowdown. We think the growth rate in the second half will come in at about 3 percent, the run rate that anchors our basic narrative of the path of the economy.

Policy decisions are guided by the outlook for achievement of the two objectives in the FOMC's dual mandate. So employment conditions and measures of inflation and inflation expectations are *vital signs* we monitor closely. To date in

2014, there has been ample and broad-based evidence of steady improvement of employment conditions. I'm sure you are aware of Friday's jobs number—321,000 for November. Net payroll jobs have been added at a monthly rate averaging 241,000 over the past 11 months. The conventional measure of unemployment has fallen from 6.7 percent at the end of last year to 5.8 percent in its last calculation (November). I don't think we're yet able to claim ultimate employment victory, but there is no question that substantial progress has been achieved and momentum looks to be pretty solid. The employment vital signs are very encouraging.

The inflation picture is not as encouraging. In January 2012, the FOMC set an inflation target of 2 percent over the long run as measured by the overall index of personal consumption expenditures. For much of the past two-and-a-half years, inflation has been stuck well below that 2 percent target. We've seen little evidence of upward price pressures across the economy, and very few of our business contacts claim much pricing power. Behind this soft inflation picture lies a very modest pace of growth of consumer spending.

I have to say that simultaneous readings of robust job creation accompanied by falling unemployment and weak inflation are somewhat puzzling. The story doesn't hang together perfectly. Normally, we would expect a 3 percent run rate of GDP growth—a rate that is above what we believe to be the longer-run trend rate of growth of the American economy—to be accompanied by both improving employment conditions *and* firming prices. But that is not what we're currently seeing.

It's possible we may be reading too much into measures of improvement in the labor market. Or we may be overestimating the underlying strength and momentum of the economy.

*Colonel Jessup to Lieutenant Kaffee: "Are we clear?"*

*Lieutenant Kaffee: "Yes, sir."*

*Colonel Jessup: "Are we clear?"*

*Lieutenant Kaffee: "Crystal."*

The data are not presenting a picture that is crystal clear. There's some ambiguity.

### **Outlook and the normalization decision**

For now, I'm prepared to treat the conundrum of strong job creation and soft price pressures as suggesting some risk around my baseline outlook for 2015. I'm holding to an outlook of continuing growth around 3 percent. I'm expecting payroll job creation to continue at a rate of more than 200,000 a month. I'm expecting broad measures of unemployment to continue lower. I'm expecting the rate of unemployment, using the familiar headline unemployment rate published by the Bureau of Labor Statistics, to fall between 5¼ percent and 5½ percent by the end of next year. And I'm expecting measures of inflation to firm up over the coming year.

Wage gains may be a telling signal that the economy remains on this basic course, a course that may justify raising interest rates. Broad-based rising labor compensation will tell us we're nearing effective full employment. And some amount of higher unit labor cost to employers should pass through to prices.

In the four years before the recession, measures of labor compensation growth were running between 3½ and 4 percent. This was consistent with inflation tracking at close to 2 percent a year and labor productivity growth between 1½ and 2 percent a year.

For much of the recovery—that is, since 2009—wage and compensation growth has been stuck at around 2 percent a year.

Back to my comment that we may be reading too much into the falling unemployment rate—my staff and I think this soft wage pressure mostly reflects the still considerable amount of *underutilized* labor resources in the economy. Our empirical work suggests that some amount of downward pressure stunting wage growth is coming from the large supply of people willing to take part-time jobs when they want full-time jobs. We believe there is more slack in the labor market than indicated simply by the share of the labor force that is currently out of work.

Even so, labor market conditions, as reflected in wages, are unquestionably strengthening. Some measures of wage growth have accelerated a bit recently. The Employment Cost Index grew at an annualized 3 percent in the third quarter. Average hourly wage growth showed encouraging strength in November. And the number of involuntary part-time workers continues to gradually decline.

Among the payoffs from fuller utilization of labor resources, accompanied by moderately higher growth of wages, should be a boost to aggregate spending. Growth of consumer spending is a key ingredient of my outlook of sustained GDP growth around 3 percent.

### **Risks to the outlook**

I've presented what is, on balance, a positive outlook acknowledging real momentum going into 2015. But there are always risks.

*Colonel Jessup: I eat breakfast 300 yards from 4,000 Cubans who are trained to kill me.*

In our narrative building and validation, we identify risks, but we do not necessarily factor them into our baseline scenario.

One risk to our baseline scenario is weakness abroad—particularly in Europe and Japan. Japan is technically in recession, according to the latest estimate of its third quarter. Both Europe and Japan are fighting to ward off the threat of deflation. Also, China's economy appears to be slowing. In general, the external environment seems somewhat precarious, which raises concerns of spillover to our economy and financial markets.

As regards domestic risk to the outlook, I've already explained that the fourth quarter may prove to be slower than the third. I don't see this as signaling the onset of a slowdown. The momentum I perceive in the economy gives me confidence that the Federal Open Market Committee can consider beginning to normalize interest rates in 2015. My publicly stated projection of liftoff is mid-year or later.

It will be a Committee decision, of course. And the Committee has been clear that a decision to begin normalization will be data-dependent. It will depend on how the economy performs, how the numbers come in, and, importantly, on what the pattern of those numbers suggests as a continuing outlook.

### **Concluding points**

If I as a policymaker intend to stay true to data-dependency in making a decision to begin raising rates, I have to bear in mind what I will know and when I will know it in 2015.

Given the lag in receiving data, the inevitable revisions to the data, and the predictable month-to-month variability of the data, I think it will be a few months before we can be sure the essential trends are solid and the economy is ready for a momentous shift of policy.

It's natural for us policymakers, business leaders like you, and the public in general to be eager to get to policy normalization. Who does not want things to move closer to a long-run normal? But I think the FOMC must do its best to avoid having to reverse course because, as it could turn out, we moved too early.

Other central banks have seen this happen. The European Central Bank and the central banks of Sweden, Norway, Australia, and Japan have raised rates only to lower them when their forecasts didn't materialize.

There would be real costs associated with an irresolute path of policy. Suffice it to say, reversing a start to interest-rate normalization, and subsequently having to go back to the quantitative easing well, would erode Fed credibility and confidence in the economy for the longer term.

*Colonel Jessup to the judge: "I don't know what the hell kind of unit you're running here."*

I'm sure my colleagues, especially Janet Yellen, would *not* like to hear something like that.

Let me wrap up. The balance of current economic evidence is encouraging and supports an optimistic outlook. That said, knowing what I know today, I think

patience regarding timing liftoff and a cautious bias regarding the subsequent pace of rate moves is a sensible approach to policy. I don't see the risks of a patient approach as excessive.

I've presented here today a working narrative of the performance of the economy in recent and coming quarters. In its basics, it foresees sustained GDP growth at an annualized rate around 3 percent, continued absorption of underutilized labor resources, and gradual movement toward the 2 percent inflation objective. If it continues to hold up, and I think it will, 2015 looks to be a year of policy transition.

*Colonel Jessup: "You want me on that wall. You need me on that wall."*

I mean nothing by ending with that quote. I just love the quote.