

An Economic Narrative

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The Federal Reserve Bank of Atlanta has a travel and tourism advisory council involving executives from tourism bureaus, the hospitality industry, and theme park operators. Tourism is an important industry across the Southeast, especially in Florida, as you might expect. I met with our advisory council on September 30. I learned that the tourism sector is strong. I also learned that there are experiments under way to marry actual roller coaster rides with virtual reality, sometimes called augmented reality. The idea is the rider will strap on a headset that will add to and vary the ordinary thrills of the ride. Two people on the same ride can see different things.

I looked up the names of the top 10 roller coasters in the world. They have names like Escape from Krypton, Tower of Terror, Dragon Challenge-Chinese Fireball, and Thunder Dolphin.

Where am I going with all this? Nowhere in particular, other than to draw a light metaphor for the experience of the last few weeks in global markets, in U.S. economic data, and in Fed watchers' reaction to these developments.

Consider the odds-making on the timing of liftoff (of the policy rate by the Federal Open Market Committee, or FOMC). The statement that followed the September 16–17 FOMC meeting was interpreted by some as dovish as regards the timing of liftoff. That statement acknowledged global market volatility as a consideration in the decision to keep the federal funds rate near zero. The statement read, "Recent global economic and financial developments may restrain economic activity somewhat and are likely to put further downward pressure on inflation in the near term." Subsequent commentary of FOMC participants was interpreted

by some as firming up expectations of a decision to begin normalization at either the October or December FOMC meeting. Last Friday, we received a jobs report that was interpreted by some as lowering the odds of liftoff in October or December. The last few weeks have provided a bit of a roller coaster ride.

I've been experiencing this ride from the vantage point of a member of the FOMC, one who participates in deliberations on the questions that provided the humps and dips of the last month or so. Today I will offer my views on how to assess current economic reality based on recently arriving data. I'll suggest that recent information on the economy gives rise to some ambiguity. I'll attempt to put current economic signals in perspective as an aid to dealing with that ambiguity.

I must emphasize, as I always do, that my remarks this morning will reflect personal views. I am not speaking for the Federal Reserve or the Federal Open Market Committee. I'm sure I have colleagues who will disagree with my views.

Recent incoming data

I'll start with a summary of what the data are telling me and my staff about the state and momentum of the economy. Overall, I interpret the data to indicate that the domestic economy continues to expand at a moderate pace, though this domestic expansion is occurring amid a backdrop of global weakness and elevated market volatility.

This conclusion requires looking through quarter-to-quarter swings. The Atlanta Fed publishes a tracking estimate of quarterly gross domestic product, or GDP, growth. Some of you may be familiar with our GDPNow tracker. Our estimate for the third quarter currently has real GDP coming in at a relatively soft 1.1 percent. This follows a strong 3.9 percent official reading in the second quarter.

Much of the weakness we at the Atlanta Fed gauge in third-quarter output is associated with an inventory drawdown. We have inventory effects subtracting 2 percentage points from third-quarter growth.

A second and related area of weakness in our growth estimate this quarter is net exports. We got a trade report earlier this week. That report revealed a

substantial widening of the trade deficit. With the arrival of the net exports number, our tracker computed a subtraction from the rate of growth of nearly three-quarters of a percentage point.

Not surprisingly, the manufacturing sector appears to have been impacted by the strength in the dollar and global headwinds. Manufacturing production has decreased in three of the past four months. The Institute for Supply Management's (ISM) manufacturing purchasing managers' index, or PMI, has dropped markedly, hovering just above what the ISM would call expansionary territory.

Exports and inventories were evidently a drag on recent growth. There is a way to look through inventory swings. Real final sales—a GDP measure that nets out inventory movements—is estimated to have expanded at a rather robust 3.1 percent annual growth rate in the third quarter. This estimate suggests that demand growth is even a bit firmer than the average over the last four quarters.

A lot of the final sales momentum can be attributed to the consumer. Growth in real consumption spending appears to have shifted into a higher gear over the past year or so, even as consumer sentiment has declined modestly. Consumption growth should continue given relatively solid income growth numbers.

Turning to employment, September's payroll report was certainly disappointing relative to expectations. In the third quarter, payroll job gains have averaged 167,000 per month. While this is a step down from the brisker pace of job growth we'd enjoyed over the first half of the year, it is still more than enough to accommodate the trend growth in the labor force.

As a result, measures of labor underutilization continued to move lower in the third quarter. The headline unemployment rate is now close to my assessment of its normal level over the longer run. Nonetheless, broader labor utilization measures that factor in the marginally attached and those persons involuntarily working part-time are still a bit elevated. This suggests that there is still some slack remaining in labor markets. I believe this remaining slack may at least partially explain why growth in average hourly earnings has been hovering around

a subdued 2 percent trend. Broadly speaking, employers have not yet needed to increase wages at a faster clip to attract and retain employees. However, our business contacts in the Southeast report wage and salary pressures in selected categories and geographies.

Finally, the headline inflation run rate is currently close to zero. This is far below the FOMC's objective of 2 percent over the longer run. I accept the view that incoming inflation data reflect the transitory influences of falling energy and commodity prices as well as an appreciated dollar. Stripping out energy prices has inflation running at around 1.3 percent.

My narrative of the economy

For the last several months, I have put forward a narrative of the economy that can be summarized as follows: moderate—above-trend—growth, continuing solid jobs gains, inflation running below target in the near term, but yielding in the medium term to accelerating price pressures once transitory factors have subsided. I think my narrative has held up pretty well in spite of differences in monthly and quarterly performance. As a policymaker, the question I have to confront at this juncture is whether the recently arriving data suggest a materially altered outlook. Should recent information cause me to change my working narrative?

A month ago, prior to the September FOMC meeting, I foresaw solid continuing growth with steady employment gains. The soft August jobs report could have easily been an anomalous reading given the volatility in the data. I continued to feel that the soft inflation data could be explained by transitory factors. And I was prepared to dismiss an inflation picture that lacked clear evidence of progress toward target. I believed, and still believe, the inflation data will show in due course the desired upward trend toward target.

I responded to incoming data at the time by reducing my longer-term projection for growth a little. I accelerated my forecast of achieving U-3 full employment, and kept the date of reaching the 2 percent inflation target at 2017. The basic

narrative I had in mind remained unchanged, and that is still the case. I maintain that the broad economy continues to move ahead at a satisfactory pace. Anecdotal feedback from business contacts in my district supports this view. And as I said, the third-quarter story is centered in inventories. We don't have anything to suggest this is a signal of some deep underlying problem. The data point *real final sales* continues to indicate healthy growth.

Nonetheless, while I have not changed my basic outlook, very recent data have not provided much confirmation that my narrative still holds. I perceive a touch more downside risk today than I saw some weeks ago.

Upcoming data

My staff and I are always paying attention to incoming data, but the ambiguity of the moment reinforces the need to closely watch the vital signs of the economy over the coming weeks to determine if the outlook has changed.

To my mind, it's useful to review the upcoming data calendar to consider what the Committee will have as available information at each of the next two meetings.

For the October FOMC meeting, we will have last Friday's employment situation report, the already-in-hand final estimate of second-quarter GDP growth, and August PCE (or personal consumption expenditures) inflation data. We will also have some new numbers. We'll have September retail sales, industrial production, producer prices, and consumer prices.

Naturally, we will have more information in preparation for the December FOMC meeting. By early December, we will have the October and November employment numbers, along with revisions for prior months. We will also have the September and October PCE inflation data and both the first and second estimates of third-quarter GDP.

As I anticipate the signal value of incoming information over the next couple of weeks to the October meeting and the nine weeks to the December meeting, I think consumer data are likely to be the most telling. The consumer-based

dimension of the economy has been robust for several months. By watching and analyzing the consumer numbers carefully, I hope to avoid the trap of letting one or two months' specific data overly influence my outlook for the economy overall.

The longer view

When weighing a big decision like liftoff in circumstances like those we face at this juncture, it's also useful, in my view, to step back and consider the longer, cumulative picture.

Since the economy bottomed out in the second quarter of 2009, real economic output is up about 14 percent. Although the pace of growth has been slower than we might have hoped, the economy in aggregate is approaching current potential. That is to say, the output gap has closed substantially, and with that has come levels of unemployment and underemployment that are way down from their peak levels in the tail of the recession. The employment situation is nearing levels that many economists associate with full employment. So we have come a long way in the almost seven years since the federal funds rate reached the zero bound and the six-and-a-half-years since the economy hit bottom.

I continue to feel that cumulative progress is consistent with liftoff relatively soon. In weighing the timing of a liftoff decision, I'm trying to keep the endgame in focus. For me, the endgame is to begin and sustain an orderly process of normalization when the time is right and when the balance of risks gives us confidence we will not be forced to reverse course. It's also vital, in my view, to keep attention mostly on the real side—the Main Street economy. Financial market gyrations should be influential in a decision only to the extent they could plausibly affect real activity through pretty clear and understood channels.

To wrap up, I believe the economy remains on a satisfactory track, and, speaking for myself, I see a liftoff decision later this year at the October or December FOMC meetings as likely appropriate. However, the data are giving off varied signals, and there is more ambiguity in the current moment than a few weeks ago. In my opinion, the situation calls for especially diligent monitoring of incoming data with particular attention to consumer activity.