

Considerations on the Path to Policy Normalization

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- Atlanta Fed President and CEO Dennis Lockhart, in a February 6, 2015, speech to the Southwest Florida Business Leaders, shares his thoughts on the monetary policy “liftoff” decision ahead.
- Lockhart says the linchpin in a decision to make a significant policy change is confidence in the economic forecast.
- Lockhart’s baseline outlook for 2015 and 2016 assumes growth at around 3 percent per annum.
- In Lockhart’s view, this outlook, combined with the improvement of economic conditions to date, indicates the economy is on a path to a satisfactory and desirable state of health.
- Lockhart says that the weakness of inflation and wages is a concern, and that firming of inflation readings will give him confidence that the outlook on which monetary policy decisions will swing remains realistic.
- From a Main Street perspective, Lockhart says, the important point for business planning is that monetary policy is likely to shift sometime this year, and that decision should be a signal that the FOMC is confident that the economy is on track to achieve its objectives.

I want to begin by expressing thanks to Gary Tice for his service on the Federal Reserve Bank of Atlanta’s Miami board. Gary follows Gay Rebel Thompson from

this community, who earlier served as a board member and chair of the Atlanta Fed's board for South Florida.

This year—2015—is widely expected to be the year the Federal Reserve initiates *normalization* of monetary policy. This prospect has generated a lot of interest and buzz.

If you follow the Fed-watching industry, as I do, you are well aware that a top-of-mind question regarding policy is: At what meeting will the Fed decide to lift off? At what meeting will the Federal Open Market Committee (FOMC) raise the policy rate target above its current near-zero range?

If you are an investor in fixed-income or interest-paying assets, a lot of money may ride on the precise answer to that question.

In contrast, if you are a business person operating in the nonfinancial real economy, you may be less concerned about the precise timing of the first policy adjustment. You are likely to be more concerned about what a change in the interest-rate environment means for the outlook for overall demand conditions and the general direction of the economy.

Today I will orient my remarks mostly to the concerns of Main Street. This keeps the focus where, in my opinion, it ultimately should be—that is, on the health, resilience, and momentum of the broad economy.

With this perspective in mind, I want to share my thought process, as one policymaker, on the decisions ahead and the economic context in which they may be made.

When a Reserve Bank president speaks publicly, he or she is expressing individual views, not an official message of the Fed or the FOMC. That is the case today. My colleagues may not agree with my views.

Economic progress and outlook

The national economy has improved greatly from the recession's trough in 2009. Much has been accomplished.

The Great Recession was a particularly severe episode. The economy lost quite a lot of ground. We lost nearly 7 million jobs—more jobs than in the prior three recessions combined. During the recovery, we have regained that ground, and nonfarm payroll jobs are now about 2 million jobs above where they were at the onset of the recession.

In terms of total output, the economy is now almost 14 percent larger than at its nadir at the bottom of the recession.

It has taken a while—the recovery is five-and-a-half years old—and the job is not finished, in my opinion. But, as I said, much has been accomplished.

I believe the economy has sufficient traction for the expansion to be extended through the medium term.

My baseline outlook for 2015 and 2016 assumes growth at around 3 percent per annum. I expect employment to continue to grow and both unemployment and underemployment to continue to decline. This morning, we received the Bureau of Labor Statistics' employment situation report for January. Payroll jobs grew by 257,000 on net. And over the past three months, job gains have averaged 336,000.

As a general statement, the improvement of economic conditions to date, in combination with the outlook I just outlined, leads me to the view that the economy is on a path to a satisfactory and desirable state of health.

The Fed's statutory objectives contained in the so-called dual mandate help define what is satisfactory and desirable. Our policy objectives are maximum employment and low and stable inflation. The Committee has put a clear definition on the inflation objective. The Committee has defined it as a rate of 2 percent annual inflation over the longer run as measured by a particular index called the personal consumption expenditures price index. Importantly, inflation is targeted on a total or headline basis including the highly variable components of food and energy prices. In practice, most Fed officials monitor a collection of inflation indicators in an attempt to discern the underlying trend. There are worrisome aspects of the current inflation picture, and reading underlying trends

is problematic at present. Hold that thought. I'll emphasize the centrality of inflation concerns a little later.

Maximum, or full, employment is less explicitly defined. Most economists assume that what constitutes full employment changes over time. Structural shifts in the economy cause the natural rate of unemployment to move around. For a good part of the recovery period, a number of Fed policymakers, me included, have estimated the unemployment level consistent with full employment as between 5¼ and 5½ percent or a little higher. Today's report has the headline unemployment rate at 5.7 percent. So, on that basis, we would seem to be approaching an acceptable steady-state level of employment.

It's a fair question, then, why the FOMC has not already started to normalize interest-rate policy. My answer is the recovery has been sluggish for much of its five-and-a-half years. To accomplish what we have, the recovery has required the support of extraordinary policy measures—measures such as a policy rate set effectively at zero and three rounds of quantitative easing. Furthermore, the economy has endured periodic headwinds that threatened to dilute or reverse progress. And although the economy is growing, its strength has sometimes seemed tentative and fragile.

A moment ago, I said the job is not finished. Some gaps remain.

Employment progress, for instance, may be less than meets the eye. Many of us have held that the conventional measure of unemployment probably overstates actual progress. There are still almost 7 million workers counted as employed who say they are working part-time involuntarily. As a point of reference, 7 million is about 4½ percent of a labor force of 157 million. There are always people in this involuntary part-time category, but the number is still elevated compared to historical levels. Over the last few years, there has been a worrisome outflow of prime-age workers—especially men—from the labor force. I believe some of these people will be enticed back into formal work arrangements if the economy improves further.

The distance between current conditions and our goals doesn't have to be completely closed for the FOMC to start moving interest rates higher. Monetary policy is, of necessity, forward looking. If, as we look forward, it seems likely we will achieve our policy objectives, then we can consider beginning to adjust policy.

From a Main Street perspective, it is the overall direction and extent of normalization that should matter most, rather than the exact date of liftoff. Liftoff will be a momentous event when it happens, but it is the evolution of the interest-rate environment over the next few years that will most influence real business activity.

Confidence as linchpin

The linchpin in a decision to make a significant policy change is **confidence**. By that, I mean confidence in a forecast—an outlook narrative, if you will—that has the economy on track to achieve the FOMC's policy objectives in a reasonable timeframe. I think a reasonable time horizon is one to two years.

I really want to emphasize this point. The Committee has repeatedly stressed that the first and subsequent policy moves will be data-dependent. It is confidence based on clear evidence in the data that will trigger the start of normalization.

One hundred percent confidence is never attainable. The test is one of sufficiency—that is, sufficient confidence that, in a defined period of time, the broad economy will reach conditions consistent with sustainable full employment and stable prices.

At this particular moment, I don't quite have sufficient confidence. There are factors at work at the moment whose effects I consider to be transient. Key among these factors is inflation.

Inflation, by almost every measure, has been running considerably below the FOMC's target of 2 percent. This was the case well before the recent drop in energy prices. Because of the sharp falloff of energy prices—especially gasoline prices—headline or total inflation has gone negative in the most recent readings.

Core inflation—the measure that excludes the direct impact of energy and food prices—has recently been running below 1 percent.

In my baseline forecast, I have inflation getting past this period of broad disinflation and resuming a gradual rise to 2 percent. It's important, in my opinion, to be confident that this will occur, and certainly that the trend in overall prices is not continuing to move away from the FOMC's target.

Just as current readings of inflation give some pause, broad wage trends seem to suggest we are not yet on the cusp of full employment. The quite modest growth of wages across the economy does not seem normal given the solid growth numbers we've seen in recent quarters.

Inflation and wages ought to be telling indicators that the gaps are closing. Their weakness is a concern.

A noisy first half

The first half of 2015 will present challenges in evaluating the validity of economic assumptions.

I've mentioned oil prices. After seven months of decline, prices firmed in trading sessions last week, then fell again. Financial market participants interpreted the firming as a positive development. A number of oil and gas sector analysts forecast that global petroleum supplies will exceed demand through the first half of the year.

The dollar has appreciated by 13 percent on a trade-weighted basis since last June. Exports in the fourth quarter seem to have been negatively affected by the dollar's rise. I will avoid predicting exchange rates, but suffice to say that the impact of the dollar on exports, as well as imported consumer goods prices, is part of the current swirl of variables making the state of the economy harder to assess.

The direction of the dollar is an aspect of the larger context of slow global growth with risk of spillover to the U.S. economy. Some of the influence of soft economic

conditions abroad is incorporated into my baseline outlook. In contrast, more extreme scenarios are not.

I should also comment on inflation compensation in inflation-protected securities. Compensation for inflation in these securities (so-called TIPS) has moved sharply lower since last summer. This decline may reflect transitory influences like falling energy costs. A less benign possibility is that investors are lowering their outlook for inflation. This could be either because their confidence is waning that the Fed will achieve its 2 percent inflation target, or because they see growing risks to the continued strength of the broad economy.

Since mid-January, some inflation-compensation measures have shown signs of reversing. A firming in the inflation compensation data from their year-end lows is an example of the kind of encouraging development that will bolster my confidence in the medium-term outlook.

To put an exclamation point on the proviso that the first half of 2015 may be noisy and hard to read, I'll just catalog a few of the obvious things that might confuse true underlying conditions: oil prices, the dollar, the effects of both oil prices and exchange rates on headline inflation, their possible impact on core inflation, slow-to-improve wages, the ups and downs of quarter-to-quarter growth, and mixed messages from measures of inflation expectations.

What am I looking for?

So, if the linchpin in a policy decision, for me, is confidence, what am I looking for?

For starters, as I said earlier, key indicators of economic conditions should not be moving away from my basic outlook. Assuming no substantial softening of GDP and employment growth, my attention will likely be on the path of inflation.

I'd like to see some evidence that what we believe to be transient factors driving recent weak inflation readings are, in fact, passing. I would like to see firming of inflation readings. This will give me confidence that the outlook on which important decisions will swing remains realistic and likely to play out.

Inflation is appropriately a focal point because its firming will reduce concerns that the economy is somehow stalling, that prophecies of long-term stagnation have any basis, and that chances of accomplishing the FOMC's policy goals are receding.

As of today, I remain comfortable with the assumption that circumstances will come together around mid-year, or a little later, that will deliver sufficient confidence to begin normalization with the liftoff decision. I won't be more definitive than that. I think all possibilities from June on should remain open. I don't at this juncture have a prediction or preference. Timing will depend on what the data tell us.

From a Main Street perspective, the important point for business planning is that monetary policy is likely to shift sometime this year, and a higher interest-rate environment will ensue. The decision to begin normalization should be a signal that the FOMC is confident the economy is on track to achieve its objectives and that the economy should have sufficient strength and momentum to handle higher rates. The start of the process of normalization should itself instill confidence on Main Street.