

Letting the Waters Clear

Dennis Lockhart

President and Chief Executive Officer

Federal Reserve Bank of Atlanta

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- Atlanta Fed President and CEO Dennis Lockhart, in a July 14, 2016, speech to the Eighth Annual Rocky Mountain Economic Summit in Victor, Idaho, gives his economic outlook.
- Lockhart says Brexit has clouded the economic waters and sees little choice but to exercise patience and let the picture clarify.
- Because of the disappointing May employment report and Brexit, Lockhart was comfortable with the FOMC's June decision to keep policy on hold.
- Lockhart expects continuing growth at around 2 percent per annum, and inflation to move closer to the FOMC's target rate of around 2 percent.
- Lockhart says the consequences of Brexit may play out over a number of years, and associated uncertainty could become an economic headwind.
- Lockhart reemphasized that policy is data-dependent. He is comfortable with a cautious and patient approach to policy in the near term.

Introduction

I have visited this part of Idaho several times, but for purposes other than talking about the economy and monetary policy.

The Snake River runs through this area. I've floated all three gorgeous sections of the south fork of the Snake testing my fly-fishing skills against the wily trout that inhabit the river.

I am no expert fly-fisher, but I've had good instructors and read a bunch of books on the sport. Before ever throwing a line, a fly-fisher has to *read the water*. Reading the water involves identifying areas where the fish are most likely to be holding on that particular day. Considerations include the speed and depth of the flowing water, soft spots in the flow made by rocks, trees, and eddies, and places where aquatic insects are emerging.

Fly-fishers are always looking for signs of rising fish. This tells you they are feeding on the surface of the water. A hatch of emerging insects is a feast for fish and usually makes for good fishing if you can "match the hatch" with your artificial fly.

Sometimes it happens that you have a fishing outing planned for a day just after a storm has passed through. Bad luck. Storms can make the water cloudy and force the fish down to lower depths. In such circumstances there's little activity on the surface, and the fishing may not be so good. A dry fly-fisher just has to exercise a little patience until the waters clear. I've found, in any event, that a bad day on the river is better than a good day at the office.

This may be a tortured metaphor, I admit, for current conditions Fed policymakers are facing. Brexit amounts to a storm that has clouded the economic waters. For the very near term, I see little choice but to exercise some patience and let the picture clarify.

I will expand on this theme in my remarks today. Here's what I plan to cover today: The bison in the room is obviously Brexit and what it means for the U.S. economy. Whether fully deserved or not, Brexit is being treated as a seminal event evoking a before-and-after comparison of perspectives on the economic outlook. So first, I'll walk you through my outlook *before* the momentous referendum of June 23. I'll follow that with my *after* perspective, that is, my outlook in light of the uncertainty brought on by Brexit. I'll also add some

comments on how I think about uncertainty as a factor influencing economic performance.

As always, these will be my personal views. I am not speaking for the Federal Reserve or the Federal Open Market Committee, or FOMC.

Outlook before Brexit

Let me take you back to the beginning of the year, just after the FOMC made the decision at its December meeting to raise the policy rate by 25 basis points. The so-called liftoff decision was anticipated through much of 2015, and when the decision was made at the meeting in mid-December, it was the first increase in the federal funds rate in almost a decade.

As 2016 began, I foresaw a year of steady, moderate, above-trend growth. I expected a pace of growth slightly above 2 percent. I expected this momentum to deliver continuing movement toward full employment. I also expected a firming of the inflation rate with clear evidence of movement in the direction of the Committee's inflation target of 2 percent. Based on this outlook, I was among the FOMC participants who forecast four rate increases over the coming year. I have since cut back that projection.

The first quarter had a spell of financial market turbulence lasting the better part of six weeks. The volatility was apparently caused by a number of global economic concerns including the slowdown in China, the selloff of Chinese equities, declining oil and commodity prices, the resulting weakness of commodity-producing emerging markets, and the perceived tightening by the Fed. The market turbulence subsided in mid-February.

For a variety of reasons, first-quarter growth was weak. The first estimate was a mere 0.5 percent annual rate of growth. This was ultimately revised higher to a 1.1 percent rate of growth, still quite weak compared to my forecast assumption for the year overall.

The employment markets in the first quarter seemed strong compared to the growth indications. Labor market data—including monthly payroll jobs growth—continued to show the strong momentum measured in 2015.

When official estimates of second-quarter growth are in hand, my staff and I believe we'll see a much stronger number than the first quarter's. Our expectation is based on the output of our tracking estimate, called GDPNow. This is a nowcast as opposed to a forecast. As data are released, our model estimates the current quarter (or the just-ended quarter) in real time. Our most recent estimate of annualized second-quarter growth is 2.3 percent. We expect the official reading to be in that vicinity.

The second-quarter bounceback reflected continuing strength in consumer spending. We believe growth of consumer spending, at an annual rate, exceeded 4 percent in the second quarter. That's a very brisk pace of consumer activity. Typically, consumer spending is influenced by factors such as the outlook for steady employment, real income growth, and the health of household balance sheets. Consumer fundamentals have been solid for several months and remain so, in my opinion.

While growth seems to have accelerated in the second quarter compared to the first, the incoming data overall have been mixed. The employment report for May was published the first Friday in June. As you may be aware, it was disappointing. The monthly net growth of payroll jobs, even adjusting for the Verizon strike, was weak, and monthly numbers were revised lower back through March. At the time of its release, this report seemed to indicate that employment momentum had been slowing starting in the first quarter and throughout the second quarter.

Because of the doubts raised by the May employment report and the timing of the Brexit vote a few days after the June FOMC meeting, I was comfortable with the Committee's decision to keep policy on hold.

In preparation for that meeting, I made modest downward revisions to my growth forecast, but I have not really changed in any significant way my basic outlook for this year and the medium term. I continue to expect growth at a pace of around 2

percent per annum. This rate of growth is adequate to continue to absorb any remaining labor resource slack. Although inflation, by key measures, is still below target, I continue to expect the inflation rate to move higher and be near the Committee's target in 2017.

Current economic performance

This, then, was my sense of the domestic economy in advance of the Brexit referendum. Most of the data we've received recently is consistent with this base-case outlook. However, recent data releases mostly cover periods before June 23. Still, I have no basis—statistical or anecdotal—for assuming any significant change in economic momentum since June 23.

As of today, in mid-July, domestic demand appears to be holding up well. As I said, consumer fundamentals remain sound. Growth of personal consumption is robust. Auto sales (that is, light vehicle sales) remain strong—above 16 million units annualized. However, we do hear reports that sales at recent levels may be difficult to sustain. Business investment remains subdued, and second-quarter residential investment has weakened compared to the first quarter. But exports have improved recently, pulling up the manufacturing sector. Oil prices have remained between \$45 and \$50 a barrel, reducing the drag from declining “mining” structures investment. While the picture presented by recent data is mixed, overall the economy is performing adequately to substantially accomplish our monetary policy objectives in 2017, in my opinion.

The healthy employment report we received on July 8 buttresses this view. Payroll jobs growth in June, even after netting out the return of striking Verizon workers, was strong and quite broad-based. Many of the negative signals in May's data reversed course. Over the past several months, it does appear that the trend in employment growth has slowed somewhat from the pace seen last year. However, I think this slowing is consistent with an economy operating close to full employment.

Brexit

Let me now turn to the impact of Brexit. The referendum outcome surprised many observers, me included. It roiled financial markets in the days just after the vote, but very importantly, the functioning of financial markets has been generally quite orderly.

After a bout of volatility, financial conditions have mostly returned to the status quo before June 23. The broad dollar foreign exchange index is roughly unchanged from a month ago. The VIX index of financial volatility rose but then settled back into a normal range.

A notable exception is the 10-year Treasury note yield, which has touched historic lows. I attribute much of the recent decline to safe haven flows reflecting a risk-off posture immediately following the referendum.

It's too early to sound the "all clear" as regards financial market stability. Fed and other policymakers will need to stay on alert for signs of instability severe enough to pose a threat to the broad economy. So far, the financial market turbulence we've seen does not seem to have caused direct harm to the country's economy. As many have stated, it is not a "Lehman moment."

In my view, a more nettlesome question is what Brexit might mean for U.S. economic prospects over the medium and longer term. I'll offer some tentative views from two altitudes.

First, Brexit has raised the general uncertainty quotient at work in the world. The range of plausible (or perhaps I should say, not totally implausible) adverse political and systemic scenarios is very broad at this moment. Economic consequences of the Brexit decision could play out over years.

What would plausible adverse scenarios actually mean for the U.S. economy? At this point, I don't think it's possible to make a prediction with much confidence. Only very tentative and very general assertions can be made, as I see things. Elevated and protracted uncertainty will not help growth prospects of an economy constrained by low business fixed investment. Weak productivity growth is at least partially explained by subdued capital investment. Uncertainty that reduces business fixed investment activity is not helpful.

More immediately, there is the question of *direct* impact of Brexit on our economy. Negative effects could materialize through the trade channel if there is a sustained realignment of the dollar-pound exchange rate. We might also see similar effects in our trade with Europe and the euro area.

Immediately following the vote, there has been a lot of effort by a number of credible parties to estimate direct near-term impacts. Again, it's early, but I'm persuaded the direct impact over a short time horizon will not be all that great.

So, to summarize my view of Brexit effects: negligible near-term effect; a risk factor over the medium term; higher uncertainty that *could* amount to a persistent economic headwind.

Thinking about uncertainty

I want to make a few comments about uncertainty as a factor influencing economic performance.

The minutes of the June FOMC meeting clearly pointed to uncertainty about employment momentum and the outcome of the vote in Britain as factors in the Committee's decision to keep policy unchanged. I supported that decision and gave weight to those two uncertainties in my thinking.

At the same time, I viewed both the implications of the June jobs report and the outcome of the Brexit vote as uncertainties with some resolution over a short time horizon. We've seen, now, that the vote outcome may be followed by a long tail of uncertainty of quite a different character.

Since the Brexit decision of the British people materialized, economic commentators have invoked heightened uncertainty as a reason to be apprehensive. To repeat, the consequences of Brexit may play out over a number of years, and the associated uncertainty could become an economic headwind.

If uncertainty is a real causative factor in economic slowdowns, it needs to be better understood. Policymaking would be aided by better measurement tools. For example, it would help me as a policymaker if we had a firmer grip on the

various channels through which uncertainty affects decision-making of economic actors.

I have been thinking about the different kinds of uncertainty we face. Often we policymakers grapple with uncertainty associated with discrete events. The passage of the event to a great extent resolves the uncertainty. The outcome of the Brexit referendum would be known by June 24. The interpretation of the May employment report would come clear, or clearer, with the arrival of the June employment report on July 8. I would contrast these examples of short-term, self-resolving uncertainty with long-term, persistent, chronic uncertainty such as that brought on by the Brexit referendum outcome.

Measuring uncertainty is quite difficult, as you would expect. We have some tools, but they are imperfect. There are uncertainty indexes. We also have survey data. At the Federal Reserve Bank of Atlanta, in partnership with the University of Chicago and Stanford University, we conduct large-sample surveys of business leaders to gauge how they assess the risks they face and how these risks inform their decisions. In a post-Brexit survey a few days ago, roughly one-third of the businesses we surveyed indicated that the result of the referendum made their sales outlook more uncertain. They indicated they would be more cautious in hiring and capital spending decisions as a result of Brexit. We had a spirited internal discussion of whether one-third is a big number or not-so-big.

Taking a long view, policymaking may have to adapt to an altered environment. To avoid letting uncertainty become a nebulous rationale for repeated inaction, refinements to how we measure uncertainty and how we gauge its effects are to be encouraged. Economists have useful work under way on the problem. I look forward to more and better tools.

I'll close with a reminder as much to myself as anyone. FOMC policy decisions are to be grounded in the Committee's statutory monetary policy objectives—maximum employment and price stability. In that regard, it's important to re-emphasize that policy is data-dependent—that the economic performance of Main Street America will be the arbiter of the appropriate stance of the Fed's monetary policy. For now, I don't believe the FOMC is behind the curve in the

setting of the policy rate. For that reason, I'm comfortable with a cautious and patient approach to policy in the near term.

Sometimes you just have to take some time and let the waters clear.