A Policymaker's Views on Inflation and Employment

Dennis Lockhart
President and Chief Executive Officer
Federal Reserve Bank of Atlanta

58th National Association for Business Economics Annual Meeting
Atlanta, Georgia
September 12, 2016

- Atlanta Fed President and CEO Dennis Lockhart, in a September 12, 2016, speech to the National Association for Business Economics 58th Annual Meeting, discusses his views on inflation and employment.
- Lockhart believes the economy is sustaining sufficient momentum to substantially achieve the FOMC's monetary policy objectives in an acceptable medium-term time horizon.
- Lockhart expects a stronger second half of the year. He sees full-year growth coming in a little below 2 percent, just shy of the growth rate we've seen over the recovery.
- Lockhart says the FOMC is continuing to make progress toward its full employment mandate. He thinks the balance of evidence suggests the residual slack in the labor market is relatively small.
- Lockhart says his base case forecast is that inflation will trend toward target once the slack in labor and product markets is sufficiently reduced.

I'd like to welcome this distinguished group of economists to Atlanta. You will see me twice today and will get a full dose of Fedspeak. I will present some views in the coming minutes, and then this afternoon I will moderate a discussion with the chair of the Atlanta Fed, Tom Fanning, who is the chairman, president, and CEO of Southern Company, based here in Atlanta. My colleague Dave Altig, executive vice president and director of research at the Atlanta Fed, will also speak this afternoon.

For those of you who closely follow commentary of Fed officials, today is your last chance to hear views of the FOMC (or Federal Open Market Committee) participants for a week and a half. As I'm sure you are aware, tomorrow we begin the observance of a blackout period on public comments related to monetary policy ahead of the FOMC meeting.

Financial markets seem to be very sensitive to remarks of Fed speakers at the moment. I'd like to avoid any chance of contributing to market volatility in advance of the September 20 and 21 meeting, so this morning I don't plan to offer an opinion on what will likely be done at the September, November, or December meetings.

Rather, I will talk about what I think are the most important considerations for a policymaker at this juncture and how I'm weighting certain considerations.

You are all familiar with the Fed disclaimer. I will offer my individual views. I am not speaking for the Federal Reserve or the FOMC.

Summary economic picture

In interviews at the Jackson Hole meeting in late August, I took the position that if the incoming data leading up to next week's meeting remained consistent overall with my sense of the economy, I would encourage "serious discussion" of a policy rate increase.

Notwithstanding a few recent weak monthly reports—from the Institute for Supply Management, for example—I am satisfied at this point that conditions warrant that serious discussion.

I believe the economy is sustaining sufficient momentum to substantially achieve the Committee's monetary policy objectives in an acceptable medium-term time horizon.

Let me provide a high-level summary of the economic picture, as I see it, and then I will go into a little more depth on key points. The economy is expanding at a moderate pace fueled mostly by growth of consumer activity. Business investment spending remains subdued. Jobs growth remains on a positive trend. I expect a slowdown as we approach full employment. Underlying inflation continues to run about ½ percent below target. Wage pressures are accelerating and broadening out as we approach full employment.

In its fundamentals, the economy seems to be chugging along, not stalling out. I'll go a little deeper on some of these points.

A more detailed look at certain elements

First, growth: After relatively weak growth over the first half of the year, I expect a stronger second half. Recent incoming evidence has pushed the Atlanta Fed's third-quarter tracking estimate above 3 percent annualized growth. I'm referring to GDPNow, our real-time nowcasting tool. The author of GDPNow, Pat Higgins, will be speaking at this conference tomorrow.

Strong readings on consumer spending, a solid report on private construction activity, and a positive signal from the latest factory orders numbers have contributed to our sense that growth is accelerating in the third quarter.

I probably don't have to explain to this audience that there are error bands around our tracking estimate. At this point in the quarter, the 70 percent confidence interval stretches from 2 1/4 percent annualized growth to 4 1/2 percent. A number of other forecasters have a point estimate in the mid-twos, so I believe I'm on solid ground saying we'll see stronger growth in the third quarter than we did over the preceding three quarters.

I see full-year growth in 2016 coming in a little below 2 percent, just shy of the growth rate we've seen, on average, over the seven-plus years of recovery. With the weak first and second quarters, arithmetic produces that shortfall, but I consider the basic narrative of growth around 2 percent to remain intact. From that perspective, I see full-year 2016 as more of the same.

Employment

Turning to employment, we are continuing to make progress toward our full employment mandate. Jobs growth has averaged 232,000 over the past three months, in line with the trend over the past year. I don't rely on any single indicator to judge the health of the labor market. Various measures of unemployment and underemployment are inside a range I would consider at or very close to full employment.

Admittedly, the headline unemployment rate has leveled off in recent months. But I attribute this to an increased flow of people into the labor force, along with fewer exits. Participation appears to have stabilized and ticked up slightly. This higher participation is likely a response to the ongoing, relatively strong employer demand for workers as suggested by surveys of job openings and measures of churn.

The 12-month trend in payroll jobs growth has slowed a bit from its peak in the beginning of 2015, and I think it's reasonable to expect some further slowing in jobs growth as the economy approaches full employment. Importantly, I consider the most recent number—151,000—to be comfortably above the various estimates of "break even," the number needed to hold the unemployment rates constant. This suggests to me that we will continue to make progress in absorbing underutilized labor resources. While it is hard to pinpoint exactly when the labor market has reached full employment, I think the balance of evidence suggests the residual slack in the labor market is relatively small.

Inflation

That said, we are not yet seeing inflation data confirming that we're near full employment. I find the continuing shortfall from the Committee's inflation target and the ambiguous evidence of movement toward target to be a frustrating element in the picture.

Headline inflation is roughly 1 percentage point below target, while measures of underlying inflation are trending about half a percentage point below target.

A number of factors are at work in any given period. To my way of thinking, inflation experience basically is a function of inflation expectations (the anchor), resource slack (the Phillips curve component), and transitory influences such as commodity prices, the dollar's effect on import prices, and seasonal factors.

As I've said, I see the slack component as modest. And unquestionably, transitory factors have had significant influence on headline numbers.

As regards expectations, even with declines in some expectations measures over the past year or so, I am satisfied inflation expectations remain stable and adequately anchored.

My staff has done some work recently looking at the spread of inflation expectations. Our conclusion is that the typical forecaster or business decision maker's inflation projection has remained fairly constant over the last few years, but the distribution of inflation expectations has tightened up. Those expecting a breakout of inflation to the upside have adjusted their expectations lower.

I am a big believer in a dashboard approach to assessing the run rate of inflation. So, working with my team at the Atlanta Fed, I look at a wide range of price measures. For policy purposes, we are always trying to discern the fundamental underlying behavior of prices separate from transitory influences. Recently we have been closely monitoring the Dallas Fed's trimmed-mean inflation index as a reasonable proxy for the underlying inflation trend.

This measure of inflation has been very constant for four years now. It's been consistently around 1.6 percent and has varied from that reading by only two-tenths or less. By this measure, progress toward the Committee's inflation objective appears to have stalled. The inflation data overall have not been suggesting disinflation or deflation, but the flat trend line is enough below target that, in my opinion, the shortfall cannot be considered immaterial. I find this to be an awkward state of affairs.

You will recall that last December, when the Committee decided to raise the policy rate for the first time in almost a decade, accompanying communication used the expression "reasonably confident" when projecting the inflation outlook on which the decision was, in part, premised.

I voted for the increase and supported the rationale. In my public comments after the meeting, I emphasized my desire to see tangible evidence of rising inflation in 2016 to support subsequent rate increases. At times during this year, we detected hints of accelerating inflation, but I have to say the evidence is not overwhelmingly convincing. I am still relying on "reasonable confidence" to a greater extent than evidence in hand. My base case forecast is that inflation will trend toward target once the slack in our labor and product markets is sufficiently reduced. Given ongoing improvement in labor markets and output, I believe that process is continuing, and, therefore, confidence is justified.

Policy setting in this context

For me, the inflation outlook is a very important consideration. I am putting a lot of weight on it. You've heard my base case inflation scenario, but I acknowledge the need to consider other narratives. I cannot totally dismiss an alternative scenario that describes the economy as stuck in a state of relatively weak growth, low productivity growth, and soft inflation. As you well know, this perspective is sometimes associated with the secular stagnation thesis. This line of thinking also shares ground with the attention given recently to the level of the neutral rate—both short-term R-star and the longer-term equilibrium policy rate.

I have not signed on to this alternative view of an economy stuck in a state of weak performance. My approach to upcoming policy discussions is to hold to my base case outlook—one that sees both mandated policy objectives achieved in the medium term. I am treating the alternative scenario as a risk.

My base case forecast lines up well with feedback from many people in the economic trenches. Anecdotal reports of my contacts among business and community leaders pretty consistently have been describing steadily improving economic conditions—not great, but not bad. Most of our business contacts expect continuing growth of demand at a moderate pace and accelerating wage pressures. They cite a range of uncertainties restraining capital investment. They perceive their worlds as steadily returning to normal. They are cautiously optimistic for the most part.

These soundings of contacts in my region—even if anecdotal—influence how I frame the key questions I need to think about in the weeks preceding an FOMC meeting.

Among these—and I will close on this note—are, first, what is the right policy setting given an outlook of getting to full employment and price stability relatively soon—in the next couple of years? And, if 1.6 percent inflation and 4.9 percent unemployment were all you knew about the economy, would you consider a policy setting one tick above the zero lower bound still appropriate? These are some of the questions on my mind as I approach the next few meetings. I think circumstances call for a lively discussion next week.