SPEECHES

Too Soon to Breathe Easy

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

Jacksonville Regional Chamber of Commerce
June 2, 2008

Thank you, Lee [Thomas], for that introduction, and thank you, too, for your service as a board member of the Atlanta Fed. Lee is in his second term as a board member and brings wise counsel to the table each time we meet.

I'm grateful to Lee and everyone associated with the Jacksonville Regional Chamber of Commerce. Your hospitality has been great. I appreciate the opportunity to speak to the city's business leadership at a juncture in the country's economic life that presents difficult trade-offs and serious challenges.

The last few weeks have had the feel—for me personally and I think many in the business and financial community—of coming up for air. Since the emergence and spread of financial turmoil starting last August, our economy has been confronting one challenge after another. These challenges include financial market illiquidity and significant losses by banks and financial institutions, a deep decline in housing sector activity and falling home prices, rapid onset of general economic weakness, and inflation pressures resulting in part from rising energy prices.

Although conditions have improved on some fronts, I don't feel we can yet "breathe easy." The path of the economy is still enveloped in considerable uncertainty, and serious risks remain.

In my remarks this afternoon, I will share my perspective on the current state of the national economy, the outlook through the remainder of the year and into 2009, and the risks to that outlook. I want to close by offering some comments on longer-term concerns that may encroach on prospects for sustained financial stability and general prosperity. I'll add at the outset that these views are mine alone and don't necessarily reflect those of my colleagues on the Federal Open Market Committee.

Global context
The global context is important, and I know you agree with this view here in Jacksonville given the port's role in import and export trade.

During the first quarter, major U.S. trading partners in Europe, emerging Asia, and Japan reported stronger than anticipated gross domestic product (GDP) growth. The International Monetary Fund (IMF) projects global GDP growth in 2008 to be 3.7 percent on an annualized basis—a very solid number but about 1.25 percent lower than the growth recorded last year. With this growth, many economies also have experienced rising inflation, which is a concern for central banks around the world.

For the next several minutes, I will present a verbal storyboard of the economy's recent past, present, and near-term future. I would argue that Jacksonville—with its role in international trade and business services, particularly financial transaction services—is highly invested in some of the key subplots of our current economic narrative.

Over the last few months, the national economy has seen developing challenges on three fronts: growth, inflation, and financial stability. In the last several weeks, financial markets have become somewhat more stable.

Growth story
I would characterize the current position of the overall economy as *growing slowly, poised for gradual recovery, but carrying real risks that could subvert the story*. Since last fall, we've suffered a pronounced economic slowdown, with positive but low growth numbers. The early estimate of first quarter growth of 0.6 percent was revised upward last week to 0.9 percent. This performance followed growth of 0.6 percent in the fourth quarter of 2007.

Consumer activity accounts for about two-thirds of the economy's output. In the first quarter, year-over-year growth of consumer spending slowed to just 1 percent—the slowest pace since 2001. And consumer sentiment, as measured by the University of Michigan's index, has reached the lowest level since 1980.

Prospects of a weak economy caused business investment to slow over the last two quarters. Businesses seemed to have become more cautious in capital outlays, with discretionary investment often postponed. Total nonresidential fixed investment, which includes spending on equipment and software as well as on nonresidential structures, was flat in the first quarter.

Industrial production growth has deteriorated in recent months. For instance, production of automotive products declined more than 14 percent in April from a year earlier. Parenthetically, I understand that soft U.S. demand for autos has dampened import traffic at the Jacksonville port. Completing the picture, exports have provided some counterweight to negative trends in our manufacturing economy. In the first quarter of the year, exports of goods increased by an estimated 2.8 percent.

The service sector—which is, as I said earlier, very important to Jacksonville's economy—has also not evaded the current economic slowdown, especially in segments directly connected to real estate. Recent readings of the health of this sector are mixed. Looking at the sector through the prism of employment, there has been job growth in health care, education, and tourism. In contrast, we've seen job losses in financial services and wholesale and retail trade.

Employment trends are a crucial indicator of overall economic health. The storyline for employment up to this point has been *weakness but not a collapse*. Nonfarm payroll employment declined for the fourth consecutive month in April, and the unemployment rate stands at 5 percent compared with 4.4 percent early in 2007. However, the most recent employment report was not as bad as expected with a modest loss of 20,000 jobs. Also, initial claims for unemployment insurance have not moved higher in recent weeks. We'll get another update on the jobs situation later this week.

Drags on the economy

We're experiencing some powerful drags on economic growth. Among them is the weak housing sector. Prices for existing homes nationwide in the first quarter declined more than 14 percent from just a year earlier, according to the Standard & Poor's/Case-Shiller index. Realtor data show the median price for existing homes sold in Jacksonville declined 6.7 percent during the first quarter of 2008 compared with a year earlier. Nationally, inventories of new and existing homes for sale remain high at more than 10 months' supply at the current pace of sales. As a comparison, the average for the past decade was around four months' supply.

In Jacksonville and the rest of the nation, new home construction has declined to low levels—a necessary adjustment to reduce inventories. Nationally, new home sales were down 42 percent in April relative to a year earlier, but the sales rate actually ticked up by 3.3 percent during the month. In addition, existing home sales have been relatively stable in recent months. Our careful assessment of the incoming data on housing suggests a storyline of *a slowing pace of continuing decline.*

A second factor weighing down growth has been energy costs. Crude oil prices have increased more than 30 percent since January 1 to the present range of $125–$130 per barrel. With higher transportation and other energy costs, consumers have less money to allocate for other types of spending.

Another drag on growth has been tighter credit standards. In the Federal Reserve's most recent Senior Loan Officer Opinion Survey, most domestic banks reported they had tightened standards on residential mortgages and some other classes of consumer loans. Also, a majority of lenders said they had tightened standards on commercial and industrial loans to large and middle market firms.

Bank credit is part of the larger story of the financial markets. Here the storyline is *more settled but still fragile*. From the exceedingly difficult conditions of mid-March (the time of the Bear Stearns action), credit markets have stabilized somewhat, liquidity has improved, and credit spreads have come down. For example, the AAA corporate bond spread over 10-year Treasuries stood last week at 165 basis points, down from more than 200 in March.

Inflation situation

Let me round out my storyboard of the current economy with a discussion of inflation. The inflation storyline so far has been *uncomfortable levels with hints of rising expectations*. We gauge inflation conditions in the economy in a number of ways. There are two principal consumer price indices—the Consumer Price Index (CPI) and the Personal Consumption Expenditure (PCE) price index. Both indices reflect price movements in hundreds of goods and services and are computed monthly at the so-called "headline" level (with everything included) and as a "core" measure, which excludes energy and food.

Core measures are considered useful in reducing monthly noise in the data to get a sense of the longer-term inflation trend. Some economics shops—including the Cleveland and Dallas Federal Reserve Banks—trim off the outlier components of the basket of goods and services each month to get another assessment of the fundamental picture.

The headline CPI and PCE inflation measures have behaved similarly in recent months and have been quite volatile, reflecting the sharp swings in food and energy prices. The headline CPI was up 3.9 percent over last year in April—down a bit from March's reading but still elevated relative to the benign inflation experience of much of the last decade.

Core CPI inflation, which excludes food and energy costs, has hovered at above 2 percent for the last few months and has displayed no clear trend. However, the most recent Federal Reserve Bank of Cleveland trimmed mean CPI index came in at 2.8 percent in April and appears to have drifted higher in recent months. If we take a longer-term view, the inflation picture also is disconcerting. The three-year average headline CPI inflation is at the highest level since the early 1990s.

With inflation elevated, I'm attentively monitoring measures of inflation expectations. Measures of consumer attitudes show that year-ahead inflation expectations have moved higher. However, survey questions about the longer term revealed more moderate attitudes, suggesting that inflation expectations have not indisputably ratcheted up. An explanation of the short-term upward movement is that rising inflation expectations are commonly associated with rising energy prices.

So, to summarize the storyline for the current state of the U.S. economy, we have a slow-growth economy poised for gradual recovery, weak but not collapsing labor markets, a slowing pace of decline of housing, more settled but still fragile financial markets, and uncomfortable levels of inflation with hints of rising inflation expectations.

The outlook

Let me now turn to the outlook. My storyline looking ahead is *not so severe a slowdown, but not so quick a recovery.* As already mentioned, the first quarter of 2008 delivered GDP growth of just under 1 percent. I believe the second quarter may be somewhat better than some earlier dire forecasts. The federal government's economic stimulus should provide some boost to household spending in the second and third quarters. On balance, I'm expecting a weak first half followed by some improvement in the second half as the drags on growth I mentioned earlier gradually diminish.

My base case for inflation assumes a fall-off from the current elevated level of inflation supported by some moderation of energy and food price increases. I also expect soft economic growth to constrain the ability of businesses to pass through energy and other costs and raise prices in the coming months.

Oil prices so far this year have risen more than I anticipated as energy supply has lagged behind demand growth. My outlook assumes that energy costs do not continue to climb much further, which is an uncertain proposition. Also, I'm assuming that financial market conditions continue to stabilize and that housing sector conditions do not deteriorate dramatically.

We remain in a period of considerable uncertainty. There are very real risks to this outlook. I will cite three.

The first is renewed financial instability. As I said, markets remain fragile. A new spell of instability could follow, for instance, from the seizing up of a systemically important credit market.

The second risk is an oil price shock in the face of growing global demand. Recent indications are that the high price of gasoline and other energy products is blunting demand in the United States. But demand continues to rise in emerging economies, most notably China.

The third is a persistent and even steeper decline of house prices. Some analysts have pointed to the risk of an adverse feedback loop—a self-reinforcing spiral. In this line of thinking, buyers would hold off home purchases in hopes of lower prices, banks would refuse to finance purchases on the basis of questionable and falling appraisals, and prices would continue to be marked down in hopes of attracting buyers.

Long-term challenges

Beyond the immediate challenges of economic growth, inflation, and financial stability, I'd like to draw attention to certain persistent structural imbalances that present serious risks to our nation's long-term and continuing economic well-being. In coming years these imbalances, if not addressed, will loom like geologic faults threatening severe economic and financial disruption and potentially requiring wrenching adjustments. Surely a lesson of the last several months is that excesses and imbalances can trigger surprising, destructive dynamics with elements of contagion and fear.

We face current and future imbalances in the form of structural trade deficits, foreign petroleum dependency, and fiscal deficits. The trade deficit is rooted in the feeble savings practices of our population along with stubborn dependence on imported oil. The growth of entitlement obligations beginning in the next decade constitutes a fiscal challenge of unprecedented magnitude. These concerns deserve high rank on the country's economic agenda.

I'm hoping breathing will come more easily as the year plays out, as we enter 2009 and as immediate challenges subside. But recent experience tells me we won't be fully at ease until a sustainable trade, energy, and fiscal balance has been achieved.

Thank you.

Contact: Jean Tate 404-498-8035

RELATED LINKS: Play Speech MP3 • Dennis Lockhart's biography • Podcasts • Speakers Bureau