

## New Monetary Policy and the Economic Outlook

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

Rotary Club of Atlanta  
Atlanta, Georgia  
January 12, 2009

Without question, last year was extraordinary. Developments included the failure of storied investment banks and the introduction of an arsenal of economic policy tools and responses.



Entering 2009—having been back in the South now for almost two years—I added one more tool to a list that includes rate cuts, special liquidity facilities, rescue funds, deposit guarantees, and interventions to save institutions whose failure would pose risk to the global system. Following an old tradition, I had a plate of black-eyed peas on New Year's Day for good luck. I figured, "Well, it can't hurt."

As a policymaker on the Federal Open Market Committee (FOMC), I want to organize my thinking by revisiting basic questions. I will structure my remarks today around two such questions. They are, first, what is Fed policy trying to accomplish in these extraordinary times? Second, how is the Fed going about accomplishing those policy objectives?

The context here really matters. The principal instrument by which the Fed influences the economy is the federal funds rate (the overnight rate at which banks lend and borrow central bank reserves). The fed funds rate can't go any lower. As you know, at the FOMC meeting December 16, the federal funds rate target was lowered to a range of 0–25 basis points. A year ago, when I last spoke to you, the fed funds rate target was at 425

basis points (or 4.25 percent).

In terms economists use, the policy rate has reached its zero lower bound. This situation has raised concerns that the Fed can't do any more to combat recession and that monetary policy—broadly defined—has lost relevance at a crucial point in time. I would argue that a federal funds rate this low will have considerable macroeconomic effect especially if accompanied by policies to improve the functioning of credit markets.

Traditionally, these January talks by the Atlanta Fed president at the Atlanta Rotary have concentrated on the economic outlook. I will talk a bit today about the outlook, but I plan to depart somewhat from tradition to explain the new monetary policy regime that I expect will be employed for the foreseeable future—while the fed funds rate can't go any lower. My intent is to assure you the Federal Reserve has not exhausted its policy tools. The policy arsenal available to the Federal Reserve remains a powerful corrective force on the economy.

As usual, I offer the disclaimer that all my remarks are my personal views and don't necessarily reflect the views of my colleagues on the FOMC.

### The state of the economy

I'll begin with some economic highlights of the year we have just put behind us. We now know that the U.S. economy was in a recession that began in December 2007, and this recession could end up as one of the longest since World War II.

Friday's employment report reinforced both the depth and breadth of the downturn. Nonfarm payrolls tumbled an estimated 524,000 in December as the unemployment rate hit 7.2 percent—a 16-year high. The economy lost around 2.6 million jobs for the year. Moreover, the job losses are very broad-based across industries, with only government, private education, and healthcare adding jobs in December.

The depth of the downturn is reflected in the dramatic decline in consumer spending in the third and fourth quarters of 2008, led by a collapse of auto sales. Motor vehicle sales were some 36 percent below year-earlier levels in December.

Just a few months ago, inflation was at very high levels following a steep run-up in commodity and fuel costs. However, commodity prices, most notably oil prices, have fallen sharply in recent months, evidencing a marked pullback in global growth. This, combined with a fall-off of broad domestic activity, has led to a substantial slowing of inflation.

As much as anything, we'll probably remember 2008 for extreme volatility and dysfunction in financial markets, particularly credit capital markets serving businesses and households. Volumes of credit flows fell off dramatically, risk spreads widened, and some markets virtually shut down. We've seen improvement since the worst period in September and October, but, all in all, financial conditions going into 2009 are still unsettled.

Today, as we move into 2009, economic conditions are extremely weak and financial markets remain impaired. In the banking sector, a posture of risk aversion—or at least caution—persists.

### What's the Fed trying to accomplish?

Keeping these circumstances in mind, let me address the first question I posed at the outset. That is, what's the Fed trying to accomplish?

In simple terms, we're focused on containing the impact of the economic downturn and stimulating a recovery as early as possible. The Fed is not alone in this effort. The Treasury Department and other federal agencies have also implemented policies to support economic growth, and the incoming administration has proposed a large fiscal stimulus package for the economy.

The Fed, as the country's central bank, conducts monetary policy—as distinct from fiscal policy—under legal mandates set down by Congress. The Fed's mandated policy objectives—the so-called dual mandate—are sustainable economic growth along with low and stable inflation.

The mandates have not changed. But what has changed is some aspects of how we pursue those objectives. Extraordinary circumstances this last year and a half have required the Fed to expand the set of tools employed to meet those objectives.

### **New monetary policy**

Modern conventional monetary policy is usually thought of as the Fed's adjustment of the federal funds rate target in the overnight market for bank reserves. Bank reserves are a liability on the central bank's balance sheet. The fed funds rate is important because it influences the whole term structure of interest rates. The lowering of the funds rate target some 525 basis points since September 2007 can be seen as a direct response to worsening economic conditions and the resulting downward revisions to the outlook.

The federal funds rate is a very general tool and one that relies on the functioning of credit markets to have its intended effects. But, as you know, credit markets have not been functioning normally even in markets strongly backed by the U.S. government, such as agency (e.g., Fannie Mae and Freddie Mac) mortgage-backed securities. In turn, mortgage markets and housing demand have suffered.

Problems that began in the subprime mortgage-backed securities market spread rapidly and often ferociously among interconnected markets and institutions. It's not too much an exaggeration to say no one and no market remained untouched. In response to events, the Fed had to be creative.

Initially, as the Fed responded to credit market strains, the focus was on interbank markets. But, as problems spread, the Fed introduced almost a dozen targeted credit and financial market facilities. The facilities now include short-term credit programs for financial institutions, longer-term lending arrangements, direct asset purchases, and swap lines with foreign central banks. The Fed has intervened, for example, in the commercial paper market, the agency market, and the private asset-backed securities market. Programs have supported banks, nonbank financial institutions, money market mutual funds, and, as you know, specific institutions deemed to be systemically critical.

Among the programs in force is the direct purchase of agency (Fannie Mae, Freddie Mac, etc.) notes and mortgage-backed securities. These securities are directly linked to mortgage rates. Purchases began just a few days ago. The goal of such a program is not, in my view, to engineer a particular interest rate level, that is, to hit a particular rate target. But direct purchases can promote directionally lower rates, help restore normal market functioning, and thereby achieve a return to reliance on private sector market-based credit allocation.

The introduction of targeted asset-side measures has been aimed squarely at the breakdown of credit markets, the circulatory system of our modern economy. In my view, a precondition of economic recovery is the return of the normal functioning of credit markets.

Let me emphasize that this asset-focused approach is a departure from what the textbooks describe as conventional monetary policy and is not without controversy. Some have called it credit policy to distinguish it from the conventional approach where the central bank achieves its objectives through its influence on bank reserves on the liability side of the balance sheet.

I don't often use slides in speeches, but I want to show you [this image](#) because it so clearly illustrates this new approach and, I believe, helps to answer the second question I posed at the outset. And that is, how will the Fed go about accomplishing the policy objectives I described earlier by using the asset side of its balance sheet?

As the graph shows, there are two aspects of this policy approach—growth of the Fed's balance sheet in absolute terms and change of the composition of assets. Even with the federal funds rate effectively at zero, there is ample scope to do more of both if conditions require.

### **Measuring policy actions**

Is it working? Well, isolating the effects unique to the Fed's policy actions on these various markets is difficult. Nonetheless, financial market functioning has shown some signs of improving in recent weeks.

By way of example, in the short-term interbank funding markets, which are of central importance, spreads have declined markedly across maturities.

Conditions in commercial paper markets also have improved. Commercial paper issuance has increased from recent lows, and spreads on 30-day, asset-backed commercial paper, for instance, have narrowed.

In addition, mortgage rates have fallen recently in response to the Fed's announcement that it will purchase large quantities of mortgage-backed securities and agency debt. Freddie Mac's most recent mortgage market survey showed the average 30-year fixed rate has declined to just over 5 percent—the lowest since the series began in 1972.

It's impossible to measure what economists call a counterfactual—what might otherwise have happened. But without a willingness to use all available tools and to adapt policy tools as conditions required, I'm convinced the economy's performance and current outlook would have been considerably worse.

### **Outlook**

Looking ahead, the overall economy is very weak, and I expect it will remain weak at least through the first half of 2009. The incoming data suggest fourth quarter GDP contracted somewhere between 4 and 6 percent (annualized). And this quarter's performance could be similar. At some point—perhaps later this year—I believe financial markets will have stabilized sufficiently to support a recovery. So I am looking for an improving economy in the second half. To temper that a bit, there is always the risk of a shock or reversal in the financial sector or elsewhere that could again alter the outlook to the downside.

Clearly, the U.S. economy is in a tough fight against pernicious economic forces. But, on balance, confidence is warranted. Indeed, restored confidence is an essential ingredient in the mix of factors that will change the momentum of the economy. To buttress confidence, I want to assure you the Federal Reserve still has considerable ammunition in reserve to be used as needed.

By this time next year, I'm hopeful circumstances will look very much better than they do today. I must admit that I don't really like black-eyed peas, so I'm hoping I can take a pass on that dish next New Year's Day.

**Contact:** [Jean Tate](#) 404-498-8035

**RELATED LINKS:** [Play Speech MP3](#) • [Play Question & Answer Session MP3](#) • [Dennis Lockhart's biography](#) • [Federal Reserve assets illustration](#) • [Press release](#) • [Speaker's Bureau](#)

**RELATED LINKS ON OTHER SITES:** [Dec. 16, 2008 FOMC Meeting Statement](#) • [Factors Affecting Reserve Balances](#)