Thanks for inviting me. It's a privilege to be your luncheon speaker for the Association for Financial Professionals Corporate Risk Forum.

I approached this speech by thinking about what I could offer an audience of risk management professionals from diverse industries in these times of risk being all too real. Your businesses and clients share at some level a common macro environment even if the implications of macro risk might play differently from industry to industry and company to company. Today I want to discuss the state of the economy and the Federal Reserve Bank of Atlanta's forecast, or outlook, for the economy this year. That sort of speech is pretty standard for a Reserve Bank president. To make the "relevance connection" to your field of risk management, you may take my remarks on the macroeconomy as one policymaker’s views on the context in which you evaluate the risks specific to your company's or client's situation.

Recently the Federal Open Market Committee (FOMC) enhanced the transparency of our policy deliberations by disclosing the central tendency of formal quarterly forecasts of each Reserve Bank. I will also provide my perspective on the macroeconomic forecasting process employed by the Atlanta Fed and comment on how you might consider the usefulness of such forecast information in your evaluation of macro risk.

I must state up front that these remarks are mine alone and don't necessarily reflect the views of my colleagues on the FOMC.

The state of the economy

A little more than a year ago, the economy entered into a recession. If the consensus economic forecast is accurate, we are likely to still be in recession through at least the first half of this year. Since the end of World War II, the United States has experienced 10 other recessions. On average, they have lasted 10 months. So the current downturn is already longer than usual.

I know that as risk management practitioners, you track the economy at whatever aggregation—regional, national, global—is most relevant to your business. Let me highlight for you some of the national economic indicators I'm following as a monetary policymaker.

First, there's housing—the source of much of the current economic weakness. New residential construction has fallen by more than half in the past 20 months, taking about one full percentage point off annual GDP growth.

Troubles with housing have taken a heavy toll on consumer spending. Purchases of big-ticket items that require a large financial commitment and access to credit—notably autos—have been especially curtailed.

Also, business spending has fallen sharply. Investment spending has been deferred and cost control intensified.

Labor markets have been shedding jobs rapidly in manufacturing and services. During the past 12 months our economy has lost a net of 3.5 million jobs, with about half of those job losses in the past three months.

If there has been a silver lining in the economic slowdown, it's prices. Inflation in recent months has declined to the point where consumer prices in January 2009 were unchanged from a year earlier—the lowest rate of change since August 1955.

The outlook

It's obvious to all that the current state of the economy is extremely weak. The more pertinent question is, what does the future hold?

The economic forecast I submitted for the most recent FOMC meeting at the end of January reflected my view that the economy faces obstacles likely to work against a strong rebound of growth over the next several quarters. Those obstacles include credit markets not yet returned to healthy functioning, a housing market still weighed down by an excess supply of homes for sale, and low business and household confidence. None of these is likely to turn around quickly.

But as discouraging as these indicators are for the very immediate future, most forecasts, my own included, see catalysts for the start of modest recovery in the second half of the year.

With production falling—and expected to decline significantly more this quarter—I expect some reduction of excess inventories, putting producers in a position to expand output as spending returns.

There are signs lower mortgage interest rates are helping housing markets on the margin. The January pending sales number was up, and there has been a spurt in refinancing activity. If historically low mortgage rates can be sustained over the coming months, I expect more buyers will be drawn into the market.

Several factors should lift consumer spending as the year progresses. These factors include the dramatic fall in energy prices, greater stability in the housing market, and improving consumer confidence. Also, as you know, the tax cuts in the recent stimulus package were designed to generate an immediate boost to consumer spending.
Forecasts as an exercise in risk management

The premise of that baseline forecast is founded, as you would expect, on assumptions that may or may not materialize. My forecast of resumption of modest growth in the second half assumes, to repeat, some stabilization of house prices, some normalization of credit markets’ functioning, some benefit from the stimulus package, and some improvement of business and consumer confidence evidenced by greater investment spending and personal consumption. A Reserve Bank's official forecast also has as its premise “appropriate monetary policy.” That is to say, whatever scenario we adopt as our baseline forecast is not independent of policy, but rather vitally entwined with Fed policy as a significant influence on outcomes.

This aspect of our forecasting is a little different than macro environmental assumptions relevant to individual enterprises. Companies can establish assumptions for the external environment and then derive implications for the business and strategies to respond to external reality. Public policy bodies like the Fed have meaningful influence on the macro environment to varying degrees over time.

Policy is a major factor in our forecasts and not a reaction to a forecast. To convey a sense of what “appropriate monetary policy” might mean for the near term, I would point to the statement that followed the January 28 FOMC meeting. The committee stated that “economic conditions are likely to warrant exceptionally low levels of the federal funds rate for some time.” The committee further advised that all available tools will be employed to get back to economic growth, which means, in my interpretation, further credit programs such as the purchase of agency debt and mortgage-backed securities or expansion of the Term Asset-Backed Securities Loan Facility (TALF), which was recently announced as part of the Treasury's Financial Stability Plan.

I should also explain that my baseline forecast is a scenario around which we at the Federal Reserve Bank of Atlanta carry out a process of “dynamic monitoring.” The stream of incoming data is analyzed for implications for the assumptions underlying our forecast, which in turn is revised as required by the unfolding of reality—weekly, monthly, and quarterly.

Economic forecasts—particularly when looked at collectively—provide valuable information for risk managers in their underlying assumptions and their information about the degree of uncertainty in the economic environment. I would argue they are less useful as point predictions of data elements or timing of turning points.

Among the lessons I’ve taken from my two years of experience as a central banker is how difficult it is to see the transition to a nonlinear future, which you might think of as the change from one phase of the business cycle to another. Forces that produce the beginnings and ends of recessions are particularly difficult to predict. Turning points are anomalous events and by their very nature are more difficult to see than variations around a more or less linear scenario, by which I mean continuity from past to present.

As a consequence, economic forecasts will tend to be overly optimistic as the economy goes into a recession but overly pessimistic as the economy comes out of recession and begins its expansion. Perhaps we should take some comfort in that observation today.

I think there are some other lessons to take away from the experience of the last two years. Tail risks—low probability but extremely consequential events—do sometimes materialize. Ignoring tail risks—“black swans,” in the words of author Nassim Taleb—may be irresponsible. Because forecasting is an inexact exercise, because shocks by nature aren’t anticipated, and because both theoretical models and econometric models cannot incorporate actual complexity, policy must sometimes take what we call a “risk management” approach. Policymakers occasionally need to take out insurance against economic tail risks, and this approach is especially relevant when traditional relationships have broken down. Case in point: Our models are based on a history where financial markets are working.

Comprehensive policy response

Let me give you my appraisal of current policy.

Responding to the scope and severity of our economic ills, policymakers have taken and will soon implement unprecedented measures to restore financial stability and economic growth. In my view, the diagnosis is substantially correct, and the actions targeted on discrete aspects of the overall problem, taken together, constitute an appropriately comprehensive approach. Let me bring focus to five dimensions of the current problem and connect them to the associated policy actions.

First, there is credit market dysfunction. The Fed has attacked this problem by introducing a number of credit market liquidity programs. For example, the TALF supports new lending in credit cards, student loans, auto loans, and small businesses. This program could provide up to $1 trillion and should help repair securitization markets and boost credit to broad categories of consumers and small and mid-sized businesses.

Jump-starting securitization markets is vitally important. Securitization markets are and will be a substantial part of the nation's total credit system.

Another problem is banking system weakness. I believe that by injecting capital into banks, the U.S. Treasury has strengthened and will further strengthen bank balance sheets. Under Treasury’s new plan, the government also will create a mechanism to remove troubled assets from bank balance sheets, which should help rehabilitate the banking system, a basic prerequisite of recovery.

A third dimension of today's weakness is falling house prices. The FOMC has stated that the Fed will continue to purchase large quantities of agency debt and mortgage-backed securities to support mortgage and housing markets, and the Fed stands ready to expand the quantity and duration of such purchases. Also, a foreclosure prevention program is included in the Treasury’s new plan. If successful, a source of pressure on home prices should be reduced.

The Administration's economic stimulus package is designed to address the recent surge of unemployment, which is a fourth aspect of economic weakness. Rapid downstreaming of funding to state and local governments should help forestall further layoffs and furloughing of public sector employees. Public works and other investment projects should put some of the unemployed back to work, depending on the speed of mobilization.

Finally, there is the broad-based economic weakness that has enveloped almost all industry sectors with a deficit of confidence as both cause and effect. We are in a period of unconventional policy measures, and that situation is especially true of the Federal Reserve. But the stimulative power of conventional monetary policy in the form of a federal funds rate at its lowest possible level should not be forgotten. As I said earlier, the FOMC has stated that low interest rate policy is likely to continue for some time.

I believe these actions—taken as a whole—are a forceful and coherent response to the problems at hand. In judging coherence, I apply these criteria:

Is the problem correctly diagnosed?
Is the response to each dimension of the problem sufficiently sized?
Is the response timely?
And, is the specific policy reversible when required or appropriate?

There is policy risk, to be sure, by which I mean risk that the policy medicine won't work, won't be enough, or will come too late. But if forecasts of improvement don't materialize, as I said earlier, the Fed is not without capacity to act, even with the fed funds rate at its lower bound.

Other risks
A sober mindset dictates that I, as a policymaker, watch for indications of both recovery and further deterioration. Beyond policy risk, the banking system, and housing, there are other downside risks that bear watching, in my view.

First, there's the commercial real estate sector. Vacancy rates are rising, and in 2009 a considerable amount of debt comes due and must be refinanced.

Second, I'm following the state and municipal fiscal situation. Revenues have fallen sharply and debt financing is constrained. Even with the stimulus money, some government entities may continue to face serious fiscal problems.

Internationally, I'm watching the external debt position of emerging markets and the effect of sovereign debt exposure on overseas banks, particularly in Europe.

I'm also paying close attention to the trajectory of Japan. Last quarter the Japanese economy contracted by 13 percent, and deflationary pressures have accelerated.

Finally, I'm concerned about growing global protectionist sentiment. The Great Depression taught that beggar-thy-neighbor policies can do immense harm.

Comprehensive, scaled, and coherent responses
In my view, we have reached a pivotal juncture.

After a rapid onset of problems in the economy and financial system—both global and national—we've reached a point where incremental responses must proceed to something more comprehensive, scaled, and coherent.

I believe the composite policy approach is correct in focus and intent, and now the devil is largely in the details and implementation. I am confident policymakers across the various relevant arms of government understand the importance of moving ahead as quickly as possible to provide detailed rules of the road and achieve clarity.

As these policy actions take effect and work in concert, I believe the economy and financial sector will respond positively. Thank you.

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