

Thoughts on Stabilization, Recovery, and Transition

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

National Association of Securities Professionals
Annual Pension and Financial Services Conference
Atlanta, Ga.
June 11, 2009



In recent weeks, sentiment about the U.S. economy has clearly improved. A modicum of optimism has returned.

I'm as ready as you are for a real turn of the economy. For several weeks now we've been hearing of so-called "green shoots"—that is, little signs of life in the economy that foretell a recovery. This imagery coincides with spring having sprung. It seems very human. Our spirits rise with the better weather, the warmer temperatures, the return of baseball, and we see encouraging signs all about us. As I said, I'm ready for recovery, but I've got to ask: Could we be kidding ourselves? Is it real?

In my remarks today, I'll respond to that question first by providing an up-to-date fix—as current as the data allow—on the economic situation. Then, I'll talk about the most serious risks I see in the economy along with my baseline outlook for a near-term recovery. I'll close with some views on the tension I perceive between short-term economic prospects—which are net positive—and longer-term structural challenges that, in my view, must be faced with a sense of urgency.

The tug and pull between immediate prospects for the economy and over-the-horizon threats seem to me to be captured in the question of the moment: What's causing rising term U.S. Treasury yields? And in what way, if at all, should policy react? Here I must repeat my usual disclaimer: The views that follow are mine alone and don't necessarily reflect those of my colleagues on the Federal Open Market Committee (FOMC).

Current fix on the economy

My view of the current economy is mixed. For the most part, the economy is still in decline, but the pace of decline has clearly slowed. I'd like to make a distinction between stabilization and recovery, and I believe we're seeing signs of stabilization.

As regards stabilization, I'd like to highlight four areas: employment, housing, consumer spending, and manufacturing.

Employment: Unemployment insurance claims data, released this morning for the week ending June 6, reinforced a two-month trend in labor markets, and that is, layoffs are gradually decelerating. However, claims remain near record-high levels, and firms' reluctance to hire has lifted the most recent unemployment rate to 9.4 percent in May.

Housing: Many of today's problems started with housing, and by most measures a clear recovery in the housing market has yet to emerge. My contacts here in the Southeast confirm the most recent data on the national housing market, namely that house prices are still falling, but the rate of decline has moderated somewhat.

Improved affordability combined with historically low mortgage rates and a new first-time homebuyers' tax credit have helped move a portion of the huge inventory of unsold homes off the market. Preliminary results from the survey of homebuilders and Realtors in the Southeast conducted by the Atlanta Fed indicate more optimism that sales will pick up in the future.

Consumer spending: In data released this morning, the Census Bureau reported that retail sales were up 0.5 percent in May after posting declines in March and April. Some of the increase may be related to higher gasoline prices. And there were areas of spending weakness. Overall, last month's retail sales numbers were more positive than negative. But compared with May of last year, sales are down a striking 9.7 percent. So sales are nudging higher but from very low levels.

With consumers holding back, the personal saving rate in April climbed to 5.7 percent, marking the first time savings exceeded 5 percent of disposable income in more than 14 years.

Manufacturing: The industrial side of the economy has been especially hard hit this year, and the sector remains under considerable stress. But there are recent signs—such as the latest Institute for Supply Management purchasing managers survey—that the rate of manufacturing decline may be slowing too.

Financial markets

As so many have said, a return to economic growth depends on working financial markets, and there's been recent progress in several areas, including with banks, short-term funding, corporate markets, and securitization markets.

The number of so-called problem banks is elevated and likely to keep climbing. However, there's been some better news from the banking industry. For instance, the Supervisory Capital Assessment Program, also known as stress tests, has provided us with a better handle on the capital buffer the largest banks would need to remain well capitalized and able to lend if the economy performs worse than expected.

Following up on the stress test results, the Federal Reserve Board on Monday announced that the 10 banks required to bolster their capital have submitted plans to meet their requirements. Then on Tuesday, the U.S. Treasury announced that 10 of the largest institutions participating in the capital purchase program had met requirements to repay the government for the Troubled Asset Relief Program (TARP) funds provided to them. I view these developments as signs that the banking system is healing, and rising confidence in the banking system is justified.

Markets for short-term funding also have improved, including the interbank lending markets and commercial paper markets. Spreads between the London Interbank Offered Rate (LIBOR) and the overnight index swap rate have declined to levels that are close to precrisis levels.

Corporate bond issuance has increased recently. Although U.S. Treasury rates have been on the rise, spreads between Treasury yields and rates paid by corporate borrowers have narrowed somewhat. Overall, the cost of capital for highly rated businesses has come down.

Finally, as regards securitization markets, the asset-backed securities (ABS) market collapsed in 2008 but this year has begun to gradually revive with the aid of public programs designed to jump-start the securitization markets.

Issuance of new ABS, including credit card, auto and student loans, and equipment leases, has totaled more than \$40 billion since the Fed launched the Term Asset-Backed Securities Loan Facility (TALF) in March. This activity is still far short of the \$200 billion annual ABS issuance before the financial crisis, but it represents a marked improvement from last year. Furthermore, risk spreads on ABS have been declining steadily this year and should help ease the cost of credit for both households and businesses.

While credit market functioning has improved, the picture I've just painted of our current economic environment is framed with caution. At this point, there's still a debate about whether business activity has reached a bottom.

Even when the recovery is well under way, I expect an extended period of sluggish growth. And the initial phase of the recovery may "feel" like a recession for many households and businesses.

Forecasts and risks

In the normal course of our work, the Atlanta Fed produces a forecast of economic growth, unemployment, and inflation. Like most forecasters, we see the economy beginning to recover in the second half of this year.

For the medium and longer term, however, I expect growth will be relatively subdued for some time after it turns positive. My thinking is the economy has to go through structural adjustments that could lower the trend rate of growth for the recovery's first couple of years at least.

Moreover, I believe there are ongoing threats that pose downside risks to sustained recovery.

At the broadest level, global economic weakness constitutes a continuing risk. This recession knows no borders, and the downturn has become especially severe in Japan, Europe, and certain developing markets such as Eastern Europe. Though there are promising signs in some countries, the International Monetary Fund still projects global growth this year will be -1.3 percent, the most severe worldwide contraction since World War II.

Domestically, commercial real estate is a problem for the economy and problematic for my outlook. My forecast takes into account worsening commercial real estate—office, retail, hotel, and warehouse, all of which are under stress. But since this is an emerging story, I don't think we should underestimate the scope of the problems of commercial real estate and the potential disruption to a still stressed banking system.

Finally, in an economy built for personal consumption, there is the risk consumer psychology and resulting consumption could turn negative. Consumer sentiment regarding the economy has improved but remains very low by recovery standards and could reverse with adverse turns in the data or worsening market conditions.

Even without such a reversal, several factors are likely to continue to hold back consumer spending. These include weak labor markets, pressures to repair household balance sheets, and still tight credit conditions. Going forward, I doubt that the financial system will accommodate the degree of household leverage consumers enjoyed before mid-2007. So I'm expecting a period of adjustment.

Resolving long-term imbalances

As mentioned at the outset, U.S. Treasury rates have risen recently. As you know, Treasury yields influence a broader array of market rates, most importantly mortgage rates. The recent rise in Treasury rates has brought sharper focus to the requirements of recovery, in terms of both policy and the real economy. And these requirements compete, to some extent, with the requirements of transition or, more precisely, rebalancing.

The rise of Treasury rates, or yields, has been characterized as both good and bad omens. Various interpretations have been put forward. To wit:

The rise of term Treasury rates reflects the improved outlook for real growth.

The rise of term Treasury rates signals declining risk aversion and the unwinding of the safe haven inflows that occurred last fall.

The rate rise demonstrates increased inflation expectations related to concerns of monetization of the burgeoning federal debt.

The rise is evidence of decreased demand on the part of foreign investors.

These and possibly other explanations may *all* be factors in the market. I'm sympathetic to the good omen explanations—that the rise is connected to the improved outlook—but I don't rule out that there is something here to monitor very carefully. The steepening of the yield curve may reflect growing concern over the nation's ability to correct profound structural imbalances; that is, to combine recovery with transition.

An immediate recovery that does not bring with it substantial progress in rebalancing the economy for the longer term will not be durable. And failure to effectively come to grips with the requirements of rebalancing could result in unwanted inflation and chronic economic underperformance.

The rebalancing agenda has been widely expounded. Among rebalancing imperatives, the U.S. citizenry must rebalance consumption and savings. Connected to this, the country must rebalance consumption and investment. And above all, the worsening fiscal imbalance must be addressed.

Higher nominal rates in the term Treasuries market can be seen as an expression of creeping doubt that the American polity, and more specifically the policy community, is up to the sacrifices, tradeoff decisions, and the courage of convictions the situation requires.

The concerns about our economic path are crystallized in doubts expressed in some quarters about the Federal Reserve's ability to fulfill its obligation to deliver low and stable inflation in the face of very large current and prospective federal deficits. In a word, the concerns are about monetization of the resulting federal debt.

I do not dismiss these concerns out of hand. I also recognize that the task of pursuing the Fed's dual mandate of price stability and sustainable growth will be greatly complicated should deliberate and timely action to address our fiscal imbalances fail to materialize. But I have full confidence in the Federal Reserve's ability and resolve to meet its inflation objectives in whatever environment presents itself. Of the many risks the U.S. and global economies still confront, I firmly believe the Fed losing sight of its inflation objectives is not among them.

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

RELATED LINKS: [Play Speech MP3](#) • [Dennis Lockhart's biography](#) • [Speaker's Bureau](#) • [Atlanta Fed speeches](#)