SPEECHES

On the Economic Outlook and the Commitment to Price Stability

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For my remarks this afternoon, I'll talk about how I see the economy at this juncture, the near- and medium-term outlook, and the growing concern about inflation. Let me add at this point my usual disclaimer that my remarks are my thoughts alone and may not necessarily reflect the views of my colleagues on the Federal Open Market Committee (FOMC).

It's especially important that I mention this caveat the day before Chairman Ben Bernanke makes his semiannual monetary policy report to Congress. Tomorrow the chairman will speak for the Federal Reserve System. Today, I am speaking just for myself, informed by advice from my colleagues at the Federal Reserve Bank of Atlanta.

Current economy
Current economic conditions are mixed at best, but the economy appears to be in stabilization mode. Stabilization necessarily precedes recovery. A recovery has not yet taken hold but should begin before too long.

I'll start with a look at manufacturing, which has been hard hit in this recession. Just last week we learned that manufacturing production was down 0.6 percent in June, month over month. In the past year, manufacturers have cut production by more than 15 percent, and the manufacturing capacity utilization rate dropped to about 65 percent, a record low.

Here in middle Tennessee, manufacturing accounts for about 12 percent of employment. The number of manufacturing jobs here declined by about 12 percent on a year-over-year basis in May, the most recent data available. I know that many of you here today have directly felt the troubles in this important sector.

Recent indicators of business investment are also down but are a bit less discouraging. Durable goods orders increased this spring and in May reached the highest levels in four months. On the other hand, the most recent data showed the liquidation of business inventories continuing, but the pace has slowed.

Consumer spending absorbs about two-thirds of economic output, and the recent picture in this area is mostly negative. After taking price changes into account, it appears that retail spending fell again in June. Restaurants, department stores, and building materials retailers all posted month-to-month declines. Overall, retail results are in line with the ongoing weakness in consumer spending we have been seeing.

There is also indication of worsening consumer confidence. The University of Michigan's July report indicated that consumer sentiment fell sharply in recent weeks, reversing the gains seen in May and June. Growing consumer pessimism has been reported in other survey data. It appears that expectations of future economic conditions, and particularly employment prospects, are weighing on attitudes.

As for housing, permits and new home starts in June improved markedly compared with previous months, and the large inventory of houses for sale has been pared back somewhat. But the housing sector is still under great stress. Reflecting a persistent pace of foreclosures, the percentage of distressed sales remains high—about one in three sales in May. All in all, this information suggests a slower pace of decline in a still weak residential sector.

Data on the overall economy suggest the same trend of slowing decline. I, along with my team in Atlanta, believe real gross domestic product (GDP) fell slightly in the second quarter. This performance represents substantial progress coming off a contraction of 5.5 percent (annualized) in the first quarter.

The most recent monthly labor market report was disappointing, but employment tends to lag improvements in economic performance. Nothing in the incoming data has altered our view that the economy is nearing a bottom and will soon begin a very slow recovery.

Financial market healing
If stabilization is to lead to sustained recovery, the health of financial markets is crucial. In this regard, I see notable signs of improvement.

For example, most short-term money markets have seen rising volume, increased liquidity, and less concern with counterparty risk.

In the corporate bond market, spreads have declined and lowered the cost of capital for investment-grade businesses.

Our credit markets include both banks and the very important securitization markets. Securitization markets have been coming back gradually from a base late last year of nearly zero. Total asset-backed security issuance in the second quarter of 2009 was $49 billion, which is 14 times larger than during the frozen market conditions of the fourth quarter of 2008.

Equity markets were up globally in the second quarter. While the calendar of initial public offerings remains weak, stock issuance in the second quarter tripled compared with the first quarter of 2009 and hit the highest level for the past year and a half.

Much of the recent equity issuance activity was capital raises of large banks. It's positive news that the banks participating in the so-called stress tests have raised a substantial portion of the required capital. Some banks have begun repaying their Troubled Asset Relief Program (TARP) funds to the U.S. Treasury. Also, use of the Fed's special credit facilities has fallen by $500 billion since March of this year.

Despite this progress, the financial sector remains in a fragile state. So far this year, 57 U.S. banks have failed, including 13 in the Southeast. Banks in this region suffer from overconcentration of loans backed by residential and commercial real estate.

Outlook

Now, let me speak to the question of the outlook from here. Often a deep recession is followed by a sharp rebound in business and overall economic activity. Unfortunately, as I look ahead, I do not foresee this trajectory. I expect real growth to resume in the second half and progress at a modest pace. I do not see a strong recovery in the medium term.

There are risks to even this rather subdued forecast. The risk I'm watching most closely is commercial real estate. There is a heavy schedule of commercial real estate financings coming due in 2009, 2010, and 2011. The CMBS (commercial real estate mortgage-backed securities) market is very weak, and banks generally have no appetite to roll over loans on properties that have lost value in the recession. Refinancing problems will not directly affect GDP—it's commercial construction that factors into GDP—but I'm concerned problems in commercial real estate finance could adversely affect the otherwise improving banking and insurance sectors.

Removing obstacles to growth

I'd like to elaborate further on my thinking regarding this forecast of an anemic recovery in the medium term. I will argue that growth is the natural state for the U.S. economy, and growth in the medium term will be slowed by structural impediments that must be removed or attenuated.

Growth is the natural state because market competition requires continuous innovation—product innovation, technological innovation, new business models, and development of new markets. Businesspeople—especially those in publicly held companies—understand that over the longer term it's either grow or disappear.

It follows then that resumption and acceleration of growth depends on removal of obstacles. By obstacles, I mean conditions that get in the way of a natural pace of growth.

I see a number of obstacles whose removal will take some time. For example, the healing of the banking system will take time. Working off excess housing inventory will take time. The reallocation of labor to productive and growing sectors of the economy will take time. It will take time to complete the deleveraging of American households and the restoration of consumer balance sheets.

In short, I believe the economy must undergo significant structural adjustments. We're coming out of a severe recession, and it's not too much an exaggeration to say the economy is undergoing a makeover. We must build a more solid foundation for our economy than consumer spending fueled by excessive credit—excessive household leverage—built on a house price bubble.

The surviving financial system must find a new posture of risk taking. The balance of consumption and investment must adjust, with investment being financed by greater domestic saving. The distribution of employment must adjust to match worker skills, including newly acquired skills, with jobs in growth markets. Some industrial plant and equipment must be taken offline to remove excess and higher-cost capacity.

As I said, these adjustments will take time and will suppress growth prospects in the process. I believe the economy will underperform its long-term potential for a while because of the obstacles to growth that must be removed, adjustments it must undergo.

Many observers see substantial slack in the economy that could persist for some years. Economists' more formal term for slack is “output gap.” We at the Atlanta Fed see a meaningful output gap developing, but in our view it is smaller than would normally be associated with the weak pace of growth we expect over the next couple of years because all the obstacles to the natural pace of growth already mentioned have brought down the economy's potential for the medium term.

Inflation risks

This observation leads me to some comments on inflation.

The inflation statistics have fluctuated in recent months, mainly as a result of volatile energy prices. But the most recent core inflation indicators continue to point to an inflation trend somewhere just below 2 percent—not much different from where it has been for some time now.

At this juncture, my assessment is that inflationary and deflationary risks are roughly balanced.

I don't believe businesses, broadly speaking, have much pricing power. I'm hearing this belief anecdotally. Recently, our regional executives asked a wide range of business contacts in the Southeast about their ability to raise prices in this economy. The great majority of respondents reported that they were not able to raise prices, and some are having to renegotiate contracts to lower prices.

Still, I recognize that concerns about inflation risks have recently risen in some quarters, and I would like to comment on those concerns.

Inflation pessimists—those predicting alarmingly higher inflation—point to growing federal deficits and the substantial growth of the Federal Reserve's balance sheet since last October. More precisely, they note the enormous increase of excess bank reserves on the liability side of the Fed's balance sheet. The argument is that surely this rapid growth of the monetary base and balance sheet must translate eventually, and possibly quite soon, into outsized growth of the money supply. This growth in the money supply is inflationary if not reversed fairly soon. That's the argument.

To carry this argument a little further, the concern is that banks will begin to lend the large quantity of reserves that exist today, putting the money into circulation as the economy picks up. The growth in spending that could result from this increase in money could push against the economy's capacity constraints in a way that creates inflationary pressures, according to the inflation pessimists.

Altered role of bank reserves

Let me draw attention to an important policy change that has altered the relationship between the quantity of bank reserves and overall spending in the economy.

Since last October, the Federal Reserve has been paying banks interest on their reserve deposits. This shift means that banks are more likely to hold reserves with the Fed than in the past and less inclined to look for a way to invest or lend excess reserves. Now banks earn on reserves where previously they didn't. So now there is less direct linkage between growth in the size of the Fed's balance sheet and inflationary pressures. In other words, the absolute size of the Fed's balance sheet isn't as scary as it was before.

Don't get me wrong. I'm not saying that the current size of the balance sheet is necessarily the most appropriate. What I am saying is one should not assume at this point that extraordinary measures to shrink the balance sheet are required to contain inflationary pressures.

In addition, let me highlight two points from the minutes of the most recent FOMC meeting. First, the size of the balance sheet is currently expected to peak later in the year and then begin to decrease. This decrease will occur as various liquidity programs are phased out or decline in use and as long-term asset purchase programs are completed.

Second, the FOMC is actively studying mechanisms to deliberately shrink the size of the balance sheet should the need arise, and to do this without causing disruptions to the economy. According to the minutes of the last FOMC meeting, a top Fed priority is "ensuring that policy accommodation can ultimately be withdrawn smoothly and at the appropriate time."

In my view, some inflation pessimists are not giving weight to the changed mechanics of monetary policy transmission to the broad economy. For some years now the Fed has used interest rates—interest rate policy—to influence economic activity and inflation. Paying the banks interest on their reserves allows the Fed to tighten monetary conditions by resetting this floor interest rate without direct manipulation of the size of the balance sheet.

Nonetheless, it's important that we policymakers remember that rising inflation fears can evolve into inflation expectations on which businesspeople and consumers act. Modern inflation fighting by policymakers is substantially about anchoring expectations. The bulwark against rising inflation expectations is the Fed's credibility. By this, I'm referring to the belief that the monetary authorities have the tools—and the commitment—to act against inflation.

I want to assure you the Fed has several tools and is readying itself to act on the balance sheet when the time comes. And I am very confident of the FOMC's commitment to price stability. I recognize, however, it's easy to say one is committed to act in advance of the need to act. Circumstances at the time may make the need less clear and the decision more complicated. So, if the incremental step of announcing a formal inflation target would serve to calm current fears and prove convincing on an ongoing basis, I would favor such a move. I think that discussion needs to continue.

Let me summarize my argument here today. The economy is stabilizing and recovery will begin in the second half. The recovery will be weak compared with historic recoveries from recession. The recovery will be weak because the economy must make structural adjustments before the healthiest possible rate of growth can be achieved. While this adjustment process is going on in the medium term, I believe inflation and deflation are roughly equal risks and require careful monitoring. Slack in the economy will suppress inflation. And inflation is unlikely to result—by direct causation—from the recent growth of the Fed's balance sheet. In any event, the Fed has a number of tools being readied to unwind the policies used to fight the recession, and it will be some time before their use is appropriate.

I will end with those thoughts and would be happy to take your questions.

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