SPEECHES

Federal Reserve Independence in a Global Context

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

World Affairs Council of Jacksonville
Jacksonville, Florida
September 10, 2009

There are around 90 active world affairs councils in the United States keeping their cities' business and government leaders abreast of world developments. Some serve a vital purpose of education and information directly pertinent to the economic welfare of the city and its hinterlands. I consider the World Affairs Council of Jacksonville one of those. Jacksonville—with its important and growing port—makes a meaningful portion of its living from global exchange. The state of the world economy matters to Jacksonville.

Today, I will discuss the U.S. economic situation along with developments in the global economy as they affect this country's economic interests. I'll put forward a current assessment of the nation's policy challenges using a framework familiar to country risk analysts. And I'll connect this analysis to the issue of central bank independence, an issue that is drawing serious attention as a result of the financial crisis and actions taken in response. It's important that I emphasize that the views I'll express are my own and don't necessarily reflect the views of my colleagues on the Federal Open Market Committee (FOMC).

Status and forecast—U.S. economy
To lay the groundwork for this discussion, I'll begin with an overview of the current state of the U.S. economy. Overall, the U.S. economy is improving but still fragile. Stabilization is proceeding, and the first stages of recovery are under way.

It is to be expected at a time like this that the vital signs of the economy are mixed. Some indicators are improving while others are not getting worse or are just declining at a slower pace. Let me detail some of the key signals we're getting from the domestic economy.

Although consumer confidence is rising, actual consumption has remained muted overall. Consumers remain cautious because of employment concerns and wealth loss. Financing for consumer durable goods purchases is tight. Households continue to deleverage—that is, pay down debt. The savings rate is high compared with recent years. For now, an atmosphere of frugality and self-restraint seems to have set in.

Manufacturing production numbers improved in July after eight months of decline, but this performance mostly reflects a surge in auto production, perhaps in anticipation of the "Cash for Clunkers" program.

Inventories were liquidated aggressively during the first half of the year. The most recent survey of purchasing managers showed a slowing of liquidation. My view is that some replenishment may be under way—notably auto inventories. But many businesses learned during the recession how to operate with leaner stocks.

Sales of both new and existing homes rose in August, and prices are up a little, according to the Case-Shiller index of 20 major real estate markets. However, regional information gathered by the Atlanta Fed across the Southeast is not uniformly upbeat.

Last week's labor market report for August showed that the economy is still shedding jobs. The United States lost 216,000 jobs in August, and the unemployment rate rose to 9.7 percent—the highest since June 1983.

Regarding inflation, the headline inflation rate has fallen over the last year in part because of lower oil prices compared with a year ago. Core measures of inflation excluding food and energy costs also have been drifting lower, currently measured at 1.5 percent. With continuing economic weakness and financial uncertainty, firms have very little pricing power. I've tested this thesis in conversations with business leaders in this region with very little pushback. I expect inflation will remain contained for some time.

As I said, the picture is mixed, but stabilization and recovery appear to be taking hold.

Recent improvements in the financial sector are supporting economic stabilization. Trust among financial institutions has been restored as reflected by risk spreads in the interbank lending market. With the support of a Federal Reserve lending program, securitization of credit card receivables, auto paper, and student loans has bounced back to almost precrisis levels. Corporate bond issuance has been strong since the beginning of the year. Overall, capital flows reflect an unwinding of the near-total retreat from risk-taking and the flight to safety that occurred last fall. Despite this improved flow of capital to riskier assets, financial conditions are still vulnerable, and the flow of credit remains constrained.

Often a deep recession is followed by a sharp rebound in business and overall economic activity. As I look ahead, at least beyond the third quarter, I do not foresee this trajectory. Over the medium term, I see a slow recovery with ongoing repair of the financial sector and structural adjustments in the broad economy.

There are risks to even this lackluster outlook. One risk I'm watching is the interplay of commercial real estate and the financial sector. Commercial real estate values across the spectrum of property types—retail, office, hotel, warehouse—have fallen as a result of the recession. These values back loans held by banks and also by nonbank financial institutions and holders of commercial mortgage-backed securities. Maturing loans will bring the deterioration of lending ratios to a head.

Status and forecast—international economy
Let me now turn to the international economy. Last fall, the financial crisis in the United States quickly spread to the rest of the world through trade and financial linkages. As a result, the world economy fell into the worst recession since World War II.

The global economy is now emerging from a recession with the help of unprecedented monetary and fiscal support. Europe is expecting slightly improved performance in the short term, although the strength of the European economy is uncertain beyond an immediate rebound. China and other developing countries in Asia are leading the global recovery. Rising domestic demand and imports in China are contributing to economic recovery in export-oriented economies in Asia and elsewhere in the world.

If it was ever the case that the fortunes of the U.S. economy were decoupled from the rest of the world, it is no longer so. In 1968 total trade (the sum of exports and imports) was about 9 percent of gross domestic product (GDP). By 1988 trade amounted to about 15 percent. As of last year, exports and imports together had risen to over 28 percent of GDP.

The impact of increasing openness extends beyond markets for goods and services. The globalization of financial markets has been as important as—if not more important than—the globalization of product markets. According to McKinsey & Co., total global capital flows rose from $1 trillion in 1990 to $11 trillion in 2007.

Because the United States runs a chronic trade deficit, foreign sources represent a considerable portion of the financing for the U.S. economy. Nonresident investors own nearly half of U.S. Treasury securities outstanding, 11 percent of U.S. equities, over 20 percent of U.S. corporate bonds, and about 15 percent of mortgage agency bonds.

Although U.S. exports declined considerably in this recession and only now have begun to recover, the drop in imports was even larger. As a result, the U.S. current account and trade deficits narrowed somewhat. If this trend holds, the United States would become less reliant on the rest of the world for financing our public sector deficit as well as overall consumption.

Country risk exposure evaluation of the United States

I began my career as an international banker in the Middle East. As a young banker I was taught the techniques of country risk and country exposure evaluation. I remember well the speeches and lectures of some of the seasoned graybeards of my bank.

They taught that analysis begins with measurement of the relative growth of a country's public sector versus its private sector. If the public sector is growing, one should determine how that growth is being financed. Is the government raising taxes or improving tax collection? Or is the government borrowing? If debt financing, is the government borrowing from domestic sources in local currency or from external sources in foreign currency? If borrowing externally, what are the ratings trends of the country's sovereign debt, and what seems to be the direction of creditor attitude and appetite?

Very importantly, if the country is financing government spending domestically, is the balance sheet of the central bank growing, and does it appear that the central bank is monetizing the growing public sector debt, perhaps under political pressure? Monetizing means issuing new money to buy the government's debt. And how independently does the central bank appear to be operating?

If—from this analysis—we saw a picture of a public sector growing relative to the private sector, with that growth resulting from deficit spending, and that deficit spending being largely financed by the central bank monetizing new government debt, the conclusion was…do not increase the bank's exposure and do not go long on the country's currency.

I was first exposed to this framework for analysis more than 30 years ago. I think it is still a sound framework. So, for our edification, let's apply this framework to the United States. Let's ask, what is our reality today within this framework?

During the recession—over the last six quarters—total federal government outlays as a share of GDP grew from just under 5 percent to about 6.4 percent of GDP.

According to the Congressional Budget Office (CBO), the 2009 federal deficit will be about $1.6 trillion, or 11.2 percent of GDP. One international benchmark is 3 percent. This is the ratio required to qualify as a new member of the European Monetary Union.

To finance federal deficits, the Treasury is issuing new debt. In 2009, the U.S. Treasury will issue about $1.7 trillion of net U.S. new debt. According to the Economist Intelligence Unit (EIU), this country's national debt-to-GDP ratio will be 51 percent this year, up from 38 percent last year and is projected to reach 79 percent by 2013.

By comparison, the European Union's debt-to-GDP ratio was higher than the United States' before the crisis and is expected to rise to nearly 90 percent by 2013. Among major developed economies, Japan is by far the most indebted. Its debt-to-GDP ratio reached 100 percent in 1997 and is forecast to hit 200 percent by 2011. By contrast, developing countries are much less indebted. For the group as a whole, debt-to-GDP ratio is not expected to rise above 35 percent.

Despite the recent growth in U.S. public indebtedness, the *level* of debt is still manageable. But the trend is unsustainable and in a less stable country would spell trouble. I am confident that we will return to a sustainable fiscal path, a judgment apparently shared by financial market participants that continue to absorb U.S. debt at quite low rates of return.

However, it would be unwise to be Panglossian about the current stance of policy, and this includes monetary policy. As I noted earlier, one of the key questions of country risk analysis is whether it appears that the central bank is monetizing the growing public sector debt, perhaps under political pressure.

Here we are fortunate that both developed and developing countries have absorbed the hard lessons of history. For the most part, they have adopted institutional arrangements that enhance the credibility of central banks in their efforts to maintain low and stable rates of inflation, even in the face of significant fiscal pressures. In the United States, such credibility has allowed the Federal Reserve, Congress, and Treasury the flexibility to aggressively respond to the financial crisis without a potentially destructive unleashing of inflation expectations. And, thanks to operational independence, the Fed is not in a situation of monetizing the federal debt.

Stable inflation expectations and credibility are not guaranteed. The circumstances that promote stable expectations—particularly in an environment with rapidly rising fiscal deficits and large injections of liquidity—arise by design, not by accident. Though the details of central bank design differ somewhat from country to country, experience clearly points to independence, accountability, and transparency as the key building blocks.

Independence, transparency, and the decentralized Federal Reserve System

To build on this theme, I believe central bank independence in the conduct of monetary policy can appropriately be considered an enduring principle of sound governance of any country or political entity that issues a currency. I came to believe this many years ago, long before I joined the Federal Reserve.

Central bank independence correlates well with low and stable inflation, which correlates with sustainable economic growth that maximizes employment. Those two very desirable outcomes, not surprisingly, also happen to be the congressional mandates for the Federal Reserve.

Over the past 15 years or so, institutional reforms designed to give central banks more independence to pursue price stability have been introduced around the world with great success.

In 1990, the EIU estimated that average inflation in the world was 40 percent. By 2000, it was 4.3 percent. This year, world inflation is expected to be a mere 2 percent—very close to what many consider price stability.

It's no surprise I'm an advocate of central bank independence in the formulation of monetary policy. But the independence of a central bank cannot be sustained without a clear and deliberate regime of accountability to the public and their representatives. That regime requires what I call defined transparency. By this I mean formal reporting and communication practices that are sufficiently comprehensive and appropriately timely to balance process integrity with the value of open government.

Let's consider where we are today. Central banks around the world now publish their objectives, publicly communicate their policy actions, and speak freely and openly in public forums. In the case of the Federal Reserve, the chairman testifies semiannually on monetary policy, policy decisions are announced in a release immediately following an FOMC meeting, and the minutes of those meetings are reported on an expedited basis. The Fed also now publishes quarterly forecasts.

Also, the Fed publishes its balance sheet on a weekly basis and provides annually a detailed report on the financial activities of the Federal Reserve that are audited by an independent public accounting firm. In addition, the Government Accountability Office audits the Federal Reserve across all its operations with the exception of, importantly, monetary policy.

Furthermore, the Federal Reserve System has a characteristic that is somewhat unique among central banks of the world. The system has a decentralized structure whereby regional, independent Reserve Banks, under the broad supervision of politically appointed governors in Washington, D.C., jointly set policy.

This decentralized structure, in my view, greatly enhances both the independence of the system and its transparency.

Regional representation at the policy table provides a means for all corners of this diverse nation to weigh in on the important monetary issues influencing the economy. Reserve Banks gather economic intelligence from around their districts representing the varied views and interests of our respective regions. And Reserve Banks are well positioned to bring important information back home again, communicating the Fed's objectives in a way that enhances the understanding of their rationale.

I strongly advocate this notion of defined transparency, which I mentioned a moment ago. I've seen firsthand the delicacy of the policy role the Federal Reserve plays opposite markets and financial institutions. The events of the last two years have exposed the fragile edifice of financial stability.

I think the principles of transparency that should apply to the making of monetary policy include the following: Disclosure that does not do systemic harm. Disclosure that does not tend to shorten policy time horizons and open the monetary policy process to short-term political considerations. And, disclosure that does encourage a relationship of trust, confidence, and credibility between the public and the central bank.

In my view, the public interest resides in policies that influence the economy over the longer term, address economic fundamentals, and are politically neutral. I welcome further discussion on ways the Fed can be more accountable and transparent but always within the context of maintaining the monetary policy independence that has proven effective in the pursuit of broad economic goals.

In striking the right balance of independence, accountability, and transparency, we must also remain mindful of the global role of the dollar and the worldwide distribution of our obligations. I believe the independence of the Federal Reserve is crucial to the world's perception that the United States will continue to pursue responsible monetary policy. This perception is an essential underpinning of a calm, reasoned, and favorable assessment of U.S. country risk.

Contact: Jean Tate 404-498-8035

RELATED LINKS: Dennis Lockhart's biography • Speaker's Bureau • Atlanta Fed speeches