

Thinking About Recovery

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

University of South Alabama
Mitchell College of Business Center for Real Estate Studies
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For a long time, we've all endured a barrage of bad news about the national economy. Now—finally, 20 months after the start of the recession—the U.S. economy is clearly showing signs of recovery. So today I want to try to answer some questions on many minds: Is the recovery for real? Will it last? How soon will happy days be here again?

This will be a speech about how to think about recovery, about how to mix appropriate optimism with a considered approach to weighing positive attributes against weaknesses, vulnerabilities, and risks.

I will begin my remarks by taking stock of the economic situation in the United States along with a few comments on the international economy as it affects our country. I will give you my views on the nation's near-term and medium-term outlook and the degree and nature of uncertainty surrounding that outlook.

These are my personal views and do not necessarily reflect the views of my colleagues on the Federal Open Market Committee (FOMC).

Taking stock

Unquestionably, the economy is improving. But the vital signs—as captured in macroeconomic data—are mixed. There are pluses and minuses, positives and negatives. It's not a uniform picture. Optimism is warranted but should be tempered by awareness that this is an economy substantially buttressed by a large number of temporary government support programs.

I agree with all who are declaring that a technical recovery is underway. We are technically in recovery when a contracting economy gives way to growth. But even vigorous growth off a low bottom does not necessarily bring back prior activity levels for some time. By most estimates, it will be the second half of 2010 before the 2007 levels of national output are reached.

Let me catalog what I believe are both positive notes and areas of weakness.

A turnaround in the housing market is key to recovery. The housing market has begun to improve as measured by sales volumes, prices, and new home starts. Yet new and existing house inventories remain high, suggesting a weak residential construction outlook. And house sales are being supported by two government programs.

One is the first-time homebuyer subsidy—in the form of a tax credit. This program is due to expire at the end of November. The other is the Fed's program of mortgage-backed securities purchases amounting to \$1.25 trillion. This program has improved liquidity in a key credit market and helped to maintain mortgage rates at historically competitive levels, currently below 5 percent for the 30-year qualifying conventional loan.

The Fed's execution of purchases of mortgage-backed securities and Fannie Mae and Freddie Mac agency notes is scheduled to run to the end of the first quarter of 2010, after which private investors are expected to power the market.

Household net worth took a big hit in the recession, and as a consequence personal consumption dropped strongly. Of course, there is more to the story of consumption pullback. Starting in 2007, households began to deleverage, and in recent months the personal savings rate is up substantially.

Rising unemployment and fear of job loss, tighter consumer credit, and the savings/deleveraging phenomenon combined to push consumption down, especially in the durables category. Consumer durables buying has recently improved, but this improvement is associated mostly with the cash-for-clunkers incentive in support of auto purchases.

The effect of this program drove an uptick in recent manufacturing numbers. Industrial production turned higher in July and August after eight straight months of decline. While output gains were most notable in the auto industry, modest production growth has been seen across a broader set of industries as well.

Stock market gains along with higher savings and stabilization of house prices have begun to restore some household net worth lost since this crisis began in 2007. It is estimated that American households saw \$14 trillion dissipate, largely from stock market losses and house price deterioration through the first quarter of 2009. This loss represents more than 20 percent of their net worth. About \$2 trillion was recouped in the second quarter of 2009, primarily from market appreciation. And stock market and house price appreciation have added to these gains in the third quarter.

A moment ago, I mentioned the pall cast over the economy by rising unemployment. When I joined the Fed in March 2007, the national unemployment rate stood at 4.5 percent. Today the rate is 9.7 percent and likely to rise from here before beginning to fall.

The consensus among forecasters is something approaching a jobless recovery. The administration's stimulus program has helped soften the pace of job loss. But a recent inquiry of Southeast state budget officials, conducted by the Atlanta Fed, suggested much of the benefit, in infrastructure construction at least, has been front-ended in 2009 and early 2010.

Nonetheless, the pace of job loss is slowing. Nonfarm payrolls fell by 216,000 in August. Analysts expect that the September report due out Friday will show a decline of 180,000. This level of job loss is an improvement in comparison to nearly 600,000 jobs lost in an average month in the first half of this year.

Business spending for capital goods and inventory retrenched dramatically in the recession. Businesses remain very cautious about spending on equipment and software. This category of spending fell at an annual rate of nearly 8.5 percent in the second quarter of 2009 after tumbling almost 37 percent in the first quarter.

The data still suggest businesses are trimming these investments, but the pace of decline slowed substantially in the first two months of the third quarter. And while inventories continue to be liquidated, the pace of liquidation is slowing. At some point, inventory replenishment is likely to begin at some level.

A surprisingly positive factor in the current domestic economy and outlook is the global economy. A worldwide recovery is materializing, led by the developing economies of East Asia and India. Data released last week indicate that global trade increased at its fastest pace in five years. Foreign demand is expected to add about 1.3 percentage points to U.S. gross domestic product (GDP) in the third quarter once the final numbers are calculated. But it should be said that this resurgence also reflects sizeable government stimulus spending, the effect of which, like here in the United States, is transitory.

Financial markets

Improving financial markets are providing support for recovery. Most large-scale credit markets are functioning much better, and I believe an array of policy actions taken by the Federal Reserve, the U.S. Treasury, and other agencies, taken together, has reversed much of the financial market dysfunction that fueled the recession.

At this juncture, interbank funding has returned almost to the precrisis normal, and the corporate bond markets have improved markedly. The important asset-backed securities market—the market that ultimately finances pools of car loans, student loans, small business loans, and credit card receivables—has seen issuance volume steadily return. But it should be pointed out that progress in the securitization markets has depended, to date, largely on a Federal Reserve support program.

In contrast, the flow of credit through the U.S. banking system is not yet approaching anyone's notion of normal. For the three months through June, U.S. commercial bank loans fell sharply for the second straight quarter despite a surge in mortgage refinances. Banks too have been deleveraging and repairing their balance sheets. A return to robust bank lending is unlikely, at least in the near term.

The banking system is healing, but it will take time. Banks across the spectrum of size have received liquidity and capital support from several Federal Reserve, Treasury, and Federal Deposit Insurance Corporation (FDIC) programs. Many of these programs are winding down as banks turn to alternative sources of funds that are more cost effective.

Commercial real estate

I want to draw attention to a developing risk that could set back the progress being made by banks. That is commercial real estate. The recession weakened the fundamentals of all segments of commercial real estate (retail, office, hotel, warehouse, and—sometimes included—multifamily residential). Vacancies have risen, rents have fallen because of vacancies and renegotiations, and capitalization rates (the discount rate used to calculate value) have risen. This combination of factors has caused property values to fall, in some cases dramatically. Since banks and securities markets lend against the value of properties, loan-to-value ratios have deteriorated. As loans come due, or as loan defaults occur, restitution of sound lending ratios has to happen. If not, loans must be written down.

In mid-September the Atlanta Fed held a one-day conference on commercial real estate involving investors, developers, bankers, and academics. Panelists made several points worthy of mention.

First, panelists said commercial real estate follows employment or, stated differently, recovery of commercial real estate is job-growth dependent. I've already commented that the recovery—the early stages, at least—might not bring much employment growth.

Lots of commercial construction is still in process, and until growth of supply stops, the industry statistics will continue to deteriorate. Panelists also said loss recognition by lenders has to occur for capital to return to the commercial real estate sector. Some panelists in the conference spoke derisively of what they termed "extend and pretend" and "delay and pray" measures on the part of both banks and regulators.

Finally, the worst is ahead of us, not behind us, according to participants.

I'm sharing these qualitative assessments of the situation to give you a sense of opinions expressed by very credible participants in a conference held just two weeks ago.

Economic outlook

As I said at the start, the economy is definitely improving, but the signals we're getting in the macroeconomic data are mixed. I expect we'll see a growth number when the third quarter is totaled up, so the economy is in recovery. But will it last? Let me give you my take on the outlook.

If you look at history, recoveries following a deep recession have more often than not been quite strong. The broad consensus among forecasters is this recovery will be weak in comparison. But even within that consensus there is diverse opinion about the speed and path by which the economy will reach its full potential for growth.

Based on recent information, we at the Atlanta Fed have been raising our estimates of near-term growth, but we remain cautious about assuming much strength in the medium term. There is too much uncertainty at the moment to project happy days almost here again.

To elaborate, I see as uncertain the time required for the housing market to return to health, the potential commercial real estate drag on the financial system, the sustainability of recovery in the absence of government supports, and the resurgence of private demand.

I would be remiss if I failed to comment on the inflation outlook. As a central banker, I am always concerned with inflation prospects, and certainly constant vigilance is required. At present, inflationary pressures seem well contained. Recent inflation measures have been benign, inflation expectations of the public are stable as best we can tell, and my business contacts tell me they and their suppliers have very little pricing power in this environment.

Further, the concern expressed in some quarters over the growth last year of base elements of the money supply—namely, excess bank reserves and the Fed's balance sheet—strikes me as exaggerated. When the time comes, I am confident the Fed has the tools to reverse the assumed monetary stimulus and exit the policies put in place in

reaction to the financial crisis and the recession.

Measured optimism

I do not think that time has yet come, and to be consistent with my outlook, I think it may well be some time before a comprehensive exit need be under way. I support the maintenance of interest rates at low levels "for an extended period," as the FOMC has communicated in its public statements. Assuming stable inflation, I would like to see more evidence of private activity in the economy before advocating change in the Fed's overall monetary policy stance.

We all ardently want to believe the nation is on the economic comeback trail. I don't think we are served by declaring prematurely that we're in the clear, nor by overweighting the lagging data and the risks. In thinking about the recovery, I recommend for now a mindset of measured optimism.

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

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