The Economy in 2010 and Preserving the Role of an Independent Fed

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Rotary Club of Atlanta
Atlanta, Ga.
Jan. 11, 2010

This is my third speech to the Downtown Atlanta Rotary since I became president of the Atlanta Fed in March 2007. An address by the Atlanta Federal Reserve Bank president at the beginning of each year has become a fixture on the club's calendar. I'm honored to carry on this tradition.

The turn of the year is a demanding juncture for a speaker. I know you expect to hear a clear summary of what has happened in the past year and what's going to happen in the year ahead. Today carries even more than the usual transition import because it's a turn of the decade—a decade that was not so easy.

In preparation for this talk I looked back at my previous two speeches to this group. Two years ago—in January 2008—I did identify the risk that problems in subprime mortgages could spread to the broad economy. But I did not anticipate the near collapse in financial markets in September of that year, and I said I expected the economy would improve through the year and into 2009. I missed the fallout of the financial crisis.

Last January, my predictions were closer to the mark. I said I thought the economy would remain very weak for the first half of 2009. I called for financial markets to stabilize enough to support a recovery in the second half of the year. That's about what happened. In fact, the pace of recovery in the second half of 2009 was stronger than I expected.

Today I will try to meet your expectations of a summary of where we are (as regards the national economy) and where we're going in 2010. But, in addition to remarks on the outlook, I want to comment on some important issues concerning the longer-term institutional arrangements for governing the country's economic policy and shaping our economic future. Specifically, I want to talk about the importance of Fed independence and insulation from short-term political pressure in the conduct of monetary policy. I also want to argue for maintaining a strong, independent, apolitical regional voice in policy deliberations through the 12 Reserve Banks. I must make my usual disclaimer: The views I'll put forward are mine alone and don't necessarily reflect those of my colleagues on the Federal Open Market Committee (FOMC) or in the Federal Reserve.

Current state of the economy

A recovery is under way, and the economy is moving ahead toward a necessary transition from government-provided life support to private sector–propelled consumer and investment activity. I concur with most economists who believe the economy moved from recession to recovery in the third quarter.

For the second half of 2009, gross domestic product (GDP) is likely to come in between 3 and 3.5 percent when the final numbers are published. That performance is not as strong as many had hoped given the severity of the recession but is certainly a welcome relief after the severe drop-off in consumer spending, business investment, and exports that occurred early in 2009.

The most recent data indicate that growth of consumer spending remains constrained by a weak labor market and modest income growth, lower housing wealth, and tight credit. But despite these headwinds, household spending is expanding modestly.

Businesses are still reluctant to invest and hire. Businesses are holding fire pending clarification of future government policy in the areas of health care, taxes, and climate change. Most importantly, many businesses are waiting for clear improvement in top-line revenues. And firms continue to pare inventories and are making progress bringing inventory levels into better alignment with sales.

Purchasing managers report growth of industrial orders and production. Also, the international economy is helping. Major emerging economies in Asia are doing particularly well. As a result, U.S. exports are improving.

In the crucial housing sector, the signs are mixed. House prices seem to be stabilizing. Existing home sales ticked up in November, and existing home inventory has fallen substantially from previous high levels. But the pending sales index fell a steep 16 percent in November, suggesting weaker months ahead. The new home sales number fell in the most recent data, and construction activity remains very soft.

Financial markets, including credit capital markets, are performing better, and this improvement has supported the economic growth we're seeing. But the banking system, although certainly in better shape than a year or more ago, is still in a weakened state and still needs a lot of repair. I continue to hear complaints that bank credit isn't flowing. At the same time, bankers tell us there is a lack of qualified loan demand under acknowledged tighter credit standards. A recent small business survey performed by the Atlanta Fed suggested that business loan demand was down primarily because of weak sales and modest revenue prospects. The credit availability picture was mixed. No surprise, construction-related firms and manufacturers had the most trouble obtaining credit during the last six months. But others did well in having their credit needs met. Of more than 200 respondents, nearly half did not look for credit at all, mostly citing weak sales or sufficient cash reserves.

To summarize the current situation, the economy is on the mend, but it's not free of drags or risk.

2010 outlook

I expect the recent growth of the economy to be sustained, but the pace of the expansion to be slow over the foreseeable horizon. This forecast of slow recovery takes account of nagging problems, particularly unemployment and commercial real estate. Near-term growth will probably not be strong enough to substantially bring down the large number of unemployed.

To back this up, growth at the economy's long-term trend rate—something like 3 percent annually or a little lower—would generate about 160,000 jobs per month under standard assumptions about population growth, labor force participation, and productivity trends. Employment growth at this level would reduce unemployment only marginally over the coming year. As Friday's payroll employment report indicates, getting to 160,000 jobs per month could be a challenge even with GDP growing.

As regards the inflation outlook, I am reasonably confident that the rate of inflation will remain in check for the immediate future. Current inflation readings are acceptable and inflation expectations seem to be stable. I talk to many business people who tell me they have little or no pricing power. On balance, I expect inflation pressures to be restrained as a slow recovery proceeds.

In sum, I expect a better overall year in 2010. The bottoming of the inventory liquidation cycle, some recovery in business investment, and better economic prospects in the rest of the world set a foundation for continued growth going forward. But it will not be a gangbuster recovery.

Risks

As I proved two years ago, economic predictions are never certain. There are risks to this outlook that bear watching. I've already mentioned commercial real estate. The risk associated with commercial real estate is linked to banks, small business credit, jobs, and ultimately consumption. The overall commercial real estate debt in the financial system is smaller than residential, but it is disproportionately concentrated in small and regional banks. Smaller banks are a significant source of credit for small businesses, and in most recoveries we look to small businesses to generate a significant number of jobs.

Much hinges on the valuation of commercial properties realized in refinancings and restructurings during the next three or four years. Commercial real estate valuations derive from jobs, among other factors, so you can see the potential for a self-reinforcing dynamic that could be worse than expected.

However, given the accumulating evidence that recovery is gaining traction, I'd say confidence is warranted. But I'd also suggest that it's prudent to be guarded in your optimism. The ride could be bumpy.

Thoughts on exit

If my outlook for 2010 is accurate, this will be the year that necessarily involves exit from a lot of the emergency policies put in place to fight the financial crisis and recession. How that process might unfold is and will be a matter of active discussion among the members of the FOMC.

Last January, I talked about the dramatic expansion of the Fed's balance sheet in response to the financial crisis in September 2008. Although the total balance sheet has not yet started to shrink, some unwinding already has begun. At our last meeting in December, the FOMC said that most of the Fed's special liquidity facilities will expire at the end of this month and the purchase of mortgage-backed securities and other agency debt will taper off and come to an end early this year.

A bit like Goldilocks' porridge, the exit or unwinding process needs to be—in my view—not too fast, not too slow, but just right. I continue to support an interest rate policy described in recent FOMC statements as low for an "extended period." What does "extended period" mean? I don't want to put a date on it. To me, it means the policy rate will be kept low until recovery has shown momentum that is based on private business and consumer demand, job growth is established or at least imminent, and the downside risks appear to be safely navigable. This unwinding is in the context of well-behaved inflation, of course.

Danger of politicization

While the economic medium term is looking more hopeful, some troubling ideas are in play that could affect the country's economic policy institutions for the long haul. Some of the proposals are a reaction to things gone wrong during the last two years. A look back to identify fixable problems is entirely appropriate, but a reaction fashioned in a heated aftermath can overshoot.

In particular, I'm concerned about measures that would have the effect of politicizing the central bank—the Fed—and especially decision making on matters of monetary policy.

Monetary policy has a long-term orientation and often takes effect with lags and interacts with other fundamental, longer-term forces in the economy. In my experience, monetary policy is about setting a course and making periodic adjustments in response to major changes in conditions. Importantly, monetary policy should not swing with the daily news or be influenced by short-term political pressures.

I am concerned that certain legislative proposals could compromise the independence that enables staying on course. I'm referring to the "audit the Fed" amendments that were passed in the House and introduced in the Senate. The audits would be performed by the Government Accountability Office (GAO). In 1978, Congress thought it wise to exempt monetary policy from GAO review. Congress did this in keeping with established international practice and studied opinion that independent central banks do a better job of keeping prices stable. The effect of these proposals would be to roll back the clear exclusion of monetary policy. The Fed has no argument with audits in the conventional meaning of the term. We're already subject to many audits by the GAO and external auditors. In government, the word "audit" can be misleading sometimes. GAO audits can amount to full-blown policy reviews. Fed operations outside of monetary policy are already subject to GAO policy review, so this proposal is about ad hoc, after-action reviews of monetary policy, potentially frequent. In my view, this notion is not about transparency and accountability. Both are bedrock principles to which the Fed should continue to be held. Rather, this is about politicizing a process that should remain apolitical.

The Fed must have the capacity to make unpopular decisions—to take away the punch bowl, as it were. Many of you remember the circumstances of the early 1980s when the Paul Volcker–led FOMC acted against inflation. One should ask—would Volcker have been effective if the intense opposition to his policies was joined with formal, statutory methods of bringing pressure? The stakes in this issue are big.

I am also concerned about ideas that have been floated that could have the effect—if taken too far—of politicizing the input of regional Federal Reserve Banks in policy deliberations. From its inception, the Federal Reserve System was designed to have checks and balances, to avoid concentration of power in New York and Washington, and to give every region of the country an apolitical voice in policy formulation.

Let me explain how we work to give voice to people like you in the Southeast. During the time between meetings of the FOMC, the Federal Reserve Bank of Atlanta collects economic intelligence and policy views from some 44 board members of the Atlanta Bank and its five branches. Most of these board members make a number of calls to collect input from their community contacts. Also, we meet periodically with members of six advisory councils representing a range of major Southeast industries and constituencies. Before each FOMC meeting my staff and I make calls to informal advisers in industry and finance. I estimate we get input directly or through directors from

about 1,000 citizens in the Southeast on ground-level economic conditions and the impact of policy. A number of members of this Rotary Club have contributed such advice over the years—some as members of our board of directors.

I feel strongly this interactive channel of citizen input to national policy should be preserved. We have worked hard to democratize the region's input on national policy decisions through aggressive outreach to business and other leaders.

The mood today enveloping much of the discussion of needed financial and regulatory reform is affected by public anger and an impulse to punish. I fully understand these sentiments. The country is just now emerging from a long and painful recession caused largely by a crisis in our financial system. We need to fix things, but purported reforms that weaken how the country's economic affairs are governed will be harmful and tough to undo. This debate is not a remote political one. It's a Main Street issue. If markets come to question the independence of Fed monetary policy, that questioning could cast doubt on the country's commitment to price stability. In the real world, uncertainty resulting from injudicious reforms will be factored into asset prices and borrowing rates by the world's markets and will make recovery more expensive.

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