The Economic Outlook: A Tale of Two Narratives

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I'm honored to be asked to speak at the Augusta Metro Chamber of Commerce annual meeting. I appreciate this opportunity to meet with the business leaders of Augusta. The Southeast, despite the severe recession, still accounts for a significant share of the country's economy. Our region today closely parallels the overall national economy in industry composition and economic behavior, so our soundings in various cities across the region tell us much about current reality as businesspeople like you are living it. Your input is very valuable in the policy process, so I look forward to your questions and comments at the end of my remarks.

I became a central banker and policymaker almost three years ago. Through the period since March 2007 I have been living that old Chinese curse "may you live in interesting times." In my experience, at every juncture of the financial crisis, the resulting recession, and the now-developing recovery, we at the Fed have faced an uncertain outlook with a very tricky set of issues.

This juncture is no different. Tonight, I will share my views on the current economic situation, the factors that could influence the trajectory of recovery, and, as a result, the Fed's policy decisions in coming months. These are my personal views and don't necessarily reflect those of my colleagues in the Federal Reserve System or on the Federal Open Market Committee (FOMC).

Primary credit rate announcement

Earlier today, the Fed announced an increase in the primary credit rate. The primary credit rate—also called the discount rate—is the rate at which the 12 Federal Reserve Banks across the country provide temporary liquidity to healthy banks. How should today's announcement be interpreted? I would not interpret this action as a tightening of monetary policy or even a sign that a tightening is imminent. Rather, this action should be viewed as a normalization step.

Specifically, the Fed increased the spread between the primary credit rate and the top of the targeted range for the federal funds rate by a quarter point to 50 basis points and shortened the term of such loans to overnight. The federal funds rate (often shortened to "fed funds rate") is the overnight rate at which banks lend excess reserves or borrow required reserves for deposit at the central bank, the Fed. Targeting this rate is the primary tool of monetary policy.

In two steps, beginning in August 2007, the Fed reduced this spread from its precis level of 100 basis points to 25. These actions, along with several other policy moves, were taken to stabilize the banking and financial system. Today's action is another example of the removal of the special credit and liquidity facilities put in place in response to the financial crisis.

A number of those special credit or liquidity facilities targeted at specific money markets during the financial crisis expired at the end of January. In addition, the Term Auction Facility, or TAF, which at its peak provided $493 billion of short-term loans to banks, has shrunk to an announced $25 billion; the last scheduled auction will be March 8. In addition, the Fed's program of purchases of mortgage-backed securities has tapered off and will close at the end of March. All of this is happening because stress in the financial system has abated.

My point is that the public and markets should not misinterpret today's move. Monetary policy—as evidenced by the fed funds rate target—remains accommodative. This stance is necessary to support a recovery that is in an early stage and, in my view, still fragile.

State of recovery

The recovery is likely in a transitional phase from an economy heavily buttressed by government support—both Federal Reserve programs and fiscal programs—to an economy propelled by private-sector business investment and consumer demand.

Positive signs in the economic data indicate that this transition is under way. For example, new orders for manufactured goods are growing, including orders for core capital goods. Industrial activity is improving, and, in fact, we learned yesterday that manufacturing output in January rose by a rather strong 1 percent. Consumer spending increased 2 percent in the fourth quarter of last year at an annualized rate, and retail sales were positive in January.

The overall housing sector is in a mixed state but with some encouraging news. Construction spending appears to be steadying after severe declines. Inventories of existing and new houses have fallen substantially. New home inventories have stabilized, and existing home inventories are still falling. The National Association of Realtors pending home sales index ticked up in December. House prices in most markets seem to have stabilized.

However, I should add that this is the national picture. In a recent survey conducted by the Atlanta Fed as part of our regional intelligence-gathering process, Southeastern builders and realtors reported improved buyer traffic in January, but the current and projected sales picture softened. The situation in our region is not quite so positive.

But, on the whole, we've got a recovery going, and there are reasons to be hopeful for sustained growth. The question is, At what level?

Outlook—two narratives

I see two competing narratives about how this recovery will play out. Growth in the fourth quarter of 2009 was quite strong and raises hope for a robust recovery. In this, the first narrative—that of a traditional sharp bounce-back following a deep recession—growth exceeds the underlying long-term potential of the economy and unemployment declines at an accelerating pace.
In this narrative, businesses rebuild inventory levels and resume capital expenditures in anticipation of growing sales. Consumers regain confidence, and retail spending grows briskly. You can add positive export growth as the economies of our major trading partners—especially in Asia—also show better growth.

Finally, in this narrative the banking system successfully navigates a weak commercial real estate sector and starts expanding credit to both business and consumers.

The alternative narrative entails some fundamental changes in business practices and consumer habits. In this scenario, businesses have learned from the recession that they can operate permanently at leaner inventory levels and flat or lower employee head counts. And the impressive worker productivity gains measured in recent data continue to accumulate.

Consumers, in this narrative, have assumed a quite different mind-set compared to the precrisis, prerecession "normal." Chastened by the recession and high unemployment—consumers are simply more frugal and more inclined to save. And even if consumers wanted to resume prerecession spending habits, the consumer finance industry, in this narrative, will not accommodate previous levels of consumption.

In this narrative, growth continues, but at a very modest pace, and unemployment is very slow to recede. The first narrative is a return to something resembling normal as we knew it; the second narrative describes a somewhat new and different world.

The Atlanta Fed’s base case outlook
The question is, Which world are we in?

Well, I’m not entirely sure. My late wife, when she heard me say “I’m not entirely sure,” would reliably fire back “you mean you don’t know.” She had a way of cutting to the essence.

In my view, we’re at an uncertain juncture and must watch closely for indicators in coming months to discern which reality is playing out. Indicators will include retail sales, inventory and capital investment, and, importantly, job creation and hiring.

My team of Atlanta Fed economists and I are forecasting the second narrative. We are forecasting a lower-growth, more gradual recovery with slow progress on unemployment. Our outlook gives weight to some challenges facing the economy and the banking sector that we believe may constrain recovery.

Let me highlight three factors I will be watching closely.

First, as has been widely publicized, the U.S. economy grew at a very healthy annualized rate of 5.7 percent in the fourth quarter of last year. A number that high would suggest a rapid-growth narrative, but most observers do not expect this pace of growth to continue through this year.

More than half of the growth surge in the fourth quarter came from the slowing of inventory liquidation. In the arithmetic of GDP calculation, slower destocking means more sales are coming out of production than out of inventory. Once liquidation has run its course, a kick to GDP from inventory changes would require more rebuilding. Because I’m not forecasting a substantial rebuilding of inventory, I don’t expect to see much inventory effect in GDP growth in 2010.

I’ve heard anecdotal comments from retailers that they have been willing to forgo sales to avoid an unwanted building of inventory. This inventory caution could very well continue. On the other hand, if uncertainties lift, businesses may be less inclined to give up revenues for inventory cost savings. If significant inventory replenishment does occur, growth could be much stronger this year than my forecast suggests.

A second factor is just the atmosphere of uncertainty and the effect this has on business investment. What are the uncertainties weighing on business decisions, especially capital expenditure decisions? I would cite problems in the commercial real estate sector that could compromise the repair of credit markets and banks and, as a consequence, business access to credit. I would also cite public policy coming out of Washington in areas such as health care, tax, regulation, and the federal deficit.

Business spending slowly trended up through 2009 from a quite negative growth rate at the beginning of the year to a barely positive growth rate at the end of the year. Because of the cloud of uncertainty, my forecast does not include much further improvement of capital spending in 2010. But again, if some of that uncertainty lifts, business spending could push the economy higher.

The third and maybe most important factor I’m watching is the labor market. I expect a very slow recovery of employment markets and, therefore, a slow decline of the unemployment rate. But it’s worth noting that as the recovery got under way in the second half of last year, businesses relied on productivity enhancements to expand production and were able to defer hiring.

A shift from productivity-driven expansion to jobs-driven expansion could materialize as benefits of earlier cost and head-count reductions reach their limit. The additional hiring that would follow would likely improve business and consumer confidence and feed a virtuous cycle.

Again, I lean to the slower-growth narrative. I expect businesses to be very cautious with respect to inventory accumulation, capital spending, and hiring. But I will be watching carefully for signs that an alternative, faster-growth scenario is developing.

Monetary policy stance
I have given you my best estimation of the world we’re in and the outlook from here. But, to be frank, which narrative will unfold is not clear, and, for this reason, in my view, monetary policy in the coming year must be nimble. If the first narrative—the more optimistic one—develops, inflation pressures could increase and the momentum of the economy could call for higher interest rates to preserve and sustain healthy expansion. If the second narrative plays out, policymakers will have to be patient and guard against removing accommodation too early.

In either case, I am confident the Federal Reserve has the necessary tools and the capacity to act. The Fed has been preparing for an eventual exit from its extraordinary policies that blunted the financial crisis and recession. As Chairman Bernanke noted last week, preparation has entailed the evaluation of the capacity of markets to absorb transaction flows, operational testing of specific tools, and arrangements with market counterparties. Whichever way the economy tips, we are prepared.
Closing
Let me close by framing what I hope is your takeaway from my remarks this evening. The economy is recovering. The strong fourth quarter GDP growth performance is probably not sustainable, but continued growth is very likely. Two economic narratives—and variations on these two, of course—could play out. There are reasons to be cautious about predicting the stronger of the two, but there is a lot of uncertainty at this juncture. For this reason, you should expect the Fed to be especially watchful and nimble in response to developments. And you can be confident that the collective judgment of the members of the FOMC is up to the task and that the Federal Reserve has the necessary tools to calibrate policy to actual developments at the appropriate time.

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