SPEECHES

The U.S. Economy and Emerging Risks

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

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This afternoon, I will give you an update on the U.S. economy and comment on conditions in the global economy that affect this country. I'll also offer views on the interplay between fiscal uncertainty here and abroad and appropriate monetary policy to achieve both growth and control of inflation.

The views that follow are mine alone and don't necessary reflect the views of my colleagues on the Federal Open Market Committee (FOMC).

Current economic juncture

First, the national economy: I expect first quarter gross domestic product (GDP) growth numbers will show the economy continues to recover. The recovery began last summer and accelerated in the fourth quarter. Fourth quarter growth was driven by what I believe was the transitory phenomenon of slowing inventory liquidation. Most forecasters expect the first quarter to clock in at a slower but quite respectable pace of around 3 percent, and I agree with that view.

Underlying continued growth is a steady improvement in private spending in the United States. Consumer spending is expanding modestly.

Business spending on equipment and software is helping to offset softer housing and commercial construction.

Here in southwest Florida, you are well aware of the challenges faced in housing. In Naples, house prices have declined 64 percent from their peak in the second quarter of 2006 and have yet to stabilize.

Nationally, home sales slowed late last year, and sales have eased further so far this year. Continued stabilization of the housing sector—especially house prices—is likely a precondition for sustained economic recovery.

Although job cuts in the United States appear to have tapered off in recent months, the share of jobless receiving extended unemployment benefits has continued to grow. Last month's U.S. unemployment rate remained very high at 9.7 percent.

Another gauge of the labor market is the percentage of people who, along with the unemployed, have stopped looking for work—so-called discouraged workers—as well as those who are working fewer hours than they want. The combined unemployed and underemployed figure is about 17 percent of the workforce.

With job growth negative to flat, real incomes have stagnated. Total personal income, including transfers from the government, has grown modestly, but income from wages and salaries has declined from a year ago.

To give a context for these domestic developments, let me comment on the international environment in which our economy is evolving. Overall, the outlook for the global economy continues to improve, and international trade has rebounded sharply.

Emerging Asia is driving the global rebound, led by China and India. China's economic growth has been especially strong, lifting global demand for raw materials and capital goods. Latin America has weathered this global crisis much better than previous downturns thanks to stronger economic fundamentals. The region is further benefiting from rising commodity prices.

Meanwhile, recoveries in key developed economies, which still account for the largest share of our export market, have been much less dynamic. Japan's economy has fallen back into deflation, and its economic growth trajectory remains very uncertain. Europe's recovery is fragile as concerns mount about Greece and other countries with large fiscal burdens. I'll discuss this topic more in a moment. Overall, despite the notable divergence in growth rates between developed and emerging economies, the global economy is expected to expand at a solid pace this year, continuing to provide support for U.S. exporters.

Looking ahead, the central question for the United States is how strong the recovery will be and how long it will take to reduce unemployment.

Views about the economic outlook fall roughly into two narratives. Scenario one is the familiar V-shaped, strong bounce back from severe recession. In this scenario, growth exceeds the underlying long-term potential of the economy, and unemployment declines at a steady pace. Both consumer activity and business investment show growth. Exports contribute measurably to GDP, reflecting growth of our principal trading partners, particularly in Asia. The banking system successfully navigates a troubled commercial real estate sector and expands credit to both businesses and consumers, fueling a rather strong recovery.

By contrast, the second scenario is a relatively modest recovery, with slow reduction of unemployment. Various headwinds hold back GDP growth. They include (1) a weak banking sector that is slow to expand credit in part because of weak loan demand and commercial real estate problems, (2) subdued consumer activity reflecting a more frugal consumer mindset as well as restricted consumer credit, and (3) extremely cautious business investment in both inventory and capital goods.

Most forecasters see a future resembling the second narrative. My forecast—and that of my staff at the Atlanta Fed—is close to the second narrative. The recovery under way seems at this juncture to be tentative and fragile.

Greece and fiscal uncertainty
My staff and I typically incorporate known, somewhat quantifiable risks into our forecasts. I referred to these as headwinds. They are factors we expect to be drags on growth. There are other plausible emerging scenarios that are not factored into my formal outlook. I monitor these for evidence that they're materializing—becoming real—and need to be more formally considered. One such concern is what might be called "fiscal uncertainty."

You've all been reading about Greece and the European Union's handling of the Greek fiscal crisis. At the moment a nexus of fiscal uncertainty is the situation playing out in Greece.

Last October, the government of Greece revised its 2009 fiscal deficit sharply higher to more than 12 percent of GDP. Consequently, the ratio of public debt to GDP was revised up by 17 percentage points this year to 125 percent of GDP.

Investors around the world are concerned about Greece's deficit and rising debt. Market pressures, along with European Monetary Union mandates, have forced the government to present a credible plan to tame its deficit. As of today, how this will play out is not clear.

It's worth considering whether this is just a distant development or one with relevance to us here in the United States. What do fiscal problems in Greece have to do with my economic outlook for the United States?

I see three ways the Greek crisis might directly affect the U.S. economy. First, adjustment across the EU to fiscal problems could dampen euro area growth and constrain U.S. exports to that region. The European Union as a whole is this nation's largest export market. Second, related to this, safe haven currency flows from the euro into dollar assets could cause appreciation of the dollar and hurt U.S. export competitiveness. Third is the possibility that the Greek fiscal crisis could lead to a broad shock to financial markets. This could play out in the banking system or in the form of a general retreat from sovereign debt.

At this point, these possibilities are not factored into my outlook in any way. But developments around the Greek situation deserve rapt attention.

We have our own set of fiscal uncertainties in this country—at all levels of government. The National League of Cities projects that municipal governments will face a shortfall of $56 billion to $83 billion from 2010 to 2012. Local governments in this country are pressured by lower sales tax revenues and shrinking property tax digests along with other demands.

On average, state-level governments began fiscal year 2010 with a revenue-expenditure gap of 17 percent. Three states had expected budget gaps in excess of 40 percent. Florida's budget gap going into the current fiscal year (2010) was 23 percent.

Across the country, state governments have responded to these strains by drawing down rainy day funds, raising taxes, cutting budgets, and furloughing employees.

To date, some amount of spending cuts and tax increases at the state level have been avoided thanks to the federal stimulus package, but that infusion of money is temporary. It appears state budgets next year will need to shrink considerably to get to balance.

I'm sure you're familiar generally with the situation at the federal level. According to the Congressional Budget Office, under current law federal budget deficits rose from an average of about 2.4 percent of GDP in the period from 1970 to 2008 to 10 percent in 2009. No budget path currently under consideration would keep the public debt from growing relative to gross domestic product. Clearly, an ever-rising debt-to-GDP ratio is unsustainable and a matter of great concern.

Government finances are severely strained at all levels. All of these fiscal pressures represent another downside risk for the broad economy. But I see a connection to inflation risk as well. Let me explain.

The FOMC met last week. In that meeting the federal funds rate target was kept at the "low as it can go" range of 0 to 25 basis points. Also, the Committee, in its post-meeting statement, said that economic conditions are "likely to warrant exceptionally low levels of the federal funds rate for an extended period." This policy is obviously very accommodative, and, in my opinion, is appropriate for a recovery that is tentative and facing headwinds.

Policy dilemma forming
By congressional mandate, the Fed in conducting monetary policy must balance support for economic growth and the associated goal of bringing down unemployment with pursuit of price stability—low inflation. In my view, the current accommodative stance of policy is not inconsistent with the dual mandate as long as inflation expectations remain well anchored.

In these times of fiscal uncertainty I am concerned about the possibility of a monetary policy dilemma developing. If you, the public, become convinced nothing will be done to restore the federal fiscal balance, especially at the federal level, this skepticism may be reflected in inflation expectations. You may come to believe that the only plausible scenario is inflating our way out of the problem.

If such a situation begins to develop, the Fed will face a difficult trade-off between continued support for the recovery and aggressive action to reanchor inflation expectations.

For the time being, inflation expectations are holding steady, and incoming data suggest price pressures are muted. It is hard for me to summon much concern about inflation in the immediate future. Almost all measures of core inflation show indications of disinflation. But this pattern could shift. As a policymaker, I have to pay constant attention.

Inflation expectations as critical factor for policy
In my view, the capacity to maintain interest rates at the level appropriate to support the recovery depends critically on containment of inflation expectations.

The Greek drama we're watching with such great interest should heighten recognition of the urgent need here in the United States for a credible path to fiscal sustainability. Rising public awareness of the country's serious fiscal imbalances should serve as a call to action.

The nation has successfully navigated such challenging circumstances in the past and can do so again. With a credible fiscal plan, monetary policy should be able to remain supportive of the recovery that I'm confident will build in strength.

Contact: Jean Tate 404-498-8035

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