

Recovery and the Challenge of Uncertainty

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

Rotary Club of Baton Rouge
Baton Rouge, La.
June 30, 2010



I appreciate the opportunity to speak here at the Baton Rouge Rotary. I'm in my third year as a Rotarian and have spoken at a number of Rotary Clubs across the Southeast. I figure the four-way test ensures a friendly audience even when my message must be a sober one and isn't thoroughly upbeat and inspirational.

I know the ongoing oil spill in the Gulf dominates attention here in Baton Rouge. Indeed, I believe it has come to affect the confidence and sense of control of Americans throughout the country. I'll comment further on the oil spill's economic impact later in my talk.

It's been just a week since the Federal Reserve's latest policy meeting in Washington. In the days running up to the Federal Open Market Committee (FOMC) meetings, my colleagues and I take stock of the national economic conditions and outlook as a baseline for deliberations on policy. Today I'd like to walk you through my version of that stock taking, updated slightly to take account of the economic news of the past week.

The central question is whether the recovery that is now well under way will be sustained or will falter, resulting in a slowdown or even a second recession—the so-called double dip.

As I said, this will be my own version of the economic picture. As is always the case, I am speaking for myself—my views may not be shared by my colleagues on the FOMC or in the Federal Reserve.

The risk of inflation

I'd like to start by talking about the risk of inflation. Price stability is half of the Fed's dual mandate; maximum employment is the other. I'd characterize the current state of inflation as low and reasonably stable.

There are several measures of inflation—headline versus core, CPI versus PCE, wholesale versus retail—and a number of ways to massage the numbers for insight into subtrends and underlying causes. But no matter the measure, it's difficult to discern much broad-based price pressure today.

Recent retail price trends have evidenced further disinflation, the intermediate condition between rising inflation and deflation. During a period of disinflation, the pace of price increases slows and the rate of inflation declines.

The rate of core consumer price inflation has declined from 2.5 percent as recently as two years ago to an annualized rate of around 1 percent over the past 12 months. Commodity prices have fluctuated up and down in response to global supply and demand, but again it's hard to interpret the rise of some commodity prices as a broad-spectrum, one-directional phenomenon.

Likewise, the measures we have of forward-looking inflation expectations are stable and relatively low. Surveys of households about their inflation concerns have shown little upward—or, for that matter, downward—tendency over the past few years. Inflation predictions that are priced into some government bonds also don't seem to signal a problem.

In the business arena, very few firms have much in the way of pricing power in the current economy. This limitation stems from the weight of excess capacity, sometimes called economic slack. Reasonable economists—I know a few—can debate the amount of slack at any given time, but I think both the hard data and the consensus of the Atlanta Fed directors and many other business contacts point to considerable slack at work.

In manufacturing, while the percent of capacity in use has been rising, the current share is quite low and still about 8 percentage points under prerecession levels.

As regards wages, the high level of unemployment has limited workers' negotiating power. As you know, nearly 10 percent of the labor force is counted as unemployed, and an almost equal number count as underemployed.

To sum up, I don't see inflation as much of a current worry. If anything, there is a small risk of deflation that must be monitored. Limited inflation allows focused attention to recovery and growth, which I'd like to turn to now.

Recovery and growth

A fairly widespread national economic recovery—seen across most sectors and geography—has been proceeding for almost a year. The pace of growth was strongest in the fourth quarter of 2009, which helped achieve a growth rate of almost 4 percent in the second half of last year. The economy has apparently downshifted a bit in the first half of 2010. Gross domestic product (GDP) growth for the first half of the year is now expected to come in around 3 percent.

The story of the climb out of recession is one of an evolving mix of factors contributing to growth. The transition last year from recession to recovery was helped by federal government stimulus. Stimulus spending is still at work but is much less forceful in 2010 compared with 2009. Fourth quarter 2009 growth was supported by a slowing in the pace of inventory liquidations. In the first half of 2010 we've seen rising consumer spending, rather strong business investment, and very strong growth of manufacturing production.

Let me elaborate on each of these factors.

Rising consumer activity surprised many in the first quarter of the year, but in April and May consumers seemed to put away their wallets to a certain extent. According to some analysts, the strong first quarter spending represented pent-up demand coming out of recession, and the apparent pause reflects the return of a more cautious attitude influenced by stock market gyrations and other worrisome developments, even including the oil spill. Yesterday it was reported that the Conference Board's estimate of consumer confidence, based on the attitudes of 5,000 households, fell sharply in June, wiping out the confidence gains seen in the prior two months.

Business spending on equipment and software has been strong in the first half of the year. Again, analysts have interpreted this performance as a sign of pent-up demand following deferrals in 2009 when so many businesses put a stop on everything but essential spending. Shipments of nondefense capital goods excluding aircraft, a rough proxy for business spending on new capital equipment, rose 1.6 percent in May alone, indicating an annualized double-digit rate of growth.

Manufacturing production is up about 8 percent over the past year through May. Almost every manufacturing industry has posted strong growth during that period, with double-digit gains across a number of durable goods, including metals, machinery, computers, and motor vehicles. Keep in mind that these industries bore a disproportionate amount of the pain associated with the recent recession, and current production is still well below peak levels.

In addition to these three factors in the recovery story over the past year, another factor I should mention is the supporting role of productivity growth. The pace of growth of productivity in the broad economy has been very strong coming out of the recession—5 to 6 percent annualized. This increase explains, at least partially, an improvement in output devoid of much progress on unemployment. Employers have increased hours of work recently but have been hesitant to hire. Businesses are making every effort to squeeze as much production as possible out of their downsized workforces and are pursuing productivity gains from reorganization, automation, and supply chain streamlining. These strategies were formulated during the recession and continue.

Here's a key point about these contributors to recovery—each could be transitory. The economy has not yet arrived at a state where healthy and sustainable final demand is underpinning growth.

I make this point not to predict a reversal of the progress made but just as a cautionary reminder to avoid counting chickens too early. There are sectors that remain in a very depressed condition—housing, for example.

Recent numbers suggest a sharp slowdown of residential real estate market activity with the expiration of the homebuyer tax credit. Home sales fell sharply in May, with new home sales plunging to their lowest level in the history of the data—47 years. Inventory problems could weigh on house prices and construction activity for some time.

The most sobering aspect of current economic reality is the employment picture. I referenced earlier the national level of unemployment being close to 10 percent.

Unemployment peaked at just over 10 percent last October and has remained stubbornly high since then in spite of the economy's growth. The most recent job creation data were discouraging. While total nonfarm payroll jobs grew by 431,000 in May, much of that hiring was for temporary Census work. Private sector employment grew by only 41,000. On Friday we'll get the employment report for June, and it's anticipated that about 240,000 census workers were pared from federal payrolls. Analysts hope that additional private sector employment will replace about half of those job reductions.

All this said, I believe the recovery will move ahead at a modest pace and unemployment will gradually come down. Impediments to growth are being removed. Financial market function is being restored. Private balance sheets are being repaired. And necessary structural adjustments are under way.

The past few weeks, however, have seen a slight retrenchment from the mind-set of optimism and growing confidence that prevailed earlier in the year.

One reason is the numbers. The first quarter was apparently a little weaker than previously thought. Just last week, the growth rate of real GDP was revised down from 3 percent to 2.7 percent. The estimate of consumer spending on services was lowered, as were measures of net exports and investment in equipment and software.

Uncertainty and risk

More influential, in my opinion, is the heightened sense of uncertainty and risk surrounding the outlook.

In your businesses and in the general economy, at any point there is more or less visibility into the future. To be sure, significant uncertainty accompanies any economic forecast. Think of a "cone of uncertainty" projected forward from today and encompassing a variety of plausible scenarios or narratives.

Recently that cone has splayed wider. Several recent sources of uncertainty have clouded the outlook. I will cite four, including the oil spill in the Gulf.

First is European sovereign debt. What started as a threat of default on public sector debt obligations of certain European countries (Greece, Portugal, Spain, Italy, and Ireland) has spread to European funding markets, both euro and dollar. Risk aversion has brought liquidity pressures onto European banks.

Our financial system here in the United States has rather small and manageable direct exposure to the Greek government and the other sovereign borrowers. But as the situation has evolved, exposure to European banks as well as foreign and local corporations in the affected countries has complicated the estimation of risk.

The concern is that continuing and possibly escalating financial market pressures will be transmitted through interconnected banking and capital markets to our economy. There is also the potential effect on our export markets of a stronger dollar and weaker European economies.

In its June publication, one-third of the economists in the Blue Chip panel of forecasters indicated they had lowered their growth forecast of the U.S. economy over the next 18 months as a consequence of Europe's debt crisis. This situation is still evolving.

A second source of uncertainty is ongoing state and local fiscal tightening. State budget gaps are expected to widen this year and in 2011 as federal support recedes. By one estimate, next year's budget gap for all states is expected to peak at \$144 billion. Closing these budget gaps means spending less and taxing more. This situation is our nation's very immediate analog of the public finance pressures being felt in Europe.

A third area of uncertainty is commercial real estate. Banks across the country, especially small and regional banks, are heavily exposed to the commercial property sector and face a heavy docket of loan restructurings that may require sizable write-downs.

It's not yet clear how much pain might be imparted to the overall economy by loan losses of banks and investors from the downward revaluation of commercial properties. Views vary on how severe a problem is developing and whether it will require an organized comprehensive resolution effort to avoid widespread damage to the economy.

And there is the oil spill, which is, naturally, the central environmental and economic concern here in Louisiana and more broadly in the Gulf region. Its effects are falling most severely on individuals employed in commercial fishing, recreation and tourism, and deepwater drilling as well as businesses and suppliers associated with those industries. So far, the measurable economic effects have been mostly local and regional.

As was the case in the aftermath of Hurricane Katrina, the oil spill brings two main risk factors for the national economy—the impact on energy supplies and transportation. To date, the supply of natural gas and refined petroleum products has not been significantly disrupted. Importantly, the Louisiana Offshore Oil Port (LOOP) is open and functioning normally. And key transportation facilities remain operational, although shipping has had to navigate around the slick.

The economic effect at the national level has been limited. I'm prepared to believe, however, that this relentless environmental disaster is an additional factor holding back consumer and business confidence. The spill disheartens us all and, I believe, makes the public a little more reticent to assume a smooth recovery path.

Thoughts on policy

So, to pull this together, a recovery of the national economy is proceeding but not yet with solid and sustainable underpinnings. Inflation appears restrained. The outlook from here is beset by somewhat more than normal uncertainty. There is a chance of overachieving forecasts of moderate growth and gradual reduction of unemployment, but at the same time there are notable risks. In my view, these circumstances suggest caution in moving away from policies designed to give the economy the best possible prospect of recovery with full employment. Adjustment of monetary policy will be needed eventually, but this is not the time.

Recent developments make me even more convinced that current policy is appropriate. Financial markets and many businesses are more nervous today than a few weeks and months ago, and it's my view that monetary policymakers should hold to a guarded policy stance and evaluate carefully the risk and reward of a change of policy.

All deeply distressing experiences—whether national economic and financial crises, regional environmental calamities with associated economic pain, or traumas on a personal level—are followed by a strong impulse to return to normal. This urge also holds for our central bank. Normalization of interest rate policy and the size and composition of the Fed's balance sheet is much desired, but I believe conditions at this moment call for patience.

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

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