Gauging the Economy and Monetary Policy

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Key Points

• Lockhart believes the recent economic softness reflects the choppy, sometimes uneven transition that occurs when the economy is shifting from public stimulus to improving private demand. In his view, the economy is experiencing a temporary downshift.

• Monetary policy is, at present, quite stimulative and appropriately so, in his opinion. At the last FOMC meeting, he believed a small precautionary action to avoid any risk associated with inadvertent tightening was prudent in the midst of disappointing economic indicators.

• The economy continues to improve in certain fundamentals and continues to strengthen defenses against a shock, according to Lockhart. The financial system continues to heal. There are signs that availability of credit is easing. Households continue to reduce debt, and businesses are increasingly resilient.

• As the economy continues to grow, even at a modest pace, and adverse shocks don't materialize, Lockhart believes negative sentiment will dissipate. By the end of the year, he expects the economy will look and feel better than today.

Thank you for the opportunity to visit the Tri-Cities area and Johnson City in particular. Today I will comment on the current circumstances of the national economy as well as my outlook. Financial markets and investors—particularly investors who operate in the ultra-short-term trading and investment world—seem very nervous these days. Some commentators are reading recent economic data as suggesting the onset of a second recession and deflationary cycle. Quite naturally, businesspeople and consumers aren't sure what to believe.

At the last meeting of the Federal Open Market Committee (FOMC) in Washington, the committee made a decision that has been widely interpreted as signaling declining confidence in the strength and sustainability of the recovery.

In my remarks today, I will provide a less alarmist interpretation of recent economic information and the Fed's recent policy decision. I will argue that, generally speaking, there was too much optimism in the early months and quarters of the recovery, and now there may be excessive pessimism.

As part of this discussion, I will review the relevant changes in the economic environment over the first half of the year and through this week. I'll round out this discussion of recent developments with my views on the economic outlook.

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 outlook

As we began 2010, I had a medium-term outlook for the economy that included the following key moving parts.

First, I looked for continued deleveraging, another term for reducing debt loads. In this regard, I expected an extended period of balance sheet repair on the part of consumers, businesses, and financial institutions. The process of household balance sheet repair would involve, in my view, relatively high (for the United States) personal savings compared with recent years, which would, in turn, restrain consumer spending. Deleveraging would also mean modest growth of capital spending by businesses and constraints on credit expansion by financial institutions.

Second, in the housing sector, I anticipated a bottoming out of house sales, housing starts, and prices.

Third, as regards the commercial real estate sector, I expected continuing adjustment and strains from a process of debt restructuring and resolution based on lower valuations with some resulting drag on the banking sector.

Fourth, I believed we would see slow recovery in employment and other labor market indicators.

Finally, I foresaw a low inflation rate. I did not expect a continually falling rate of inflation.

Simply stated, I was expecting a relatively modest recovery, a typical pattern following the kind of financial crisis we experienced.

Economists sometimes get teased about needing both hands to do their job. This is because they're prone to say "on the one hand, on the other hand." I am not an economist by training, but I have picked up the two-handed approach to economics from the many hours I've spent with my research staff at the Atlanta Fed.

So, on the one hand, as we entered this year, I believed the economy was on a path of sustained recovery, the pace of which would be restrained by the factors I just discussed. I expected modest growth and slow healing. Today that description still fits my broad outlook on the economy for the foreseeable future.

On the other hand there have been some developments whose severity my staff and I did not anticipate when the year began and have complicated the story. Most prominent among these is the European sovereign debt scare, which some have called a crisis.
In May, concern escalated dramatically in financial markets of a default by Greece, to be followed by some other countries in the European Union (EU). The EU and European Central Bank (ECB)—along with the International Monetary Fund—took decisive action, and European sovereign debt concerns have substantially abated. The Federal Reserve did its part by reinstituting swap lines with the ECB, the Bank of England, and other central banks in an effort to ensure an adequate flow of dollar funding to global capital markets. This episode was a major test of global financial markets, including U.S. markets. I believe that in terms of financial stability our markets passed the test. But concern about global sovereign debt added to uncertainty and weighed on our economy into the summer.

While my outlook for recovery was—and, I will argue, remains—thematical correct, it's also true that I've been off somewhat in the particulars of the story. Growth at the end of last year and early part of this year was stronger than I anticipated while economic activity in the second and third quarters seems weaker than I expected.

But such ups and downs are not unusual during a recovery. A little history: following the 2001 recession, gross domestic product (GDP) grew at the annualized rate of 3.5 percent in early 2002. Growth then decelerated to about 2 percent for the next two quarters then fell to almost zero in the fourth quarter. Entering 2003, growth edged up to a little over 1.5 percent and then accelerated from there to a sustained period of relatively strong growth for two years.

Looking at the 2009–10 recovery, it seems clear that some of the early strength was promoted by policies that pulled forward spending from the second and third quarters of this year. The recent sharp decline in housing-related indicators following the expiration of homebuyer tax credits is the most obvious example of this effect.

Allow me to use both hands again: on the one hand, downbeat news has commanded much of the spotlight recently, but on the other hand there are developments I would put in the positive news column. Let me cite some of these.

Corporate earnings: in the second quarter, companies in the S&P 500 reported average year-over-year earnings growth of 38 percent.

Business balance sheets: larger businesses are generally in good shape after trimming losses and improving their balance sheets. As opportunities present themselves, these businesses will be able to move quickly to seize them.

Business investment in equipment and software: largely because of deferrals during the recession, this form of business capital spending has been strong, in excess of a 20 percent annualized rate during the first half of 2010.

Manufacturing: Wednesday's Institute for Supply Management report on manufacturing conditions showed continued expansion. By this measure, the U.S. manufacturing sector has expanded for 13 consecutive months.

Consumer confidence: the Conference Board's consumer monthly confidence index released Monday posted a modest gain after falling in recent months.

Bank balance sheets and lending terms: many banks continue the process of repairing their balance sheets. And banks participating in the Federal Reserve's most recent Senior Loan Officer Opinion Survey (mostly larger institutions) reported easing of credit terms for commercial and industrial loans.

Clearly, the news isn't uniformly negative. In addition, there are economic indicators that deserve to be interpreted on both hands. For instance, the personal savings rate of U.S. households has been well above historic norms for most of the year. Rising savings advances the necessary rebalancing of consumer and household finances after a period of consumption fueled by excessive leverage, but, of course, savings take away from current consumption needed for recovery. In this case, a long-term virtue is a short-term vice.

Among the likely causes of the elevated savings rate is the unambiguously negative fact of high unemployment. The news this morning did not substantially change the picture.

Unemployment is taking a significant toll on household spending, even households untouched by unemployment. In an environment where the psychology of consumers and businesses is fragile, weak data cannot be completely dismissed even when—as I would suggest—the weakness is temporary.

Melding all this mixed information, my basic view of the economy has not changed, but my perception of risks has shifted somewhat to the downside.

Policy decision from August FOMC meeting

It was this perspective—a perspective I'd characterize as moderate optimism tempered by acknowledgement of weaker conditions and greater downside risk—that I carried into the last FOMC meeting on August 10.

As the minutes issued Tuesday of this week depict, the FOMC was presented with the possibility that the Fed's balance sheet might shrink more rapidly than previously predicted as mortgage-backed securities (MBS) mature or are prepaid.

To briefly review, the Federal Reserve's balance sheet was expanded rapidly from about $900 billion to $2.3 trillion between September and December of 2008. This expansion mostly funded emergency lending facilities designed to counteract acute stress in various credit markets. As those loans expired, they have been largely replaced by purchases of government and agency securities, including $1.25 trillion of agency MBS and $300 billion of Treasuries. These purchases injected liquidity into the economy and helped shape an environment of lower long-term interest rates.

Over the course of last year, purchases offset the runoff of direct loans such that the size of the balance sheet remained more or less constant. Earlier this year—at a time when the economy appeared stronger than it has recently—the FOMC decided to let the balance sheet slowly shrink with MBS runoff.

At the last meeting there were two important considerations as I saw it. First, as already discussed, some economic data came in weaker than expected, shifting the balance of risks to slower growth in the near term and further disinflation. Second, the Fed's holdings of MBS were projected to decline faster than previously thought because lower rates were generating heavy mortgage prepayments and refinancings.

So, in the context of a softening economy, the FOMC was confronted with the prospect of unintended withdrawal of support for the recovery through a decline in the level of liquidity provided to the economy.
Monetary policy is, at present, quite stimulative and appropriately so, in my opinion. It's entirely possible that the effects of some decline of current accommodation would have been negligible. But a small precautionary action to avoid any risk associated with inadvertent tightening was prudent, in my view, in the midst of disappointing economic indicators.

That is how I interpret the decision announced following the August meeting—a small tactical change designed to preserve the level of liquidity provided to the system. I supported the committee's decision, but I do not view it as a fundamental change of outlook or strategy. I do not believe this change necessarily heralds the beginning of a period of further expansion of the Fed's balance sheet. Nor do I think the decision precludes a return to a policy of allowing the balance sheet to shrink on its own.

I think the decision has been over-interpreted in some quarters. These interpretations, along with alarmist commentary about deflation and a double-dip recession, are feeding an exaggerated sense of foreboding.

**Negative sentiment will dissipate**

Let me sum up. As I see it, the economy has slowed somewhat but remains on a gradual recovery track with all that implies for top-line growth for businesses and employment.

The recent economic softness reflects the choppy, sometimes uneven transition that occurs when the economy is shifting from public stimulus to improving private demand. The economy, in my view, is experiencing a temporary downshift.

I believe the economy continues to improve in certain fundamentals and continues to strengthen defenses against a shock. The financial system continues to heal. There are signs that availability of credit is easing. Households continue to reduce debt, and businesses are increasingly resilient.

As the economy continues to grow, even at a modest pace, and adverse shocks don't materialize, negative sentiment will dissipate. By the end of the year, I expect the economy will look and feel better than today.

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