The Approaching Monetary Policy Decision Dilemma

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Key Points

- Although the pace of economic expansion has slowed, Lockhart believes the slowdown will likely prove temporary. He expects a gradual improvement in economic growth and employment.
- The risk of deflation cannot be dismissed, but Lockhart does not expect outright deflation to take hold.
- Lockhart said that one possible explanation of slow growth and low inflation in the United States is an elevated state of uncertainty, which is affecting consumer and business behavior. Business contacts tell him that the uncertainty is related to the path of the economy and the direction of fiscal, regulatory, and tax policies, as well as the sovereign debt situation in Europe and the outcome of upcoming U.S. elections.
- A monetary policy dilemma is taking shape about causes of the slowdown in the U.S. economic expansion and the low measured rate of inflation, whether the Fed can do more to improve the situation, and, if so, the appropriate policy prescription. If it is determined the Fed should do more, Lockhart said the Fed has scope for further action to influence the course of recovery. According to him, the Fed has the will to act—or not—as demanded by economic conditions. If action is taken, a clear option is to grow the size of the balance sheet by a second round of asset purchases.

The University of the South (Sewanee) has academic strength across the board, I know, but when I hear the name Sewanee, it evokes an immediate association with fine writing and literature, particularly modern American literature. I think of the School of Letters—a unique academic asset in both name and substance—as well as the famous summer workshops for writers.

I'm sure I can safely assume that literature professors, especially here at Sewanee, are deeply conversant with all types of American letters—the essay, short story, and novel. But I'll bet little critical attention has been paid here at Sewanee to a widely read and interpreted textual form that is published every few weeks from 20th and Constitution Avenue in Washington. I'm referring, of course, to the statements on monetary policy decisions of the Federal Reserve after each meeting of the Federal Open Market Committee (FOMC), in which I participate. I'm a special fan of this literary genre.

I realize this seems a pretty obscure category of literature to many of you here. Believe me, I'm not insulted. I assure you these short narratives are as anxiously awaited in certain financial and economic circles as, say, a new novel of Jonathan Franzen, and very carefully deconstructed to discern the intended nuance of the authors.

The most current FOMC statement came out Tuesday of last week. It was about 300 words in its four key paragraphs. On the basis of impact per word, this is some of the most powerful writing in America. So today I want to conduct a short seminar on this literary form—the post-meeting FOMC statement—and, in particular, last week's installment. I will give you my personal interpretation of the plotline traced in the September 21 statement and why students here today should care. As I always do, I must emphasize that the views I will express are my own and may not reflect the views of my colleagues on the FOMC or within the Federal Reserve.

You students here today have a big stake in the story encapsulated in the statement and especially what it foretells. It conveys the central bank’s assessment of the current state of the U.S. economy as well as the outlook for economic growth, inflation, and employment. It explains the policy decision taken at last week’s meeting and signals the future course of policy. The economic and employment world you will enter on graduation will be significantly affected by how accurately the FOMC gauges the path of the nation’s economy and devises policies to influence that path.

So let me guide you through this small example of what might be called "econlit." I’ll start with highlights from the first paragraph, which deals with the current state of economic activity and the outlook.

Economic activity

In the September statement, the committee characterized the economy in this way (and here I’m excerpting words and phrases verbatim from the statement): "The pace of recovery…has slowed in recent months. Household spending is increasing gradually…but remains constrained by high unemployment, modest income growth, lower housing wealth, and tight credit. Business spending on equipment and software is rising, though less rapidly than earlier in the year. Employers remain reluctant to add to payrolls. Housing starts are at a depressed level. Bank lending has continued to contract."

To summarize, the picture painted is one of lackluster economic expansion with several drags on recovery. And, importantly, the pace of expansion slowed markedly in the second quarter and continues to be weak in the third quarter.

I believe this slowdown will prove to be temporary. In my view, much of the strength we saw last fall and winter was a consequence of policies that brought forward spending that would have occurred later. For example, the "cash for clunkers" program accelerated car buying, and the first time homebuyers’ tax credit helped the homebuilding sector.

To put numbers on this slowdown, the economy grew at a 1.6 percent annual rate in the second quarter. This is about 1 percentage point below the so-called trend rate of growth of the economy (the normal long-term rate of growth), which is generally accepted to be in the neighborhood of 2.5 percent.
Growth at this anemic level is unlikely to generate enough new jobs to bring down unemployment to any significant degree. Unemployment currently stands at 9.6 percent. Given the growth of population, we need sustained job creation of at least 150,000 per month to make significant progress on the unemployment problem. Private sector job creation for the past three months has averaged 78,000.

You students who will graduate in 2011 and 2012, or later, have a direct interest in the health of the employment market you will enter. Realistically, I expect improvement to be gradual.

**Inflation**

The second paragraph of the statement focuses on the FOMC's view of inflation. Here's what the statement said, and, again, I am quoting: "measures of underlying inflation are...below [emphasis added] those the Committee judges...consistent...with its mandate to promote maximum employment and price stability." To explain, the Fed is mandated by Congress to pursue two longer-term goals—maximum employment and price stability. It's the Fed's responsibility to define what is acceptably low inflation, or price stability. Note that the statement used the word "below"—that is, too low, not too high. It is a surprise to many people that the committee is worried that inflation is running at a rate that is too low.

Consumer prices have been rising at an annual rate around 1 percent for the past three months. This follows a period spanning several months of disinflation, or the slowing of the rate of inflation. The concern is that disinflation may tip over into deflation. Deflation is defined as a broad and persistent decline in prices.

As individuals, we might not mind paying lower prices for food, books, cars, and other consumer purchases. But deflation can be a very bad state of affairs for the economy as a whole.

Deflation can feed on itself, turning into a deflationary spiral. The Great Depression was essentially a deflationary spiral. Believe me, none of us wants an economy that falls into a deflationary spiral.

I do not expect outright deflation to develop, but the slowing of the economy in the middle of this year, combined with a very low measured rate of inflation, suggests to me the risk of deflation cannot be dismissed.

There are a number of plausible explanations for this troublesome situation of slow growth and too-low inflation. One that I'm giving serious weight comes from anecdotal feedback from business contacts across the Southeast. Business people are citing the elevated state of uncertainty as a reason they are reluctant to hire and are very careful about investment spending.

To be more specific, my business contacts point to the uncertain path of the economy itself as well as the direction of fiscal, regulatory, and tax policies. Some also cite the chance that the recent sovereign debt scare in Europe might return and bring stress in financial markets and the banking system, even here in the United States. The uncertain outcome of the upcoming elections is also mentioned.

I believe this cloud of uncertainty is also affecting consumer behavior. Consumers are very careful about spending in part because of the still-treacherous job situation and concerns about which way the value of houses might go.

There are other explanations for the slowdown. Views about what should be done, if anything at all, follow from one's view of the underlying causes. I will return to this central question in a moment when I frame the monetary policy decision dilemma that, in my opinion, is taking shape.

But before that, let's go to the third section of the FOMC statement, which tells the public what policy actions, if any, the FOMC decided to take during its meeting.

**Policy decision**

There are two parts to the policy section of the latest statement. The first part reads, "the Committee will maintain the target range for the federal funds rate at 0 to 1/4 percent and continues to anticipate that economic conditions...are likely to warrant exceptionally low levels for the federal funds rate for an extended period." The federal funds rate is the rate at which banks borrow from each other, mostly overnight, to meet their reserve requirements at the central bank. Think of this interest rate as the foundation rate from which the whole structure of interest rates paid by consumers, businesses, and governments is determined, mostly by market factors. The Federal Reserve lowered the target rate to this range in December 2008, when it ended a series of interest rate cuts that began in the fall of 2007 in response to the financial crisis and the recession. A key point is that this base level rate cannot go much lower. It is at its "zero lower bound."

The third paragraph also explains the FOMC's decision on whether any changes will be made to the size or composition of the Federal Reserve's balance sheet. Again I am quoting: "the Committee also will maintain its existing policy of reinvesting principal payments from its securities holdings."

Let me try to put what seems a small technical matter in context. Just as decisions the Federal Reserve makes about the federal funds rate influence other rates, the size and composition of the Fed's balance sheet typically have a big influence on the economy. This decision affects how much money banks have to lend and the mix of investors' security portfolios.

The balance sheet has increased considerably over the past two years from around $900 billion to more than $2.3 trillion. Changing the size and composition of the balance sheet is one of the monetary policy tools the Federal Reserve began to use at the height of the financial crisis. The current size and composition of the balance sheet reflects the policies that the Federal Reserve implemented to stimulate the economy and support financial markets.

The size of the balance sheet began to decline in June of this year, just as the economy started to lose momentum. So at the August meeting, the FOMC decided to reinvest principal payments from its securities holdings into Treasury securities to keep the size of the balance sheet constant. The intent was to prevent the inadvertent tightening of monetary conditions. The September statement indicated the committee will maintain that policy.

So the decision last week was to keep policy the same.

**Forward guidance**

This brings me to the fourth paragraph of the committee's statement, in which the FOMC provides guidance to the public about future monetary policy actions.
In the latest statement, the sentence read: “The Committee will continue to monitor the economic outlook and financial developments and is prepared to provide additional accommodation if needed to support the economic recovery and to return inflation, over time, to levels consistent with its mandate.”

To the casual reader, this sentence may seem boilerplate. But at the risk of over-dramatizing, the plot thickens with the words “if needed.” In the coming weeks monetary policymakers must come to grips with the question of whether there is anything they can do to improve the situation in the economy and, if so, what that action should be. The circumstances of weak recovery, persistent unemployment, dangerously low inflation, and the policy interest rate (the primary tool of modern monetary policy) at the zero lower bound present a tough analytical challenge.

Earlier I referenced a monetary policy dilemma. A necessary debate is jelling on the diagnosis of our economic troubles and the appropriate prescription. As I think about it, there are three lines of argument. One argument maintains there is not enough spending occurring—in economists’ terms, a shortfall of aggregate demand—and that this shortfall can be reduced by further stimulus. A second argument is that the economy is undergoing deep structural adjustments in industry composition, labor markets, and household finances, especially the level of debt, and these adjustments will take considerable time to play out. Finally, it can be argued that much of the uncertainty has to be dealt with in other areas of government, and monetary policy can’t do much about this kind of problem. This characterization doesn’t do full justice to the complexity of the matter, but it lays out in broad strokes what questions are in play.

As I see it, this debate will intensify over the coming weeks. If action is taken by the Fed, a clear option is to grow the size of the balance sheet since the policy interest rate, for all practical purposes, cannot go any lower. Growth of the balance sheet would be accomplished by a second round of asset purchases (probably Treasury bills and notes) paid for by newly created money. The technical term for this policy is “quantitative easing,” and the prospect of more of this approach is being referred to as QE2.

Will it work? And, how much would be needed to make a difference? In my view, a consensus on these pivotal questions remains to come together, and I will not take a position here today. In the weeks ahead my staff and I will be tackling these and related questions to prepare for the important decisions coming.

Writing the policy story
My remarks this afternoon may not have spurred you to become an avid reader of the Fed’s post-FOMC statements. Again, I’m not insulted. But I hope you better appreciate that woven through the deliberate, technical, and—for many—tedious language of the September 21st statement is a suspenseful plotline in which all of us have an enormous stake. I cannot tell you how the economic policy story will play out. I can assure you, however, that the Fed has scope for further action to influence the course of recovery. And, importantly, I believe the Fed and the committee have the will to act—or not—as demanded by economic conditions in the near term.

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