SPEECHES

The Challenges of Monetary Policy in Today's Economy

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Key Points

- Lockhart sees the **prospect of continued slow but gradually accelerating economic growth**, with quite low but stable inflation and a positive but frustrating pace of job creation. He believes that the possibility of deflation cannot be completely dismissed, although deflation is by no means his base case expectation.
- Lockhart thinks that there is scope, at the margin, for further monetary stimulus to boost demand growth and reduce unemployment. Therefore, he is **sympathetic to more monetary stimulus** in the near future and views additional quantitative easing as a form of risk management. He will factor in the deliberations of the FOMC before arriving at a final view.
- Lockhart is open to the adoption of a **more explicit inflation objective** as a further step to ensure the anchoring of public expectations about long-term inflation and the response of the FOMC to adverse price developments.

Savannah is a city where insiders use the shorthand of initials—MGGE (*Midnight in the Garden of Good and Evil*) and SCAD (Savannah College of Art and Design). Today I will talk about an economic policy issue that, similarly, has been reduced to shorthand: QE2. This is not the famous luxury ocean liner; QE stands for quantitative easing, and the "2" denotes a second round of this policy activity. QE2 is a policy option currently under consideration to support the sputtering economic recovery and deal with two of its by-products: high unemployment and low inflation that could spill over into deflation.

This policy option is the issue of the moment among Fed watchers. Commentators and market participants appear to have a high expectation that the Federal Open Market Committee (FOMC) will decide to go forward with another program of large-scale asset purchases (LSAP—another set of initials used officially in the recent past). The Fed used this policy tool starting at the end of 2008 until spring of 2010 when it purchased $1.25 trillion of mortgage-backed securities, $300 billion of Treasury securities and $175 billion of agency debt securities, creating fresh money in the process to make the purchases. These actions were taken to combat the recession at a point when there was no more scope for use of the Fed's more conventional policy tool, interest rate policy. The policy rate still remains at its zero lower bound and, for all practical purposes, cannot go lower. If something is to be done about the state of the economy, quantitative easing is the leading option.

To opt for more quantitative easing at this juncture is a big decision. Today I will walk you through the thicket of considerations that lead me, at this moment, to be sympathetic to more monetary stimulus in the near future. I take this view with a measure of tentativeness. Some more economic data will be posted before the next meetings of the FOMC in early November and mid December, and, as I always do, I would factor in the deliberations of the committee in the meeting before arriving at a final view.

I must emphasize that the views I will express are my personal thoughts and may not reflect the views of my colleagues on the FOMC or within the Federal Reserve.

State of the economy

The recent performance of the economy has been disappointing. Growth has slowed from earlier in the year and unemployment remains high. After a period of disinflation last year and early this year, inflation has settled at a level considered by many to be unacceptably low.

This experience is worse than many had forecast. Over the past few months, a number of forecasters have written down their projections for the remainder of 2010 and 2011. A year ago, looking ahead to 2010 and 2011, our forecast at the Federal Reserve Bank of Atlanta was less optimistic than those of many forecasters, so we have not revised down our outlook all that much. But overall it's fair to say the consensus outlook has deteriorated.

The Fed is mandated by Congress to pursue two policy goals—maximum possible employment and price stability (or put differently, the acceptable rate of inflation). The committee has the implicit responsibility of defining the rate of inflation that over the longer term constitutes price stability. In my view, that rate is around 2 percent.

With current inflation running at about 1 percent or a little higher and with official unemployment measured at 9.6 percent, it's clear that the economy is not where we want it to be. In my mind, the question is whether this situation is a call to immediate action.

To answer that question, I start with the outlook from today in the absence of further monetary stimulus. As a starting point, I expect final measures of third quarter GDP growth to be close to that in the second quarter which came in at 1.6 percent. My current forecast sees a modest increase in the rate of growth in the fourth quarter and further, but still modest, improvement in 2011. In this forecast, inflation remains low but with no further disinflation, and unemployment comes down very gradually.

In my thinking, the range of plausible divergence from this forecast is quite wide, and the risks are more to the downside. Very importantly—and this is a key point for me—the fact that growth is so sluggish and inflation so near zero presents the possibility of a deflationary situation developing, with very serious implications for employment. We want to avoid deflationary territory. Deflation can feed on itself, turning into a deflationary spiral. This possibility is by no means my base case expectation, but I don't think it can be blithely dismissed. For now it is a risk, not an actual developing feature of the economy.

So, again, my staff and I see the prospect of continued slow but gradually improving growth, with quite low but stable inflation and a positive but frustrating pace of job creation. We have to ask: Is this the best we can achieve?

Structural or cyclical?
Well, it's debatable, and it revolves around the question of whether the underlying problems of the economy—the obstacles to faster recovery—are mostly structural or mostly cyclical. These words can mean different things to different people and represent code words for an array of conditions. I think of structural obstacles as very slow and resistant to change and not responsive in the short term to monetary stimulus. I use the term cyclical to encompass aspects of the economy that are evolving on a shorter timeline that can be accelerated by policy action.

There are a number of features of the current economic situation that might be described as structural. Certain industries—homebuilding, for example—are likely to operate at a much lower unit volume for a long time, if not permanently. Well-informed opinion holds that the commercial real estate sector will take several years to work through the burden of property loan resolution. And the central debate focuses on the degree to which unemployment reflects structural impediments.

In my opinion, the evidence either way is not conclusive. My best assessment is some unemployment is structural in nature and some of it represents weak demand. That so-called natural rate of unemployment is probably now well above the very low level of joblessness we saw prior to the recession, but it is not the current rate of 9.6 percent. There is some labor resource slack that can be worked off with improved consumer demand and business investment. But there is little scope for monetary policy to have much effect on the mismatch between skills and jobs caused by industrial dislocations and the skill erosion that can be associated with long-term unemployment.

Although not usually classified as a structural issue, uncertainty is a key factor constraining job growth and investment. I hear this refrain often from business contacts about the current environment. They cite the future of the economy itself as well as uncertainty related to employee health care cost, regulatory uncertainty, and fiscal and tax uncertainty. My contacts frequently make the point that much of this uncertainty cannot be dispelled by monetary policy.

I do believe there is scope, at the margin, for further monetary stimulus to induce households and businesses to overcome their current spending caution, even while deleveraging. A quantitative easing program of scale should have the effect of making credit cheaper and, if successful in upgrading the outlook, more available as loan demand rises.

This comment on the potential and effect of lower interest rates raises a question: Through which channels or mechanisms would additional stimulus have its intended positive effect on the economy? There are a number of possible channels of influence. The credit channel is certainly one. Skeptics, however, point out that there is no lack of liquidity in the banking system. Today the Federal Reserve holds over $960 billion of excess reserves of banks on its balance sheet. This money is part of the monetary base but has not yet been transformed into broad stimulus in the real economy through bank lending.

A second possible channel is called the portfolio balance effect. If the Fed buys a significant portion of available Treasury securities, for instance, investors may feel the need to migrate their holdings to other assets that carry more risk, such as corporate bonds and equities. The buying pressure in these asset classes could push up values and generally improve the atmosphere that supports risk taking and spending.

A third channel is the dollar exchange rate and stimulus to net exports. Speculation about QE2 has already caused a drop in the dollar's value on exchange markets and contributed to the rising concern over competitive efforts among nations to influence the relative position of currencies. Sellers of the dollar are responding to the prospect of lower yields.

Pros and cons of QE2
In this walk-through of considerations, pro and con, on the QE2 policy question before Fed policymakers, I could be accused of playing Hamlet. To cut through it all, let me summarize the case for and the case against, and then I'll express my personal opinion.

Proponents of QE2 might argue that not all the headwinds the economy faces are structural in nature and that further stimulus will raise demand. Purchases of Treasury securities will lower long-term interest rates (some of this effect on rates may already have been priced into the yield curve), and lower rates will generate some additional purchase and investment activity. And, yes, the portfolio balance effect and the export effect will raise the economy's boats. Taking a defensive perspective, proponents of QE2 argue that the risk of deflation is not negligible and this potentiality must be forestalled. Furthermore, patience with the high level of joblessness and underemployment runs the risk of weakening the fabric of the country if long-term unemployment erodes skills and creates a permanent class of unemployed. Finally, proponents may argue that the risks associated with an even larger Federal Reserve balance sheet—the challenge of a policy exit or unwinding as the economy improves—are acceptable. The exit tools are well advanced and scalable. So this is the case in favor.

The case against QE2 at this time goes like this: Further monetary stimulus will have limited effect. The financial system already has plenty of liquidity. Interest rates are very low, and lower mortgage rates, for example, won't generate a lot of new home buying given eligibility requirements. Further, the problems besetting the economy are not fundamentally amenable to a monetary policy solution. They will take time and depend more on getting clarity on the country's long-term fiscal path, taxes, and regulatory impact on businesses. Skeptics also argue that the Fed, by further expanding its balance sheet, incurs exit risk that could dislodge inflation expectations and lead to an unstable inflation situation. Finally, critics of this policy direction may argue that QE2 amounts to monetization of federal debt in another year of deficits exceeding $1 trillion. Accusations of monetization could undermine confidence in the dollar and American monetary policy with substantial long-term costs.

In my view, the decision is not clear cut. We policymakers have to weigh these arguments pro and con, potential costs versus benefits, and competing risks. As I said earlier, I am leaning in favor of additional monetary stimulus while acknowledging the longer-term risks the policy may present. At this juncture, and given the circumstances of sluggish growth and measured inflation that is too low, I give greater weight to the risk of further disinflation leading to deflation. In my mind, QE2 is a form of risk management—an insurance policy that is prudent to put in place at this time.

More explicit inflation objective
I am also open to a move that I believe would strengthen the effect and compensate for potential risks of the policy action—that move is the adoption of a more explicit inflation objective by the committee. I believe doing so might serve as a further step to ensure the anchoring of public expectations about long-term inflation and the response of the FOMC to adverse price developments. I consider a more explicit inflation target as something the public could easily understand, and I believe it would reduce uncertainty at a time when it is badly needed.

You here in Savannah—one of the country's leading port cities—will understand the metaphor of navigating shoals. The economic challenges of the moment call for careful navigation. There are risks accompanying both action and inaction, but the risks that weigh more heavily on my mind are those associated with a movement toward deflation. I am prepared to consider action in the near term that can help avoid that danger and change the course of the economy for the better.

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