SPEECHES

Toward a Faster Recovery and Reduced Risk of Deflation

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Key Points

- Lockhart **supported the recent Federal Open Market Committee policy decision** to conduct further purchases of Treasury notes. He sees the additional purchases as a **precaution** aimed at reducing or eliminating downside risks to the economy. Chief among those is the risk of tipping into a long spell of disinflation.
- Lockhart expects that the policy will have some **incremental positive effect on overall demand**. He believes that this policy has already **shown some success** by altering inflation expectations and reducing the risk of unwanted disinflation.
- **The policy was not undertaken to prompt dollar depreciation**. He says the effectiveness of the policy will not hinge on the price of the dollar in foreign exchange markets. He believes that the most critical factor in maintaining the dollar's value is a strong U.S. economy with stable inflation, which is also in the world's interest.
- Lockhart is confident that the Fed will begin to reduce the size of its balance sheet once inflation moves closer to the FOMC's desired objective, and this decision will be made **independent of fiscal considerations**.
- Lockhart expects the **recovery to strengthen** in the coming year, although not to a pace robust enough to rapidly return income and employment to prerecession levels.

Thank you for that introduction. It's a pleasure to be in Montgomery this evening and to address the Alabama World Affairs Council. I feel a kinship with your group. I am serving as the first chairman of Atlanta's new World Affairs Council.

I took on this role because, in my view, every significant city needs a forum for building awareness and exchanging views on the major issues of the day. I appreciate your invitation to contribute to Montgomery's and Alabama's understanding of monetary policy and the conditions influencing the Federal Reserve's recent decisions.

Before I begin, let me state my usual disclaimer that the views I offer here are my own and do not necessarily represent the views of my colleagues on the Federal Open Market Committee (FOMC) or the Federal Reserve System.

Recent FOMC decision

As you know, the FOMC made and announced a policy decision on November 3 to conduct further purchases of Treasury notes over the coming eight months, with these purchases accumulating to $600 billion.

In normal times, monetary policy is conducted by affecting short-term interest rates by purchasing and selling small quantities of Treasury debt in the open market. Now, short-term rates are at zero and are likely to stay exceptionally low into the foreseeable future, as reflected in the "extended period" language in the FOMC statements. As a consequence, small-scale open market purchases cannot drive short-term rates lower to provide stimulus. Instead, the Fed's approach to monetary policy has been larger-scale asset purchases.

I supported the policy decision in the deliberations of the FOMC on November 2 and 3. This policy has come to be known as QE2. The QE stands for quantitative easing. I believe the term quantitative easing is best reserved for a policy that operates primarily through the expansion of bank reserves. To me, the Fed's current policy is more in the spirit of last year's large-scale asset purchase program.

This policy is designed to further improve financial conditions and thereby support a faster recovery, to reduce the potential of deflation, and to accelerate the eventual achievement of the Fed's two statutory mandates—maximum employment and price stability.

There are several ways that large-scale purchases of Treasury securities from the private sector can affect economic activity. For example, the sellers of Treasuries will have more funds available to buy goods and services. Or they may buy other assets like corporate bonds or shares. Doing so will tend to push up the prices of those assets, making the people who own them either directly, or through their investment funds, better off. And higher asset prices mean lower yields, which bring down the cost of borrowing for businesses and households and thus provides a further boost to spending.

In my opinion, the decision to purchase additional Treasury securities was not made in a black-and-white world. It was a policy decision made under considerable uncertainty—involving judgments in gray areas requiring sober weighing and careful weighting of risks and rewards, costs and benefits. Well-informed and rigorous thinking could lead one to come down on either side of this decision. In my view, every policy option before us had the potential of bringing serious challenges down the road that policymakers would later have to tackle. There were no riskless options.

The FOMC's decision to purchase additional assets has been controversial both here in the United States and abroad. As is often the case in controversial policy matters, there are varying characterizations of decision makers' intent and even different interpretations of key terms and concepts. Tonight I would like to give you my perspective on potential misunderstandings as I address the following four views that critics of the policy seem to hold: (1) The Fed is monetizing the federal debt; (2) the Fed is purposefully devaluing the dollar; (3) the policy is unconventional, with unknown risks, and may create serious unwanted inflation; and finally (4) this additional easing simply won't work.

Monetizing federal debt

Let me first address the issue of debt monetization, a practice that historically has resulted in higher inflation and, as a result, loss of wealth and savings by those who hold government bonds.

A policy of monetizing debt would be most properly understood as a policy in which the Fed ties its purchases to new Treasury debt issues. The intent would be to enable the government to finance near-term deficits and/or eventually inflate away some of the nominal value of government debt. This is not the objective.

In my view, the current policy is resolutely designed to support the expansion of the economy and to maintain inflation near the FOMC's desired objective for price stability. I have every confidence the policy will revert to reducing the size of the Fed's holdings as those conditions are met.

I feel it is particularly important for you, the public, to understand that the FOMC's purchase program is conditional and will be evaluated in light of developing economic conditions. When conditions warrant, these purchase operations will cease, and eventually sales will be instituted. And I am confident these decisions will be made independent of fiscal considerations.

Dollar devaluation

It has also been argued that the Fed's asset purchases have the intent—and also the effect—of devaluing the dollar. Ordinarily in my remarks I would defer to the U.S. Treasury Department on matters related to the dollar. That said, I don't think it is out of line to state clearly that, as I see it, there is no monetary policy intent to engineer specific values—or even a direction—for the dollar. In other words, this policy was not undertaken to prompt dollar depreciation.

Prices of many types of assets are affected by monetary policy actions. The monetary transmission mechanism works by altering the relative price of various assets. The effectiveness of the policy will not hinge on dollar depreciation and, therefore, the price of the dollar in foreign exchange markets.

For those concerned about the dollar's value I believe it is important to stress that the most critical factor in maintaining the dollar's value is a strong economy with stable inflation. It is certainly true that the short-term effect of recent policy has put downward pressure on the dollar. But the purpose of the policy is to strengthen the U.S. economy, which is in the world's interest.

Serious unwanted inflation and other risks

A number of people have raised a third concern, namely, that this approach is new and unconventional and is fraught with risks that are going to harm the economy over the longer term.

True, a large-scale asset purchase program is an unfamiliar policy in the sense that we are not targeting the federal funds rate. And I acknowledge there is uncertainty associated with this policy action as compared with fed funds rate targeting. Much of that uncertainty revolves around scale and lags—how large do the purchases need to be to have a noticeable effect? And how quickly will we discern that effect? In my mind, the perceived risks—particularly the risk of overshooting inflation—must be weighed against the risks that could be associated with a policy of inaction. Chief among those risks is a recessionary relapse possibly tipping into a long spell of deflation. Through the summer there were some signs of renewed disinflation, which could lead to deflationary expectations taking hold.

I think it is important to stress that our experience in dealing with inflation versus deflation is not symmetric. In the event of a policy overshoot, inflation containment requires the implementation of the mostly familiar strategy of raising short-term interest rates. In the event of an undershoot, however, dealing with a deflationary spiral and the attendant real consequences would be far less familiar territory for policymakers.

Doubts about the efficacy of large-scale asset purchases

A final criticism levied against the asset purchase program is that it will fail to foster economic growth and price stability. That is to say, it won't work. I think it's important that we be measured in our expectations about how much further stimulus can accomplish in the current environment. I don't have outsized expectations. I see it as a precaution aimed at reducing or eliminating downsides. Further, in terms of near-term economic activity, I see the additional asset purchases as buttressing the ongoing effects of policies that have already been put in place. I expect it should have some incremental positive effect on overall demand. Also, it should reinforce, and accelerate somewhat, the growth momentum that is currently evident and, in my opinion, counter to some extent the strong headwinds the economy is facing.

In regard to price stability, this policy has already shown some signs of success by altering inflation expectations and reducing the risk of unwanted disinflation. To explain, inflation expectations extracted from Treasury inflation-protected securities, or TIPS, spreads over like-duration Treasury securities were declining persistently over the course of late spring through summer. Following the August 27 Jackson Hole speech by Fed Chairman Ben Bernanke, these spreads have recovered to previous levels. In addition, according to analysis we've done at the Atlanta Fed, deflation probabilities reflected in TIPS have fallen from the high levels prior to the September FOMC meeting.

Managing inflation expectations requires following through with policy actions consistent with stated objectives—in this case ensuring that inflation trends remain in a desired zone. The FOMC's November decision should be seen in that light.

Outlook

During the summer of this year—when the possibility of another round of large-scale asset purchases was first broached—the economy was arguably nearing a danger zone. At that juncture, the pulse of the economy was quite weak, having fallen off rather precipitously from earlier in the year, and the possibility of tipping into a deflationary dynamic was conceivable. Now, in my view, the economy is better positioned to definitively avoid the danger zone.

An unanticipated shock leading to a reversal is always possible, but absent such a development, the outlook is one of a deliberate pace of improvement. The potential for further disinflation turning into deflation is becoming more remote.

I expect the recovery to strengthen in the coming year. Though growth is likely to be near or slightly above my assessment of its long-term trend, the pace is unlikely to be robust enough to rapidly return income and employment to prerecession levels. The recovery continues to be constrained by factors I earlier called headwinds. These include a cautious credit environment, ongoing deleveraging by businesses and households, a depressed housing market that has not yet stabilized, painful restructuring in the commercial real estate sector, and uncertainty related to government policies.

These headwinds are still with us, but we've made some progress. As the banking system continues to heal, banks have begun to ease lending standards for certain types of loans. Households and businesses have notably improved their balance sheets. The percent of household income going to service financial obligations has reached the lowest level in a decade as households reduced debt and credit usage. In the business sector, U.S. companies' cash holdings have risen to nearly $1 trillion.

I give credit for some of the recent improvement to the anticipation of the policy action that was formally decided and announced on November 3. As the policy decision moves into the implementation phase, I see it as a modest, measured, and well-calibrated action program that can be adjusted as conditions evolve. Together with the policy stance that preceded it—that is, maintaining a large balance sheet and a very low policy interest rate—the $600 billion asset purchase program should serve to reinforce the progress we've seen in the economy and help ensure the conditions for continued and accelerating improvement.

At some point, as conditions develop, the purchase program will need to be reversed. I have full confidence the Fed has the tools to do this. So rest assured, should inflation begin to move above desired levels, I am confident the FOMC will work hard to keep it from getting away from us.

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