SPEECHES

The Economy in 2011: Sustainable Growth despite Headwinds

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Note: Inclement weather has forced the cancellation of Dennis Lockhart's delivery of this speech. Below is the text of his planned remarks.

Key Points

- According to Lockhart, the economy seems to have gained durable momentum. **Growth in gross domestic product, personal income, and jobs should be better this year compared with 2010**. Lockhart thinks that although the **growth pace** is likely **to remain relatively modest**, economic performance could surprise on the upside.
- In Lockhart's view, the **recovery** continues to be **constrained by headwinds**, especially the interplay among the housing market, household finances and consumer spending, ongoing credit market repair, and lingering uncertainty restraining business and consumer spending. Lockhart believes these headwinds to a significant degree reflect structural adjustments that in the longer term will place the U.S. economy on a stronger footing.
- Lockhart believes the **housing market** will be **slow to improve**. Weakness in the housing market, especially the downward trend in home prices, has been restraining consumer spending. Consumers have been reducing debt and saving more, and this process of **deleveraging may continue** for some time.
- In Lockhart's opinion, the credit system is not yet back to full health, but the stage is set for **some credit expansion in 2011**.

In the early 1980s, when I was a banker here in Atlanta, I was invited by the then president of the Atlanta Fed, Bill Ford, to a one-on-one lunch at the old Fed building on Marietta Street. This was long before I had any idea of becoming a central banker and serving on the Federal Open Market Committee (FOMC). I was pretty young at the time and a little nervous about the lunch.

As I recall this lunch with my predecessor, we chatted about the situation in the banking industry, particularly the then hot topic of interstate banking. Toward the end of the lunch—trying to come up with an intelligent question for a Federal Reserve Bank president—I asked, What is it like to formulate monetary policy?

He responded with an interesting metaphor. He said conducting monetary policy is often like flying an airplane in difficult conditions. You don't have much visibility, so you must fly using instruments. You have a wide array of instruments in front of you, but at any given time half the instruments are giving inaccurate readings. And you don't know which half.

He was talking about policy formulation, and that's not really my focus today. But it's such a great metaphor that I will put it to another use. I think the metaphor of a plane flying into weather is apt for an economy that is recovering but is constrained by forces that are slow to dissipate. We often talk of "headwinds." Headwinds can be sectoral conditions in the economy that have broad effect, and headwinds can be structural in nature, by which I mean fundamental imbalances that are slow to correct.

In my remarks today, I'd like to provide an update on the progress of the recovery, my views on economic prospects for 2011, and a current evaluation of the most powerful headwinds affecting the pace of recovery.

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.

Status of the recovery
The national economy stopped contracting and began recovering a year and a half ago. At year-end 2010, we'd seen six quarters of expansion and recovery. The ride has been bumpy. The economy enjoyed a steep ascent in the fourth quarter of 2009, and that strength continued through the first quarter of 2010. This strong growth of output was based, for the most part, on a combination of inventory rebuilding, a pickup in international trade, and the satisfaction of deferred demand on the part of businesses and individuals that had been put on hold during the recession. Government stimulus programs also contributed to growth.

Then the economy hit an air pocket in the middle of 2010 as these forces played out and were not sufficiently replaced by sustained private demand. Importantly, though, the economy did not go into a nosedive as the year progressed. The third quarter of last year steadied to a modest rate of growth around 2.5 percent, which is in the range of the widely perceived long-term potential of the economy.

We won't have preliminary measures of fourth quarter growth until January 28. But monthly data on manufacturing, international trade, and consumer spending indicate that growth accelerated somewhat in the quarter just ended. Also, anecdotal input from some of our key contacts in the Southeast suggests that strong consumer spending at the end of last year exceeded the expectations of retailers, shippers, and mall owners.

Friday's job report confirms the picture of an economy that is moving forward but at a modest pace. The rate of job creation is still below the level that will consistently bring down the unemployment rate, but the labor market is showing signs of improvement.

When I spoke to you a year ago we were coming off a much stronger fourth quarter, but I did not believe that strength would be sustained. Year-end growth in 2010 does not appear to have been nearly as strong, but in my view the economy seems to have gained durable momentum as we begin 2011.

Additional purchases of Treasury securities
The deceleration of growth in the middle of last year, along with worrying signs of disinflation and falling inflation expectations, prompted the FOMC in November to announce

a $600 billion program of Treasury securities purchases.

I made the decision to support that policy, and I remain comfortable with that decision. I saw these purchases as support for a shaky recovery and insurance against serious downsides. Since late August, when Fed Chairman Ben Bernanke discussed the policy at the Kansas City Fed's annual economic symposium, the S&P 500 index has risen about 20 percent, the probability of deflation as measured by Treasury Inflation-Protected Securities has declined markedly, and fears of a double-dip recession have faded. I won't claim that all those developments have been the direct result of the monetary policy actions, but I definitely believe policy has contributed to accumulating momentum and a better outlook.

The Federal Reserve's decision to implement additional purchases of Treasury securities has been unpopular with many people here in the United States and abroad. Domestic critics expressed fear of high inflation or even hyperinflation. However, various measures of inflation as well as inflation expectations continue to show little hint of a buildup of broad-based inflationary pressures.

Foreign criticism painted the policy as an intentional effort to debase the value of the dollar for trade advantage. Let me be clear—there is no monetary policy intent to influence the dollar exchange rate. Expectations of monetary policy easing initially put downward pressure on the dollar. But subsequent developments showed that there are many influences on our currency, and some of that depreciation has subsequently reversed. The most critical factor in maintaining the dollar's value is a strong economy with stable inflation.

I have argued—as have others—that in a world where the U.S. economy still accounts for nearly a quarter of global output, it's in everyone's interest that the U.S. economy come back as quickly as possible. I believe monetary policy has helped in this regard.

While things are looking better, I don't expect a quick fix. And this observation leads me to the subject of headwinds.

I will focus on three powerful constraining forces in our economy. This is not an exhaustive list of every problem in the economy, but these forces are significant constraints, in my view.

The three headwinds are (1) the general psychology of uncertainty holding back consumer spending and business investment, (2) consumer spending and the interplay between household finances and the housing market, and (3) the ongoing process of credit market repair.

Uncertainty as a headwind

Through last year, in numerous conversations with business contacts across the Southeast I heard a pretty consistent message—there's just a lot of uncertainty. First, there was the uncertain path of the economy in general. Then there was the regulatory scene, which included both financial system regulation and other regulatory issues—environmental, for instance. Uncertainty related to the impact of the new health care legislation was often cited as a bar to hiring.

Another big uncertainty was how the country's fiscal problems will be resolved through the political process. Related to that was uncertainty regarding extension of the Bush tax cuts. Also, starting in the second quarter, the European sovereign debt crisis raised the sense of fiscal and financial uncertainty once again at a global level.

Both Europe and the United States face profound public debt concerns. In this country, the challenge of budget balancing at the state and municipal level, together with the effect of state and municipal spending cuts, is a downside risk to an improving economy.

The drag of uncertainty on economic activity persists as we enter 2011. That said, I would argue that the pall of uncertainty has lifted somewhat, and improved visibility could encourage more business risk taking and consumer spending. The results of the November elections clarify which party will control the House and shape, in part, the national agenda. The extension of the Bush era tax cuts allows at least short-term expenditure planning. Passage of the Dodd-Frank Act eases some financial regulatory uncertainty as we move to the next phase of implementation and rule writing. And the accumulating strength of the economy has given us glimpses of clearer skies ahead.

The past year has brought progress in dispelling uncertainty, but much remains to be done.

The interplay between household finances and the housing market

Now, I admit my argument that the headwind of uncertainty has abated somewhat is hard to quantify. On the second headwind—the housing sector's impact on household finance—I can provide more concrete evidence of intensity. And this headwind remains intense.

The housing market is still struggling to recover. In 2010, the homebuyer tax credit boosted home sales in the first half of the year. Subsequently, sales declined in the summer and were slow to rebound in the fall. From the peak five years ago, sales of existing homes fell almost 50 percent before rebounding slightly over the past few months. New home sales and housing starts are down nearly 80 percent from their peaks. Housing starts have been bouncing around the bottom for the past two years.

The magnitude of declines might give hope of a sharp bounce back, but I don't see that happening. In my view, home sales are likely to trend up only gradually as the economy continues to improve. On a little more positive note, home building nationally may be poised for some growth and should start to contribute positively to economic growth this year after five years of being a drag on the economy.

The path for home prices is less clear. Although they began to increase in early 2010, gains were later reversed, in line with slower sales. The consensus is for home prices to remain roughly flat this year, but some forecasters are predicting further, and in some cases substantial, declines.

I see four major factors standing in the way of a clear turn in the housing market. These are stricter mortgage underwriting standards, foreclosures continuing at a high level, elevated inventories of unsold homes, and slow employment and income growth.

The direction of home prices will depend to a large degree on the future flow of foreclosures. There are currently about 5 million mortgages either in some stage of foreclosure or seriously delinquent. Nearly all of them may enter the market as distressed sales over the next year or two, adding to the already high inventory of homes on the market and putting downward pressure on prices and values.

Moreover, about 22 percent of residential properties with mortgages are underwater—in other words, homeowners owe more on their mortgages than their homes are currently worth. So defaults and foreclosures could remain elevated for some time.

For many Americans, the loss of wealth associated with the fall of home prices has been a severe shock to household finances. This aspect of the headwind perhaps matters most for the broad economy. Starting in 2008, in reaction to the loss of wealth, households began to repair their balance sheets. Households have been actively deleveraging—that is, working down debt levels and saving more of their income. The savings rate has increased from a little over 1 percent in 2005 to more than 5 percent currently.

Consumer debt as a percent of disposable income has declined markedly over the past three years after rising steadily since the 1980s. Most nonmortgage consumer debt reduction has been in credit card balances. As consumers have reduced their debt, the share of income used to service financial obligations has fallen sharply to the lowest level in a decade.

Consumer action to reduce debt is not the whole deleveraging story. In the numbers, the decline in overall household indebtedness has been highly affected by bank write-offs. Also, banks' stricter underwriting requirements for new consumer debt have contributed to runoff.

I expect the phenomenon of household deleveraging to continue.

Credit market repair

And this brings me to the third headwind, the condition of the banking system and credit markets more generally. Virtually all aspects of global credit markets were impaired, some quite severely, during the financial crisis. Because credit functions as fuel for economic activity and investment, the repair of credit markets is key to a solid recovery and longer-term economic growth.

In the interest of time, and because the topic is complex, I'll give you the sound-bite version based on a deeper analysis done by my staff.

The bottom line is that we are still experiencing a headwind as the process of credit market repair continues. The requirements of balance sheet repair hold back credit expansion.

During 2009, total U.S. credit shrank for the first time since the 1940s. During 2010, financial institutions continued to deleverage. So did small businesses, while borrowing by corporations rebounded and, of course, the federal government debt continued to expand.

Conditions in the banking system today are mixed.

On the one hand, many banks have raised new capital, repaid government support, and seen the pace of write-offs come down.

On the other hand, the FDIC still lists 860 problem institutions, and more bank failures can be expected in 2011.

In the broader credit arena, corporate debt markets, both investment grade and high-yield, showed robust issuance and low spreads in 2010. That trend is likely to continue into 2011.

Securitization markets have made a comeback since their near shutdown during the crisis, but issuance is well below precrisis levels.

Overall, credit markets have come a long way since the fall of 2008, but the credit system is not back to full health and must adapt to a new regulatory landscape. Nonetheless, I think the stage is set for some credit expansion in 2011.

2011 outlook

In my comments today, I have focused mainly on forces that I believe will restrain growth over the next year. I don't mean to leave you in too pessimistic a mood, so let me close with three important points that I hope will serve to balance the overall sense you take away from this talk.

First, today's headwinds to a significant degree reflect structural adjustments that will, in the longer term, place the U.S. economy on a stronger footing. The preconditions for strong future growth are reduced uncertainty, improved consumer and household finances, and healthy credit markets.

Second, I believe the headwinds I have emphasized will restrain growth but not stop it. I fully expect growth in gross domestic product (GDP), in personal incomes, and in jobs to be better in 2011 than in 2010.

Finally, I acknowledge the potential that economic performance this year could surprise me on the upside. Businesses, for example, are sitting on lots of cash. Cash accumulation is not something that can continue forever, particularly in the case of public companies. It may not take much weakening of headwinds to unleash some of the economic forces that thus far have been bottled up.

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