SPEECHES

# Economy Today and Policy Framework for Today and Tomorrow

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**2011 NABE Economic Policy Conference**
**Arlington, Va.**
**March 7, 2011**

**Key Points**

- Lockhart thinks that the **economy is demonstrating moderate strength** and the pace of growth is accelerating somewhat. He expects a sustained pace of growth in the range of 3 to 4 percent, inflation firming to a trend rate around 2 percent, and gradual employment growth in the next one to two years.
- In Lockhart's view, the **balance of risks has shifted** with the unrest in the Middle East and Africa. His base case forecast sees continuing improvement, but with concern about **growth downsides** and **price upsides**. Given the emergence of new risks, Lockhart prefers a posture of flexibility regarding policy options.
- Lockhart thinks about the desirability of another round of large-scale asset purchases and an exit to a less accommodative policy stance within a **framework** that emphasizes **forward-looking rules that depend on forecasts**. First and foremost, he will be looking for **signs of emerging price pressures**. He will continue to monitor various inflation indicators, including median and trimmed-mean measures of core inflation, measures of inflation expectations, and a "sticky-price" index. Lockhart recommends renewed focus on monetary and credit aggregates.
- Lockhart believes that Fed **independence on monetary policy** remains an essential feature of sound economic policymaking.

Thank you for the opportunity to address this group of eminent economists.

Today I will offer my views on the current state of the economy and the outlook. I will comment on the appropriateness of the current stance of monetary policy for this outlook and the range of plausible scenarios around my base case outlook. And I will discuss policy at a strategic level, offering my thoughts on a policy framework for the near and medium term.

I know you are aware of my need to issue a disclaimer. I am not speaking for the Federal Reserve or the Federal Open Market Committee (FOMC). My remarks today reflect my personal thinking, and my views may not be shared by my colleagues on the FOMC or in the Federal Reserve System.

Today is likely the last day you will hear from FOMC policymakers for a few days. FOMC participants generally refrain from speaking publicly about the macroeconomic outlook and near-term monetary policy the week before meetings—and our next meeting is a week from tomorrow. Since you might say I'm getting in a last word here, I also want to emphasize that I have a few more work days ahead of me involving data review and collecting the opinions of my staff, directors, and business contacts. All this will be to finalize a point of view that I will take to the committee next week. I don't go to the committee with a rigid position, and I find my views are influenced by the rigorous discussion at the table. So take that as a second caveat.

It's also worth mentioning that my staff and I don't rely exclusively on the data to form our opinions. Because the Sixth Federal Reserve District is a pretty significant portion of the national economy and resembles the nation overall in industry composition, we go to great lengths to generate grassroots economic intelligence that supplements our analysis of the incoming data.

**State and direction of the economy**
My assessment of the state of the economy and the outlook is pretty mainstream. In terms of gross domestic product (GDP) growth, the economy is demonstrating moderate strength, and the pace of growth is accelerating somewhat.

The private spending components of GDP are trending positively. Personal consumption overall is growing briskly even while the savings rate continues at a healthy level and households continue to deleverage. Retail sales excluding autos are growing at a solid pace, just a little below total retail sales including autos. And, importantly, consumer confidence appears to be gaining strength.

Industrial activity has been strong in recent months. Industrial purchasing managers reported accelerating activity in February. The proportion of managers reporting improved orders is at its highest level in more than six years. Anecdotal accounts of manufacturers in the Southeast confirm this picture.

Business investment on equipment and software, a bright spot for most of last year, slowed in the fourth quarter. But January orders for core capital goods were consistent with forecasts for another year of solid growth in business spending

Exports, which expanded strongly in the fourth quarter, should also be a significant contributor to final demand in 2011.

The housing sector remains a soft part of an otherwise encouraging picture. House sales are still recovering and house inventories, although down from the peak relative to sales, remain elevated. Prices of homes were still falling at year end and may still be seeking a bottom. Residential construction picked up a little in January but remains very weak.

In sizing up the likelihood of sustained growth, it's useful, I think, to compare early 2011 with early 2010. It is true that GDP growth was slower at the end of 2010 than at the end of 2009 and will likely be somewhat slower in the first quarter of this year than it was at the beginning of last year. Despite that, I have more confidence in the fundamental strength of the economy than I did a year ago.

A year ago, the handoff between public-sector stimulus and private demand did not occur as smoothly as anticipated, and some of the growth in the early part of last year was clearly borrowed from later in the year. In addition, the GDP statistics at the end of 2009 and beginning of 2010 were dominated by changes in inventories. In contrast, as 2010 ended, changes in inventories arithmetically exerted a significant drag on GDP growth. Unlike the beginning of last year, recent GDP growth has been dominated by strong growth in private final demand. The stronger growth in consumption and investment by households and businesses along with the stronger demand for exports give me more confidence in the sustainability of economic activity than I had at this time last year.

**Inflation outlook**

My views on inflation also fall in what I would argue is the central tendency of economists and professional forecasters, but on this element of the economic picture there's more divergence of opinion.

Here is the inflation situation as I see it. There has been some acceleration of headline consumer inflation over the past three months, mostly coming from food and energy prices. Core inflation has also firmed. This firming is not undesired. It puts the recent inflation trend in a zone—around 2 percent or a little less—that most Fed policymakers consider in line with our congressional mandate for price stability and maximum employment. Policymakers generally don't like to see inflation dipping too close to the zone of deflation—that is, generally declining prices and wages.

Today, in reaction to the rise in headline inflation, there is considerable public concern that this recent rise just represents chapter one and that consumer inflation will accelerate from here. I don't expect this to happen.

Producer price inflation is on the minds of many in the business community. Throughout the fall we weren't hearing business contacts claim much, if any, pricing power. Now, however, we're hearing some of our business contacts express conviction they can push through price increases and plan to try to do so over the course of the year. That said, my sense is there is still concern that demand is fragile and pricing power too limited for most markets to take extensive price increases.

To recap, one can't help but notice rising inflation anxiety among the business community as well as consumers based on recent experience with highly visible and highly publicized commodity prices. So far, this anxiety has not translated to a loosening of the moorings of inflation expectations. Readings of the Treasury Inflation-Protected Securities (TIPS) market, for instance, indicate that longer-term inflation expectations are holding steady. But my concern is that broad inflation worries—even if in reaction to what are probably temporary relative price movements—could shift and cut loose inflation expectations. It goes without saying that we policymakers must watch indications of expectations very carefully and be on guard for an approaching inflection point.

In my opinion, central to the question of the potential for price action becoming broad inflation is the behavior of wages. I remember the early eighties well. I was in a management role in a bank then, and in my organization we were moving salaries around 10 percent a year to retain our people. Wage accommodation of rising prices has the effect of institutionalizing and embedding inflation. However, I do not see widespread wage pressures developing any time soon in the current circumstances of upwards of 20 million people either out of work or working part-time for economic reasons.

**Employment outlook**

As you know, inflation is one part of the Federal Reserve's dual mandate. Employment is the second element of the mandate.

Certainly, Friday's jobs report was encouraging, particularly considering that the January report had so much noise. But, in my opinion, it is premature to declare a jobs recovery firmly established. I continue to hold to the view that achieving something close to full employment will take some time. I spoke in Tallahassee, Fla., a few days ago on the nature of the unemployment problem. If my base case view of the future plays out, accumulating demand will favorably affect demand-sensitive job generation. But I also think there will remain what I called a harder nut of unemployment that will come down only gradually.

**Outlook summary and risks**

So to summarize my outlook, I expect a sustained pace of growth in the range of 3 to 4 percent, inflation firming to a trend rate around 2 percent, and gradual employment growth. As I said, this is a pretty mainstream view of the future.

Where my views might depart from the mainstream to some extent is on the question of the range of plausible economic scenarios from this juncture. In thinking about an appropriate and balanced policy for at least the near term, it seems to me a critical question is whether the range of plausible scenarios is narrowing (that is, is certainty growing) or widening (that is, is uncertainty growing). My view is the range has widened—not dramatically, but somewhat. For some time, my list of headwinds and risks has encompassed European sovereign debt, our own federal, state and municipal fiscal challenges, house prices, and commercial real estate. My sense of the balance of risks has shifted with the addition of unrest in the Middle East and North Africa.

I began my banking career in the Middle East in the seventies and spent more than six years in the region, so I have some instinctive predispositions as I watch events unfold. Chief among these is an appreciation of how complex and unpredictable the situation is.

I also constantly remind myself that seemingly distant developments can connect via unforeseen linkages and compound a shock or downside trend. Nonetheless, my base case forecast sees continuing improvement but with concern about growth downsides and price upsides.

**Questions on large-scale asset purchases**

With the information I have today, my first inclination is to be very cautious about extending asset purchases after June. Given the emergence of new risks, however, I prefer a posture of flexibility as regards policy options. As we have seen, conditions can change rapidly, so I will continue to evaluate the incoming information as much as possible with fresh eyes as I approach each meeting and each decision.

I'd like to add that I am not one to naysay the contribution of the second round of large-scale asset purchases (LSAP2) in getting the economy to its encouraging current position. I supported the decision to undertake LSAP2. I viewed it as largely a defensive measure to avert a double dip, take any deflation prospects off the table, and reverse the direction of what were at the time falling inflation expectations. It's hard to claim causation, but I think the policy has helped achieve a favorable positioning of the economy for sustained expansion.

**A framework for near-term policy decisions**

Let me now offer some thoughts on a framework for policy decisions in the near to medium term. As background, I'll explain the technical rationale of my Reserve Bank in supporting the scope of LSAP2 last November.

Through the summer and into the fall of last year, our internal forecasts at the Atlanta Fed were calling into question whether the policy stance at the time assured progress toward the committee's growth and price stability objectives. In more normal times, these circumstances would have prompted a cut in the FOMC's target for the federal funds rate. This approach would be (would have been) the prescription of the so-called Taylor rule which relates policy rate moves to forecast "misses" on the Fed's sustainable growth and stable inflation objectives.

Cutting the policy rate is obviously not feasible when the federal funds rate is already as low as it can effectively go. We did, of course, have in hand the experience of LSAP1 and at least some evidence of how those purchases affected longer-term market rates. The research suggested a $600 billion purchase program would equate to about a 75-basis-point reduction in the federal funds rate. Such a policy move was, to me, an appropriate response to the clear weakening of forecasted progress toward the FOMC's objectives.

I want to highlight the analogous character in practical effect of traditional monetary policy using interest rates and the less familiar asset-purchase tools we have employed since the federal funds rate hit its lower bound. Though some have argued otherwise, I believe the FOMC hasoperated for at least a decade with a consistent and fairly well understood rules-based framework. It is within this framework that I think about the desirability of both LSAP3 and the inevitable exit to a less accommodative policy stance.

**Exit strategy**

A year ago, the exit plan was a focus of much discussion, but a soft patch in the middle of the year put it on the backburner. Even though I personally am not expecting an immediate need to implement an exit, I think it's fully appropriate to revisit the implementation assumptions and tools readiness. As I contemplate an exit, two basic and obvious questions come to mind—when will it be appropriate to undertake an exit, and how to implement the exit.

Judgments regarding when to change the direction of policy are difficult, and much of our thought and energy are devoted to getting it right. But by employing a forward-looking Taylor-rule framework, when to exit is not a particularly bewildering problem conceptually. Upside surprises in GDP growth, employment growth, and inflation would certainly argue for implementing exit strategies sooner rather than later.

It would be nice if we were to find ourselves in circumstances in which the large build-up in the Federal Reserve's balance sheet could be unwound passively over time. Passive unwinding would be accomplished as the securities of the first and second asset-purchase programs mature. It would be nice, but I think it highly unlikely such circumstances will prevail. In balance-sheet terms, it would resemble something like the current policy posture for several years.

Since I think passive unwinding is probably not feasible, we will have to decide when to actively implement an exit strategy. And though the answer to when to do this is clear in concept, it is not straightforward in practice. Lags in the effects of monetary policy mean that action generally needs to be taken in advance of definitive changes in the path of economic activity and prices. That is why the policy framework I am describing emphasizes a forward-looking rule-like construct to which the FOMC would simply react.

**Forward-looking indicators**

Forward-looking rules necessarily depend on forecasts, which by nature are shaped with a somewhat cloudy crystal ball. My staff and I in Atlanta will be watching for signs that, stated in positive terms, our growth projections are remaining on track and we see consistent progress in the area of employment growth and falling unemployment. And, first and foremost, we will be looking for signs of price pressures that are likely to build in the absence of some tightening up of monetary conditions.

What will those signs be, particularly with respect to inflation? We will certainly continue to monitor the usual forward-looking indicators. Among these indicators, my staff and I especially watch the more refined measures of core inflation. For example, we'll monitor the median or trimmed-mean measures that have been shown to be better predictors of headline inflation over medium-term horizons. We will certainly want to look at measures of inflation expectations, particularly those based on market "bets," such as forward breakeven rates derived from TIPS yields. And we will certainly continue to monitor the measures of basic cost structures that businesses confront, such as movements in labor costs adjusted for productivity growth.

But we have started thinking a bit out of the box as well. At the Atlanta Fed, we have begun monitoring a so-called "sticky-price" index, derived from subsets of consumer prices that change relatively infrequently. The idea is businesses that only periodically change prices have a big incentive to make pricing decisions that incorporate their best guesses of how prices will move until their next opportunity to adjust prices again. Like TIPS-based measures, the sticky-price index gives us a measure of inflation expectations derived from people making real decisions in markets. *Unlike* TIPS-based measures, the sticky-price index focuses on signals from the product markets that we ultimately care about.

As to *how* to exit, there has been a great deal of work on the tools for the exit strategy since the beginning of last year, and those preparations have been well documented in FOMC minutes and other Fed communications. Briefly, the implementation of the exit strategy would involve a combination, in some order, of increases in the federal funds rate target (supported by increases in the interest rate paid on excess bank reserves), the "locking up" of reserve balances through term deposit arrangements with banks and open market reverse repurchase operations, and outright sales of assets currently held by the Federal Reserve banks. It's the right time to review and refresh those plans, particularly now that we are in the latter stages of LSAP2, but I think that the general approach remains workable.

**Aggregates and money measures**

Finally, as an element of a framework for the near term, I want to push the notion of a renewed focus on monetary and credit aggregates. The anxiety about the large size of the Fed's balance sheet revolves around fear that reserves currently idle on bank balance sheets will suddenly come off the sidelines. If those balances get in the game faster than the economy can absorb them, there might be serious inflationary consequences.

Practically speaking, I find it hard to imagine circumstances in which the credit channel would heat up so fast and in such volume that broad money creation would get away from the Fed's capability to drain liquidity. But precautionary monitoring is certainly warranted.

In recent history, there has not been much attention put on monetary aggregates. I would argue this is not because economists and policymakers have abandoned belief in the fundamental long-run relationship between money and inflation. Instead, monetary measures have not factored into policy discussions for quite some time because fluctuations in money multipliers and velocity made broad measurement elusive. Financial innovation has been such a force that forecasting methodology based on the money-price level growth connection came to be viewed as unreliable for policymaking.

It's worth remembering, however, that it was Paul Volcker's return to a focus on money growth that led the way to defeating the Great Inflation. The Volcker Fed's success set the stage for an extended period of controlled inflation approaching three decades.

A closing thought: Volcker took extraordinary measures in response to extraordinary times. He was able to do so because the bedrock principle of central bank independence in the formulation of monetary policy was respected. The eventual unwinding of the necessary, but historically unprecedented, monetary accommodation of the last three years combined with the requirements of fiscal adjustment make for new and quite extraordinary circumstances. Fed independence on monetary policy remains an essential feature of sound economic policymaking now as before.

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