SPEECHES

Two Views of the Economy

Dennis P. Lockhart
President and Chief Executive Officer
Federal Reserve Bank of Atlanta

Third Annual Rocky Mountain Economic Summit
Jackson Hole, Wyo.
July 29, 2011

Key Points

- Lockhart expects greater economic strength in the second half of 2011 and 2012, accompanied by inflation numbers that are converging to around 2 percent. He believes that we are in a temporary slowdown. As temporary negative forces of the first half of the year recede and positive forces gather strength, consumer spending should strengthen and joblessness decline.
- However, Lockhart thinks that a continuing flow of weak numbers through the third quarter and into the fourth will call for a reconsideration of this relatively optimistic forecast. While at present Lockhart does not see much risk of another outright recession, he does not dismiss the possibility that the United States may be in a persistently slow recovery that portends high unemployment and painful structural adjustments.
- If the U.S. economy is in a world of persistently slow growth, the FOMC, in Lockhart's view, may have to define a supportive policy stance that will be held in place for quite a long period while letting nonmonetary fixes do their work.
- For now, Lockhart is not yet ready to change his more optimistic base case outlook. If this outlook becomes reality, he expects conditions to develop that will support an argument in favor of policy normalization certainly by the end of 2012. At the moment, Lockhart supports a wait-and-see approach because he cannot tell with enough certainty whether the slowdown will prove temporary or whether the United States is in a persistently slow recovery.

Some data for the first half of the year have once again raised questions about the strength and durability of the economic recovery. The lack of recent progress in bringing down unemployment has provoked a debate in economic circles about the extent of structural factors holding back hiring. The measured economic weakness combined with falling confidence and heightened uncertainty is feeding concern about the deeper character of the country's economic problems. Just what is the nature of this economic situation we are dealing with?

Today I want to share some necessarily tentative thoughts about this question. At the moment, I'm in wait-and-see mode. I'm not ready to make a call, but I will outline the Atlanta Federal Reserve Bank's diagnosis of the situation, how we are framing the question I just posed, and implications for monetary policy.

As always, I will be discussing my personal views. They may not be shared by my colleagues on the Federal Open Market Committee (FOMC) or in the Federal Reserve System.

Recent economic performance
To repeat, incoming data on the economy have been disappointing, on balance, relative to expectations.

The expectation at the beginning of the year was for carryover of the relatively solid fourth quarter into 2011. This expectation was undermined to some extent by weather events, the spike in gasoline prices, and the effects of the Japanese tsunami.

At the end of the first quarter, the expectation was that the effects of the one-off factors I just mentioned would be transitory and that a stepped-up improvement in the economy would begin in the second quarter.

The advance estimate of the second quarter gross domestic product (GDP) growth released this morning was much lower than the consensus view among economists just three months ago. (GDP growth was substantially revised down for the first quarter of this year as well.) Weaker than previously expected growth in the second quarter has caused a significant write-down of the full year GDP growth estimate by most forecasters. Overall, it appears that the economy is experiencing a pretty broad-based slowdown. In spite of this, corporate profits and cash accumulation remain strong because corporations have positioned themselves to perform well in a weak or even mildly weakening environment.

Indicators of inflation began to reflate last fall, evidenced mostly by a sharp rise in commodity prices, including oil. However, a firming of price pressures more generally was fairly evident.

The period of elevated inflation has lasted longer than expected even with the retreat of some key commodity prices, especially oil. There were hints of easing price pressure in the June headline consumer price report. But the broadening of the phenomenon of rising prices within a number of inflation measures suggests an ongoing pass-through of commodity and import costs as well as a more receptive general environment for price increases.

That said, inflation expectations seem to support the proposition of temporary price pressures. Short-term inflation expectations are significantly higher than they were a few months ago, but longer-term expectations appear to remain well-anchored.

The level of unemployment has been stuck around 9 percent or a little higher for the first half of the year. Notwithstanding three months of encouraging job creation numbers from February through April, the overall labor market situation has been static. The most recent employment report reflecting June's data has triggered some amount of angst regarding the true nature of the economy we're dealing with.

Emerging debate—what kind of recovery are we in?
My staff and I have recently been pondering the following questions: Are we experiencing a temporary slowdown—a soft patch—on a recovery path that should return to a rate of 3 to 4 percent GDP growth? Or, instead, are we dealing with an inherently slower pace of economic growth that, because of some combination of persistent economic headwinds and deeper structural adjustment requirements, has the potential to be of much longer duration and more intractable?

I detect an emerging debate on this basic question among close observers of the economy.

In thinking about this question, our Reserve Bank has used the long-term trend rate of growth as a point of reference. Our estimate of the long-run trend rate of growth—also called the long-term sustainable rate of growth—is 2.5 percent. This is essentially the central tendency of the FOMC's longer-term growth projection.

The debate isn't so much about this trend, but about whether the economy will approach it from above, after some quarters of faster growth, or below, with a much slower recovery. The former means we make up for lost ground in the foreseeable future; the latter means we don't. Which world are we in?

Approaching trend growth from above is a more mainstream perspective. The economy by almost every metric has significant slack that would ordinarily be absorbed. Consequently, a traditional economic forecast would build in a period of growth above trend following a recession so as to eventually take the slack out of the economic system.

When I say "traditional forecast" I am referencing the historical experience of some quarters of above-trend growth after recessions. It's a fair generalization to say that in the decades after the Second World War, recessions have regularly been followed by periods of above potential growth in GDP. The implication is that resource slack was eliminated during the course of every postwar expansion, though the length of time required to accomplish this has varied across business cycles.

Approaching the trend rate from below is something quite different. Converging to the trend rate from quarterly or annual GDP growth rates under 2.5 percent could amount to a very long fight against economic problems and imbalances.

And growing only at the trend rate during a recovery may very well prevent reemploying and redeploying the resources that were idled over the course of the recession.

To elaborate, based on historical experience, an economy growing in the neighborhood of 2.5 percent would tend to be associated with net new jobs growth of a little less than 100,000 per month. In our current circumstances, this will likely not be enough to produce a meaningful decline in the rate of unemployment. This shirt-sleeve computation makes clear what can be at stake—a recovery that approaches potential from below hints at substantial and persistent misallocation of national resources, notably labor resources.

Case for the "from below" thesis
While at present I do not see much risk of another outright recession, I don't think we can dismiss the possibility that we're in a persistent slow-growth recovery, with all the challenges this presents.

Here's the case for this viewpoint: first, economies are very slow to recover after a recession caused by a severe financial shock. This is the thesis put forward by Carmen Reinhart and Kenneth Rogoff in their work on recoveries following financial crises.

More generally, this view holds that we're dealing with problems that are more structural in character than cyclical. Foremost among these hindrances, in my view, is the need for fundamental fiscal rebalancing that will take several years. Also included is a banking and financial system that, although much healthier, still must go through a lot of structural change in the way of consolidation, adaptation to intensified regulation, and adjustment of business models. Another hindrance, the removal of which will take time, is the depressed state of the housing market, including house values. Improvement of the housing sector is likely to involve reform of national housing policy, a political issue that may not be addressed in the near term.

Related to house values is the shock incurred by households and the likelihood of continuing deleveraging, perhaps for quite a long time, with the weakness this suggests for consumer activity.

Finally, this view holds that there are real structural aspects of the high unemployment we're experiencing.

Argument for the "from above" thesis
The more mainstream view of the world we're in is that of a temporary slowdown to be followed by above trend growth. This view is based on the argument that there have been some very unusual developments in the first half of the year that either won't reoccur or that have generated the adjustments necessary to weaken their effect going forward. Key among these one-time shocks is the rise in oil prices and gasoline resulting from the loss of Libyan production and the higher risk premium tied to the potential for supply interruption in the Middle East. Another shock was the greater-than-initially-anticipated supply chain disruption caused by the Japanese earthquake and tsunami. A third factor contributing to a slowdown is the uncertainty associated with the debt ceiling in the United States and the debt crisis in Europe.

In this view, the assumption is that the effects of these one-off developments will be short-lived.

There are also a number of strong positive forces that should continue adding to the strength of the recovery. For example, exports and business investment in equipment and software are likely to remain major contributors to growth. Economic expansion in our major trading partners remains relatively strong. U.S. exporters should benefit from sustained foreign demand. Nearly half of U.S. exports are sold in emerging markets, which are expected to continue outperforming advanced economies. Meanwhile, low borrowing costs, ample cash, and continued search for efficiency gains are likely to support business investment.

As temporary negative influences recede and positive forces gather strength, the all-important factor of confidence should build, with the result that consumer spending strengthens and joblessness declines.

So there you have two views of the economic world we're in. I realize the real world isn't this binary, but my staff and I have found the "from below versus from above" thought process a useful device.

My base case forecast is consistent with this latter view of the recovery. I am expecting greater strength in the second half of 2011 and into 2012, accompanied by inflation numbers that converge to around 2 percent. But, as I said, I don't dismiss the possibility that we're in the alternative, more problematic world I described of low and slow growth improving only very gradually. At this juncture, I think we have to wait and see what the incoming data indicate.

Decision framework

An obvious question is, what evidence would push me to switch to the "from below" narrative?

I don't believe conclusive evidence will come together in the very near term. It's entirely possible the headwinds that affected the first half of 2011 will exert a drag on the economy further into the year. Such an outcome could still be consistent with the more optimistic characterization of the economy even if the timing of an eventual resumption of above trend growth is off. It's also entirely possible that ambiguity will persist for some time.

But to try to put some time limit on indecision, I think a continuing flow of weak numbers through the third quarter and into the fourth will call for a serious reconsideration of the situation. The weight of cumulative data could point to a different order of problem—that is, different than just a passing slowdown—if indicators show continued weakness much past year's end.

It also needs to be said that the relatively optimistic base case forecast has been conditioned on the assumption of no new shock effects—that is to say, there will not be another oil price shock, the European debt situation will be contained, and we will get to the other side of the U.S. debt limit matter without serious downside developments.

Policy implications of the two diagnoses

If we're in a temporary slow period of a recovery that will shortly return to faster growth, as my base case forecast suggests, I would favor a stance of monetary policy that maintains current policy accommodation at least until it's clear the labor market is improving again and growth indicators show sustained improvement. This assumes well-behaved inflation, of course.

I think patience with the current policy is appropriate for this forecast even if the ramp-up in growth takes somewhat longer than expected.

Though this baseline forecast could call for keeping the current highly accommodative policy in place for some time, on balance I think steps toward normalization of policy are more likely than additional steps in the direction of easing.

If, however, I come to conclude that we're in a world that portends a long period of very weak growth, high unemployment, and painful structural adjustment, the much-anticipated policy normalization may have to be rethought. The FOMC, in my view, may have to define a supportive policy stance that will be held in place for quite a long period while letting what are essentially nonmonetary policy fixes do their work. Among the nonmonetary fixes are policies to address labor market gaps and fiscal rebalancing implemented over a number of years.

If the more optimistic forecast I've outlined comes true, I expect conditions to develop that will support an argument in favor of policy normalization certainly by the end of 2012. If, however, we're facing prospects of long and persistent weakness, I favor keeping all options open.

Still expect strong second half

I am not yet ready to shift away from the more optimistic outlook I presented. I feel it's premature to abandon the expectation of a stronger second half that will bring renewed gradual progress on unemployment and a leveling out of inflation pressures. I'm not resigned to the view that we are dealing with economic problems that are more persistent and intractable than I thought.

I support a wait-and-see approach because, at the moment, we cannot tell with enough certainty whether the economy is likely to approach its long-term trend rate of growth from above or below. I need some more time before making that call.

Contact: Jean Tate 404-498-8035

RELATED LINKS: PDF version • Dennis Lockhart's biography • Speaker's Bureau • Atlanta Fed Speeches