SPEECHES

Five Questions and Answers about Today's Economy

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Key Points

- Lockhart says he is currently cautious about the need for further monetary action. He believes the economy will resume a healthier pace of growth. But if that assessment proves wrong, Lockhart says the Federal Open Market Committee has the tools available to address whatever circumstances arise.
- Lockhart believes root causes of recent market volatility are the increasing recognition of an economic slowdown in the United States and Europe, a generalized reaction to the downgrade of the United States' credit rating, and concerns about European sovereign debt, particularly Italy's, and market concern about a downgrade of France's debt rating.
- Lockhart indicates that he's concerned about the effect of the wild stock market on consumer spending. He says that volatility alone could have a negative impact on consumer psychology at a time of already weakening spending.
- While the Atlanta Fed has revised down its near and intermediate gross domestic product growth forecast, Lockhart says the Bank holds the view that the economy will continue to grow at a very modest pace. While Lockhart does not expect an outright contraction of growth—a recession—he indicates that the risk of recession is higher than he perceived a month or two ago.
- As he looks ahead, Lockhart continues to expect positive effects as the unusual forces that constrained the economy in the first half of 2011 begin to peter out. He expects improvements in auto manufacturing and assembly as supply chain disruptions resulting from the Japanese earthquake and tsunami dissipate. He also expects the U.S. economy to be helped by strength in business investment in equipment and software, an active U.S. energy sector and strength in tourism.

I appreciate the opportunity to speak with you, and I want to thank former Atlanta Fed director Simpson Russell for inviting me. Business leaders in northwest Alabama, like Simpson, have a long tradition of public service on the Atlanta Fed's head office and branch boards of directors. I also want to thank Macke Mauldin, who is currently a director at the Atlanta Fed's Birmingham Branch, as well as former Birmingham Branch and Atlanta Fed Board Chair Larkin Martin. And while I'm recognizing people, I want to make sure that you all meet Lesley McClure, the Atlanta Fed's new regional executive for Alabama, who is based in Birmingham.

The views about on-the-ground business conditions from directors and other contacts, including Lesley's contacts, provide particularly important insights during periods of economic uncertainty. And that's where we find ourselves today.

Recent developments have been troubling and confusing. I imagine you have a lot of questions.

So, in my talk today I will survey the current situation as I see it and try to paint a coherent picture of reality. I'll do that by structuring my remarks as a sequence of top-of-mind questions that are most pertinent to current economic circumstances and the outlook from today. After my formal remarks, I will welcome your further questions.

In my view, the top questions of the day are these:
One: What's causing the current financial market volatility?
Two: What does this financial market volatility mean for the real economy?
Three: What's the outlook? Is there a risk of recession? Is there inflation risk?
Four: Is current Fed policy appropriate for the circumstances? In this vein, I know that many people have questions about the rationale for last Tuesday's statement that the Federal Open Market Committee (FOMC) anticipates keeping the policy rate at current levels until mid-2013.
Five: What are the Fed's policy options if more action is needed? Put another way, is the Fed out of bullets?

As always, I'm presenting my personal views. These views may not be shared by my colleagues on the FOMC or in the Federal Reserve System.

Financial market volatility
So, to the first question—what's behind the recent financial market volatility?

In recent weeks, we've seen a lot of volatility principally in the equity markets with spillover into some debt markets.

As evidence of this volatility, the VIX—an option index based on the volatility of the S&P 500 and sometimes called the "fear index"—has more than doubled since the end of July and is at the highest level seen since early 2009. At the same time, long-term Treasury yields have fallen sharply, despite the S&P downgrade of U.S. Treasuries.

I believe the root causes of this volatility are the increasing recognition of an economic slowdown in the United States and Europe, a generalized reaction to the downgrade of the United States' credit rating, and concerns about European sovereign debt, particularly Italy's, and market concern about a downgrade of France's debt rating.

There has been escalating concern about the condition of specific banks in Europe that have high exposure to Italy and other peripheral countries.

As a result, markets globally have been exceptionally jittery and share prices have been swinging on each piece of news and each day's developments in both Europe and the U.S. economy.

The real economy
It's natural then to ask what does this financial market volatility mean for the real economy—for Main Street?

In spite of the equity market volatility, it's hard to say that overall financial conditions have tightened for Main Street. The cost of credit remains low, and bankers tell me they are very eager to lend.

There is no lack of liquidity in the banking system. There has been, however, some stress in the money market mutual fund world, mostly before the debt ceiling was raised. This stress was related to uncertainty regarding defaults on Treasury securities.

We have seen longer-term Treasury rates decline in recent days because there are very large capital flows in and out of risky assets. Money managers are shifting between "risk on" and "risk off" positions.

When the impulse is to take risk off, there is nowhere to go as deep and liquid as the U.S. Treasury securities market. Flows into Treasuries have pushed longer-term rates to very low levels, closing at 2.24 percent for the 10-year Treasury last Friday. Ironically, the safe asset when you want to take risk off is U.S. Treasury securities, which were just downgraded (but still AA+, of course).

Bank stocks have been especially hard hit by the equity sell-off. The hit to bank stocks appears to be caused more by concerns raised by the general economic slowdown and matters specific to individual banks as opposed to concerns about funding more generally. We have not seen a renewal of solvency concerns here in the United States.

Credit is a principal channel by which economic shocks are propagated through the real economy. (Also, credit is the principal channel through which Fed policy is transmitted to the real economy.) If, as I suggested, recent market volatility has not impaired the credit channel, what is the risk that it could still do so or that it could damage the economy through other means?

I'm most concerned about the effect of the wild stock market on consumer spending. Volatility alone could have a negative impact on consumer psychology at a time of already weakening spending. Last Friday, it was reported that the University of Michigan's Survey of Consumer Sentiment fell sharply in early August to its lowest level in more than 30 years. Furthermore, if the loss of stock market value persists, the effect from the loss of investment value could combine with the loss of value in home prices to discourage consumers more and longer.

The outlook for the economy and inflation
It's been an eventful two weeks, to say the least. Let's now look ahead. The $64,000 question is what's the outlook from here? Is there a risk of recession? And, what about inflation risk?

Whether we're seeing a temporary soft patch in an otherwise gradually improving growth picture or a deeper and more persistent slowdown, most of the arriving economic data lately have caused forecasters to write down their projections. Also, and importantly, the Bureau of Economic Analysis in the Department of Commerce has revised earlier economic growth numbers. These revisions paint a different picture of the depth of the recession and the relative strength of the recovery.

At the Atlanta Fed, we have revised down our near and intermediate gross domestic product (GDP) growth forecast, but we are holding to the view that the economy will continue to grow at a very modest pace. In other words, we do not expect the onset of outright contraction—a recession—but I have to say the risk of recession is higher than we perceived a month or two ago.

As I look ahead, I continue to expect positive effects as the unusual forces that restrained the economy in the first half of this year peter out. Some of these will be in auto manufacturing and assembly, which should rebound as the supply chain disruptions caused by the Japanese earthquake and tsunami are eliminated.

Add to that business investment in equipment and software, which should continue to be relatively strong even if business people have pulled back investing to some degree because of greater uncertainty.

Also, the U.S. energy sector is active again. Demand for coal is high, firms are investing and hiring to explore and develop shale gas, and demand for alternative energy sources is strong.

Tourism has been very strong this summer. Hotel and cruise bookings and attendance at theme parks and resort venues have been very good.

These are just four examples. A somewhat darker outlook has intruded on the consciousness of the market and the public in recent days. But, as I said, I believe there are identifiable sectoral sources of strength that will serve to counter forces of weakness in the second half of this year and into 2012.

That said, it stands to reason that at a lower growth rate, the economy is closer to the threshold of contraction. As growth expectations have been revised down, economists have evoked the image of "stall speed." Indeed, economic history suggests that the probability of recession increases markedly at GDP growth rates below 2 percent.

Economic stall speed is a metaphorical description. The basic idea is that there may be a growth rate that is too slow to be sustainable. If, for example, the economy does not grow at least at the rate of its potential, the rising amount of unused resources will eventually destabilize the economy.

Of course, metaphors to describe economic phenomena should be employed with care. The idea of stall speed is based more on a statistical regularity than on a deep theory explaining why slow growth is likely to foreshadow a downturn. Slow growth doesn't lock in a recession. In fact, some recent data we have on hand—retail sales and initial unemployment claims, for example—seem to contradict the direst predictions.

Let me comment on prices. I am comfortable that inflation is following the pattern that we at the Atlanta Fed envisioned earlier in the year during the period of rapidly rising commodity prices. We expected that the inflationary pressures would subside as the year progressed, and this seems to be occurring.

At present, growth appears to be a bigger problem than inflation. With only modest growth, gaining ground on the unemployment problem is challenging. Private sector job creation, while positive, remains anemic at a time of shrinking public sector employment. In July, the U.S. economy added 117,000 jobs after adding only 46,000 jobs in June. While job growth is positive, it has only been strong enough to nudge down the unemployment rate a bit to a still quite elevated 9.1 percent.

Complicating the employment picture is the trend in labor force participation. Labor force participation has fallen more than two percentage points since the onset of the recession—an unprecedented exit of workers from the labor market. This trend is continuing and is difficult to explain.

One plausible explanation is that idled workers are dropping out after long-term unemployment. The average unemployed worker has been jobless for almost 10 months, and a large share of unemployed workers have been out of work for an exceptionally long period of time. The longer that workers are idle, the more difficult it is for them to assimilate back into the economy. But this is still conjecture. The labor force participation question is representative of many open questions related to the job market and employment.

Fed policy

So let me now turn to the policy implications of the picture I've painted.

Monetary policy needs to be very supportive of growth as the recovery seeks to regain its footing. Conditional on stable inflation expectations, I believe maintaining the current low interest rate environment is the right posture for the time being.

At our meeting last week, the FOMC indicated that, given current projections for GDP growth, employment, and inflation, the 0 to 25 basis points range for the federal funds rate will likely be in place through mid-2013. (The federal funds rate is the target interest rate set by the FOMC that banks charge each other to hold reserves. It also is the policy rate that influences the level of interest rates across the maturity spectrum.) Every FOMC participant speaks for himself or herself, but in my view this guidance is based on a particular view of future economic conditions. Should those conditions materially change, the timing of any policy decisions would have to change accordingly.

The FOMC has not been explicit about the likely timing of changes in the size of the Federal Reserve's now-large balance sheet. But it makes sense to me that policies related to the overall size and composition of assets on the balance sheet should align with explicit rate policies.

Not every economic problem we face has a monetary policy fix. That is the reason I have said repeatedly that the hurdle to justify additional monetary policy stimulus should be high. But the events of the last several weeks are a reminder that circumstances can quickly arise that may call for additional monetary actions.

Policy options

If additional actions are required, I can assure you the Federal Reserve is not out of bullets. If the anemic growth in the first half of this year is a soft patch in an ongoing, moderately paced recovery, additional monetary stimulus is probably of limited marginal value. But saying this is not the same thing as saying that monetary policy would be ineffective if conditions deteriorate. Expansion of the balance sheet or changes in the composition of the Fed's asset portfolio are available, in my view. These could be quite effective, particularly if done in sufficient size, in the event that the economy retreats back into contractionary territory.

It should also be emphasized that the Federal Reserve, as the central bank, has ample tools to deal with any reemergence of acute financial or liquidity strains in dollar funding markets here and abroad. Given the interconnectedness of global markets, it is in the best interest of the U.S. economy to quell liquidity strains in dollar markets when they arise.

I'm currently cautious about further monetary action. As I see it, we do not yet have enough information to conclude the economy won't resume a healthier pace of growth. I still maintain that a resumption of growth is the most likely case. But if that assessment proves to be wrong, I believe we do have tools to address whatever circumstances arise.

Don't jump to conclusions

As recently as two weeks ago, there was a widely held view that the U.S. economy was in a soft patch with a good chance of turning up in the second half of 2011. The rapid-fire developments of the last several days, along with some troubling data releases, have shaken confidence. People are worried. Investors, Main Street businessmen and women, and consumers are wondering which way things will tip. The public—and for that matter, policymakers—are operating in a fog of uncertainty that is thicker than normal.

My final point is a simple one. At this juncture, we should not jump to conclusions. A clearer picture of economic reality will be revealed in time as immediate uncertainties dissipate. It's premature, in my view, to declare these important questions relating to our economic future settled.

Thank you very much. I would now be happy to take your further questions and comments.

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