Monetary Policy and the Credit Channel

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

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- Federal Reserve Bank of Atlanta President Dennis Lockhart believes the current stance of monetary policy is a sober response to the reality of economic conditions, both actual and projected.
- Lockhart says the pace of economic recovery has been inconsistent, with sporadic growth periods, in part because of problems with the transmission mechanism of monetary policy.
- Lockhart believes banks today are facing challenges, including issues related to the supply and demand of credit. Business and consumer loan demand has been soft, and banks are using tighter underwriting standards. New data show loan demand is beginning to pick up.
- Lockhart believes given the circumstances of the economy, the benefits of low rate policy outweigh the costs at present.

I want to add my welcome to this conference and the Atlanta Fed. This conference is hosted by our Supervision and Regulation division, and most of you in attendance are bankers.

Today I will connect thoughts on the banking system—informed by my interaction with our senior supervision people—with thoughts on the current effectiveness of monetary policy, particularly the transmission of monetary stimulus through the credit channel. I will begin with a brief discussion of the current economic situation and the outlook. I will conclude with comments on what I consider to be the central question regarding the appropriateness of today's policy posture for the economic circumstances we face.

I will be sharing my personal views. I do not speak for the Federal Reserve System, and my views may not be shared by my colleagues.

The economy today

John Silvia did a thorough job this morning of surveying the economy in some detail. Let me, therefore, touch on some highlights.

The economy is gaining strength. Most recent data and indicators have been positive. Anecdotal accounts we hear have been mostly upbeat. Consumer and business confidence seem to be accumulating.

That said, the economic recovery is now 32 months old and in some ways is still getting its legs. By that I mean while growth is proceeding at a moderate pace, the question of sustainability continues to hang in the air. The economy is generating jobs, and unemployment has come down. Still, there remain significant levels of unused and underutilized resources in the economy, especially human resources. The economy remains far from its optimal condition.

Growth in the current quarter appears to be tracking a little lower than in the fourth quarter. Real GDP for this quarter is currently projected by economists to rise around 2 percent annualized.

The housing market is still a mix of positives and negatives. Sales are improving and new residential construction activity is positive again. But the housing market is rising from an exceptionally low level and home prices are still declining.

Business spending on equipment has lost some momentum in recent months. Tuesday's durable goods orders report was a disappointment.

The most evident softness in the incoming numbers comes from cutbacks in government spending, which declined in the fourth quarter for the sixth consecutive quarter.

Inflation, in my view, appears to be tracking along a path that is consistent with my interpretation of price stability. And inflation expectations appear stable. But gasoline prices are on the rise again, and cost pressures—both positive and negative—warrant a watchful eye for any shift in the underlying overall inflation trend.

Looking ahead to 2012, I expect full year growth in the 2.5 percent to 3 percent range, assuming no significant adverse shocks. This performance would be significantly better than the 1.6 percent pace of 2011.

Monetary policy

My reading of the situation is that the economic challenges we face are still formidable. Monetary policy support remains an important and necessary contributor to the ongoing recovery.

As you know, the federal funds rate has been targeted at just above zero since late 2008. If this level is maintained through 2014 as the FOMC has projected, the extraordinary low-rate environment will have prevailed for close to six years.

Expansion of the Fed's balance sheet has also contributed to the accommodative stance of monetary policy. After two rounds of large-scale asset purchases (known popularly as QE1 and QE2), the size of the Fed's balance sheet has held at around $3 trillion. The Fed's recent maturity extension program (called "Operation Twist" by some) was launched last fall and is designed to put pressure on longer-term interest rates without growing the balance sheet further. These components of policy remain in place.

Last August, a novel communications component was added to policy. The Federal Open Market Committee's (FOMC) post-meeting statement gave definition to the previous "extended period" guidance regarding future federal funds rate actions. The FOMC stated an expectation that the policy rate would remain near zero at least through mid-2013. The committee recently revised this guidance to the latter part of 2014. Of course, that stance is conditional on how the economy performs. Also, the committee took the important step of announcing a formal inflation target of 2 percent as a means of anchoring inflation expectations. To avoid misinterpretation, the committee buttressed the inflation target with a statement stressing the FOMC's balanced approach to its dual mandate.

How low rates are supposed to work
The current stance of monetary policy, in my view, is a sober response to the reality of economic conditions, both actual and projected. At the risk of telling you what you already know well, let me recite the textbook version of some ways a policy of low interest rates can influence economic activity.

Lower interest rates increase the amount of credit demanded in the economy. When met by an elastic supply of credit, spending increases.

For housing markets, lower rates generate higher housing demand and, with increased demand, higher house prices.

Lower rates may free up household cash flow for spending by lowering mortgage costs either by variable-rate resets or refinancing of fixed-rate mortgages.

Lower rates can also increase demand for a variety of financial assets, boosting their prices.

Impaired transmission mechanism
As I said a moment ago, the almost-zero fed funds rate policy has been in effect since December 2008. Yet the pace of recovery has been very inconsistent, and the periods of stronger growth have been sporadic. Why is that?

Well, one frequently heard explanation is that the transmission mechanism of monetary policy is—choose your adjective—broken, clogged, impaired. I think this view has much validity. I recently heard the analogy of a clogged drain in a kitchen sink. The speaker posed the question of whether the Fed should push on the blockage by running the water more intensely or instead put on a rubber glove, reach down, and pull the stuff out. Even the normally technical discussions of monetary policy can have a "yuck" factor from time to time.

Like so many widely cited and potentially facile explanations for why things aren't going as they should, this one deserves deeper inspection. Let me give you my take on what "impaired transmission mechanism" means and what the reality is at this juncture.

First, it means low rates aren't stimulating much in the way of credit growth. It means some bankable loan demand is not being met in spite of ample liquidity. And it means final demand for goods and services remains subdued and the added employment that growing final demand ought to generate is slow to materialize.

The state of the banking system is central to this picture. There are a number of reasons familiar to everyone in this room why credit flows via banks have been weak. They can be categorized under two headings: demand and supply.

Here are some factors that have restrained the demand for bank credit.

Larger businesses are flush with cash as a result of strong cash flow generation. Corporations have aggressively controlled costs and exploited productivity gains. All this has added up to relatively weak commercial and industrial loan demand.

Smaller businesses haven't yet seen much revenue growth and remain cautious about borrowing given their perceived growth prospects. In addition, collateral values supporting small business borrowing haven't recovered, in many cases.

Households continue the process of deleveraging, and, as a consequence, consumer loan demand, broadly defined, has been soft. While there have been pockets of growth like auto loans, most categories have been pretty feeble. There are a number of reasons, including fear of job loss, lack of income growth to cover debt service, lost home equity value, repair of personal balance sheets, and impaired credit scores.

And as for the supply of bank credit, here are some factors that you bankers have been living.

Underwriting standards across all loan categories have been tightened as a result of the financial crisis and recession.

Some banks are capital-constrained and cannot grow their balance sheets even if there were stronger loan demand.

Many banks are reducing sector concentrations, most prominently commercial real estate. The mix of loan portfolios is being reconstituted.

And there is the factor of regulatory supervision. I understand there can be different perspectives on this one, but no one would argue with the view that lending to creditworthy borrowers is good for the borrowers, good for the economy, and good for banks. In some cases, the combination of intensified supervision and bank management's need to improve regulatory ratings has put the focus on dealing with problems and suppressed appetites for aggressive loan growth.

Long story short, low funding costs and abundant bank reserves produced by monetary policy still have not resulted in significant, broad-based loan growth. Still, as you are aware, we are starting to see some movement in the right direction. New data from the FDIC show that as of the end of 2011, U.S. banks are issuing loans at the fastest rate in about four years. But it's too early to claim victory for lending.

At the same time, the functioning of credit capital markets has not been fully restored. While bond markets and securitization for auto loans and credit card receivables are functioning, the mortgage market is still impaired. This impairment limits the stimulative effect of lower rates and lengthens the timeline for clearing out the inventory of homes in the foreclosure process.

I think it can be argued that because of the interplay of demand and supply factors, the interest rate sensitivity of the U.S. economy has been dampened.

The debate swirling around policy
The question of the moment, in light of a weak transmission mechanism for monetary policy, is what to do? There are serious people making well-reasoned arguments on all sides of this question.

One line of argument is that monetary policy should push harder to compensate for the weakened transmission mechanism. Since the policy rate is effectively at zero, this view would contemplate more bond purchases (or quantitative easing).

A second line of argument asserts that further easing involves an element of futility or even potential harm. I will take a moment to develop this idea. Some have argued, for example, that pushing harder to increase aggregate demand would not be a good thing because the economy's potential level of output is actually lower than conventional estimates suggest. Accelerating demand, then, is more likely to compromise the Fed's price stability mandate than to improve the prospects for lower unemployment.

Another argument is that the elements of recent policy designed to suppress long-term rates challenge long-term lenders and investors, including life insurance companies and pension funds. With respect to the banking channel, what could be a six-year period of very low rates poses a risk-management challenge. The argument goes, with short-term rates close to zero, banks may see their exposure to interest rate risk as outsized. This potential interest rate risk could cause banks to grow loan activity more slowly—or, it is argued, meager yields will just spur imprudent risk.

As a policymaker, I weigh these divergent views and the policy stances they suggest by asking what policy balance will promote the most robust sustainable growth and the healthiest overall employment markets in the context of price stability. This, in my mind, is the question that policymakers must return to in all circumstances.

My view of appropriate policy

So let me wrap up this afternoon by telling you how I come out on this question at the moment. Given the circumstances of the economy, which I described earlier as still striving to get its legs, I continue to think the benefits of the low rate policy outweigh the costs.

I take seriously the risks of holding to this policy. But I think a realistic assessment of the challenges associated with closing the employment gap calls for sustained extraordinary support for what is, like it or not, a gradual process. At the same time, I'm cautious about doing more involving expansion of the Fed's balance sheet. Precisely because I see the transmission mechanism of monetary policy through credit channels as constricted, I have my doubts that the gains from such a policy action taken in the near term would outweigh the longer-term potential costs, including the risk to the Fed's medium-term inflation outlook.

Contact: Jean Tate 404-498-8035

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