SPEECHES

Headwinds, Risks, and Monetary Policy

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Key points

- Federal Reserve Bank of Atlanta President Dennis Lockhart said the U.S. economy remains in recovery, which he expects to continue. As recent disappointing employment numbers illustrate, however, the economy is working against some strong headwinds.
- Lockhart said these headwinds include continued deleveraging by the household and financial sectors, a weak housing market, a contracting government sector, and an "uncertainty drag" on confidence and economic activity.
- In addition to headwinds, Lockhart described four risks in his outlook: the behavior of home prices, effect of pending sharp federal fiscal adjustment, financial instability along with recession in Europe, and slowdown in emerging market economies.
- Lockhart views today's highly accommodative stance of monetary policy as being appropriate for the outlook he envisions.
- His views about further policy measures consider two possibilities. First, if his baseline scenario of continued, though modest, growth becomes unrealistic, further monetary actions to support the recovery will need to be considered. Second, he believes the FOMC must maintain a state of readiness to respond to financial or economic instability.

It's a pleasure to be back in South Florida at the Broward Workshop. This is the second time I've spoken to this group. My hat goes off to the Broward Workshop because you bring together leaders from Broward County's major businesses to focus on important community issues. In most communities, little happens unless the business community gets on board and takes the lead.

Community-based businesspeople also play an important role in helping the Federal Reserve get an on-the-ground view of what's really happening in the economy at any given point in time. We're interested in whether or not businesses are making investments, building staff, seeing stronger sales, or passing through price increases. Sometimes we can extrapolate this regional and local input to the national economy. And sometimes not, but it's always helpful.

Over the years, Broward Workshop members have served on the Atlanta Fed's Miami Branch board of directors, a group that helps us at the Atlanta Fed get the economic and business intelligence I just described. Workshop members who have served on our board include Walter Banks, Keith Cobb, and Tom Shea. Currently, Mike Jackson serves on the board. Thanks to each of you.

Our board members are accustomed to how we think about and structure a discussion of the economy. Today, I want to walk you through a pretty conventional treatment of current economic concerns. I'll start with some local flavor—Florida and South Florida. I'll then provide my views on the state of and outlook for the national economy. I'll comment on the headwinds holding back stronger growth and the key risks to the outlook. And I'll close with a few points on the Fed's monetary policy, particularly the question I engage every few weeks before Federal Open Market Committee (FOMC) meetings—is current policy appropriate to the outlook and risks?

As you listen, please understand that these are my views and may not be shared by my colleagues on the FOMC or in the Federal Reserve System.

State of Florida and Broward County
I would describe the pace of the ongoing economic recovery in United States as moderate—and that's been true in Florida as well.

While the economy of Florida continues to recover at a pace not too different from that of the United States overall, one difference is that Florida experienced a deeper recession than most of the rest of the country. For example, Florida's unemployment rate increased more than 7 percentage points between 2007 and 2010, peaking at 11.4 percent. In contrast, the average rate for the nation as a whole increased about 5.5 percentage points to a peak of just over 10 percent.

Conditions in Florida have been improving since 2009, but progress has remained relatively slow. The state's unemployment rate is down about 2.5 percentage points from its 2010 peak. Closer to home, the unemployment rate in the greater Fort Lauderdale area continues to decline, having reached 7.6 percent in April compared to a peak of 9.6 percent in 2010.

The economy in South Florida has seen a resurgence in foreign spending, primarily on real estate and tourism. Our contacts in the real estate sector have noted for some time that international investors, mainly from Canada, Europe, and South America, have been active buyers of this area's distressed residential real estate assets.

On the tourism side, international visitor spending has been supported by rapid growth in South American visitors. Looking ahead, our travel and tourism contacts expect this sector to show solid performance for the remainder of 2012. That said, we also hear anxiety about the impact of a slowdown in global economic activity on bookings this summer and into the future. I'll discuss this risk in a moment.

The national economy
The national picture evokes a similarly mixed and cautious reaction to the flow of data and world news.

Coming off a reasonably strong fourth quarter of 2011, the indicators of economic strength so far in 2012 have been underwhelming. First-quarter gross domestic product growth was recently revised to 1.9 percent. The May employment report, combined with downward revisions to the March and April jobs statistics, was clearly a disappointment. There remains some question about the degree of weather-related payback from the robust job growth earlier in the year. Losses in construction jobs, for example, were unexpectedly large in May. But it is nearly impossible to escape the conclusion that we are replaying in some manner the spring-summer slowdowns of the past two years.

The economy remains in recovery but, as the disappointing employment numbers illustrate, the economy is working against some strong headwinds.

First, key sectors of the economy are still deleveraging. This is true of the household and financial sectors. In the household sector for example, while consumer credit is expanding, overall consumer debt (including mortgage-related debt) is declining and the debt-service-to-income ratio is shrinking. Overall, deleveraging is arguably a fundamental improvement for the long term as financial institutions and households return their balance sheets to health. However, over the medium term, deleveraging is not conducive to spirited growth.

Second, the housing sector remains weak even while showing signs of stabilization and improvement. Home prices—more than house building—influence the health of the broad economy through their effect on consumer attitudes. Home prices in many markets appear to be stabilizing, but there remains a sizable inventory of unsold homes that is likely to work against a sustained firming or upturn in home values.

At the same time, the government sector overall—including, importantly, state and local government—continues to contract. A shift of relative weight in the economy of the public and private sectors requires significant adjustments. Labor and other resources have to be reallocated to other areas of the economy. These adjustments take time and also limit the pace at which the economy can reasonably be expected to expand.

Finally, there continues to be what I'll call an "uncertainty drag" on confidence and economic activity. While the makeup of the array of uncertainties has moved over time and the intensity of restraining effect has modulated, it's clear that uncertainty is holding back hiring and capital expansion plans of U.S. businesses.

As a result of these various headwinds, I expect the recovery process to be slow and drawn out. I think the most reasonable expectation is moderate growth, a slow and possibly halting decline of unemployment, with inflation staying close to the FOMC's 2 percent target. I do not see this narrative changing much to the upside over the medium term.

Let me describe the key elements of this baseline outlook.

The modest recovery and associated slow jobs growth is keeping income growth subdued, and vice versa. These conditions are likely, in my view, to restrain consumer, or retail, spending. Consumer spending has been running a little stronger than income growth over the past year, supported by a drop in the rate of personal savings. This is not healthy for the longer term. Without a marked acceleration in household income growth (which, again, is not in my baseline projection), consumer spending growth will likely be held in check.

Export growth has been strong over the recovery, and U.S. manufacturers in particular have benefited from growth of exports to emerging economies. The slowdown in Europe has resulted in some cooling of overall export growth and a slowing in U.S. manufacturing. Our trade imbalance—with imports exceeding exports by a good measure—could well be exacerbated by the recent appreciation of the dollar on the export side and the relative strength of the U.S. economy as a driver of imports.

As I already mentioned, the decline in government spending has been a net drag over most of the past three years and is likely to be a slightly negative factor, or worse, over the medium term.

These are the key factors that are influencing my baseline forecast. Forecasting is a dynamic exercise. We continually re-evaluate key assumptions and risks that both affect the outlook (that is, are in the forecast in some measure) and pose potentially high-impact contingencies not in the baseline forecast.

It is my sense that material risks to the economic outlook are gathering, so it is worthwhile to spend some time talking about risks in some detail.

Risks to the outlook

In my view, there is an array of serious concerns, but I'll emphasize four key potential sources of downside risk. They are the behavior of home prices, the effect of sharp federal fiscal adjustment, financial instability along with recession in Europe, and a slowdown in emerging market economies.

For our Atlanta Fed forecast, we assume that home prices will hold steady, a view supported by recent readings from a variety of home price indicators like the Case-Shiller and the CoreLogic indexes.

I've already cited the housing sector as a headwind. It's also a risk in that a large further drop in home values could undermine my outlook for the economy.

Next, without congressional action, current law calls for increases in taxes and reductions in federal spending to begin on January 1, 2013. Estimates of the seriousness of the so-called "fiscal cliff" vary, but most indicate that the immediate (that is, 2013) impact on the economy would be negative and large.

The Congressional Budget Office (CBO), for example, estimates that without congressional action, mandated spending cuts and tax increases would cut the federal deficit by 4 percent or more of GDP. The CBO notes that this could be large enough to push the U.S. economy into recession during the first half of 2013.

My baseline projection assumes that, while some amount of federal fiscal restraint on growth is likely, the phase-in of tax and spending actions will occur more gradually, mitigating the "cliff" effects just described.

Let me turn to the risk posed by the situation in Europe. I am giving more weight and higher probability to a negative influence on our economy coming from Europe than I did as recently as the last FOMC meeting in late April, so I'd like to spend a little time today developing this scenario in more detail.

First, the euro area as a whole is in or near recession, as I mentioned earlier. Southern Europe is contracting sharply. Of the larger euro area economies, only Germany appears to be showing much resilience. A more severe euro area recession will negatively impact the U.S. economy through the export channel.

Exports of goods to the euro currency area in 2011 totaled around $200 billion, about 13 percent of the total dollar value of U.S. goods exports. More broadly, exports to the European Union totaled about 18 percent of U.S. goods exports. A mild European recession, which is what I expect, would slow but not derail the U.S. economic recovery.

While the trade channel with Europe is important, the greater concern, in my view, relates to the European financial system, in particular the risk of an event that might trigger a widespread seizing up of global debt markets. Financial stress in Europe increased measurably after the failure to form a government following the last Greek elections. With increased fears that Greece may leave the euro area, deposit flight from Greek banks reportedly has surged. Sovereign debt spreads and credit default swap cost-of-protection have increased in Greece, Portugal, Spain, Italy, and Ireland.

U.S. financial institutions have been taking steps to limit their direct European financial exposure. Banks have moved to limit their direct exposure to peripheral European sovereign debt but still maintain exposure to European banks through complex counterparty relationships, including their participation in the credit default swap market. Also, exposures of money market mutual funds to unsecured European debt have been declining in recent months, especially longer-dated (greater than 30 days) unsecured placements with European banks.

Reduction of direct exposures within our domestic financial system can only go so far to insulate the U.S. economy from spillover in the event of financial sector instability in Europe, in my view. The global financial system is too integrated, too networked to expect that problems could be isolated to Europe. Arguably, in the current risk-on, risk-off environment, U.S. financial markets have also experienced the effects of European risk in equity markets.

Another connected global risk is the apparent slowdown occurring in a number of large emerging economies—notably in the economies of China, India, and Brazil. Our recent export strength is substantially related to strong economic performance in emerging market economies. A growth slowdown in emerging economies would aggravate the effects of the European slowdown by further limiting the role of exports in the U.S. recovery.

I should add that, although the intensity of concern has receded somewhat, the risk of conflict related to Iranian nuclear proliferation in the Middle East has not gone away. Sudden developments would likely be felt in oil markets. Research has connected the onset of recessionary conditions in our economy with spikes in oil prices.

Stance of monetary policy

To close the circle, let me tie my view on the outlook and risks to monetary policy. In thinking about the array of headwinds and risks out there, I can say my base case outlook for the economy incorporates some impact of downside forces on the economy. That said, the full potential impacts of a downside scenario related to Europe, a global economic slowdown, or some other externally-sourced shock are not factored into the outlook.

In the context of the outlook I just described, policy remains accommodative and supportive of the ongoing recovery whose essence is summarized in my baseline forecast. The key elements of current policy are an interest rate policy designed to keep borrowing rates at very low levels, a stable Federal Reserve balance sheet whose average maturity has been extended as a result of so-called Operation Twist, and a communication policy that I think goes a long way in helping the public form expectations about interest rates, inflation, and the intent of policy in general.

I view this policy stance as appropriate for the outlook I depicted. However, as the employment report of last Friday illustrates, there continues to be a halting and tenuous character to the recovery.

Looking ahead, my viewpoint as regards further policy measures considers two possibilities. Should it become clear that something resembling my baseline scenario of continued, though modest, growth is no longer realistic, further monetary actions to support the recovery will certainly need to be considered.

In addition, the situation we face requires that the FOMC maintain a state of readiness to respond to financial or economic instability should the need arise. I am confident that the committee retains the capacity to act and the tools to promote stability.

Importantly, the economy itself is in a better condition to withstand threats to stability than it was at the time of the financial crisis in 2008 and 2009. I still think it is prudent to acknowledge a degree of fragility, but in its fundamentals, the U.S. economy has made substantial progress toward resilience.

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