SPEECHES

The Debate Over Further Monetary Action

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Key points

- Federal Reserve Bank of Atlanta President Dennis Lockhart says the pace of economic expansion has been inconsistent over the past three years. With each apparent change of pace in economic activity, monetary policymakers have had to consider whether to take action to try to improve future outcomes.
- At the June meeting of the Federal Open Market Committee (FOMC), all participants, including Lockhart, lowered 2012 GDP growth expectations. At that meeting, the FOMC made the decision to extend "Operation Twist" until the end of 2012.
- Lockhart says it is possible that another policy decision looms—whether or not to respond more aggressively to the economy's apparent weakness.
- Lockhart says his support for the current stance of monetary policy rests on a forecast for a step-up in output and employment growth by year-end. But if the economy continues on the track indicated by the most recent incoming data and information, he believes that forecast will become untenable, as will the policy premises underlying it.

Thanks for inviting me. As I begin, I want to recognize a few folks who have a Federal Reserve Bank of Atlanta connection: Jerry Host of Trustmark National Bank has been serving on our New Orleans Branch board of directors since 2008, and Dave Dennis of Gulfport served on our New Orleans board from 2001 to 2007. Our directors, who are like Jerry and Dave from throughout the Southeast, provide the Atlanta Fed with important on-the-ground views of what's happening in the economy, offering insights and texture beyond what we get from looking just at data.

I am pleased to be back in Mississippi and to have the opportunity to speak to the Mississippi Economic Council, a group that addresses the bigger issues facing your state's economy. Sometimes trends in the national economy are mirrored at the state or municipal level, but sometimes not. Each jurisdiction has its own unique circumstances and conditions. What I can do as a Federal Reserve official is provide a national perspective on the economy in hopes my input will contribute constructively to your deliberations here in Mississippi about what to do to improve economic outcomes for your citizens. That's what I plan to do today.

More specifically, in my remarks today I will discuss the appropriate policy response to an apparent slowing of the economy and a weakening of the outlook for growth and employment gains. In this discussion, I'll walk you through a more layered recitation of the issues at play in the debate about whether the Fed should apply more monetary stimulus. I will be sharing my personal views. They may not be shared by my colleagues on the Federal Open Market Committee (FOMC) or in the Federal Reserve System.

The policy juncture

The national economy has been in recovery—that is, expanding—for three years. The pace of expansion has been far from uniform. There have been episodes of accelerating growth and episodes of slowing. With each apparent change of the pace of activity, policymakers as well as business planners, government planners, and forward-looking consumers had to ask whether the new trend is likely to be transitory or persistent. And in each episode of slowing, those of us involved in monetary policy formulation have to consider whether to take more action to try to improve future outcomes.

We are in such a moment now, and it is a challenging situation. Let me give you my personal sense of how we got to this juncture. My colleagues and I at the Federal Reserve Bank of Atlanta began the year expecting pretty solid gross domestic product (GDP) growth of between 2.5 percent and 3 percent. We expected gradual but steady progress in reducing unemployment, and we expected moderate inflation around the target of 2 percent.

As our Reserve Bank was preparing for the FOMC meeting in late April, data in hand showed several months of strong employment growth and an economy that appeared on track to grow at around 3 percent in the first quarter of the year. The economic picture was reasonably encouraging at that point.

Of course, with more data available and better-informed hindsight, we now know that economic performance in the first quarter was soft in terms of GDP growth. The most recent estimate of first-quarter GDP growth is 1.9 percent. And after enjoying healthy job growth in the first three months of the year, employment gains have slowed dramatically in the second quarter and were much weaker than expected.

So, the incoming data have disappointed over the course of the first two quarters of the year. Also, our contacts on the ground in the economy seemed to have changed their tune. Optimism and rising confidence earlier in the year have shifted to a more cautious mindset.

In addition, as the year has unfolded, my colleagues and I at the Atlanta Fed have recalibrated our risk evaluation. While not fully factored into our baseline outlook, we're acknowledging darker possibilities. Risks associated with developments in Europe, the so-called fiscal cliff here in the United States, and a global economic slowdown have weighed more heavily on our outlook.

In reaction to all this, we recently downgraded our official forecast to one of weaker growth and slower progress on unemployment. This was the perspective I took to the June FOMC meeting.

We were not alone. All 19 FOMC participants submit forecasts for GDP growth, inflation, and employment four times each year. The central tendency for 2012 GDP growth dropped from a range of 2.4 to 2.9 percent in April to a range of 1.9 to 2.4 percent in June. In my view, this was a rather abrupt and material adjustment to the outlook.

In recognition of this change of outlook, the FOMC decided last month to extend the so-called Operation Twist program until the end of 2012. This program is aimed at putting downward pressure on long-term interest rates. This is accomplished by purchasing additional longer maturity Treasury notes while simultaneously selling short-term Treasury bills with the effect of moving out the average maturity of the Fed's portfolio. I supported this decision.

Key questions

It's possible another policy decision looms. My colleagues and I on the FOMC may confront a decision on whether or not to respond more aggressively to the economy's apparent weakness.

At the risk of oversimplification, there are in broad terms two schools of thought related to this issue of further aggressive monetary stimulus in the near term. One point of view is the outlook as-is calls for further policy action now or before too long. A second point of view is that further aggressive monetary stimulus—while definitely an option that cannot be dismissed—should be held in reserve to respond to a sharp further deterioration in the outlook.

Before taking a position on this two-sided question, it's my view that one has to wrestle with three sub-issues.

Output gap

The first relates to the size of the output gap, as it is called. The output gap is a measure of how far the level of GDP is from its potential. The conventional view is that the potential of the economy grows at a more or less steady pace through time, driven by growth in the labor force, productivity, and capital investment. Deviations from potential are undesirable because they signal that the economy's resources are not being fully utilized or at least not utilized in the most effective way. In the conventional view, the most important thing about an output gap is the presumption that it can be closed by economic policies that stimulate spending in the economy. These policies could involve, for example, expansionary government spending and reduced taxes, or the maintenance of very low interest rates by the central bank.

The Congressional Budget Office (CBO) regularly publishes one popular estimate of the output gap in the United States. To give you a reference point, they estimate the gap today is 5.5 percent. That is, the level of U.S. GDP is 5.5 percent below its potential. Five-and-a-half percent is a very large number, and it has changed little over the past two years. The bulk of the June projections for GDP growth reported by FOMC participants, including my own, imply very little progress in moving GDP toward potential in the foreseeable future. In any event, a quick return to what the CBO would calculate as the potential level of GDP is just not happening.

An output gap that persists over several years without narrowing is unprecedented in the post-Great Depression era.

It's been argued that the conventional estimate of potential GDP overstates the true capacity of the U.S. economy. Potential GDP, according to this alternative view, has been overstated as a result of distortions created during the precrisis bubble years and has fallen in the aftermath of the crisis and recession to a level that is permanently lower. If this is the accurate view, the output gap would be much smaller than 5.5 percent and might even approach zero.

You can appreciate, I'm sure, how these different views of underlying economic reality would set the stage for vigorous debate about the proper policy course. If the true output gap is near 5.5 percent, there is ample reason to do something with the policy levers that are available. But if the output gap is actually close to zero, policy stimulus will be counterproductive and could do harm in the longer run.

Size of the Fed's balance sheet

One potential source of harm relates to the size of the Fed's balance sheet and its possible consequences. This is the second sub-issue. The balance sheet of the Federal Reserve has more than tripled since the financial crisis in 2008. It's widely viewed that the size of the balance sheet is far beyond "normal" and will have to be scaled back as monetary policy is normalized.

Everyone who has studied basic macroeconomics learned that an outsized monetary base, as part of a scaled-up balance sheet, should raise concern about future inflation. This apprehension would obviously be raised further by any future policy action that would expand the size of the balance sheet.

There is an opposing view that, while not dismissing the eventual need to downsize the balance sheet, argues that the risk is quite manageable. When policy normalization begins, the FOMC should be able to control the expansion of money and credit through adjustments of policy rates. Very importantly, Congress gave the Fed the power to pay interest on excess reserves in 2008. The FOMC, it is argued, will have the ability to push up interest rates by lifting the interest on excess reserves rate, thereby countering credit expansion and money expansion, if that is required.

Effectiveness of the transmission mechanism

You might accept the argument that the potential benefits of more monetary policy stimulus are significant because the output gap is large. And you might concede that the costs of further stimulus are minimal because the risks associated with a large balance sheet are manageable. But there is still a third relevant sub-issue: Are the policy tools available to the Fed likely to be effective in improving the performance of the economy? Will further monetary stimulus work? Will it make a difference?

I frequently hear the opinion that further Fed stimulus won't accomplish much. Interest rates are already very low; there is no shortage of liquidity; and anyway, many borrowers cannot get access to credit or don't require it as they continue to reduce their debt levels. By way of example, a homeowner who is underwater on his or her mortgage is unable to refinance at any interest rate. More generally, the argument goes, for any number of reasons, both consumers and businesses would not be very responsive to changes in interest rates, at least to the rate levels monetary policy might be able to deliver.

This argument speaks to the current condition of the credit system in the country. Monetary policy impulses are mostly transmitted to the economy through credit channels, and this mechanism is still in a state of repair, it is claimed.

Here are the arguments against that view:

First, if the economy is just not that responsive to lower interest rates at the moment, policymakers ought to push harder on policy levers—harder than would be necessary in more normal times. Some recent homeowner programs have tried to eliminate barriers to refinancing and have helped. For example, I hear from bankers that the second version of the Home Affordable Refinancing Program, or HARP II, appears to be quite successful in helping homeowners who are saddled with negative equity and mortgage rates well above the current market rates.

And, it is argued, higher interest rates would worsen the situation. To say that the benefit of driving rates lower is limited is not the same as saying that there would be no damage if rates were to drift higher. Monetary policy can be effective in offsetting upward pressure on rates.

Where I come out on these questions

Through this two-handed discussion, I hope I have conveyed the sense that reasonable people can consider the issues I have laid out and come to different conclusions. That said, I think the stakes in the policy discussion around the FOMC table today are very high. Elevated levels of joblessness have been very persistent and the burdens of the very weak job market have been particularly harsh for the segments of our population where job attachment is already most tenuous—the young, minorities, and those at lower income levels. And to make a broader point, I am concerned that the already significant long-term jobless problem may harden into something more structural.

The question that the members of the FOMC confront is whether there is more that can be done to address the related challenges of slower GDP growth and tepid job creation. So, to wind up, let me give you my take on the key questions underlying a decision to bring on more monetary stimulus.

I think the output gap—the amount of slack in the economy—is neither as sizeable as the high-end estimates, nor is it zero. If there were no slack at all, 8.2 percent unemployment would represent full employment. If this were so, the economy would have undergone profound structural change over the last five years. As I weigh the findings of research by Federal Reserve economists and others, I do not think a compelling case has yet been made that structural adjustment has played a dominant role in slowing growth and progress against unemployment.

If, on the other hand, slack in the economy were close to the high estimates, we should have seen more and more persistent downward pressure on prices and wages than has, in fact, been the case. Deciding on the extent of the output gap is not straightforward. I believe the truth is in the gray middle.

On the risk associated with the balance sheet: in my judgment, some further use of the balance sheet to promote continued recovery and/or financial stability brings with it manageable risks. I think reversal of the cumulative balance sheet scale and maturity structure can be accomplished in an orderly manner. But the step of additional balance sheet expansion should be undertaken very judiciously. Such a step would take us further into uncharted territory.

On the likely effectiveness of further monetary stimulus—a policy that would necessarily be brought to bear at least in part through credit channels—I think we should have modest expectations about what further action can accomplish. I do not think this means monetary policy is impotent or has reached its limit. But I don't see more quantitative easing or similar policy action as a miracle cure, especially absent fixes in policy areas outside the central bank's purview.

So, as one policymaker, here's my situation: my support for the current stance of policy rests on a forecast that sees a step-up of output and employment growth by year-end and into 2013. If the economy continues on the track indicated by the most recent incoming data and information, that forecast will become untenable, as will the policy premises underlying it. So, as I said at the outset, this is a challenging juncture for policymaking.

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