SPEECHES

U.S. Economic Outlook and Monetary Policy

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

Atlanta Institute of Internal Auditors
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Key points

- Federal Reserve Bank of Atlanta President Dennis Lockhart said that, based on the slowing growth in the economy along with still-high unemployment, further monetary policy support was called for.
- In Lockhart's view, the policy question was more about which combination of tools would have the greatest chance of stimulating faster growth and producing employment gains while also preserving price stability.
- Lockhart said the initiation of a program of mortgage-backed securities purchases is well-timed given recent improvements in the housing market.
- Lockhart said the necessary natural healing from the large disruption of the financial crisis will be supported and likely accelerated by the "package" of policy measures with the new features introduced last week.

Introduction
Thank you for the opportunity to talk to you today about the economic outlook and the stance of monetary policy.

Just a little over a week has passed since the last meeting of the Federal Open Market Committee, or FOMC, where the decision was made to launch a new program of large-scale asset purchases, often called QE3, for the third round of quantitative easing. There was more to the policy action than just a program of purchases of mortgage-backed securities (MBS). Forward guidance about the duration of ultra-low interest rates was revised, and there were other communication innovations, as reflected in the official statement that followed the meeting.

Today I plan to provide a before-and-after perspective on the committee's action of last week. This is an opportune time to explain why I supported the policy decision and to share my personal views about why action was called for and what it can be expected to accomplish.

I want to emphasize that these are my personal views that may not be shared by my colleagues on the FOMC or in the Federal Reserve System.

State of the economy
Let me start with a summary of the current economic situation and the outlook that prevailed going into last week's meeting.

The national economy has been on a roughly 2 percent growth trend for most of the recovery. The recovery officially began in June 2009, so the economy has been expanding for more than three years. There have been quarters of faster than 2 percent growth and quarters that fell short of that pace. But when I step back and try to discern the basic economic narrative of the last three years, I conclude that the underlying trend has been one of very sluggish growth with occasional, short-lived periods of acceleration off that trend. Given the severity and breadth of the financial shock that precipitated the recession of 2008 and 2009, I don't think it's surprising that growth has been slow in comparison with earlier post-recession recoveries.

For most of the first half of this year, I held to a view on the medium-term outlook that predicted continuing growth at a modest pace, a gradual decline in unemployment, and inflation staying close to the FOMC's 2 percent target. Recent data have called even this modest growth scenario into question. Data for the first three quarters of the year suggest slowing momentum under the 2 percent trend, and, importantly, a slowing of progress in bringing down the high rate of unemployment.

Too much can be made of one month's data releases. At the Atlanta Fed, we are always trying to tease out the noteworthy signals from the accompanying noise. However, the accumulation of data through August suggested a slowdown from the already anemic pace of growth and a stagnating labor market.

The FOMC conducts the business of monetary policy under two mandates from Congress. The committee is charged with promoting low and stable prices—a low rate of inflation—and maximum employment. In January of this year, the committee formalized an inflation target of 2 percent. The record of inflation—judged against a number of inflation indicators and measures of inflation expectations—has hewed closely to this target and continues to do so.

The record of employment gains has been less comfortable. Taking a two-year view, the trend rate of gains in employment has been roughly 150,000 per month. This pace would be sufficient, at current levels of participation in the workforce, to sustain a steady, gradual reduction of the unemployment rate. Over the past six months, however, jobs growth has averaged only 97,000 net new jobs per month. At 8.1 percent in August, the rate of civilian unemployment has essentially shown no clear downward trend since the beginning of the year.

I've been describing the national picture. Let me bring this into sharper relief for you by summarizing conditions closer to home in the Southeast.

There are anomalous pockets of strength in our region—industries and geographies that defy the national trends. For example, the auto assembly plants across the Southeast have been very busy, reflecting the strength of light vehicle sales nationally. Louisiana and the Gulf Coast have been bolstered by the strength of the energy sector. Residential real estate markets in Florida, particularly South Florida, that were hard hit in the recession have shown signs of turnaround.

To generalize, though, the economy of the Southeast has been growing but has lagged to some extent behind the national economy. The recession cut deeper into economic activity and employment in our region, and the road back has been longer.

Here in Georgia, total employment fell by more than 340,000 in the recession. About one-third of the jobs lost have been restored. The state's unemployment rate stands at 9.3 percent, more than a percentage point above the national figure and double what it was before the recession.

The hiring slowdown—both national and regional—can be attributed to a number of factors, including some that could well be transitory. My colleagues and I talk to a lot of employers across the Southeast. Many business contacts say that the economy is not getting much better, but also not a lot worse. They cite various uncertainties that cause them to assume a very cautious posture as regards bringing on new employees. These include the outcome of the election, the fiscal cliff and other federal fiscal matters, Europe, and health care costs. Many business people also cite weak sales expectations in this environment of slow growth.

There has been a vigorous debate in economist and policymaker circles around the question of whether the main impediments to job creation are structural in nature or attributable to weak demand. The distinction between structural weakness and weakness related to slow demand growth is not all that clear cut. For my purposes, the essential issue is whether the problem of slow employment growth is amenable to a monetary policy treatment or not. That is the heart of the debate, and this debate continues. Unquestionably, the country's employment situation is complex, with many factors at work to produce the static condition we now seem to face. But I have been persuaded that the problem is, to a significant enough extent, one of weak growth that can be ameliorated by prudent monetary policy actions. A stronger overall pace of recovery is central to improvement in the labor market. As I approached the FOMC meeting of last week, I concluded that there was indeed a call to action falling out of the discouraging conditions of slowing growth and still-high unemployment with meager recent progress in bringing it down.

It's worth mentioning that the drop of the official unemployment rate from 8.3 percent in July to 8.1 percent in August was due, in large part, to an increase in the number of people who were previously unemployed dropping out of the workforce.

The dynamics of today's labor market are complex and not fully understood, even by those who have brought the greatest expertise to bear on analyzing the problems. We have the unemployed, the long-term unemployed, the underemployed (including part time seeking full time), temporaries preferring full-time permanent employment, and discouraged workers who are no longer looking.

The FOMC's decision last week

As the FOMC meeting of September 12 and 13 approached, I concluded that, although open to debate, further monetary policy support was justified. For me the policy question was what tools in combination have the greatest chance of producing real results in terms of faster growth and employment gains while preserving price stability.

Let me do a review of the key elements of last week's policy move and put this in the context of the cumulative monetary accommodation deployed so far to support recovery.

To support recovery, the FOMC has held the policy rate—the federal funds rate—at a range of zero to 25 basis points since December 2008. In August of last year, the committee provided guidance to the effect that this low rate would likely be maintained until mid-2013. In January, the Committee revised this guidance to at least the latter months of 2014. In last week's meeting, the guidance was revised to at least through mid-2015.

In the statement that followed the meeting, the committee reinforced and clarified the rate guidance by explaining that the low federal funds rate policy will likely remain in force even after the economy shows signs of picking up, provided the inflation outlook remains benign.

With the policy rate effectively at the zero lower bound for better than three-and-a-half years, additional monetary accommodation has been applied through the use of balance sheet tools. At the end of 2007, the Fed's balance sheet stood at around $900 billion, made up of mostly Treasury securities on the asset side. Today, the balance sheet is about $2.9 trillion. The growth of the balance sheet resulted from emergency credit facilities put in place during the financial crisis of 2008, later replaced and augmented by two rounds of large-scale asset purchases, or quantitative easing. These rounds of quantitative easing involved purchases of Treasuries and agency mortgage-backed securities. In January of this year, the committee supplemented the earlier balance sheet actions (QE1 and QE2) with a maturity extension program. This program was designed to be largely neutral in its effect on the scale of the balance sheet and bank reserves. Its intent was to shift out the average maturity of Treasury holdings through purchases of longer-term Treasuries and sales of shorter-term Treasuries. This has put downward pressure on long-dated Treasury rates and on longer term interest rates in general.

Last week, the Committee decided to continue the already existing maturity extension program through year's end. This program will increase the Federal Reserve's holdings of longer term Treasuries by about $45 billion per month.

In addition, the committee decided to initiate a new program of purchases of agency mortgage-backed securities at the pace of $40 billion per month. The extent of purchases was not defined and was left conditional on the state of the economy, particularly employment.

The policy statement along with comments of Chairman Bernanke in his postmeeting press conference emphasized that further policy actions, possibly in the form of additional asset purchases, will be decided on the basis of the extent of improvement in the outlook for labor market conditions over the coming months. As always, the outlook for inflation will also be a critical consideration.

In my view, a holistic evaluation of employment conditions is necessary because the unemployment rate, taken alone, may not be a reliable indicator of progress. The unemployment rate can fall for both good and not-so-good reasons and may rise for what amount to good reasons.

All together, the rate guidance, asset purchase, and communications policy actions taken last week represented a forceful attempt to improve the outlook for the economy.

I supported the package of policy measures because I believe together they will help. The necessary natural healing from the large disruption of the financial crisis will certainly be supported, and likely accelerated, by the stance of policy with the new features introduced last week.

Let me explain how I think the purchase of mortgage-backed securities will help. I think the initiation of a program of MBS purchases is well-timed given recent improvement in the housing market. Sales activity has picked up in many markets, and it appears that the recent increase in purchases is being driven primarily by mortgage-financed buyers for owner occupancy rather than cash investors. House prices are beginning to rise in many markets. Multi-family housing development continues to be a favored sector of commercial real estate. New single-family permitting and home building have picked up somewhat.

Here in the Southeast, it's clear that one of the main reasons the downturn was deeper than for the country overall is the reliance on in-migration and residential housing development as an economic engine. We are now seeing some signs of life in the housing sector in Atlanta, in Georgia, and across the Southeast generally.

By maintaining downward pressure on mortgage rates and by encouraging growth of mortgage-financed purchase activity, sales activity in the Southeast and nationwide should accelerate, and upward pressure on home prices should contribute to consumer confidence. The policy action should have positive sector-specific effects with spillover to general conditions. An improving housing sector will help calm one headwind that has impeded a stronger recovery.

And I don't entirely rule out the weakening of other headwinds. If Congress deals effectively with the fiscal cliff threat, and if the uncertainty associated with the European debt crisis dissipates further, the outlook could be considerably more favorable in a few months' time.

Closing

As I said earlier, the incoming data, on balance, had deteriorated to the point that I thought additional policy action was warranted. The core rationale of my support was to better assure that the economy remains on a growth trajectory sufficient to steadily, if gradually, reduce the rate of national joblessness. I am not expecting miracles.

I think the action recently taken by the committee has improved the country's economic prospects by reducing the potential downside apparent in the incoming data. In this sense, the policy action was a preventative. But I expect policy will do more than just prevent backsliding.

However, to be effective, the measures taken last week must work their way through multiple steps to have the desired effects. They must lower interest rates, raise asset prices, and reduce policy uncertainty. These intermediate results must increase the confidence of consumers and businesses. That must lead to a heightened inclination to spend, invest, and take risk. And these actions must result in more economic activity, rising demand, and ultimately hiring.

Last week the FOMC adopted a package of strong measures to further support the recovery. To repeat, low rates will be needed through at least mid-2015 even if the recovery quickens ahead of this date. MBS purchases will continue until we see a better employment situation. If we do not see improvement, more action may be taken. And inflation will be monitored closely and kept near 2 percent. Speaking for myself, I hope the resolve of the FOMC is clear.

Contact: Jean Tate 404-498-8035

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