

## Policy Actions and the Economic Outlook

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### Key points

- Atlanta Fed President and CEO Dennis Lockhart, in an August 13 speech to the Kiwanis Club of Atlanta, Georgia, reviews the Fed's monetary policy actions to support economic recovery, including large-scale asset purchases—often called quantitative easing, or QE.
- Lockhart says the Federal Open Market Committee (FOMC) made no substantial policy shift at its last meeting, deciding to continue asset purchases at a pace of \$85 billion per month.
- Lockhart stresses that decisions to reduce asset purchases will be data-dependent. Economic performance will dictate the path of policy.
- The Atlanta Fed's economic outlook calls for GDP growth to pick up, consumer activity to strengthen, business investment to accelerate somewhat, and housing sector growth to continue, but Lockhart has some concerns about the potential for ambiguous or disappointing data.
- Lockhart says that the first adjustments to asset purchases, when they occur, should be the beginning of a process with steps determined as certainty about the direction of the economy accumulates.
- Lockhart notes that steady progress in economic fundamentals has been made since the launch of the most recent asset purchase program.

### Introduction

Thank you for that very kind introduction. And I would like to thank the Atlanta Kiwanis for inviting me to speak here today.



Today, I want to review with you the policy actions the Federal Reserve has taken to support recovery from what has come to be known as the Great Recession. I also want to talk about a sometimes controversial aspect of the Fed's policy—large-scale asset purchases. The public knows this policy as quantitative easing, or QE. Specifically, I want to discuss prospects for winding down the most recent version of this policy, known as QE3, and how I, as one policymaker, am thinking about the decision—or multiple decisions—to do so.

I would like to emphasize that I am speaking for myself, and that my views are not necessarily the views shared by my colleagues on the Federal Open Market Committee (FOMC).

#### A brief look back

To understand the context of upcoming deliberations on this policy, I think it would be helpful to take a look back. The Federal Reserve responded to the Great Recession and supported the recovery with aggressive policy actions, including some that are considered unconventional by historical standards.

In late 2008, the FOMC cut its policy rate to nearly zero, and it remains there today. The Fed's policy rate is the federal funds target rate, the rate at which banks lend and borrow from each other to meet their reserve requirements. The level of the fed funds rate influences other short-term interest rates and establishes a foundation on which a wide array of market interest rates, including long maturity rates, are determined by market forces.

In addition to lowering the federal funds rate to effectively zero, the FOMC brought to bear less conventional methods of monetary stimulus. Beginning in early 2009, the Federal Reserve began purchasing long-term assets in the form of Treasury notes and agency mortgage-backed securities.

There have been three rounds of asset purchases. These purchases have been intended to put downward pressure on longer-term interest rates and raise prices of financial and other assets. I supported these decisions and believe the asset purchase programs have been successful in helping the economy to recover.

The recession ended in June of 2009, and since then the economy has averaged annual growth at a rate of 2.2 percent over 16 quarters. In October 2009, unemployment reached 10 percent. Today, unemployment stands at 7.4 percent. Inflation over this period has averaged 1.8 percent. Over the longer term, the Committee projects that achievement of full employment would see an unemployment rate between 5.2 and 6 percent. And the Committee's target for inflation over the long run is 2 percent.

At the Committee's last meeting in late July, there was no substantial policy shift, and the Committee decided to continue asset purchases at the pace of \$85 billion per month. So that is where monetary policy stands at this moment—a near-zero policy rate and ongoing asset purchases.

#### Talk of tapering

As early as the January meeting this year, FOMC participants were discussing the possibility of varying the pace of purchases. Mention of these discussions in the minutes of the FOMC meetings initially surprised financial markets and increased market volatility.

Fed Chairman Ben Bernanke and others subsequently clarified the Committee's position by making several important points. First, the asset purchase program and the FOMC's guidance on interest rate policy are two separate tools. The federal funds rate is the lead policy tool aimed at improving economic conditions and achieving the Fed's statutory objectives. The asset purchase program plays a complementary and supplementary role. It clearly was intended to have a beginning and end. It is not QE infinity.

Second, keeping short-term interest rates near zero for a considerable time after asset purchases end will help maintain a high degree of monetary policy accommodation. Very low rates will continue for a while. The Committee's guidance on the policy rate is that it will stay near zero for at least as long as the unemployment rate stays above

6.5 percent.

And third, the asset purchases might be dialed back and ultimately phased out based on evidence of progress in the economy and an outlook of sustained progress, especially in labor markets.

This is a key point. Decisions to reduce asset purchases will be data-dependent. Economic performance will dictate the path of policy.

Over the past several weeks, the first question on the minds of investors and much of the public regarding monetary policy has been: What specifically is the FOMC going to do with asset purchases?

Participants in the financial markets understandably would like to know the dates, amounts, and proportion of reductions in purchases. But up to now, the uneven performance of the economy has not permitted the FOMC to provide this certainty.

Nonetheless, the expectation that purchases will be tapered and ultimately ended is now firmly established. Financial market participants put a higher probability on near-term tapering happening than not.

#### **What the data tell us**

As I just suggested with the phrase "uneven performance," I would argue that recent data do not present a clear picture.

One feature of the data in hand that contributes to a lack of clarity is the fact that employment gains have been strong enough to lower the unemployment rate while GDP growth has remained lackluster.

As a matter of arithmetic, healthy employment growth coupled with tepid GDP growth implies weak labor productivity growth. And in fact, productivity growth in recent quarters has been significantly below historical norms.

The likely direction of productivity measures is the subject of considerable debate. On one side of the debate are innovation pessimists, if you will, who argue that the country is entering a long period of slow productivity growth because of the relative dearth of transformative technologies coming along.

Others—and I include myself in this camp—believe that the recent low growth of productivity is probably just a temporary downdraft after the rather strong productivity growth when the economy emerged from recession. Productivity grew in the early months of recovery because firms held staffing levels flat while business activity expanded. That's one way to get productivity growth—squeezing greater efficiency out of the existing workforce instead of expanding payrolls. Another spur to productivity growth is capital spending, and capital expenditures appear to be on the rise. Orders for nondefense capital goods have recently been on the upswing. An expansion of business investment bodes well for growing productivity going forward.

If productivity growth rebounds to more typical levels, the coincidence of job gains at a pace of around 190,000 per month in recent months and GDP growth below 2 percent cannot persist. Again, it's a matter of arithmetic. Either GDP growth will rise to levels consistent with recent employment growth, or employment growth will fall to levels more consistent with the weak GDP data we've been witnessing.

#### **Baseline outlook**

How this dynamic plays out is quite relevant to upcoming policy deliberations on asset purchases, in my opinion. The answer will be in the data. I've got a working assumption on this question, and it is captured in the Atlanta Fed's baseline forecast for the second half of this year and 2014.

This outlook calls for a pickup in real GDP growth over the balance of 2013, with a further step-up in economic activity as we move into 2014.

I base this outlook on a number of factors. I expect consumer activity to strengthen, I expect business investment to accelerate somewhat, and I expect the rebound we have seen in the housing sector to continue. I expect the recent improvement in exports to last. And I expect to see an easing of the public-sector spending drag at the federal, state, and local levels.

I think this is the most probable forecast. But it's not a sure thing.

The play-out of deliberations in Congress in September on the debt ceiling and other fiscal matters could contribute to a weaker scenario by influencing business and consumer confidence. I don't think the risk of a fiscal confidence shock is negligible. Remember that just two years ago, Standard & Poor's (S&P) downgraded the credit rating of the U.S. federal government based on an assessment of the ability of fiscal policymakers to address serious issues relating to the nation's growing debt obligations. S&P specifically cited "political brinksmanship" as a reason for the downgrade, and this had a damping effect on confidence. Between July and October of 2011, consumer confidence fell sharply, the worst reversal of confidence we've seen over the recovery period. Some of that decline was certainly attributable to the spectacle of dysfunction in Congress and the downgrade.

#### **Other considerations**

When I weigh the balance of risks around the medium-term outlook I laid out, I have some concerns about the potential for ambiguous or disappointing data. I also think that it is important to be realistic about the degree to which we are likely to have clarity in the near term about the direction of the economy. Both the quantity of information and the strength of the signal conveyed by the data will likely be limited.

As of September, the FOMC will have in hand one more employment report, two reports on inflation, a revision to the second-quarter GDP data, and preliminary incoming signals about growth in the third quarter. I don't expect to have enough data to be sure of my outlook. For that reason, I don't think a decision that commits the Fed to a full phase-out of asset purchases and lays out a precise, beginning-to-end path for doing so would be advisable.

In my mind, the first adjustments to asset purchases, when they occur, should be the beginning of a process with steps that will be determined as later information arrives and certainty about the direction of the economy accumulates. As I see it, a decision to proceed—whether it is in September, October, or December—ought to be thought of as a cautious first step.

Policymaking is quite appropriately forward-looking because monetary policy actions affect the economy with a lag. The rolling outlook from here is what really matters in making future decisions on asset purchases. I will need to get comfortable that the employment progress we've enjoyed is not stalling and that disinflation pressures are not building.

All that said, in considering a decision to reduce purchases, I think it is important to acknowledge the progress that's been made since the launch of QE3. The most recent program of asset purchases has been in force for just short of a year. In August a year ago, the unemployment rate stood at 8.1 percent. A year later, the unemployment rate has fallen to 7.4 percent and monthly job gains, looking back over the year, are averaging just below 200,000. Consumer activity has grown, house prices and housing activity have picked up, and equity markets have shown strength.

We have continued to see steady progress in economic fundamentals, in my opinion. Progress is evident, and we should not lose sight of that.

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