

## Heart to Heart: An Economic Outlook and Federal Reserve Policy

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### Key points

- Lockhart says news about the economy has been generally positive lately on balance.
  - Barring shocks, he expects a return to moderate economic growth of between 2.5 and 3 percent this year, with gradual employment gains.
  - Lockhart supports the FOMC's intention to leave the federal funds rate low until late 2014. But he says that intention should not be viewed as a commitment, independent of how the economy evolves.
  - The FOMC's recently announced inflation target of 2 percent can act as an aid to understanding how policymakers will react to developments in the economy, Lockhart says.
  - Lockhart believes better and fuller communications are an effective policy. The FOMC's dated rate guidance and inflation target should help consumers, businesses, and financial markets anticipate the future path of interest rates, he says.
  - At present, Lockhart favors a posture of "vigilant restraint" on future policy action, stating he is prepared to be somewhat patient in watching how the situation develops.
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I'm sure you know it's Valentine's Day. You'll be amused to hear that the Fed has been the subject of Valentine flirtations over the past few days on, of all places, Twitter. The flurry of posts is pretty clever, and uses economic and monetary policy language to craft Valentine messages. Here are a few of my favorites: "I'd like to borrow you overnight and hold you to maturity," "You're a systemic risk to my heart," and "Hey girl, you're the only number in my beige book." The tweets came from folks as varied as former government policymakers, journalists, and even our own staff at the Atlanta Fed. One of our posts read "Being with you hikes my pulse by several basis points."

Since it's Valentine's Day, let me start the serious part of my remarks with this observation. If I were thinking of the national economy as a love interest, I'd say she's been rather frisky lately, but I'm wary of being jilted. It's happened before and my heart was broken. Now let me revert to type. I'm going to talk about the economy in the language you expect.

The recent economic news has been positive on balance. This evening I want to put this improved picture in context and explain how I'm mentally processing the improving data. I'll address a timely question: is better news a sign the recovery is getting real traction, or is the economy likely to disappoint us as the year unfolds? I will also offer my interpretation of recent FOMC policy pronouncements.

I must emphasize that I will be presenting my personal views. My views may not be shared by my colleagues on the Federal Open Market Committee (FOMC) or in the Federal Reserve System.

### **Recent positive developments**

As I said, the news has been positive on balance. The most obvious signs of improvement have come in the labor market. According to the latest Bureau of Labor Statistics report, payroll employment increased by 243,000 jobs in January. Over the past five months, job gains have averaged more than 180,000 per month.

Over these months, the unemployment rate has fallen by just over three-quarters of a percentage point. The current unemployment rate of 8.3 percent is the lowest it's been since February 2009.

Consistent with a strengthening labor market, growth in household sector income—which was anemic for the last year as a whole—posted a surprisingly strong gain in December. This is a positive sign because a pickup in income growth is almost certainly necessary to sustain growth in consumer spending in 2012.

The business sector is showing positive signs as well. Surveys by the Institute of Supply Management in January show continuing confidence among manufacturers and a strong uptick for other types of businesses, reflected in their service sector survey.

Also, we're starting to see the beginnings of credit expansion, which has been basically flat for quite awhile. The Federal Reserve's just-released quarterly survey of lending conditions (known as the Senior Loan Officer Opinion Survey on Bank Lending Practices) indicates strengthening loan demand, especially in commercial and industrial lending, as well as in credit card and auto loans.

Not all the recent economic news has been uniformly positive, but the balance of incoming data has been rather upbeat. This gives me confidence in the view that economic growth in 2012 will be noticeably better than in 2011.

### **We've been here before**

But such a projection of year-over-year improvement should seem familiar. You might recall that GDP growth in 2010, the first full year of the recovery, exceeded 3 percent before falling off to less than 2 percent last year. The economy has had a fickle character in this recovery.

In the first four months of last year, the payroll measure of employment growth averaged over 200,000 jobs per month. But then came a late-spring/summer "swoon" during which that payroll number never exceeded 100,000. From April to August, the unemployment rate stopped declining, and the economy grew at an anemic pace.

So what should we make of the recent good news? Are recent improvements in the incoming data a sign the economy is gaining traction?

I'm pretty confident it is. There's always a caveat, however, and the caveat is "in the absence of shocks." The story of 2011 was one of shocks. There was a run-up in oil prices as a result of the Arab Spring. Commodity prices also rose rapidly for a variety of reasons. The earthquake and tsunami in Japan and the

floods in Thailand disrupted global supply chains. The European debt crisis and the U.S. debt ceiling impasse shook confidence.

Significant unanticipated developments are part of economic life, but barring shocks, we at the Federal Reserve Bank of Atlanta expect 2.5 to 3 percent growth for 2012.

### **Working through adjustments**

This relatively optimistic outlook may strike you as being at odds with the latest statement of the FOMC. After the meeting of January 24, the committee announced it “anticipates that economic conditions...are likely to warrant exceptionally low levels of the federal funds rate at least through late 2014.”

I supported, and continue to support, that statement.

Let me explain my thought process. As I said, I expect the economy to return to a better growth trajectory than what we saw in 2011. But I also foresee a slow and arduous return to full capacity, including full use of the nation’s human capital. To get there, the economy must labor through a variety of adjustments that will simply take time. In my view, the task combines elimination of considerable slack in the economy with engineering a foundation of solid fundamentals.

Some required adjustments derive directly from the boom and bust of the housing market. I’ll comment on two such adjustments.

First, many homeowners saw their wealth shrink as house prices fell and found a new, much diminished level. House prices are likely to grow slowly over time, at best. Many forecasters believe house values are likely to remain flat or even decline in the next several years. Homeowners who previously had a lot of their net worth in residential real estate have to rebuild their wealth by saving and paying down debt.

Second, for many years before the recession, start-up business activity relied on home equity as a major source of financing. The subdued outlook for house values is likely to impede access to this source of funding for entrepreneurs. A new model for funding startups, which are key to job growth, has to evolve.

More broadly, business and consumer borrowers are adjusting to the reality of stricter bank lending standards. Even with an improving economy, I think it is highly unlikely banks will revert to the lending standards that prevailed in the heady days of 2003 through 2007. One implication is that potential homeowners, for example, will have to save more and consume less to accumulate savings for higher down payments.

And beyond the housing sector, the government sector will almost certainly continue to contract. Ultimately, the resources released from the public sector have to be absorbed by private sector activity, but the adjustment process will be neither fast nor painless.

All this is to say that we are in the process of adjusting to new economic realities. Such adjustments take time. Therefore I think the reality of where the economy is and what lies ahead justifies the 2014 policy statement.

I would also emphasize that it's a conditional statement. It's based on a best estimate of the path the economy is on. It is not a commitment to maintain a near-zero federal funds rate without consideration of how conditions on the ground are evolving.

Here's how I think you should interpret the 2014 guidance: The Fed's policy rate will likely stay at rock bottom at least through 2014 if the economic story goes as projected. If it doesn't, the time horizon could change.

### **Perspective on the inflation target**

A key aspect of that economic story is inflation. In the last FOMC meeting, the committee approved a statement of longer-run goals and policy strategy.

In that statement, the committee formally announced a longer-run target for inflation of 2 percent. Technically, it's 2 percent annual growth in the price index for personal consumption expenditures. Though the Fed's inflation objective has been widely understood to be in the neighborhood of 2 percent for some time, the announcement is the first official and explicit articulation of how the FOMC defines its mandate to preserve price stability.

The 2 percent inflation target is an aid to understanding how the FOMC will react to developments in the economy within an overarching approach that can be called "flexible inflation targeting."

The word "flexible" describes and qualifies the committee's exercise of judgment in reaction to adverse developments. The word "flexible" also reflects the principle that it is not always feasible or desirable to hit the target in the short run. Short-lived shocks to the economy can temporarily move measured inflation well away from the 2 percent target.

Consider last year's energy and commodity price increases. Those cost pressures pushed up inflation in the early part of the year. Then, as expected, their influence dissipated as the year progressed.

Had the FOMC tightened monetary policy early last year in response to the inflation threat, we might have compromised progress on growth and employment to no particular benefit with respect to our inflation mandate.

Formalizing an inflation target should serve to further anchor the public's inflation expectations. That is the hope and intent. If you the public have confidence that we policymakers are serious and committed to price stability over the longer run, the FOMC may have some flexibility in dealing with developments in the shorter run.

The statement of longer-run goals and policy strategy also espouses a balanced approach to the FOMC's dual mandate of price stability and maximum employment. To paraphrase the relevant text of the statement, the two objectives are generally complementary over the longer horizon. However, when the objectives conflict, the FOMC will take a balanced approach to promoting them. Early last year, as I mentioned, we saw the unfortunate confluence of rising inflation and an unemployment rate that was too high.

The FOMC had to make a decision about how to respond to the fact that both inflation and unemployment were above the levels that would be satisfactory over the longer run.

The decision was to maintain an accommodative policy stance designed to support growth and greater employment. That decision was made because inflation expectations appeared to be well-anchored and it was reasonable to expect that inflation would return to a path consistent with the objective of 2 percent. That, in fact, has happened.

If Fed policy makers had not expected the elevated rate of inflation to decline naturally as cost pressures eased, the Committee would have had to reassess its judgment of the speed at which monetary policy should be trying to reduce the rate of unemployment.

As I see it, this is a recent real-world example of a balanced approach in action. It illustrates the idea of flexible inflation targeting.

An explicit longer-run target for inflation is part of a broader communications strategy. Better and fuller communications is a policy tool. This tool now includes both dated rate guidance and an inflation target over the longer run. Both of these expectations influencers should help consumers, businesses, and financial markets anticipate the path of interest rates.

By providing guidance on interest rate policy, the FOMC can eliminate some of the guesswork between the private sector and the central bank. In current circumstances, this should in itself lower interest rates below where they might otherwise be.

And by helping private decision makers predict the path of interest rates, our enhanced communications should help lenders and investors decide how to best allocate their resources.

### **Current policy stance is appropriate**

To wind up, the recent economic news has been encouraging, but in my view we haven't seen enough sustained improvement to be sure it will last. I think the current policy stance is appropriate for an outlook of steady, moderate growth with gradual employment gains. I do not see this accommodative policy compromising the objective of 2 percent inflation.

At the moment, I favor a policymaking posture I'd call "vigilant restraint." I am prepared to be somewhat patient and watch how the situation develops.

Let me assure you I'll be vigilant. Another of the Valentine's Day tweets I mentioned at the beginning sums it up nicely. This one says "It's the economy, Cupid."

Happy Valentine's Day.

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