

Headwinds and Tailwinds

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The text for this speech is similar to remarks delivered by Dennis Lockhart on Friday, March 25, 2011, to the Bonita Springs/Estero Market Pulse Conference. The speech's introduction and inflation risks sections have been updated.

Key points

Lockhart weighs economic headwinds and tailwinds and comes to a **net positive outlook** for the rest of 2011 and 2012. **Headwinds** holding back economic recovery include continued declines in home prices, higher food and energy prices, crises abroad, and fiscal adjustments. Favorable forces—**tailwinds**—that are pushing the economy forward include improved household finances, moderate employment and income growth, and corporate profitability and ample liquidity. The financial system continues to heal, supporting growth, although lenders remain conservative and some businesses and consumers still have only limited access to credit.

Lockhart foresees continuation of **moderate growth, gradually declining unemployment**, and the settling of price movements around an **inflation rate that is consistent with the Federal Reserve's price stability objective**. While short-term measures of inflation have accelerated in the last few months, in Lockhart's view this trajectory will not continue.

Lockhart believes that growth in overall consumer prices—at around 2 percent per year through a period of three or four years—is consistent with the Federal Reserve's price stability mandate. He continues to see this objective as attainable.

Lockhart remains satisfied with the current stance of monetary policy but **is prepared to support a change of policy if evidence accumulates that the low and stable inflation objective is at risk**.

Today I will talk about the state of the national economy and the forces acting on it. Since we are only a few days away from March 31, my talk today will amount to a stocktaking of the economy at the close of the first quarter of 2011.

It's important for me to emphasize that I am speaking for myself only. My views may not be shared by my colleagues on the Federal Open Market Committee (FOMC) or in the Federal Reserve System.

Our economy is constantly changing and evolving. Change occurs across four principal dimensions and on different timelines.

Demographic changes occur gradually. Trends like the retirement of the baby boomers, for example, exert a profound influence on what gets produced and consumed.

The industrial composition of the economy can shift on a shorter timeline. The bursting of the housing bubble in 2007 resulted in a big drop in homebuilding and construction employment. Meanwhile, health care and education continued to grow.

Relative geographic strength can ebb and flow with industry conditions. For example, the Southeast—including Atlanta—is lagging other regions because before the recession, the Southeast was more dependent on construction activity, which is currently quite depressed.

And the job composition of the economy is continuously adjusting to the makeup of sectoral, industrial, and geographic movement.

The point is the economy is never static. Certainly, the economy is never static from the point of view of growth or its opposite, contraction. The recent recession began in the fourth quarter of 2007 and ran for seven quarters. Recovery began in the summer of 2009, and, including the first quarter of this year, the economy has been expanding for seven quarters.

At any given time there are conditions—both domestic and global—that hold back growth. Call these headwinds. And there are favorable forces (also both domestic and global) that push the economy forward and contribute to growth. Call these tailwinds. In taking stock of the economy at this juncture—the end of March 2011—I'm going to survey the headwinds and tailwinds currently in force. These are the primary factors I see shaping the outlook for the near and medium term.

Let me say in advance that the meteorological metaphor of tailwinds and headwinds is useful only up to a point. In economics, winds don't blow totally in one direction or another. Winds blow in both directions and produce a *net* effect either helping or holding back expansion.

As an organizing device, I will talk first about tailwinds and then headwinds and under each I'll comment on consumer spending, business investment, and a third rubric that includes things like exports and government spending.

Consumer spending tailwinds

Consumer spending increased last year after two years of declines. Consumer spending continues to grow both as cause and effect of improving economic conditions. There are a number of tailwinds bolstering consumer activity.

Household finances have improved substantially. Personal net worth has increased as equity prices have rebounded. By the end of last year consumers had recouped nearly half of the massive wealth losses brought on by the recession and the financial crisis. Consumer debt, including mortgages and credit cards, fell in 2010 for the second consecutive year. Consumer debt levels have declined as people paid down their debts and banks wrote off bad loans. As a result, at year-end 2010, the portion of personal income

going to debt payments reached the lowest level in a decade. All this is putting consumers in a better position to increase spending.

Consumer credit availability has improved somewhat. Auto loan securitization has been robust and lending terms have improved. This has helped auto sales, which have increased significantly over the past year and were up nearly 30 percent in February from a year ago.

Employment has been growing gradually and incomes have been rising. Private payrolls have been increasing since February of last year. As a result, aggregate income—which includes wages but also other sources of income—has grown in line with the recovering economy.

I want to make another point about employment growth, but this is a bit more speculative. In 2009, in pursuit of increased efficiency, businesses cut payrolls and met production needs with a smaller workforce. In contrast, over the past year, the scope for big efficiency or productivity gains seems to have narrowed. Going forward, to meet production goals in response to growing demand may more and more require hiring additional workers. Expanded employment should, in turn, provide a further boost to total income, consumer confidence, and spending.

Business investment tailwinds

Business spending and investment also demonstrate tailwinds. Investment in equipment and software has been rather strong, although much of this capital spending has up to now been aimed at productivity enhancement or necessary replacement and maintenance, not growth.

Corporate profits have recovered to pre-recession levels, thanks partly to efficiency gains achieved. The financial position of businesses—generally speaking—has strengthened, and firms are better positioned for growth.

Credit markets and banks are healthier, and business access to credit is improving for most company categories. This improvement has allowed companies to refinance their debt and lower debt service costs. Large corporations are cash rich. U.S. businesses have nearly \$2 trillion in cash (and cash equivalents) that has not yet been deployed. With rising confidence, I would expect businesses to start making use of that liquidity by increasing investment and boosting hiring.

One more tailwind: foreign growth has increased demand for U.S. exports, especially for manufactured goods. Demand from major emerging economies has been favoring U.S.-made high-value-added goods, such as computers, aircraft, and communications equipment. Last year, the export sector made its largest proportional contribution to GDP growth since 1946.

Consumer spending headwinds

Let me now turn to headwinds. And again I'll start with the consumer sector. Consumers see a yellow light, not a green light. Measures of consumer confidence remain well below levels typical for a growing economy.

Despite the improvements I mentioned, U.S. households are still burdened by a “wealth gap,” by which I mean a substantial shortfall from the wealth levels that existed prior to the recession.

Home prices remain under pressure. Nationally, home prices have dropped more than 30 percent since 2006 and continue to decline in certain markets. These declines are holding back repair of household balance sheets. More than one-fifth of U.S. households with mortgages owe more on their homes than those homes are worth, adding to the financial vulnerability of consumers and their caution about spending.

Increases in the cost of gasoline and food are forcing adjustments in household budgets. Since last August, the cost of groceries is up about 2.5 percent, and gasoline costs are up about 25 percent. Back-of-the-envelope calculations suggest that over the past six months, the rising cost of groceries and gasoline has added just over \$50 a month to the average household's expenses. Tighter budgets can mean less spending on more discretionary items.

Foreign developments can influence consumer attitudes. Uncertainty breeds caution, and consumers have been reminded in recent weeks that we live in an uncertain world. I am referring, of course, to the earthquake and tsunami in Japan and unrest in the Middle East and North Africa.

Business investment headwinds

Businesses are also feeling some headwinds, so let me comment on these.

The banking system and credit markets, while much stronger, are not fully back to health. Credit is available for most segments, but lenders remain conservative and are very carefully moving to relax the risk-averse stance they assumed in reaction to the recession.

New business formation is constrained by tight credit. Early-stage businesses—a major source of jobs—are often financed in ways other than direct loans. Continuing difficulties getting home equity loans—related to lower home values, of course—and tighter credit card availability are holding back some entrepreneurs.

Commercial real estate continues to be a stressed sector. Nonresidential private construction has plunged over the past two years and is unlikely to bounce back any time soon.

Uncertainty is still a restraining factor for businesses. Global uncertainty has loomed large in recent weeks. The unrest in the Middle East and North Africa, which I commented on a moment ago, has raised worries about availability of oil supplies and higher energy and petroleum-based input costs. The natural disaster in Japan has shaken financial markets and raised concerns about supply chain disruption. And uncertainty persists about the resolution of sovereign debt problems in Europe.

The political process associated with continuing federal budget resolutions and the debt limit is also an uncertainty factor at the moment. The federal government has been funded based on a series of temporary spending measures since September 2010 instead of an annual budget. The latest continuing resolution has been passed to fund the government until early April. Meanwhile, the debt limit is likely to be reached between mid-April and the end of May.

Necessary fiscal compromises will unavoidably result in spending cuts. Fiscal adjustment at the federal, state, and municipal levels of government represents a direct headwind to economic growth. Government

spending cutbacks at all levels need to be offset by private demand. This year and next, the government sector is likely to be in contractionary mode for the first time since 1994.

Growth outlook and inflation

Weighing all these economic tailwinds and headwinds, I come to a net positive outlook for the economy for the rest of 2011 and 2012. Notwithstanding headwinds and risks, a self-reinforcing virtuous circle of final demand is increasingly becoming established. Our base case forecast at the Federal Reserve Bank of Atlanta sees continuation of the storyline of moderate growth, gradually declining unemployment, and the settling of price movements around an inflation rate that is consistent with the Federal Reserve's price stability objective.

Inflation risk

I know inflation is on everyone's mind at the moment. It's worth taking some care to explain current circumstances as regards inflation. In the summer of last year, there were widespread signs of disinflation in price data and there was legitimate concern of a deflationary cycle becoming established. Financial markets had priced in more than a 30 percent chance of deflation over five years, about twice the probability indicated in the spring. That trend has been reversed in recent months.

Starting in the fall of last year and running through the most recent readings, prices have been firming, and this is bringing trend inflation closer to the desired levels for the longer term. By trend inflation I mean the average rate of inflation measured over a time frame long enough to allow the factoring out and dismissal of monthly noise and one-off signals in the data. Historically, food and energy prices have been volatile and not necessarily indicative of the broad inflation trend in a given period. Food and energy prices have been moving up strongly over the last few months. But broader measures of prices have been growing as well at a rate that would not be acceptable if sustained for very long. This price growth is largely attributable to increases in food and energy prices, but even so-called core measures of inflation rose at a higher-than-desirable pace in February.

For the time being, I think the risk of deflation has retreated. For a variety of reasons, many commodity-based prices have risen sharply. I expect these strongly accelerating upward movements of commodity prices to be short-lived, and, in fact, many of these prices have either moderated somewhat or leveled off in the past month. Nonetheless, in such circumstances, it's understandable to be somewhat apprehensive about the inflation climb path we're on, and whether or not it will level off.

In light of these developments, let me make three observations.

First, inflation pressures associated with rising commodity prices will dissipate if, as currently expected, the *rate of growth* in these prices slows. Let me emphasize that this is not a prediction that the prices of gasoline or groceries will actually fall. I'm distinguishing here between the rate of inflation and the level of prices. These higher costs are a result of real growth in emerging economies, developments in the Middle East and North Africa, and the fallout from natural disasters around the world, be they droughts, floods, or earthquakes and tsunamis. The pain of having to allocate a larger share of your income to driving your car or preparing dinner may well persist.

Second, contrary to popular opinion, Fed officials actually do eat and fill up their gas tanks. The FOMC's mandate, as I see it, is to control the inflation rate we all experience—so-called headline inflation. In other words, I interpret the Fed's price stability mandate as requiring the FOMC to manage the growth rate of the average of all prices, including food and energy.

Third, it's our job to control that headline inflation over the course of time. It's not feasible to exert such control day to day or month to month or even quarter to quarter. But monetary policy can control the rate of overall inflation over the medium term. In general operational terms, I think growth in overall consumer prices at an annual rate around 2 percent through a period shorter than the proverbial "long term," say, a medium-term period of three or four years, is consistent with the Fed's price stability mandate.

While short-term measures of inflation have accelerated in the last few months, I hold to the view that this trajectory will not continue. I continue to see the Federal Reserve's inflation objective I just outlined as attainable.

That said, like my colleagues on the FOMC, I continuously monitor performance against our price stability objective. This involves monitoring not just inflation today but importantly the course of inflation expectations, whether derived from surveys or pulled from financial market prices. I am prepared to support a change of policy if evidence accumulates that the low and stable inflation objective is at risk.

For now, however, I remain satisfied that the current stance of monetary policy is appropriately gauged for the current state of the economy and the outlook from here.

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