Current Economic Performance, Underlying Fundamentals, and the Outlook

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

Rotary Club of Atlanta
Atlanta, Ga.

Jan. 9, 2012

Key Points

- Lockhart says 2011 was a year of ups and downs for the U.S. economy.
- He says some of the fundamentals of the economy are improving, including banking and household balance sheets. He thinks other areas, including public sector finances and new business formation, are still challenged.
- The uncertainty of the financial situation in Europe, Lockhart believes, will be the biggest wild card for 2012.
- Lockhart's outlook for 2012 calls for modest GDP growth of between 2.5 and 3 percent, with inflation at an acceptable range and slow but steady progress on unemployment.

The current economic recovery is two-and-a-half years old this month. After the deep recession and financial crisis, two-and-a-half years of economic growth sounds pretty good. But this recovery has felt like a roller coaster ride, with many ups, downs, and unexpected turns from quarter to quarter. In 2011, the economy absorbed some shocks and surprises that made for another such year. Economic performance in a recovery is never going to follow a completely linear path.

Today, I'll review the story of 2011, and discuss where the economy stands as we enter the new year. I'll also offer a progress report on some of the economy's key fundamentals. I'll lay out the outlook for 2012, as I see it, and close by discussing the stance of monetary policy at this juncture.

As always, my comments are my views only and might not be shared by my colleagues in the Federal Reserve System or on the Federal Open Market Committee (FOMC).

Review of 2011

First, let's take a brief look at how 2011 played out. Gross domestic product (GDP) growth during the year was quite slow, but with each successive quarter, growth accelerated somewhat. It appears that growth in the fourth quarter was relatively strong, continuing that acceleration trend. (I say "appears" because the numbers aren't yet in.)

Remember that the economy was hit with shocks early in the year from many directions, including weather events and other natural disasters. The earthquake and tsunami in Japan and disastrous tornadoes here in the Southeast are just two examples.

Growth of consumer spending, which absorbs about two-thirds of U.S. GDP, suffered a midyear dip, falling from a growth rate of 2.1 percent in the first quarter to around 0.7 percent in the second. Consumer activity grew somewhat faster in the third quarter and appears to have picked up even more in the last three months of the year.

The inflation story played out as many economists, including most of my Fed colleagues, expected. Early last year, commodity prices rose considerably as global demand increased. The stronger commodity demand came particularly from developing economies. In addition, because of the so-called Arab Spring, oil supplies were disrupted and prices spiked. These rising commodity costs drove inflation readings higher as, in some instances, they were passed along to intermediate and end users. As commodity price pressures eased, headline inflation settled back into a more acceptable range, and longer-term inflation expectations held steady throughout the year.

The employment picture continued to be a major concern in 2011, especially considering the high levels of long-term unemployment. That said, job creation picked up in the second half of the year and, as you know, Friday's jobs report was encouraging.

The beneficiaries of this job creation and re-employment were disproportionately older, college-educated men. The recession was dubbed the "mancession" because men took the brunt of job loss.

So, that, in brief, is the story of the past year.

Fundamentals of the economy

There is a deeper, multi-year story to be told about the repair and restructuring of foundational elements underpinning economic performance. I'd like now to give a progress report on certain of the economy's fundamentals. I will comment on five.

The **first** of these is the condition of household finances. The financial health of households and consumers is better, broadly speaking, but not yet rosy-cheeked. The process of achieving full health will take longer. Consumer spending is in the long run driven by income growth and wealth. For quite a number of years, consumers believed house price appreciation could be counted on as a source of individual wealth accumulation. And consumers believed that income growth would continue more or less uninterrupted. As a consequence, households were highly leveraged as the recession hit. Consumer debt levels have since improved, admittedly in part because of charge-offs and foreclosures, but also thanks to higher saving rates and less inclination and ability to take on new debt.

However, the apparent stronger consumption at year-end was associated with falling savings rates, compensating for stagnating income growth. I question whether this consumer spending momentum will be sustained without a pickup in income growth.

A **second** fundamental is business finances, which are in a healthy state, especially for larger companies. Corporate balance sheets are liquid, and much deleveraging has been accomplished. Businesses have worked hard to increase productivity and cut costs. As a result, even with overall demand growth still modest, large businesses are profitable and in a position to sustain decent results. Business investment was relatively strong in 2011, but much of that spending continued to be focused on productivity enhancements rather than on aggressive expansion.

Smaller firms are generally not in such solid shape. I would argue that, in some respects, large businesses and small businesses have been on different tracks through the recovery.

A **third** fundamental is the state of the banking and financial system. Since 2008, the banking sector has improved its capital position and worked down nonperforming assets. Risk management processes have been enhanced. Banks are mostly very liquid and in a much better position to grow their lending as loan demand increases. Capital markets—securitization markets, for example—have recovered substantially from their earlier impaired state, but they have not reached pre-crisis volumes.

Overall, much progress has been made but the financial system is not yet back to full strength. We can't really have a healthy economy without a strong banking and financial sector.

A **fourth** fundamental is public sector finances**.** Public sector finances have been under great strain and continue to be stressed.

State and local governments have been aggressive to get current spending under control, but often at a painful cost in terms of services and jobs. Also, state and local governments continue to face serious challenges related to long-term pension obligations.

At the federal level, spending and revenues are still far out of balance. To finance those deficits, federal debt is rising. The Congressional Budget Office now estimates that, under some circumstances, debt held by the public could reach 82 percent of GDP by the end of 2021. That would be higher than any year since 1948. In the studied opinion of some analysts, national debt at that level would approach a tipping point and become a serious drag on growth.

Government finances are not on a sustainable path and continue to be a weak element in the overall economic picture.

Finally, I'll call out new business formation as a **fifth** fundamental. Here's why it's a fundamental: new and young businesses are an important source of jobs. Start-ups account for about 10 percent of firms but generate almost 20 percent of new jobs each year on average. Admittedly, many start-ups fail quickly, but research shows that those that survive tend to grow quite rapidly relative to more mature firms.

Because of the obvious concern about jobs, my colleagues at the Atlanta Fed have been studying the recent record of new business creation, relying on data on establishment creation. A new establishment is a new place of business, including start-ups as well as new stores or production facilities of large, existing businesses. Starting in 2007, the rate of new establishment creation dropped appreciably and has been slow to recover. At the same time, there appears to be something of a secular trend, dating from the late '90s, of a progressive decline in the number of employees at new establishments. In short, new businesses employ fewer people.

More research is called for, but we think we could be looking at a double whammy of sorts—a cyclical decline in new business formation combined with a longer-term trend of fewer jobs per new business.

Uncertainty

I selected these fundamentals for comment because I think they are shapers of the recovery to date and the economy's prospects going forward. Let me add a parenthetical on the subject of uncertainty.

Uncertainty is a nebulous factor. Definition and measurement of uncertainty are elusive. Uncertainty is not as concrete and measurable a fundamental as business balance sheets or public finance, but it's affecting the behavior of consumers and businesses nonetheless. Most of the evidence I've seen for the effect of uncertainty comes from anecdotal comments. These comments reflect on a variety of concerns that are fueling risk aversion. Beyond lots of angst about the direction of the macroeconomy, concerns in 2011 included regulation, taxes, health care costs, and Europe.

There is, however, a growing body of work in the economics profession trying to measure uncertainty, and correlate it to actual spending by firms and consumers. For example, economists at Stanford University and the University of Chicago have built an index based on economic, tax, and forecast uncertainties. Last year, this index reached its highest level since the mid-1980s. The economists concluded that this level of uncertainty has been a significant drag on the expansion. You already knew that.

European situation

The uncertainty related to the European sovereign debt crisis was a very significant factor in 2011 and will continue to be with us in one way or another in 2012. A number of economists believe Europe is in or entering a recession. A recessionary Europe will have a direct negative impact on U.S. exports and tourism. The more serious and disruptive impact, in my view, could come through financial market channels. Direct exposure of U.S. financial institutions to European banks and sovereigns has been worked down, but rapid-fire developments could give rise to severe market turbulence and contagion. And even absent dramatic developments, there is the ongoing psychological impact on the confidence of actors in the United States, as was the case in 2011.

Although policymakers here cannot do much to influence European developments, the Federal Reserve has been doing what it can to protect the U.S. economy. Recently, to ease strains in dollar funding markets in Europe, the Fed extended and took other measures affecting so-called swap lines with several other central banks. A swap line—as the term suggests—is an arrangement in which two central banks temporarily exchange quantities of their currencies. When a swap line is used, the foreign central bank lends dollars directly to financial institutions in its jurisdiction. This reduces funding pressures on those institutions and helps them avoid having to purge dollar assets from their portfolios. A forced sale of dollar assets in Europe could drive up interest rates for U.S. businesses and consumers and crimp the flow of credit that is sustaining the recovery and job growth.

Outlook for 2012

This brings me to the outlook for 2012. Europe is the biggest wild card for the coming year. Also, the rising tensions in the Persian Gulf and the jumpiness of oil market prices cannot be ignored.

If there are no surprises from Europe or elsewhere, we at the Atlanta Fed are expecting modest GDP growth for the year in the range of 2.5 to 3 percent, but we will not be surprised to see some retrenchment of consumer activity as well as exports and inventory accumulation in the first quarter as compared to the last quarter of 2011.

As I mentioned earlier, inflation has come down since the first quarter of 2011. Inflationary pressures did turn out to be transitory, as many of us argued. We see inflation continuing to perform in an acceptable range in the coming year.

From its peak of 10.1 percent, the level of measured unemployment has fallen to 8.5 percent. We expect this progress will continue but at a slow pace.

So, overall, the Atlanta Fed's outlook anticipates a moderate pace of improvement but real progress on most fronts. This relatively slow pace of recovery is consistent with the narrative laid out by economists Kenneth Rogoff and Carmen Reinhart. Their thesis, in a nutshell, is that following severe financial crises, it takes a number of years for an economy to return to full health. This view seems to be proving out.

The stance of monetary policy

The outlook of the Atlanta Fed assumes the continuation of a supportive monetary policy. So, let me discuss that aspect of the picture. Over the last four years, the Federal Open Market Committee, or FOMC, has taken a number of steps to contain the recession and to help the U.S. economy recover. The FOMC lowered the policy interest rate effectively to zero. The FOMC undertook two rounds of large-scale asset purchases, known as quantitative easing. In August, the committee announced a conditional commitment to keep the federal funds rate in the 0 to 25 basis point range at least through the middle of

2013. In September, the committee decided to push out the average maturity of the central bank's portfolio of Treasury securities. This has been dubbed Operation Twist, and it was designed to put further downward pressure on longer-term interest rates.

The FOMC has done a lot with monetary policy, and the economy is in a better place. The economy has made progress, but it remains far from full health. So, it's shaping up to be another challenging year for charting monetary policy. Speaking for myself only, steady even if unspectacular growth accompanied by inflation in the neighborhood of 2 percent justifies some reluctance to change, in either direction, the FOMC's accommodative policy. At the same time, I think slow progress toward full employment justifies continuing consideration of whether more can and should be done. So for me as a policymaker, now is not a time to lock into a rigid position.

To conclude, I am encouraged by the better performance of the economy, including progress on fundamentals, and I expect more progress in the year ahead.

###