Monetary Policy and Emerging Challenges

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

University of Virginia Investing Conference
Charlottesville, Virginia
November 16, 2012

Key points

- Atlanta Fed President and CEO Dennis Lockhart, in a November 16 speech at the University of Virginia Investing Conference, stresses that the fiscal cliff, if mishandled, could threaten the current economic recovery, add new challenges to monetary policy, and create an uncomfortable tension between monetary and fiscal policy.
- Lockhart cites some firming of economic conditions and is holding to a base case outlook with real growth at a little above a 2 percent growth trend.
- Lockhart expects that the Federal Reserve's continued aggressive use of balance sheet monetary tools will be justified by economic conditions for some time even if fiscal cliff issues are properly addressed.
- Lockhart says that resolution of the fiscal cliff is appropriately left to Congress and the administration, but the solutions should support continued growth. Monetary policy would not be able to make up for the body blow to the economy that "going over the cliff" would represent.

Introduction

As a policymaker in a very fluid world, I think it is sound practice to periodically take stock of the sum of all policy elements in place and the appropriateness of the full stance of policy for prevailing conditions. At this juncture, it's possible to imagine economic scenarios that are quite divergent, depending especially on how fiscal questions play out.

Fed officials—as monetary policymakers—typically maintain some distance from fiscal policy issues. Federal fiscal policy is the domain of the administration and Congress, while monetary policy is the domain of the Federal Reserve.

Today I will venture more than usual into fiscal territory because, given the threats to the broad economy growing out of immediate fiscal concerns, it is unavoidable. In this vein, I want to draw your attention especially to the tension between the downside potential associated with the fiscal cliff and the Federal Open Market Committee's (FOMC) open-ended quantitative easing policy. The dramatic conflict—to use a literary term—boils down to this: if the fiscal cliff is mishandled, the economic outcome could be a recession, adding new challenges to monetary policy and an uncomfortable tension between monetary policy and fiscal policy.

It's that tension I want to comment on today.

I must emphasize that these are my personal views. My colleagues on the FOMC and in the Federal Reserve System may not agree.

Review of stance of monetary policy

I'll begin by reviewing the complete makeup of current monetary policy. By any accounting, today's monetary policy is very accommodative, very aggressive.

Current policy has three active ingredients—interest rate policy, balance sheet policy, and communication as an actual policy tool versus just an explanatory device. These three elements are intertwined. Balance sheet policies are being used because the policy rate cannot go lower. Communication policies are meant to strengthen the credibility and actionability of both interest rate and balance sheet policies, in effect making expectations a real policy lever.

Let me review these three elements of policy individually.

The policy interest rate (the federal funds rate) has been at the "zero lower bound" since December 2008. The FOMC has stated that the policy rate is likely to remain at that level at least until mid-2015. Said differently, what we call "liftoff" (the beginning of a tightening phase) is unlikely to occur before mid-2015. This is not an absolutely firm, cast-in-stone commitment. Rather, it's conditional on the economy evolving as the Committee expects. This means the date could be advanced or pushed back.

Balance sheet policies have been focused, by and large, on the composition of the balance sheet without significant net changes in scale. Initially, this involved increasing the size of the balance sheet, but since 2011, the balance sheet has held steady in scale.

The balance sheet has grown from about $900 billion prior to the crisis to about $2.9 trillion today, as the first two quantitative easing programs more than replaced special credit facilities established during the crisis. But since 2011, the two main balance sheet programs are the maturity extension program (or "Operation Twist") and the large-scale asset purchase program (or QE3, for the third round of so-called quantitative easing), which involves monthly purchases of $40 billion of mortgage-backed securities. Operation Twist is scheduled to conclude by year's end, and a decision will have to be made as to whether to replace it by another round of Treasury securities purchases.

It should be noted that there is one additional balance sheet policy element in place, and that is the reinvestment of maturing Treasury and mortgage-backed securities.

Let me now turn to the FOMC's communication as an active tool of policy.

The Committee has had a longstanding practice of providing guidance in some form on the path of the policy interest rate, but this practice has really ratcheted up over the past few years. The most recent iteration has involved communicating a date up to which the low-rate policy is expected to remain in effect. In August of 2011, the Committee provided a date of mid-2013. In January of this year, the date was extended to late 2014. Then, most recently, in September the Committee again extended the date, this time to mid-2015.

The September statement changed this forward guidance on the interest rate in an important way by adding the condition that the FOMC's low-interest-rate policy would likely remain in effect beyond a point at which the economic recovery strengthens. This escalation in the communication approach could be interpreted as signaling an intention to maintain stimulus and hence deviate from the policy that would be indicated by simple rules for policy formulation—for example, the rule authored by John Taylor, who is here today.

Another communication innovation introduced in the September statement conveyed that the QE program of mortgage-backed securities purchases is open-ended and that conditionality for stopping the purchases will be tied to "substantial improvement" in the outlook for the labor market in a context of price stability. That section of the statement also suggests that the Committee might conduct further asset purchases and deploy other tools if improvement in the labor market is slow to materialize.

What constitutes "substantial improvement" has not yet been defined. As I said in a recent speech, the health of the labor market is more complex than a single number like the unemployment rate can convey. As with any assessment of the economy, I think it will be appropriate to take a "dashboard" approach to get a full picture of prevailing conditions.

The more aggressive use of communication methods—it's fair to say—is an attempt to improve the public's sense of how the FOMC will respond to changing economic conditions. This would serve to remove uncertainty as much as possible from the environment and improve the confidence of businesses and consumers so they can predict where monetary policy will be, given developments in the economy. The idea is that this predictability is itself potentially stimulative.

Just as balance sheet policies are a natural step when the policy interest rate is at zero, higher-powered communication methods are a natural step as a complement or substitute for balance sheet policies. To sum up my review of policy, monetary policy is certainly very accommodative at this time. Policy is not at its limit, but is well out there on a spectrum measuring degrees of accommodation.

State of the economy and outlook

Let me now talk about the economy and the outlook. The economy is recovering from a deep recession at a pace of GDP growth gravitating around 2 percent. This may be close to the economy's long-run potential growth rate. In a cyclical sense, we should expect the economy to be growing faster than its long-run trend as a result of the still-substantial amount of slack in the economy, as evidenced by an unemployment rate that is still near 8 percent. Moreover, this sluggish pace of growth implies vulnerability to shocks and stall-out.

That said, there are positive signs suggesting some firming of economic conditions. The Institute of Supply Management's index of manufacturing activity ticked up in October, and new orders—a forward measure of activity—were encouraging.

Consumer spending growth continues to hold up, and sentiment about prospects for future conditions is improving.

The housing market has shown signs of life across a variety of indicators, from sales to construction to inventory levels to prices. These trends give me some confidence that a sustainable recovery in this crucial sector is under way. This improvement in turn reinforces my confidence that our policy actions to support this recovery will be effective.

Similarly, the recent employment numbers have been encouraging. According to the latest report from the Bureau of Labor Statistics, payroll employment gains over the past four months have averaged 173,000 net new jobs. If sustained, this pace is fast enough to bring the unemployment rate down at a more rapid rate than we have seen over the past couple of years.

Nonetheless, I am not prepared to say we are remotely close to substantial improvement on the employment front. There is still a disproportionate share of part-time jobs reflected in the overall employment gains, long-term unemployment remains unacceptably high, labor force participation rates are still surprisingly low, and initial unemployment gains have not yet fallen to levels that seem consistent with a truly robust jobs picture.

So in spite of some signs of firming in the overall economy, I'm holding to a base case outlook that has real growth only modestly above a 2 percent growth trend. Inflation should remain moderate and close to the Committee's target of 2 percent. For the reasons I just cited, I expect the employment picture to improve only gradually. This forecast does not incorporate significant effects coming from the major potential sources of downside risk, most prominently the fiscal cliff threat in early 2013.

I expect that continued aggressive use of balance sheet monetary tools will be appropriate and justified by economic conditions for some time even if fiscal cliff issues are properly addressed. I hold to this view even though further growth of the Fed's balance sheet raises concerns of longer-term unintended consequences.

Risk components and the path forward

Concerns about risks accompanying the Fed's nontraditional monetary policies fall mostly in three areas. There is the risk of distorting and damaging financial market function both in the further expansion and normalization phases. There is the risk of overstimulating the economy in a period of accelerating growth, credit expansion, and possibly increase in money velocity, which could lead to a repeat of boom-and-bust cycles. And there is the risk of dislodging inflation expectations, leading to a far higher than desired level of inflation.

I think it's best for policymakers to assume an attitude of humility when on a path not trod before. There is no guarantee further easing won't bring on the unintended consequences I just mentioned, but I remain comfortable with the course the Committee has chosen. Let me detail the "whys."

A plan for eventual exit has been developed, and the principles that will guide this exit have been published. These principles are sound and actionable. The tools to manage the balance sheet have been developed and tested in small volumes, and I expect they will be effective when employed. The timing question—when to implement these tools—will be critical.

I believe signs will be evident, especially in relevant data like the credit aggregates, which will foretell a credit-fueled pickup in growth and activity. Credit markets hardly seem poised for a great leap that would put monetary policy in a catch-up mode.

The inflation expectations of the public remain in a zone of comfort. I see no indication of a developing expectations problem, and, if expectations began to drift in a worrisome direction, I'm confident the problem will be identified early enough and addressed.

The Fed is now an inflation-targeting central bank, having established a formal target of 2 percent in January of this year. The formality of the target should reinforce the Fed's credibility as regards the intended path of inflation.

Fiscal concerns

At the beginning of my remarks, I pointed out the tension between monetary policy and fiscal policy. That tension is caused by an open-ended asset purchase program whose cessation is conditioned on economic conditions that may be highly and negatively affected by the handling of the fiscal cliff. I'd like to come back to that thought.

The length and persistence of the FOMC's asset purchase program, and hence the ultimate size of the Fed's balance sheet, depend critically on the pace of economic recovery.

It's obvious that it's in everyone's interest that the recovery gain momentum and that labor market conditions improve sooner rather than later. I believe that monetary policy is providing the appropriate level of support for that goal. But the FOMC's open-ended commitment to providing monetary accommodation raises the stakes with respect to the outcome of the other big policy elephant in the room: the avoidance of the fiscal cliff and the pursuit of budget sustainability for the federal government.

As a monetary policymaker, I will stick with my practice of not recommending specific fiscal measures, but I do want to emphasize that Congress and the administration must find a way to avoid the fiscal cliff or risk very serious economic consequences. The near-term economic risks presented by failure to deal effectively with the fiscal measures collectively referred to as the fiscal cliff are so serious that to sidestep this concern feels like trying to whistle past the graveyard.

Here's my operating assumption regarding the economic impact of going over the fiscal cliff: The Congressional Budget Office, or CBO, estimates that the fiscal cliff would cost the economy a little more than 2 percentage points in GDP growth in 2013. Most of the impact would be felt in the first half of the year. In terms of the labor market, the CBO estimates that going over the fiscal cliff would raise the unemployment rate to 9.3 percent. A number of private-sector forecasters have come up with numbers that are broadly similar to the CBO's.

From early in the year, my Atlanta Fed colleagues and I have detected a fiscal-cliff drag on activity in grass-roots soundings of business people. But in the 10 days since the election, media attention to the fiscal cliff has risen dramatically. This is only going to be compounded, in my opinion, until resolution is achieved. Observers across the globe are riveted on this potential shock, and that reality suggests the possibility of financial market disturbance if the matter is not handled well.

The right way to resolve the fiscal cliff and bring the federal budget closer to balance is appropriately left to the political process. But, at a minimum, the chosen solutions should support continued growth. Any approach that compromises the continuation of the economic recovery will be, in my view, very damaging. While the Fed could extend the period of time over which monetary policy accommodation is required, monetary policy would not be able to make up for the body blow to the economy that "going over the cliff" would represent.

I have supported with my votes each of the FOMC decisions made this past year. I think that monetary policy is appropriately calibrated to give the U.S. economy its best shot at ongoing, or even accelerating, growth. A sustainable fiscal strategy would provide necessary further support to that process.