

Deleveraging in Today's U.S. Economy

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Key points

While acknowledging that downside risks to the recovery have increased, Lockhart expects a **modest cyclical recovery** to proceed. In his view, a number of necessary **structural adjustments** are holding back economic growth in this recovery. One of the major adjustments is deleveraging.

In Lockhart's opinion, it is necessary that the process of **deleveraging** plays itself out, which may take several more years. While the private sector has made progress in lowering its debt burden over the past two and a half years, government debt has surged. So for the economy as a whole, debt relative to GDP has barely changed over the period.

Lockhart believes that policy must continue to help the economy achieve a healthy enough cyclical recovery, while at the same time recognizing the long-term need for directionally opposite structural adjustment, including deleveraging. The test policymakers must step up to is **balancing short- and longer-term needs**.

Lockhart is comfortable with the **current stance of monetary policy**. However, given the recent weak data and considering the rising concern about chronic slow growth or worse, he does not think any policy option can be ruled out at the moment. But in his view it is important that monetary policy not be seen as a panacea. Structural adjustments take time, and Lockhart is acutely aware that pushing beyond what monetary policy can plausibly deliver runs the risk of creating new distortions and imbalances.

The country is in the ninth quarter of a disappointing and frustrating recovery. We at the Fed were hopeful of (and many private forecasters envisioned) a modest version of a classic bounce back after a recession. Yet, over the past four quarters for which there are growth measurements, the economy has grown at only a 1.6 percent pace. If the economy's potential for growth is a pace of 2.5 percent, as many economists believe, then slack in our economy is rising even though we are technically in recovery.

The unimpressive recovery is evident in the U.S. labor market. In July, the national unemployment rate stood at 9.1 percent—a percentage point below its peak, but three-tenths higher than it was last March.

This sluggishness has been blamed on a variety of temporary and more persistent headwinds. That's the term often used to describe forces that are impeding growth. Since the recession ended and expansion resumed, certain underlying "structural" (or more long-term) headwinds have been recognized, but these factors were taken as reasons postrecession growth would clock in at a moderate rate in the range of 3 to 4 percent per annum instead of a much more robust rate typical of a rebound from deep recession.

Very recently—with the incoming data of the last few weeks—awareness of and attention to the deeper long-term impediments to growth have become more acute. There is rising concern the U.S. economy may be facing a longer period of very slow growth because of more intractable structural forces in play. These deeper impediments to growth imply structural adjustments in the economy that may take years to accomplish before the economy achieves full and well-balanced health.

In my view, there are three likely protracted and interconnected adjustment processes of significance. They are 1) deleveraging (that is, the reduction of total debt levels in our economy), 2) fiscal adjustment, and 3) financial system repair. In addition, the accumulating pressure of an aging population will affect labor force participation and output potential.

In my remarks today, I want to focus particularly on the first of these—deleveraging, the process of debt reduction by households and businesses. I will review how this process of deleveraging has affected the economic recovery to date. I will offer a forecast for the remainder of 2011 and 2012. And I will share my views on the role of monetary policy in the context of growing concern that we're facing the prospect of a long period of slow growth.

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

Before I get into a discussion of the outlook in light of the ongoing process of deleveraging, let me pose what I think is a key economic outlook question, and that is how well can we expect the economy to perform (we can call this cyclical performance) while these profound structural currents run their course?

So now let me review the state of the economy at this juncture and the near-term outlook.

Economic outlook

To repeat, after a severe financial crisis and a recession, the economy began to grow again two years ago. The recovery has been uneven. Initially, growth came back strongly, boosted by inventory rebuilding and strengthening private sector activity. Last summer, however, the recovery started to weaken and has slowed markedly this year. Temporary factors, such as spiking commodity prices and supply chain disruptions related to Japan's natural disaster, held back economic activity earlier this year. But the slowdown cannot be explained by those factors alone. Over the past few quarters, the recovery has lost dynamism, and downside risks to growth have risen notably.

Consumer spending, which accounts for approximately 70 percent of total demand, grew very modestly in the first half of the year. Higher cost of living and the weak labor market are likely to have discouraged consumers from increasing expenditures. The consumer spending numbers for July were a bit higher than expectations, but still not at a level that would make for a robust recovery.

The depressed state of the housing market has also discouraged consumption. The stream of foreclosures is contributing to a high inventory of homes for sale and keeping downward pressure on home prices.

Slow improvement in the labor market has been particularly disappointing. Job growth remains too low to bring down the unemployment rate, which remains above 9 percent. People in all age groups continue to leave the labor force, and the employment-to-population ratio is now at its lowest level in over 25 years.

In response to a slew of weaker-than-anticipated data, most forecasters, including the Atlanta Fed, have revised down gross domestic product (GDP) projections for this year and next.

Although the overall picture has worsened, there remain pockets of strength in the economy. Business investment is growing, in part supported by low financing costs. Export growth also remains solid as economic expansion continues in our major trading partners.

Positive news is coming from the oil and gas industry, especially here in Louisiana. Business contacts in the region have been reporting an influx of fabrication work and backlogs in orders for pipelines, supply boats, and drilling equipment. In Lafayette, employment in the energy sector has increased, providing a big boost to the local economy.

On a national level, the negative effects of the unusual forces that restrained the economy in the first half of this year have diminished. For example, auto production that was disrupted by shortages of supply parts from Japan has bounced back. Also, inflationary pressures seem to be in check as prices of many commodities have come off their peaks.

While the risks have increased, I do not expect a recession. In my view, there is sufficient fundamental strength in the economy for a modest cyclical recovery to proceed while the process of necessary structural adjustments moves along. I believe the unemployment rate will come down very gradually over time.

Now I am going to talk about one of the major structural adjustments that is holding back the recovery—deleveraging. Deleveraging is a process of reducing the debt burden of a household, a business, or a government. It has proved to be a potent force that has reduced the economy's ability to heal quickly after the last financial crisis and the ensuing recession.

Background on deleveraging

Debt is not in and of itself a bad thing. Debt supports economic growth by allowing households, businesses, and governments to smooth their spending and investment over time. Borrowing and lending can help facilitate the allocation of capital to productive uses in the economy. But high debt levels can also result in

lower economic growth, a point that Stephen Cecchetti, of the Bank for International Settlements, made in a paper presented at the Kansas City Fed's symposium in Jackson Hole, Wyo., last week.

Relative to the size of the U.S. economy measured in terms of GDP, the total domestic debt of nonfinancial sectors of the economy reached 248 percent in 2009, increasing by almost 75 percentage points over the previous decade alone.

So let's take stock of how we got to this point. Much of the growth in debt over the last decade was in the form of real estate debt of households. During the 1990s the amount of outstanding mortgage debt of households was relatively stable at around 45 percent of GDP, but from 2000 to 2007 household mortgage debt increased to almost 75 percent of GDP.

As long as home prices were rising, the increasing debt burden of households was not particularly problematic. But the level of household debt turned into a drag on the economy once home values began to drop. According to the Case-Shiller price index, home values have declined by over 30 percent since their peak in 2006.

Deleveraging across sectors

Declining home values along with rising unemployment set in motion a process of deleveraging by the household sector. Household deleveraging has occurred mostly through a combination of increased savings, debt repayment, and also debt forgiveness. At the same time, there has generally been less access to credit for households as a result of stricter underwriting standards. The inability to qualify for home equity loans and other forms of credit has slowed the pace at which new debt is taken on by households replacing paid-down debt. The effect is to reduce their debt burden over time. From its peak in 2009, total household debt has declined to around 90 percent of GDP (the lowest level since 2005), and the household savings rate has risen to about 5 percent.

Debt in the nonfinancial business sector also increased over the last decade, reaching an historical high of 79 percent of GDP in 2009. By the first quarter of 2011 nonfinancial business debt had declined to about 73 percent of GDP. To give you a point of reference, nonfinancial business sector debt becomes a drag on economic growth after it increases to above 90 percent of GDP, according to Stephen Cecchetti's estimates.

In contrast to reductions in debt by households and businesses, government debt has surged, increasing from about 50 percent of GDP prior to the recession to around 80 percent in the first quarter of this year.

Deleveraging going forward

For the economy as a whole, debt relative to GDP has barely changed.

While the private sector—households and businesses—has made notable progress in lowering its debt burden, discussions of how to reduce public debt have only just begun. The government still needs to introduce major policy changes to put public debt on a sustainable path. Demographic trends, which I referenced earlier, will make public debt reduction even more challenging.

It is necessary that the process of deleveraging plays itself out, which may take several more years. When economies are deleveraging they cannot grow as rapidly as they might otherwise. It is obvious that as consumers reduce spending they divert more of their incomes to paying off debt. This shift in consumer behavior increases the amount of capital available for financing investment. But higher rates of business investment are not likely to fully offset weakness in consumer spending for some time, as businesses continue to grapple with uncertainties about the future.

As I said, rebalancing simply takes time. A 2010 report by McKinsey surveyed 32 international periods of deleveraging following financial crises and found that, on average, the duration of these episodes was about six and a half years. U.S. debt to GDP peaked in the first quarter of 2009. By that standard we are much closer to the beginning than the end of our deleveraging process.

Role of monetary policy

To my mind, it's becoming increasingly clear the challenge we policymakers face is balancing appropriate policy responses for the near to medium term with what's needed for the longer term. In other words, we must continue to help the economy achieve a healthy enough cyclical recovery, especially with unemployment high and consumer spending lackluster. At the same time, we must recognize the longer-term need for directionally opposite structural adjustments, including deleveraging.

To support the recovery, low interest rates and ample liquidity help to encourage spending by consumers and businesses. Because this is an aim of policy in the near term, Fed economists, like those in the private sector, watch with intense interest the monthly data on consumption and surveys of consumer confidence. But at the same time, there's broad acknowledgement that policy must support the long-term rebalancing required to sustain our economic health. Finding the right path through these seemingly conflicting pressures is challenging.

The situation brings to mind a quotation from F. Scott Fitzgerald's 1936 article titled "The Crack Up." He said "the test of a first rate intelligence is the ability to hold two opposed ideas in mind at the same time, and still retain the ability to function." In a way, that's the test we policymakers must step up to in balancing short- and longer-term needs.

Against that backdrop, I would characterize the stance of monetary policy at this time as accommodative. As you know, the FOMC stated after its last meeting the intention to keep the policy rate at near zero for two more years. Also, the current policy is to maintain the Fed's balance sheet scale for the foreseeable future. I support this position.

Given the weak data we've seen recently and considering the rising concern about chronic slow growth or worse, I don't think any policy option can be ruled out at the moment. However, it is important that monetary policy not be seen as a panacea. The kinds of structural adjustments I've been discussing today take time, and I am acutely aware that pushing beyond what monetary policy can plausibly deliver runs the risk of creating new distortions and imbalances.

We may find, as economic circumstances evolve, that policy adjustments are required. In more adverse scenarios, further policy accommodation might be called for. But as of today, I am comfortable with the

current stance of policy, especially considering the tensions policy must navigate between the short and long term and between recovery and the need for longer-term structural adjustments.

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