

The Economy and Monetary Policy—The Latest “Twist”

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Key Points

- Federal Reserve Bank of Atlanta President Dennis Lockhart said that he went into last week’s FOMC meeting grappling with a complicated picture of the economy and the need to balance maximum employment and price stability. Lockhart anticipates gradual improvement on the employment front and inflation falling back over the next few months.
- According to Lockhart, the FOMC’s decision to undertake a maturity extension program and reinvest principal payments from agency debt and agency mortgage-backed securities into an equal amount of new agency mortgage-backed securities should put downward pressure on longer-term Treasury rates and support mortgage markets.
- Lockhart believes the FOMC’s actions last week will lower the cost of borrowing for both consumers and businesses, freeing up money for other uses.
- Further, he believes the Fed’s actions last week should be viewed together with other policy elements already in place as part of the larger effort to promote economic recovery.

Good afternoon. Today is September 27. We are about to wrap up the third quarter of what has been, so far, a disappointing year.

We’ve had an especially bumpy ride over the last week, with events buffeting the markets and the economy. I’d like to use this opportunity to step back and take stock.

I’m going to give you an overview of the economic situation today, focusing on three indicators of economic performance—growth, labor, and inflation. And I will comment on the risks as I see them.

Last week, the Federal Open Market Committee (FOMC) decided to undertake something called a maturity extension program. This policy action has been dubbed Operation Twist by commentators, a reprise of the 1961 strategy originally named after singer Chubby Checker’s hit song of the same year, “The Twist.” When asked about that last week, Checker summed up the development by saying “The Twist has always meant money for everybody.” Chubby must be a monetarist.

Whatever you call the Fed’s latest policy, it’s meant to put downward pressure on long-term interest rates and help make broader financial conditions more supportive of growth. I’ll explain how it will be implemented, and more importantly, what the policy is intended to accomplish for the American

consumer and business person. I'll also comment on what we can expect from this policy in terms of overall economic impact.

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

Now let's look at where the economy is today and the outlook.

The economy today

Overall, the economy is growing slowly and my outlook is for modest improvement through the remainder of the year and 2012.

My base case forecast calls for Gross Domestic Product (GDP) growth in the 1 to 2 percent range for this year, moving up to a range of 2 to 3 percent next year. In full disclosure, this forecast is lower than my staff and I projected at the beginning of the summer. Following official revisions to earlier growth estimates and because of weaker-than-expected incoming data more recently, we revised down our growth forecast. Most forecasters have done the same.

This base case growth forecast assumes some of the forces that have been holding back the recovery will prove transitory. For instance, the effects of negative shocks that held back growth earlier this year—like the earthquake and tsunami in Japan and the rapid rise of oil prices—are dissipating.

Also, there are some restorative processes at work that should contribute to improved economic performance. For instance, while many households face serious financial problems, overall the financial health of households has been improving over the last two years. At the same time, the banking system is in better condition, and financing constraints for businesses have eased to some extent. My outlook for modest improvement rests on the assumption the economy will not be hit by another major shock such as another large oil price spike or severe financial instability caused by a significant worsening of conditions in Europe. The European debt crisis looms as the biggest threat at the moment, in my opinion.

In addition to monitoring economic growth indicators, I've been closely following developments in labor markets, which continue to present a complicated and vexing challenge.

In terms of job creation, we appear to be trading water. Basically, the weak pace of growth in output since the end of the recession has translated to only modest net job creation. Modest gains in the private sector have been partially offset by ongoing losses in the public sector.

As a result, there has been little progress in bringing down the high rate of unemployment. As of August, official unemployment stood at 9.1 percent, essentially the same level it was at the beginning of the year. The unemployment rate would be even higher if it weren't for the fact that some people are dropping out of the labor market completely.

I think it's most realistic to expect only a gradual improvement in the unemployment rate, consistent with the subdued growth trajectory for output and spending.

As for inflation, the recent numbers have been higher than desired and higher than expected. The August Consumer Price Index had prices rising at an annualized rate of 4.6 percent. Obviously, a rate of inflation this high would be unacceptable if it were to continue for a long period of time.

I do expect the rate of inflation will fall back over the next few months, which is the assumption in my baseline forecast. Among the causes, the prices of most commodities, including oil, have eased from their recent highs. Further, the painfully high unemployment rate is consistent with considerable slack or excess capacity in the economy, which tends to constrain wage growth. You are familiar with the term wage-price spiral. I don't see any prospect of such a development in the foreseeable future, as long as unemployment remains high, and longer-term inflation expectations remain well anchored. Measures of longer-term inflation expectations remain within acceptable bounds. These factors should combine to put downward pressure on inflation over the coming months.

To sum up, in the absence of a shock, I don't see a recurrence of economic contraction. That said, we are in a period of greater risk and uncertainty. The reason I refer to our base case or baseline forecast is because other, more adverse, scenarios are plausible.

Personal views entering the last FOMC meeting

I went into last week's FOMC meeting grappling with a complicated picture. I am just one participant in FOMC meetings—I can't speak for others.

As background, let me remind you that Congress has given the FOMC two mandates—maximum employment and price stability.

I was concerned by not only the persistence of high unemployment but also the complicated internal dynamics of the current labor market. To me, it is not clear to what degree structural factors are impeding the filling of job vacancies. And with some 43 percent of the unemployed out of work for more than six months, it is not clear to what extent the long-term unemployed are becoming a class of permanently unemployed, creating a problem resembling the so-called structural unemployment of some European countries. Further, it is not clear why participation in the labor force continues to fall. Finally, it is not clear what level of unemployment should be considered the natural or equilibrium rate under current circumstances.

I was also concerned by the trend and complexion of inflation data. Inflation has trended higher for a longer period than I expected. That trend is true for both headline and various measures of core inflation (which I use to gauge the broad, underlying trend in prices beyond the month-to-month volatility). Going into last week's FOMC meeting, I had several questions on my mind regarding inflation and prices. For instance, will factors that caused the spurt of inflation early in the year really prove transitory? How long will the pass-through of higher costs continue before businesses lose pricing power in a weak economy? And what accounts for the quite broad-based price movements measured in recent core inflation readings, and what signal should we take from these movements?

I accept the premise that there is no tradeoff in the long run between the two policy objectives expressed in the FOMC's dual mandate. The best environment for achieving and sustaining full employment is one of price stability. However, it's plausible (and again, these are my personal views) that the forces shaping economic performance at the moment create some tension between these two objectives. The formulation

of monetary policy currently requires an assumption about whether and how far accommodative policy can push down unemployment as well as an assumption about whether we're dealing with transitory or more persistent price pressures.

These were my concerns going into the meeting and represented, in my thinking, the context for last week's decision making.

The FOMC's decision

As you are aware, the committee decided to undertake what's called a maturity extension program. Let me explain what that is. Over a period of about nine months the Fed will sell \$400 billion of our current holdings of Treasury securities with maturities of three years or less. While we're selling short-maturity Treasuries, we will buy an equal amount of longer-maturity securities—those with maturities of six to 30 years.

The intent of this program is to put downward pressure on longer-term interest rates and help ease financial conditions broadly.

Also, at the last meeting the FOMC decided to reinvest the principal payments from its holdings of agency debt and agency mortgage-backed securities (MBS) into an equal amount of new agency mortgage-backed securities. The word "agency" refers to the government backers of mortgage loans, such as Fannie Mae and Freddie Mac. The move is aimed at supporting mortgage markets and, by extension, the housing sector. Buying for reinvestment should lower the yield of mortgage-backed securities, which in turn should help bring down mortgage rates. In my view, this strategy is designed to work in conjunction with downward pressure on longer-term Treasury rates resulting from the maturity extension program.

What "Operation Twist" should mean for consumers and businesses

More generally, the decision to undertake a program of maturity extension is an attempt to achieve a further easing of financial conditions. Let me take a second and spell out what is meant by the somewhat abstract phrase "easing of financial conditions." Essentially, it means lower interest rates—a lower cost of borrowing—across the whole spectrum of loan maturities involved in financing consumer and private sector activity. In the case of maturity extension, it means lower rates for medium- and longer-term maturities. It also means lower spreads between the rates consumers and businesses pay for loans, as well as bonds issued by larger businesses, versus the rate the U.S. Treasury pays for an equivalent period. For the typical American consumer and business, it means borrowing should be cheaper. It means purchases you might finance and pay for in monthly installments should be more affordable. It means, for some people, refinancing your mortgage may make a lot of sense, and the money saved by lowering your mortgage payments can go into your pocket for whatever use. And for a business, it means some investments—for example, in new equipment—may be a little more financially justifiable.

The Fed's maturity extension program and additional mortgage-backed securities purchases are meant to further ease financial conditions *ceteris paribus*, other things being equal. Of course, other things almost certainly will not stay equal, and other factors will influence what really happens to rates and spreads as policy intent encounters the real world.

Realistic expectations for these policies

These are things that *should* happen as a result of the FOMC's action of last week. However, a number of commentators have questioned how much positive effect can result because of what is perceived to be the "impaired transmission mechanism" through which monetary policy operates at present.

Let me put this in plain English. Monetary policy mostly works through the lowering or raising of interest rates. It can also work through a shift in the composition of financial assets held by the public. An example would be a shift from low-yielding, more secure assets to those that offer a higher potential return but with higher risk. Monetary policy makes this happen by changing the composition of the central bank's own balance sheet.

Those who argue monetary policy transmission is impaired assert that lower interest rates won't stimulate much new activity because many consumers are still deleveraging (that is, paying down debt). As for business, many larger businesses already have lots of cash. Also, banks are keeping a lot of their liquidity on the sidelines. Loan demand is weak in this soft economy, and stricter credit standards mean fewer potential borrowers qualify. There are other reasons cited in support of this view, but you get the idea.

I share the view that the transmission mechanism for monetary policy remains somewhat impaired, and for this reason I am not expecting large gains from the Fed's most recent action. I think it's realistic to expect modest positive impact from this program.

In my view, the maturity extension program along with the MBS purchases represents a measured, incremental attempt to add more support to the recovery. It's not a fix for everything that ails the economy, but it should help.

Monetary policy actions in total

In this vein, I think the recent decisions to adjust the composition of the Fed's securities holdings should be seen as augmenting a total stance of policy intended to promote recovery and facilitate necessary adjustment. In my view, this policy action is not just one more thing tried in a series of stand-alone attempted remedies for the weak economy. Instead, I believe the potential of the latest policy actions should be assessed on a composite basis together with elements of policy already in place, which include previous large-scale asset purchase programs, a conditional commitment to keep the federal funds rate in the 0 to 25 basis point range at least through mid-2013, and maintaining the overall size of the Fed's balance sheet. The power and sufficiency of these efforts should not be evaluated individually but as a cumulative total policy of support and accommodation.

I'll end with this thought—again, my personal view. The decisions of last week's FOMC meeting should be taken neither as signaling further action on the part of the Fed nor conveying that "we're done." The direction of policy going forward will depend on how economic circumstances and the outlook evolve from here.

As I said earlier, I expect the pace of the recovery to build, albeit modestly, and this will bring a gradual reduction in unemployment. I think disinflationary pressures will cause inflation to moderate to more acceptable levels.

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