The Fed's New Regime and the 2013 Outlook

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Wisconsin Economic Forecast Luncheon
Wisconsin Bankers Association
10 January 2013
Madison, Wisconsin

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This talk

- Some recent changes to U.S. monetary policy.

- My macroeconomic outlook for 2013.

Two aspects of current U.S. monetary policy

- Interest rate policy.
  - The policy rate has been near zero since December 2008.
  - The FOMC has promised to maintain the near-zero rate into the future, so-called “forward guidance.”
  - The Committee has replaced fixed-date forward guidance with a “threshold” approach.
- Balance sheet policy.
  - The Committee has promised to maintain an aggressive asset purchase program.

Key questions for current U.S. monetary policy

- On interest rate policy:
  - What are the differences between the recently-adopted threshold approach and the previous fixed-date approach?
- On balance sheet policy:
  - Why is the forward guidance less extensive on the balance sheet portion of monetary policy?

U.S. macroeconomic outlook

- I have argued that the U.S. potential growth rate is lower today than it has been in the recent past, about 2.3 percent.

- Forecast growth will be faster than potential, at around 3.2 percent in both 2013 and 2014.
  - Easier monetary policy.
  - Reduced headwinds.
  - Reduced uncertainty.

- Unemployment will fall, and inflation will remain near target.

Thresholds and the Policy Rate

Thresholds

- The Committee previously used a given date to indicate when the first increase in the policy rate will likely occur.
  - This approach has some problems.
- In December the Committee instead adopted "thresholds," values for inflation (2.5 percent) and unemployment (6.5 percent) that give an indication that the time for a policy rate increase may have arrived.
- This is a more state-contingent policy.
  - "State-contingent" means "dependent on economic conditions."

The pessimism problem

- The Committee previously stated that the policy rate will likely remain near zero until "mid-2015."

- This created a "pessimism problem" for the Committee.
  - The date could be interpreted as a statement that the U.S. economy is likely to perform poorly until that time.
  - I have called this an "unwarranted pessimistic signal."
  - Michael Woodford of Columbia University has called it potentially counterproductive.
  - The Committee did not intend to send such a signal.

Fixing the pessimism problem

- The Committee has now switched to a description of economic conditions at the time of the first rate increase.
- Now, as data arrive on U.S. economic performance, private sector expectations concerning the timing of the first rate increase can automatically adjust.
  - Vice Chair Yellen has called this an "automatic stabilizer."
- The Committee is no longer sending the pessimistic signal, because the threshold conditions can be met at any time.

Thresholds have some challenging aspects

- The use of thresholds is not a panacea.
- I have described elsewhere a number of issues that the Committee is likely to face going forward with this strategy, including:
  - The FOMC cannot pretend to target medium- or long-term unemployment.
  - The Committee needs to reiterate that it considers many more variables in attempting to gauge the state of the U.S. economy.
  - The thresholds will likely be viewed as triggers for action.

Balance Sheet Policy

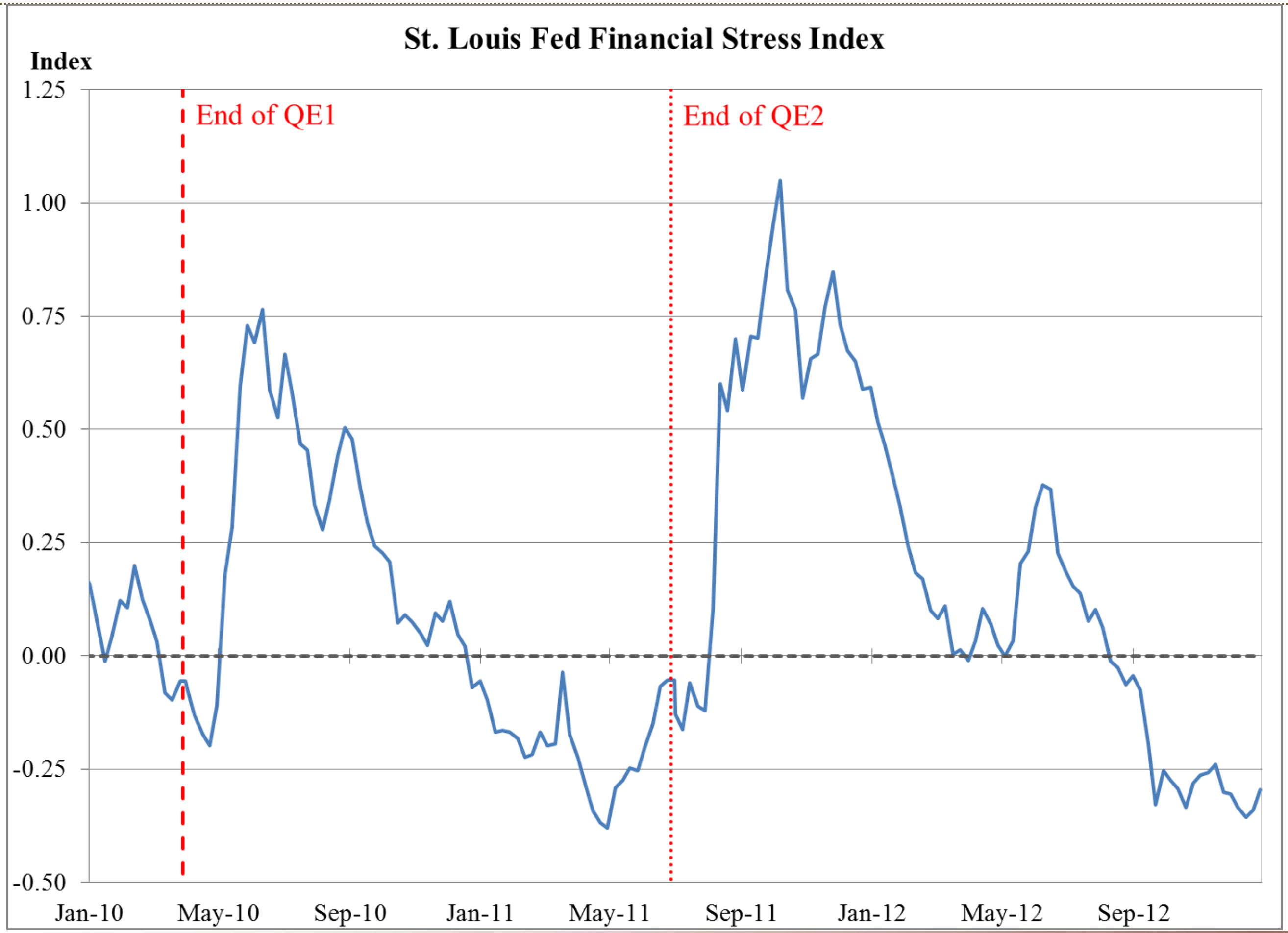
The FOMC balance sheet policy

- The Committee adopted "QE3" at the September 2012 meeting.
- This program is also more state-contingent, so-called "open-ended" QE.
  - Unlike previous programs, no end date was specified.
- This program was extended at the December meeting with the replacement of "Operation Twist" by outright purchases.
- The current approach is to purchase $40 billion in MBS and $45 billion in Treasury securities per month.
  - The annualized pace would be more than $1 trillion.

The end-date problem

- The Committee previously specified end dates for asset purchase programs.
- These end dates tended to occur at times which were characterized by relatively poor economic data.
  - Examples: March 2010, as the European sovereign debt crisis was heating up, and July 2011 as the debt ceiling debate was occurring.
- With QE3, the Committee instead seeks "substantial improvement" in labor markets before pausing purchases.
  - The Committee may also taper the program as needed.

Financial stress



Source: Federal Reserve Bank of St. Louis. Last observation: week of December 28, 2012.

No thresholds

- The Committee has maintained a qualitative approach to the state-contingent aspect of balance sheet policy.
  - Attempts to also put thresholds on the timing of asset purchases may be a bridge too far.
- The FOMC will have to make a judgment concerning the program as macroeconomic data arrive.
- Private sector expectations concerning the program will also adjust appropriately as data arrive.

Is monetary policy more accommodative today?

- I view the overall monetary policy stance as more accommodative today than it was six months ago.

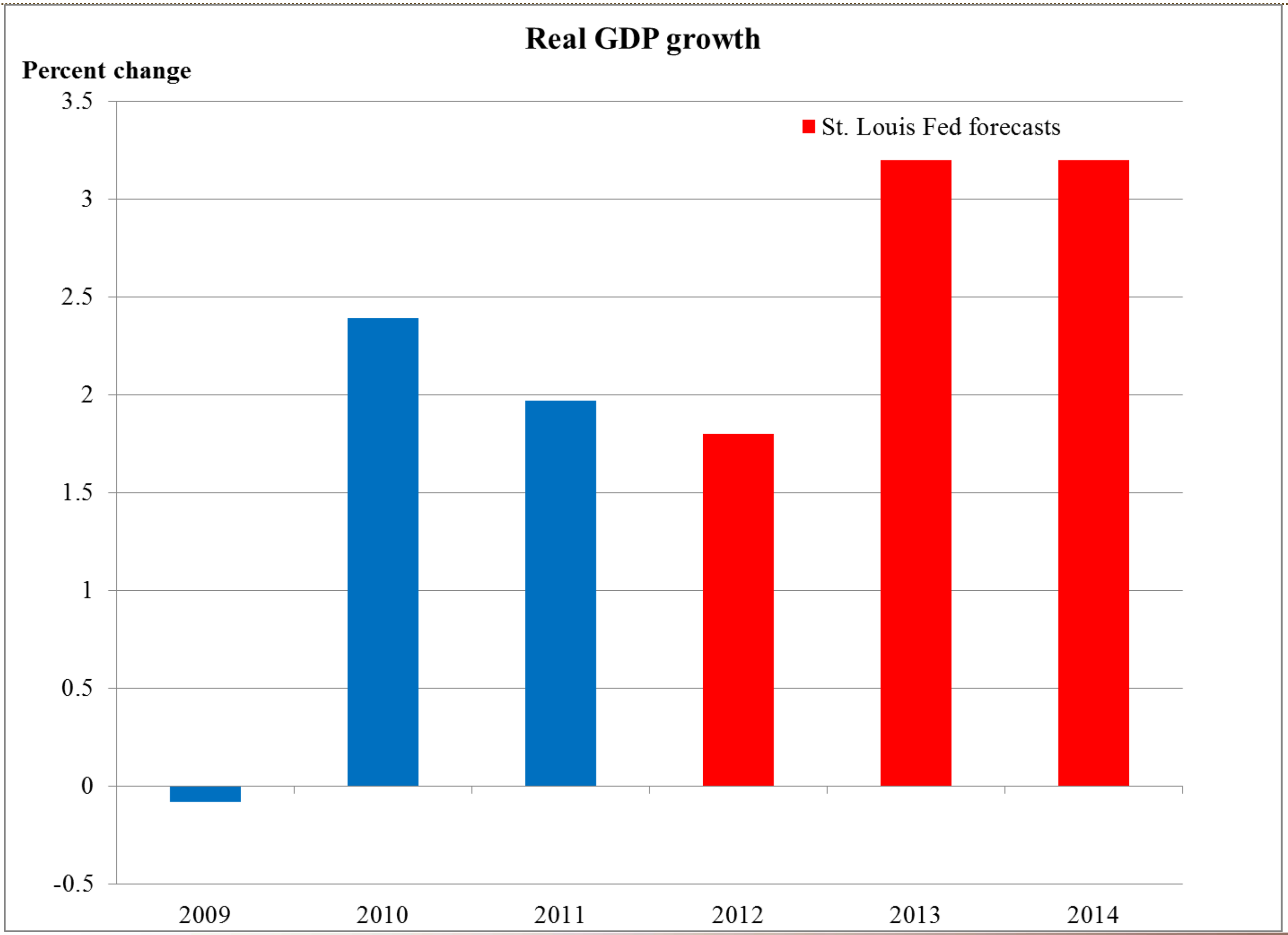
- Why?
  - The Committee undertook QE3.
  - The QE3 program is more open-ended and state-contingent, making it more effective.
  - The twist program was replaced with outright purchases.
  - The policy rate guidance was revised, helping alleviate the pessimism problem I described earlier.

The U.S. Macroeconomic Outlook

U.S. macroeconomic outlook

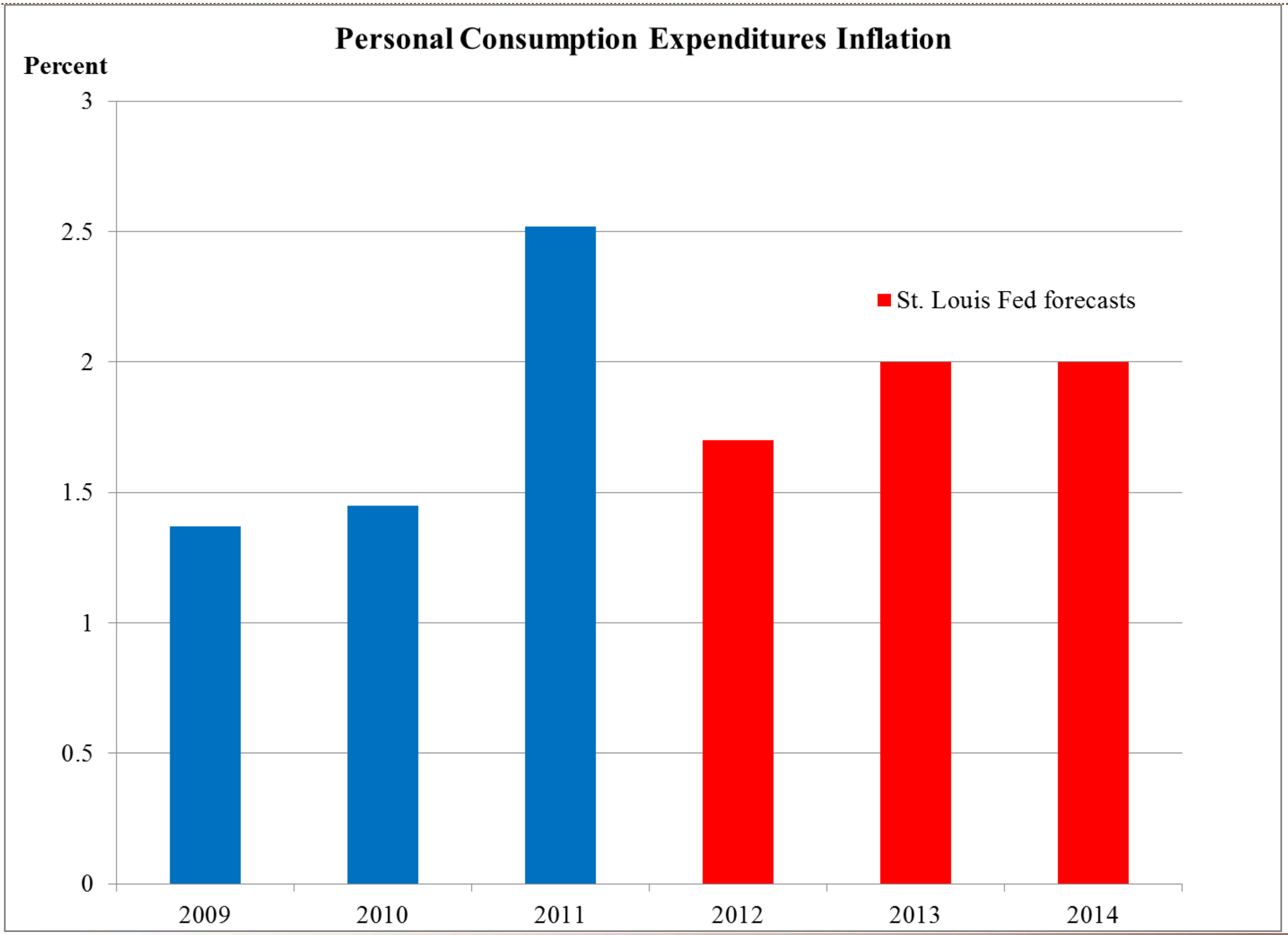
- I have argued elsewhere that the U.S. potential growth rate is lower today than it has been in the recent past.
  - Let's put this at about 2.3 percent.
- My forecast is that real GDP growth will be faster than potential, at around 3.2 percent in both 2013 and 2014.
- Main factors:
  - Easier monetary policy.
  - Reduced headwinds.
  - Reduced uncertainty.
- Unemployment will fall, and inflation will remain near target.

Real GDP growth



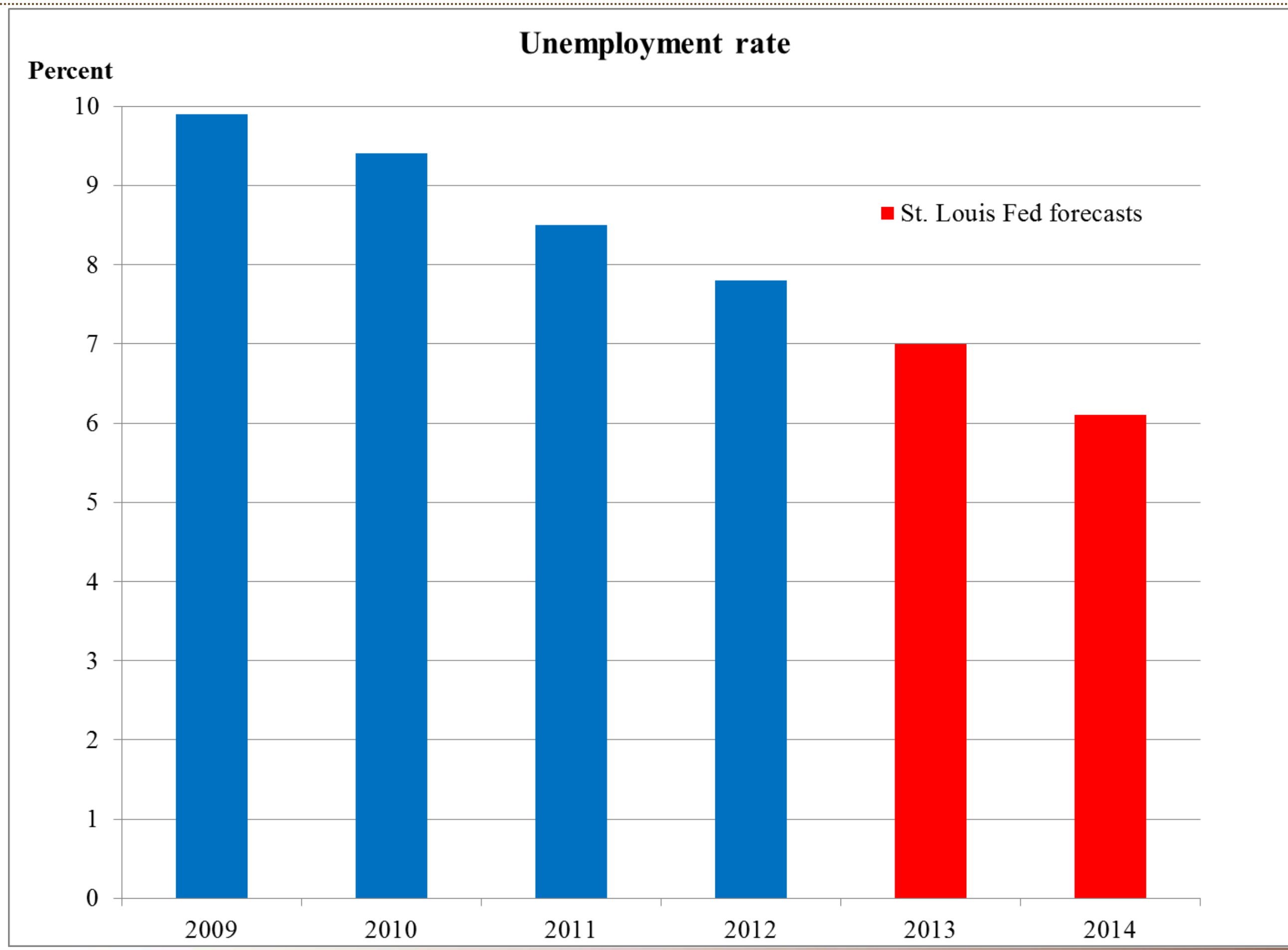
Source: Bureau of Economic Analysis and Federal Reserve Bank of St. Louis. Last observation: 2011.

Inflation



Source: Bureau of Economic Analysis and Federal Reserve Bank of St. Louis. Last observation: 2011.

Unemployment



Source: Bureau of Labor Statistics and Federal Reserve Bank of St. Louis. Last observation: December 2012.

Unemployment continues to improve

- I project a continuing downward trend in unemployment.

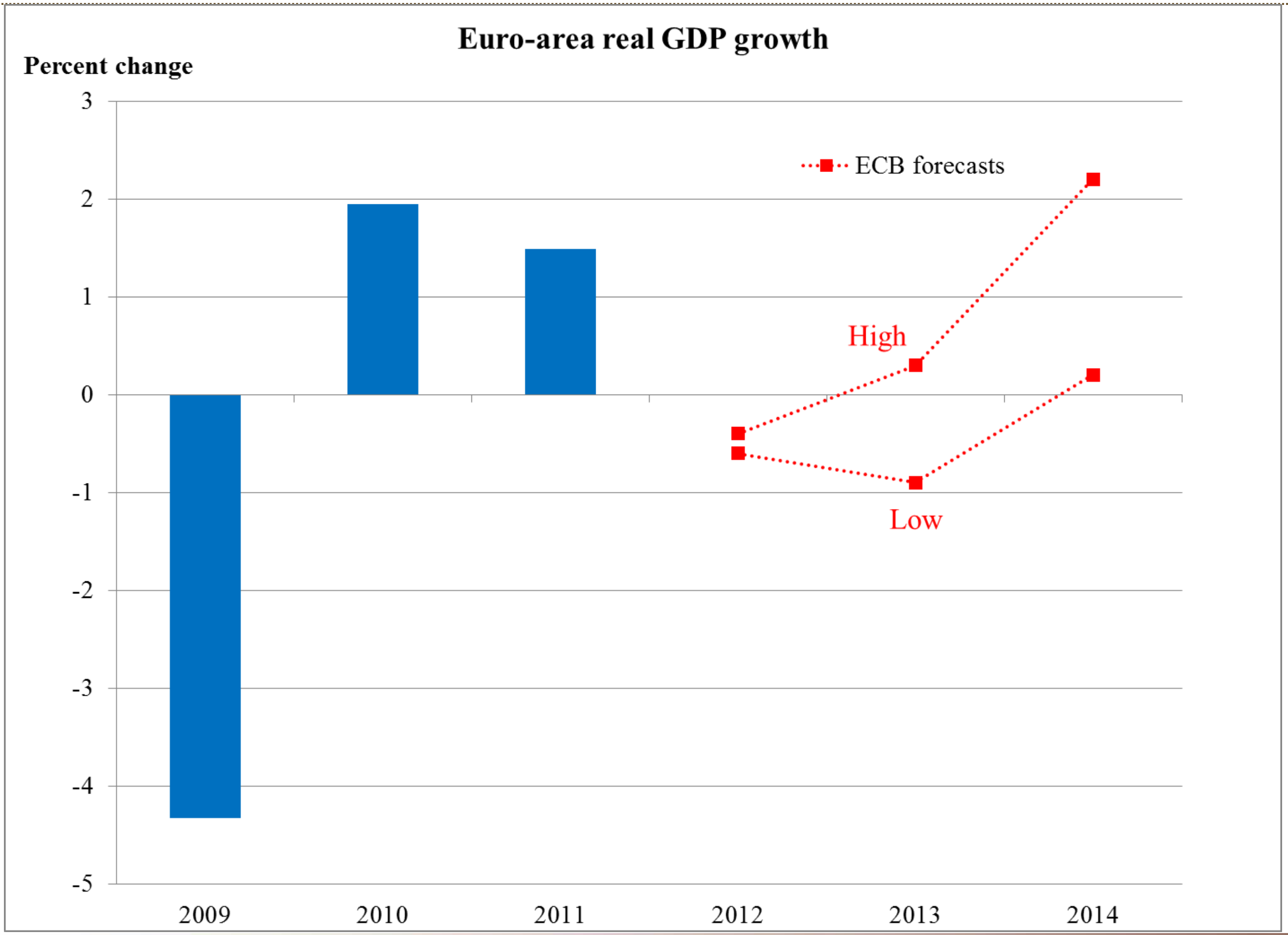
- Unemployment has improved over the last three years despite sluggish GDP growth.
  - I forecast somewhat faster growth in the next two years.

- I do not think unemployment has yet fallen enough to entice those that have left the labor market to re-enter.

Reduced headwinds and reduced uncertainty

- The U.S. housing market has improved during 2012 and I expect this will continue in 2013.
- Some aspects of the U.S. fiscal situation have been addressed and I expect more to come.
- Growth in emerging markets will likely improve in 2013 relative to 2012.
- The sovereign debt crisis in Europe has recently been less disruptive for global financial markets.
  - Euro-area growth will probably not deteriorate the way it did in 2012.

Euro-area growth

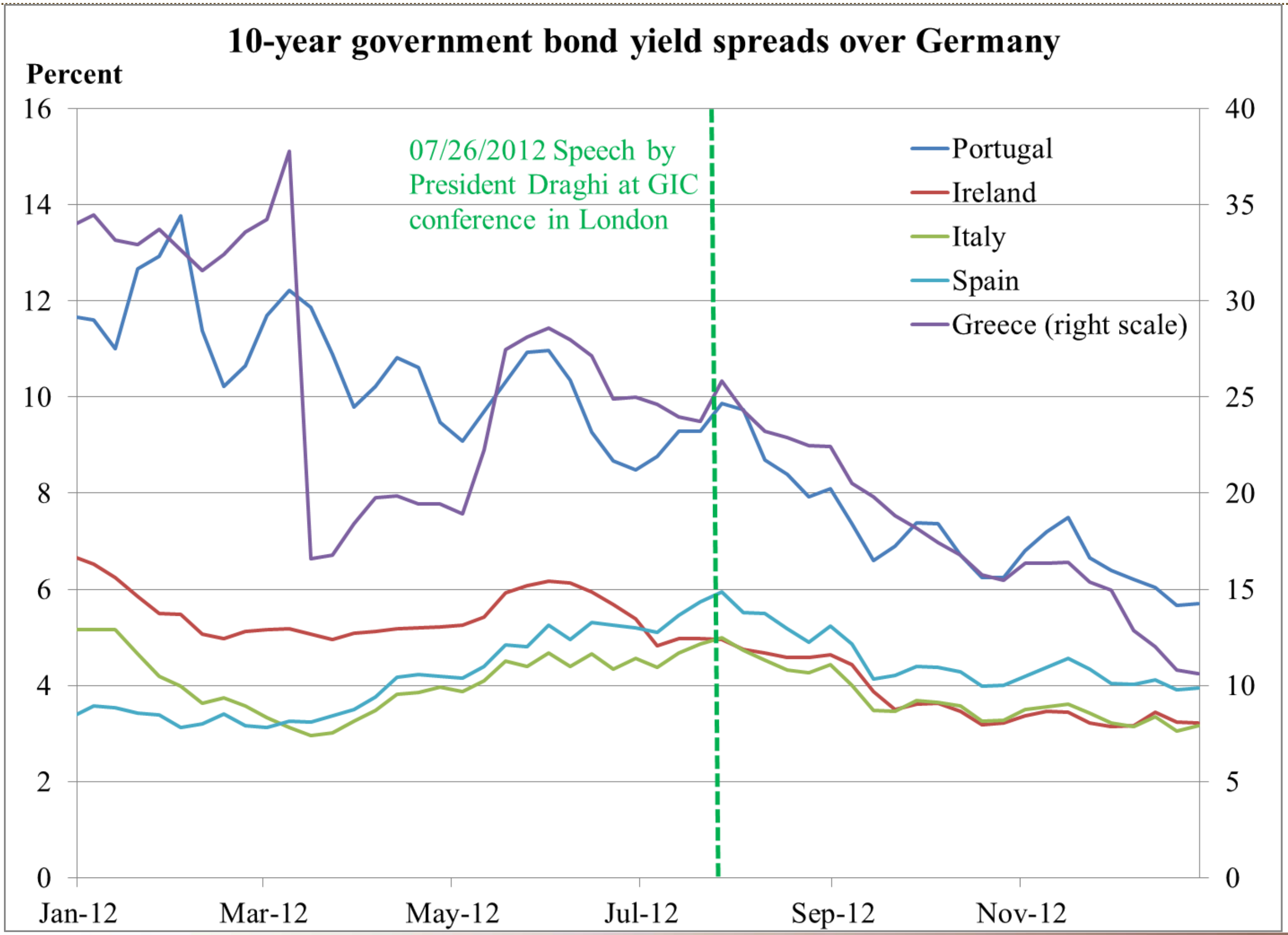


Source: European Central Bank, Monthly Bulletin December 2012. Last observation: 2011.

Key issue: The European sovereign debt crisis

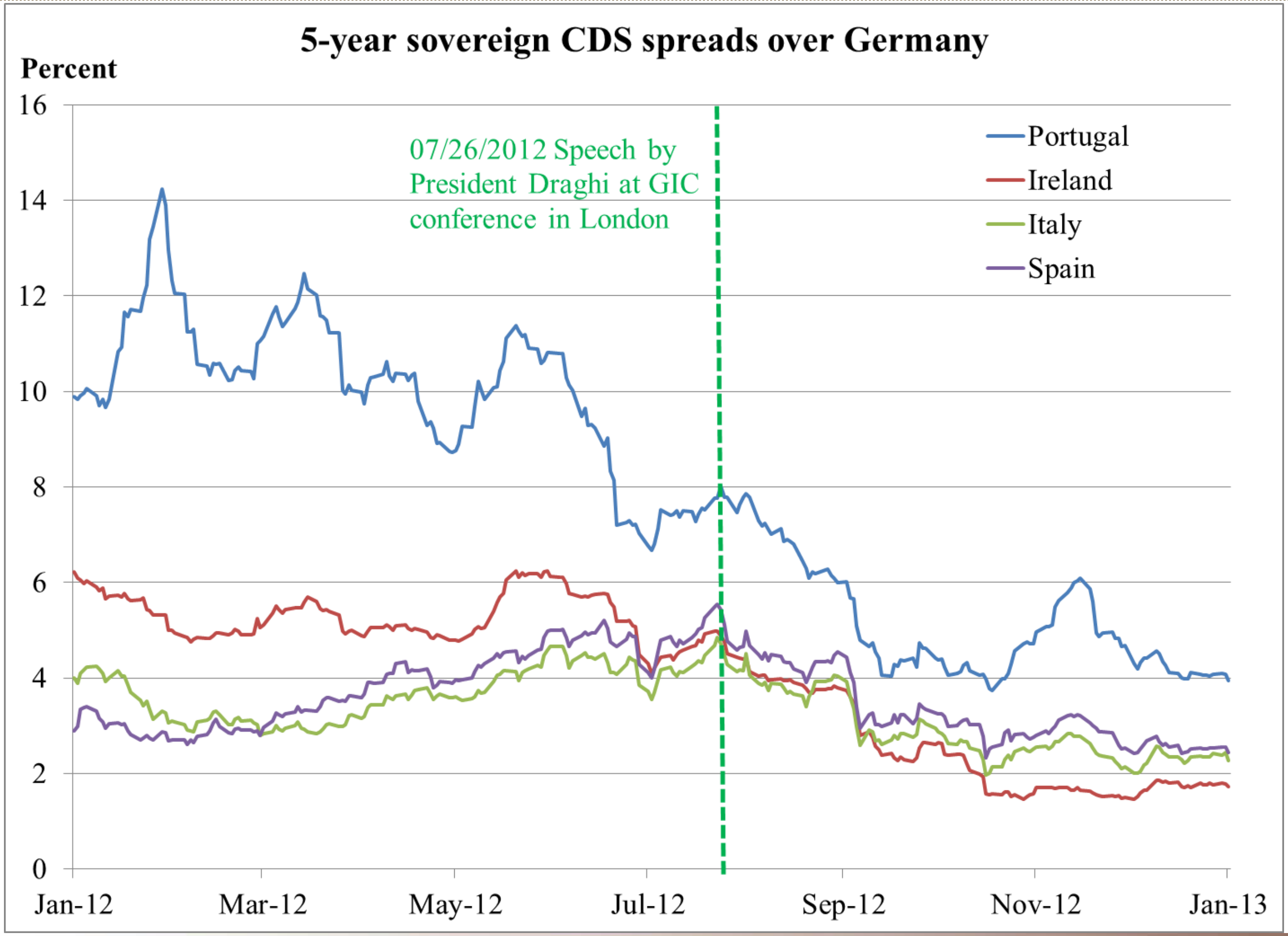
- The announcement of the ECB's "outright monetary transactions" program has so far been more successful than it might have been anticipated.
- The ECB has so far not been required to purchase national sovereign debt under the program.
- How the program will proceed during 2013 is difficult to predict.

Euro-area 10-year bond spreads



Source: Financial Times and author's calculations. Last observation: week of December 28, 2012.

Euro area 5-year sovereign CDS spreads



Source: Bloomberg and author's calculations. Last observation: January 2, 2013.

Conclusions

Summary

- Overall, U.S. monetary policy looks more accommodative today compared to six months ago.
- This may combine with reduced headwinds and reduced uncertainty in the U.S. to produce a better growth environment during 2013.
- In 2011 and 2012, this type of forecast proved overly optimistic.
  - However, I still think it is the right way to view the situation given the information available today.
- One wild card continues to be the European economy.

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