The Fed’s New Regime and the 2013 Outlook

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Any opinions expressed here are my own and do not necessarily reflect those of others on the Federal Open Market Committee.
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?
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 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

St. Louis Fed Financial Stress Index

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
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

Inflation

Unemployment

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

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

Euro area 5-year sovereign CDS spreads

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.