Fiscal Uncertainty, Monetary Policy, and the Economic Outlook

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Key points

- Atlanta Fed President and CEO Dennis Lockhart speaks to the Atlanta Rotary Club about the effects of fiscal policy uncertainty on the U.S. economic outlook.
- Lockhart: Last year, Congress and the administration deferred decisions on U.S. fiscal imbalances. Meanwhile, these imbalances have continued to build and to hinder a robust recovery, as have the damaging effects of budget crisis after budget crisis.
- In December, the Federal Open Market Committee decided to continue open-ended purchases of longer-term Treasuries, an action designed to put downward pressure on long-term interest rates. But, Lockhart says, “open ended” does not mean “without bound.”
- Lockhart notes that we are beginning this year in a mode of slow growth, hovering around 2 percent, which compares unfavorably with past recoveries. Still, depending on how fiscal policy deliberations go this year, there may be an upside to the outlook. Atlanta Fed business contacts believe there is some pent-up demand among businesses and consumers, which could be unleashed with removal of fiscal uncertainties.
- Lockhart believes 2013 is a pivotal year. Fiscal policy uncertainty is part of what is keeping businesses and consumers “on the sidelines.” If fiscal policymakers successfully address the remaining issues and provide a multiyear roadmap toward fiscal health, these actions would help reduce the uncertainty that has been holding back the economy.

I am delighted to provide my first official remarks of the new year here at the Rotary Club of Atlanta.

I see 2013 as a pivotal year for national economic policy.

Fiscal policy decisions were subordinated last year to the November elections. Congress and the administration deferred action on many of the stickiest fiscal questions, including the most basic question of how and when the federal government will take steps toward long-run budget sustainability. Electoral considerations gave fiscal authorities something of a pass for the year.

I doubt that any such passes will be issued in 2013. Our fiscal imbalances are still building, as are the damaging effects of moving from one short-term budget crisis to another. Lawmakers have a short period of time before the political cycle associated with the midterm elections kicks in. These realities lend a “now-or-never” dimension to the year ahead.

Fiscal uncertainties have challenged the Federal Reserve just as they have challenged all private decision makers. The Fed has done a great deal to date to promote recovery, but the ongoing effectiveness of Fed efforts does depend critically on the removal of fiscal policy uncertainty. In addition, consumer and business confidence—factors that have great influence on the direction of the economy—may swing on how these policy concerns play out.

If 2013 is a pivotal year for fiscal authorities to deliver clarity on future policy, it is by extension a pivotal year for the course of monetary policy. In my remarks today, I’ll lay out my sense of the economic context in which critical policy choices will be made. I’ll begin by briefly reviewing how economic conditions evolved in 2012. I’ll summarize where I think the economy stands at this moment, the beginning of 2013. And I’ll present my outlook for the year ahead.

I will also detail the moving parts of the Federal Reserve’s monetary policy and try to clarify aspects that may not be well understood.

As always, my comments are my personal views and may not reflect those of my colleagues in the Federal Reserve System or on the Federal Open Market Committee (FOMC).

State of the economy and outlook

First, let’s briefly look at what happened in 2012. The economy grew slowly as it continued to struggle with various restraints on growth. These restraining forces kept overall economic activity subdued with the result that employment expanded only very gradually. For 2012, real GDP growth is expected to come in at around 1.8 percent when finally totaled. Nearly four years after the end of the Great Recession, the pace of recovery remains sluggish.

Perhaps the most potent restraint on growth was wariness born of uncertainty. The uncertainty factor presents analytical challenges. Businesses (and for that matter consumers) always face risk. There’s always risk in making a decision to invest, expand operations, or hire another employee. Businesses try to manage risk, but uncertainty, if severe, paralyzes businesses. The distinction between risk and uncertainty is like guessing the outcome of a bet based on a coin toss versus guessing the outcome of a bet when you don’t know the rules and have no idea how a winner will be determined.

In 2012, an array of uncertainties rendered both consumers and businesses quite cautious about spending. The uncertainties that most weighed on economic actors related to the outcome of the elections, fiscal issues here at home, the cost of health care, regulatory rules, and the European sovereign debt crisis. Two severe storms, obviously unanticipated, also set back the economy in certain regions of the country.

The question is whether we’ve been facing degrees of uncertainty materially more confounding than in whatever you think of as normal times. Recent attempts to measure comparative uncertainty conditions over time suggest the answer is yes. And I heard over the past year a lot of comments by business people to the effect that they were
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and financial stability. Also, depending on the interplay between the eventual shrinking of the balance sheet and the path of interest rates, the Federal Reserve's net income could be impacted.

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My view is that purchasing longer-term Treasury and mortgage-backed securities helps housing markets in particular. At the same time, the benefits of indefinite purchases are debatable, and it's been argued that the potential costs could rise as the size of the balance sheet increases. Let me explain what I mean by "costs."

There is a risk, given the Fed's cumulative share of the Treasury and MBS markets, that at some point securities purchases could have adverse effects on market functioning and financial stability. Also, depending on the interplay between the eventual shrinking of the balance sheet and the path of interest rates, the Federal Reserve's net income and its remittances to the Treasury could be significantly affected during the period of policy normalization.
Furthermore, the accumulating purchases of bonds could complicate the FOMC's efforts to withdraw monetary stimulus when the appropriate time comes. We have tested tools for exit, but it will be uncharted territory.

As my second point, let me make clear that expansionary monetary policy based on bond purchases does not increase the fiscal deficit or the federal debt.

The liabilities of the central bank do not add to the national debt that must be serviced by tax receipts.

And, virtually all of the income the Fed earns from the securities it buys is remitted to the U.S. Treasury, which means these earnings are used to reduce the fiscal deficit.

Such an asset purchase program is designed to strengthen economic activity and reduce joblessness. This should add to government tax revenue and reduce the burden of spending on extended unemployment and other social benefit programs.

It's been argued that the Fed policy of keeping interest rates low makes it easier for Congress to kick the can down the road. Well, this critique can be applied to every expansionary monetary action. An easier monetary policy necessarily lowers the cost of borrowing to the government. We simply cannot use our policies to stimulate economic activity and be neutral regarding the cost of funds to the Treasury. Monetary policy is certainly not formulated with the intent to influence fiscal deliberations and outcomes. The monetary policy decisions of the FOMC are directed by law to promote the goals of maximum employment and stable prices.

Open-ended purchases and forward guidance

My third point is that "open ended" does not mean "without bound." The program is not "QE Infinity." There appears to have been some confusion about this.

In determining how long the purchase programs should continue, the FOMC has indicated that it intends to assess labor market developments on the one hand and review the program's efficacy and costs on the other.

For now, I think the open-ended nature of the asset-purchase programs is called for because the outlook for the pace of improvement in the labor market and the broader economy remains unclear. From this juncture, with so many unknowns, quite divergent economic scenarios are plausible. In these circumstances, it would not be prudent to commit up front to a specific size, pace, and mix of asset purchases.

In December, the FOMC also adjusted its so-called forward guidance on how long it expects short-term interest rates to remain near zero.

Specifically, the FOMC announced that it anticipates the federal funds rate will remain near zero as long as the unemployment rate exceeds 6 1/2 percent and as long as projected inflation one to two years out does not exceed the Fed's long-run 2 percent inflation goal by more than one-half percent. I want to stress that these are thresholds, not triggers.

Previously, the guidance on how long interest rates would remain near zero was expressed in terms of a date, specifically mid-2015. The 6 1/2 percent threshold is fully consistent with the FOMC's earlier guidance of interest rate "liftoff" in mid-2015. The majority of the Committee still believes that the "liftoff" date for the FOMC's policy rate will be in 2015 or later.

The 6 1/2 percent unemployment threshold—conditional on inflation being contained—was introduced to make it easier for people to assess how policy might evolve along with economic conditions. It was not intended to signal any fundamental change in policy. Equally important, the 6 1/2 percent unemployment rate threshold does not apply to the FOMC's asset purchase programs. The asset purchase programs are designed to provide a boost to the economy, to put "wind in the sails" of economic recovery. For me, the decision to continue with these programs will be based on the ongoing assessments of benefits and costs, as I mentioned earlier.

Close

How fast might the economy reach the 6 1/2 percent threshold? To get some idea, consider that the average pace of job gains over the past six months has been 160,000 a month. And suppose that this pace is sustained going forward and that labor force participation remains at the current level of 63.6 percent. Using a tool we've developed at the Atlanta Fed—the Jobs Calculator—it is straightforward to compute that it would take almost three years to reach an unemployment rate of 6 1/2 percent.

It's obvious that the faster the average pace of job creation, the sooner the 6 1/2 percent will be reached. For example, job gains of 184,000 a month implies about two years to reach 6 1/2 percent. But it takes job creation averaging 262,000 a month to shorten the time period to around one year.

Clearly, a lot is riding on the pace of job creation. And to a substantial extent, the pace of job creation is riding on reducing uncertainty, especially policy uncertainty. The coming months will be, in my opinion, something of a moment of truth for fiscal policymaking. The year 2013 will be a test of the country's ability to govern itself in the realm of public finances.

Monetary policy has done a lot to move the country to this juncture. Monetary policy actions over the past four years have fostered faster growth than we otherwise would have experienced. Without these policy actions, growth of GDP and jobs would have been lower, in my opinion. The tools of monetary policy remain at work in support of continued recovery and an acceleration of growth and hiring. But monetary policy simply cannot offset the effects of failing to resolve today's fiscal crisis.

That is why 2013 is a pivotal year. I had a boss once who, bless his heart, was a classic hard-charging, action-oriented type A. He ran us ragged, but he got results. He had a plaque on his desk that read "Get the spectators off the field." I'll rework that idea. Fiscal policy uncertainty is part of what is keeping businesses and consumers "on the sidelines." If our fiscal policymakers can successfully address the remaining issues and provide a multiyear roadmap toward fiscal health, I believe those actions would go a long way toward reducing the uncertainty that has been holding back the economy and get spectators off the sidelines and onto the field.

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