SPEECHES

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 longer-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, those 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

(and remain) very reluctant to step out and expand aggressively.

This was especially the case in the final weeks of the year, starting just after the election, when anxiety about the fiscal cliff no doubt had a damping effect on activity in spite of some encouraging developments in the course of the year.

Some good things *did* happen last year. There were a number of positive signs in the economy from which we can take heart, I think, as we enter 2013. For example:

The housing market appeared to stabilize and begin a recovery as measured by home sales, house prices, and, to some extent, construction activity. The bleeding stopped.
The energy industry was vibrant in both exploration and production.
The auto industry, important in the Southeast, continued to record strong and rising sales.

That said, at a macro level, the national unemployment rate changed little during the first half of 2012. From January through July, the unemployment rate hung between 8.1 percent and 8.3 percent. By September, the rate had fallen to 7.8 percent, where it remains today.

The overall employment situation continues to be a major concern. Despite pretty steady job creation since 2010, unemployment remains far too high. About 40 percent of the people who are out of work have been so for six months or more, and many people who desire full-time work are still working part time. Participation—that is, participation in the labor force—has been falling over recent years and is very close to the lowest rate on record since 1980. Unemployment, underemployment, and abandonment of efforts to find a job, taken together, present a sobering picture for policymakers.

At the same time, inflation stayed somewhat below the FOMC's 2 percent target for a good part of the year. We saw a slight uptick in inflation numbers during the first quarter of 2012, mostly due to higher energy prices, followed by numbers below 2 percent later in the year.

In brief, the story of 2012 was one of moderate growth with occasional, short-lived periods of acceleration off that trend. That's been the case, for the most part, since the recession ended in the summer of 2009.

So we begin the year in a mode of slow overall growth, tolerable inflation, and gradual progress on unemployment.

One of the ways we "do" economics at the Atlanta Fed is to step back and try to discern the basic trend lines of the economy looking through the month-to-month up-and-down movements of the data. We try to frame a basic narrative for the evolution of the economy. When the incoming data and other indicators seem to diverge consistently and materially from this narrative, we rethink our explanation of what's happening.

Over the last months our narrative has not changed much. The continuing theme is slow growth hovering around 2 percent. This rate of growth compares unfavorably with past recoveries. We remain in a long slog.

For 2013, we at the Atlanta Fed are expecting GDP growth in the range of 2 to 2 1/2 percent—basically more of the same.

However, there may be some upside depending on how fiscal policy deliberations go. A number of our business contacts across the Southeast believe that there is some amount of pent-up demand on the part of businesses and consumers resulting from deferred spending and that this demand could be unleashed with removal of fiscal uncertainties. I want to believe this is realistic.

The FOMC's asset purchase programs
Now let me turn to a discussion of monetary policy as an element of the effort to promote economic recovery.

The FOMC has held its policy rate—the federal funds rate—at a range of zero to 25 basis points since December 2008. That's a little over four years now.

As you know, the Fed has also applied additional monetary stimulus through use of what might be called balance sheet tools.

In September, the FOMC decided to increase its support for housing market recovery and began an open-ended program of purchases of agency mortgage-backed securities at a pace of $40 billion per month.

At its December meeting, the FOMC decided to continue purchasing longer-term Treasury securities at a pace of $45 billion per month. You may know this program by the commonly used term quantitative easing. It is also open ended.

In continuing these purchases, the Fed replaced what we called the maturity extension program, or the so-called "Operation Twist," with outright purchases of the longer-term Treasuries. Operation Twist involved simultaneous purchases of long-term Treasuries and sales of short-term Treasuries. We stopped because we effectively exhausted our stock of short-term Treasuries.

I'd like to make three points about these policy actions. First, the December action shouldn't be viewed as new, additional stimulus, but rather as a continuation of an already-in-force policy designed to put downward pressure on longer-term interest rates. The difference between Operation Twist and the open-ended purchase program is that the latter expands the size of the Fed's balance sheet, while the former did not. I do not view this distinction as important in its economic effects, but I do think the growth of the Fed's balance sheet could have longer-term consequences that are worrisome. While I've supported these policy decisions to date, I acknowledge legitimate concerns.

My view is that purchasing longer-term Treasury and mortgage-backed securities *has* likely put some downward pressure on longer-term interest rates broadly and has helped 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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