Economic and Policy Environment

Atlanta Economics Club Luncheon

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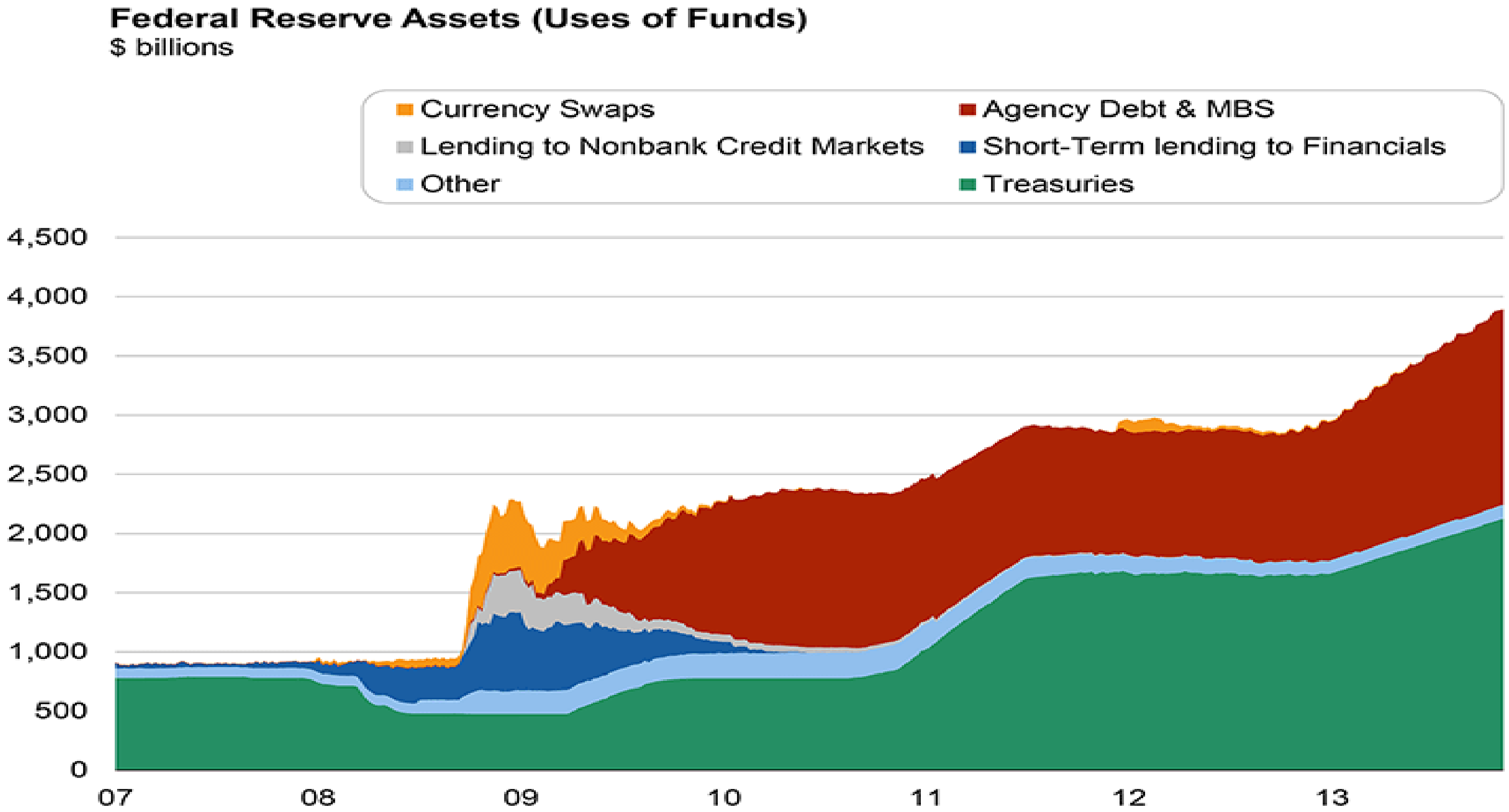
November 21, 2013

So here’s what the FOMC said following the October FOMC meeting: “Quantitative easing” continues until they have confirming evidence of sustainable improvement in the labor market and inflation firming in the direction of 2%.

…the Committee decided to continue purchasing additional agency mortgage-backed securities at a pace of $40 billion per month and longer-term Treasury securities at a pace of $45 billion per month...In judging when to moderate the pace of asset purchases, the Committee will, at its coming meetings, assess whether incoming information continues to support the Committee's expectation of ongoing improvement in labor market conditions and inflation moving back toward its longer-run objective.

FOMC statement, October 30, 2013

At this pace, the balance sheet of the Federal Reserve will soon top $4 trillion.



Source: Federal Reserve Board of Governors; Table 1: Factors Affecting Balances of Depository Institutions of the H.4.1 release.

through November 06, 2013

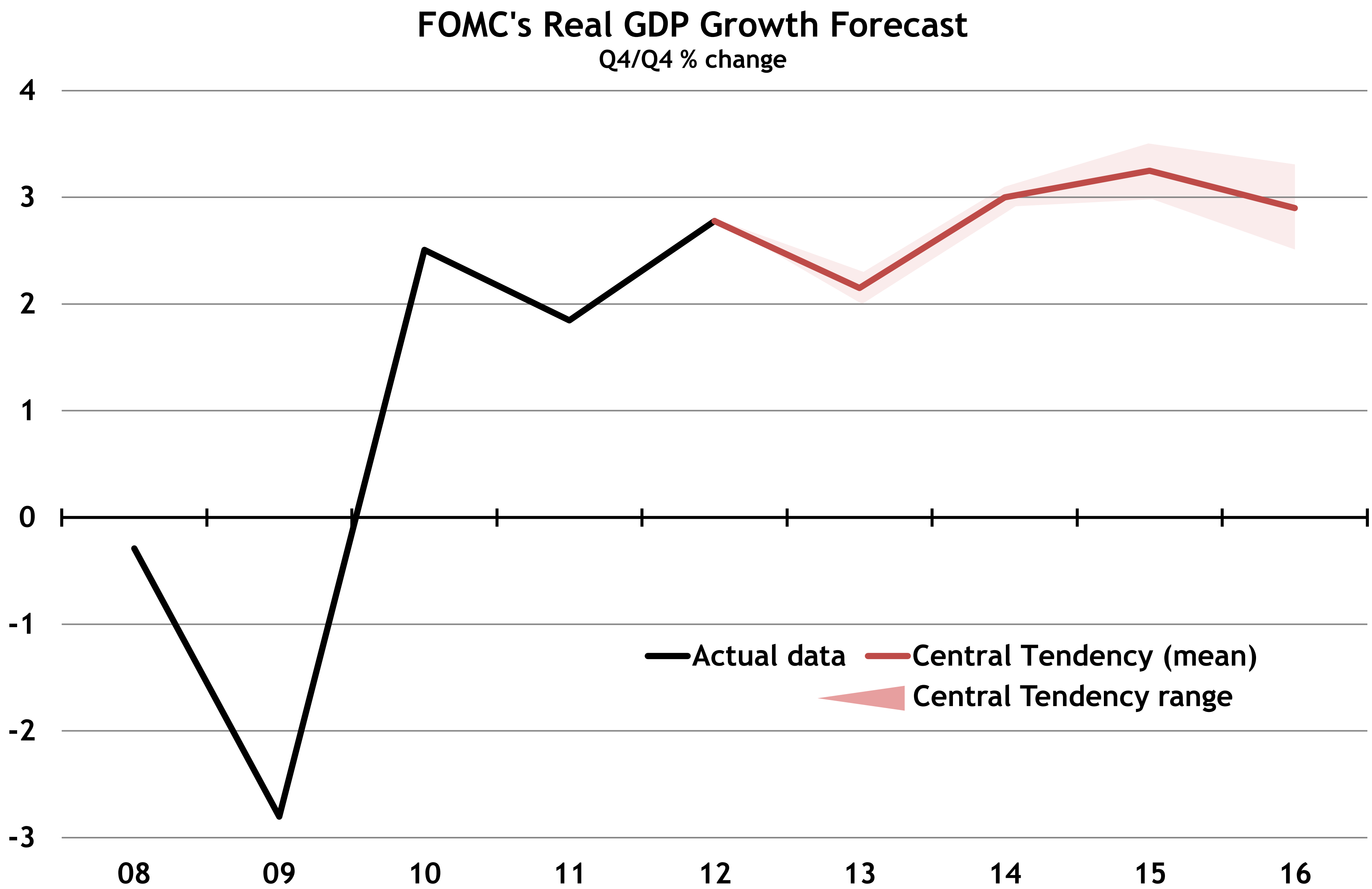
Note: "Other" = Other assets, Float, Gold Stock, SDRs, Currency outstanding, Holdings of Maiden Lane I, II, III and Foreign Currency Assets.

What is your real GDP growth expectation for 2014?

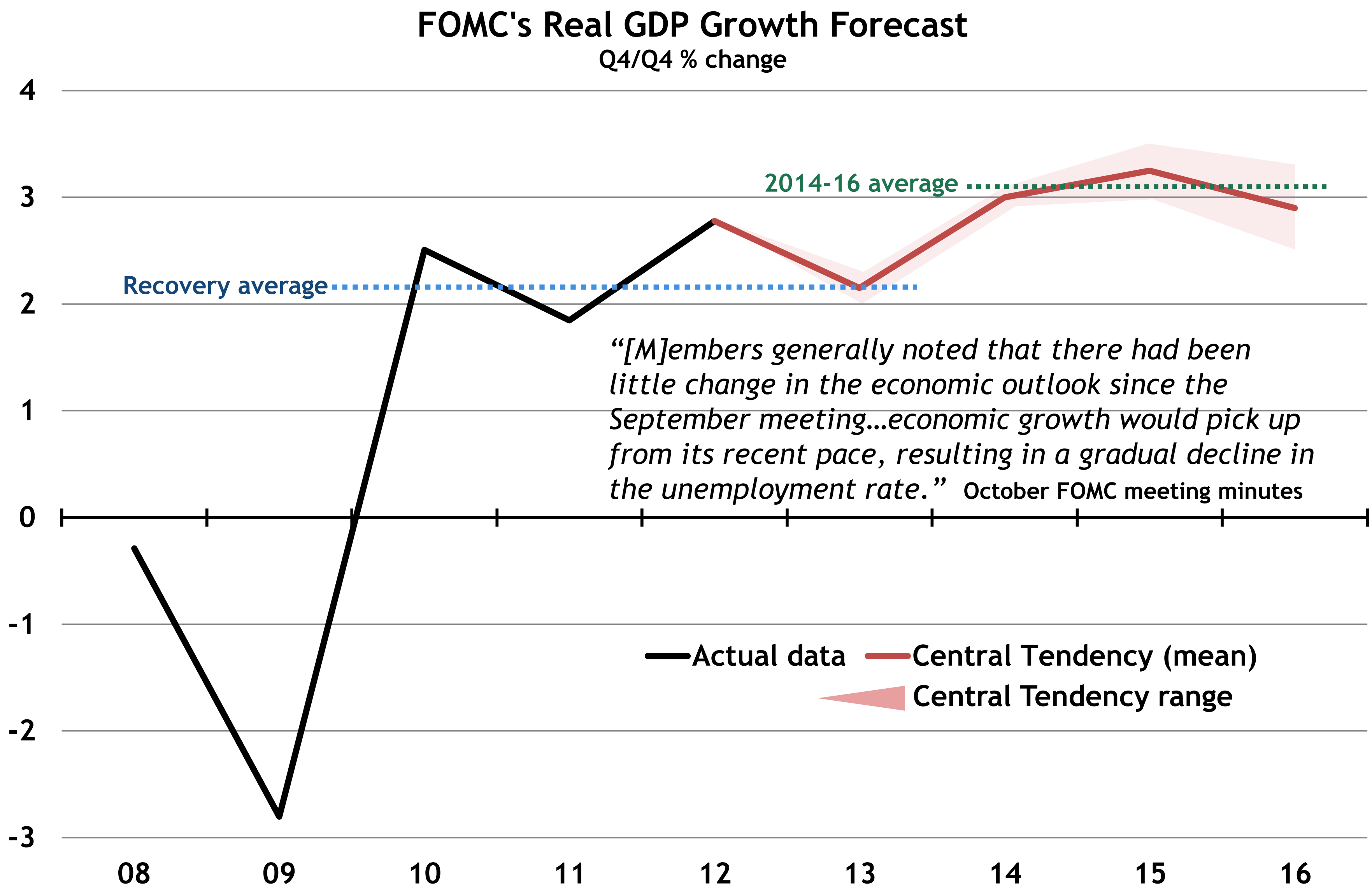
I see growth over in 2014 (Q4 to Q4)…

a. Less than 2% (we've already seen the best)
b. About 2% (recovery average)
c. About 3% (return to historical normal)
d. More than 3% (return to *recovery* normal)

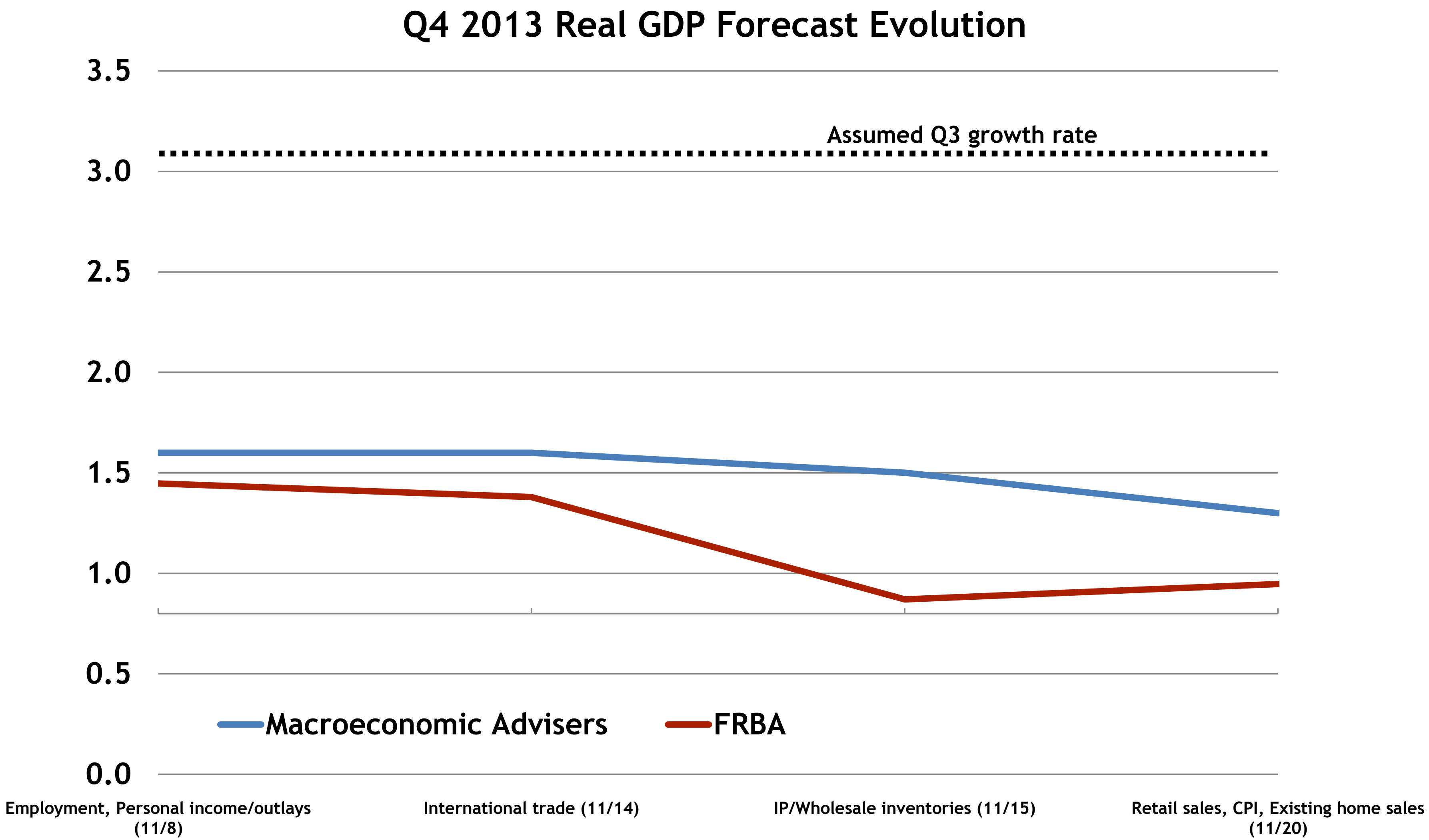
At the September FOMC meeting, the "consensus" forecast of the Committee put growth this year at just a shade above 2%--virtually identical to the recovery average growth rate. The FOMC's central tendency projection showed real GDP growth accelerating to around 3% next year and slightly better in 2015. The Atlanta Fed was at the low end of this central tendency.



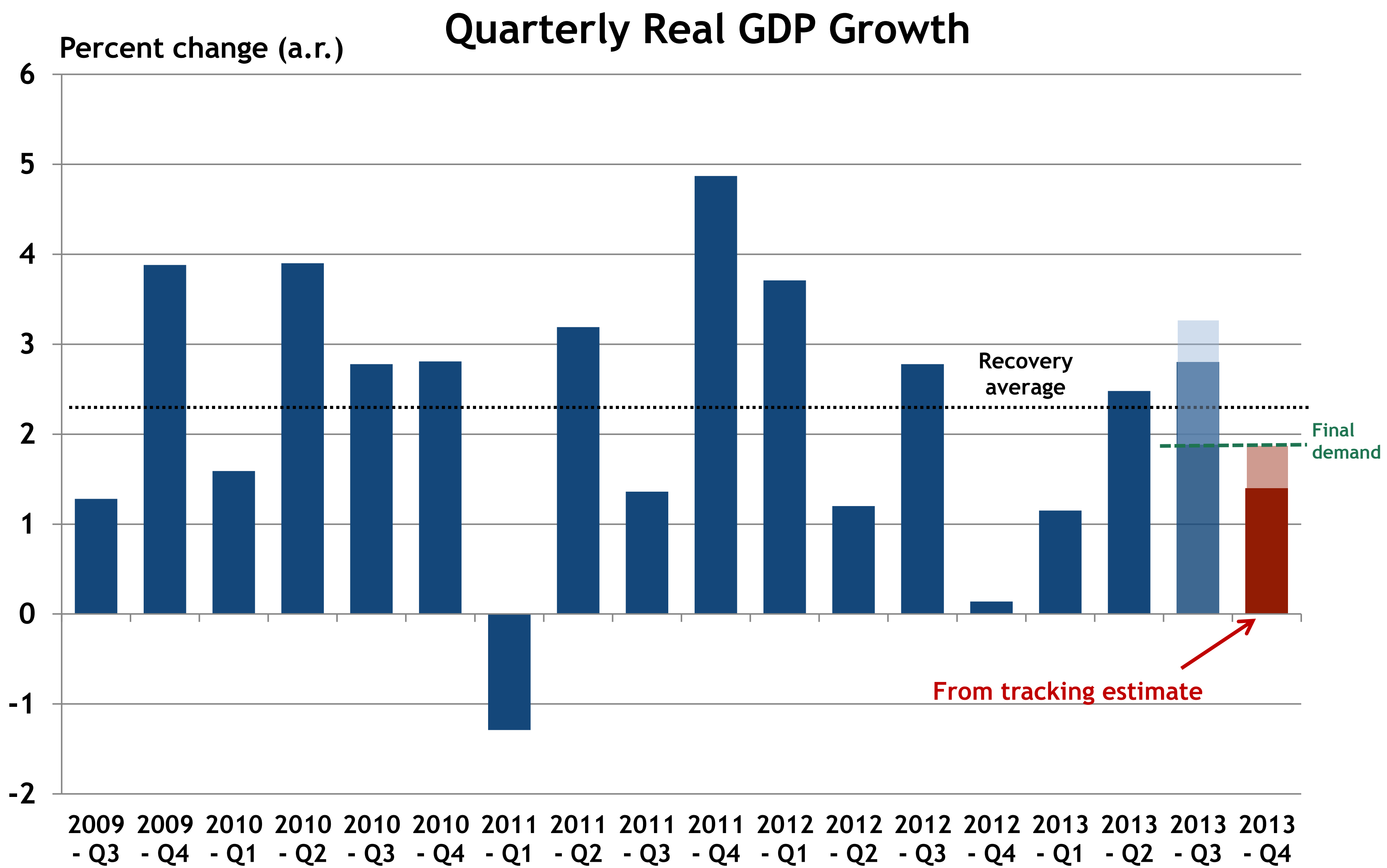
Nothing much changed regarding the outlook at the October FOMC meeting. Growth is still expected to accelerate as we move toward 2014 and beyond.



So far, the data haven't been very supportive of that view. FRBA's "data-driven" tracking estimate currently puts Q4 growth at 0.9 percent (a.r.), somewhat below MA's 1.3 percent. The upward revision to Q3 wholesale inventories decreased both Q4 GDP tracking estimates

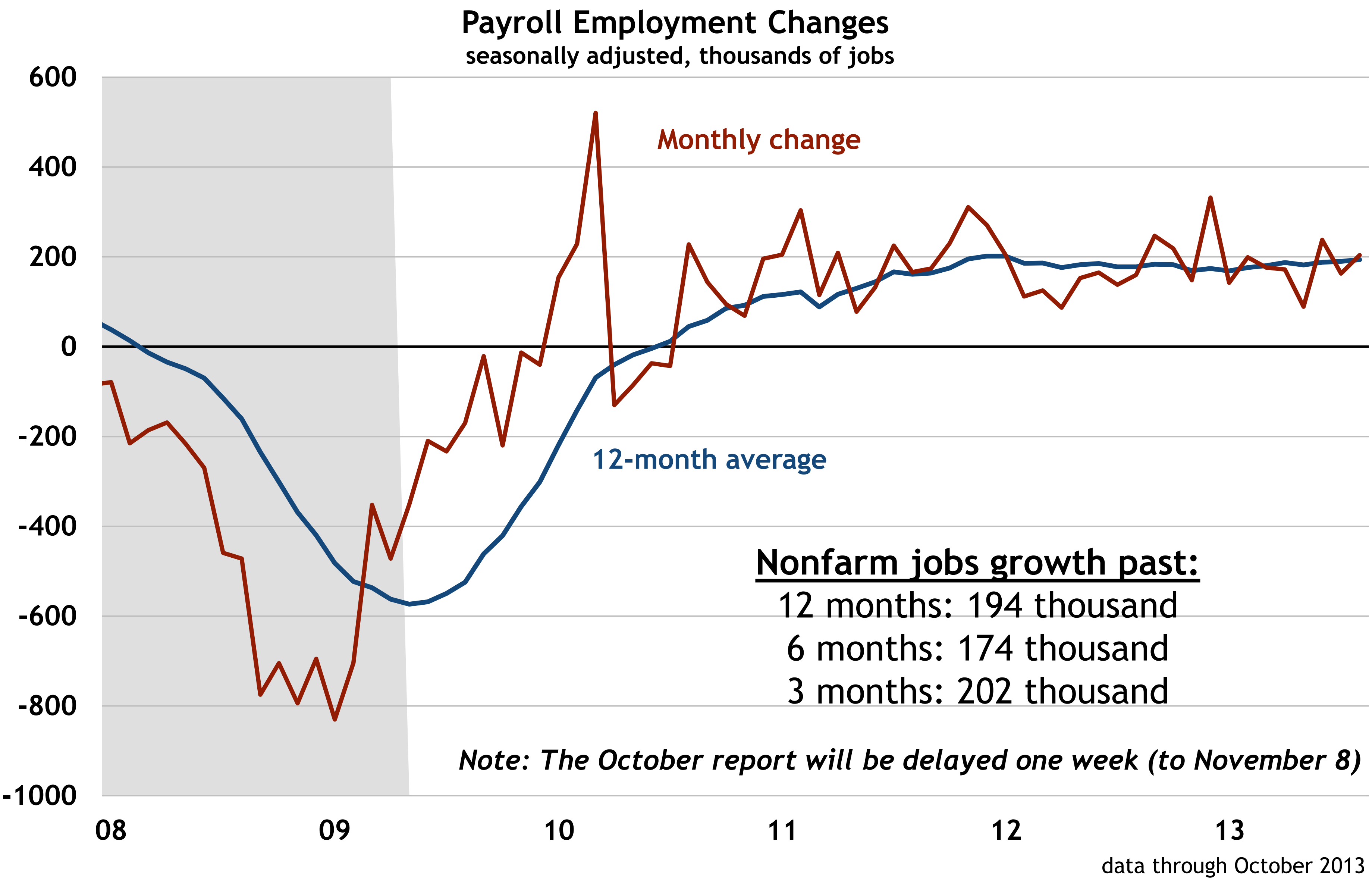


So what happens when you add up all the data? Our “tracking estimate” of the incoming data? It’s likely Q3 will be revised upward, but this strength appears to be heavily influenced by inventories. What do we make of that inventory swing?



Source: Bureau of Economic Analysis; FRBA

Labor markets are still improving with a steady, though not very spectacular pace of jobs growth. Still, it appears strong enough to constitute a gradual continuation of the trek toward full employment.



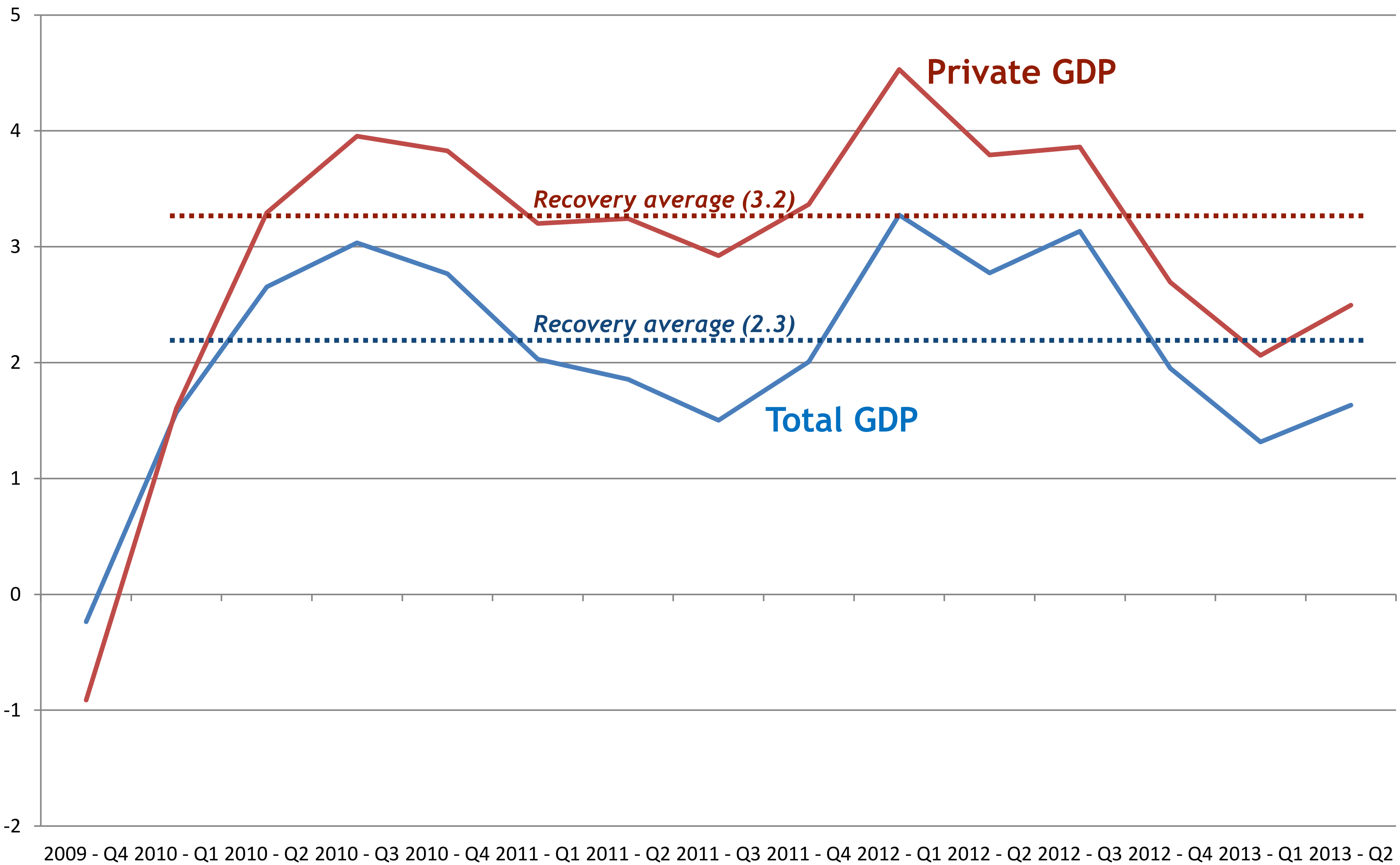
Source: Bureau of Labor Statistics

Why the optimism about the growth acceleration? Two things (I say). First, history says this must happen. Second, we've been working through headwinds that appear to be dissapating some.

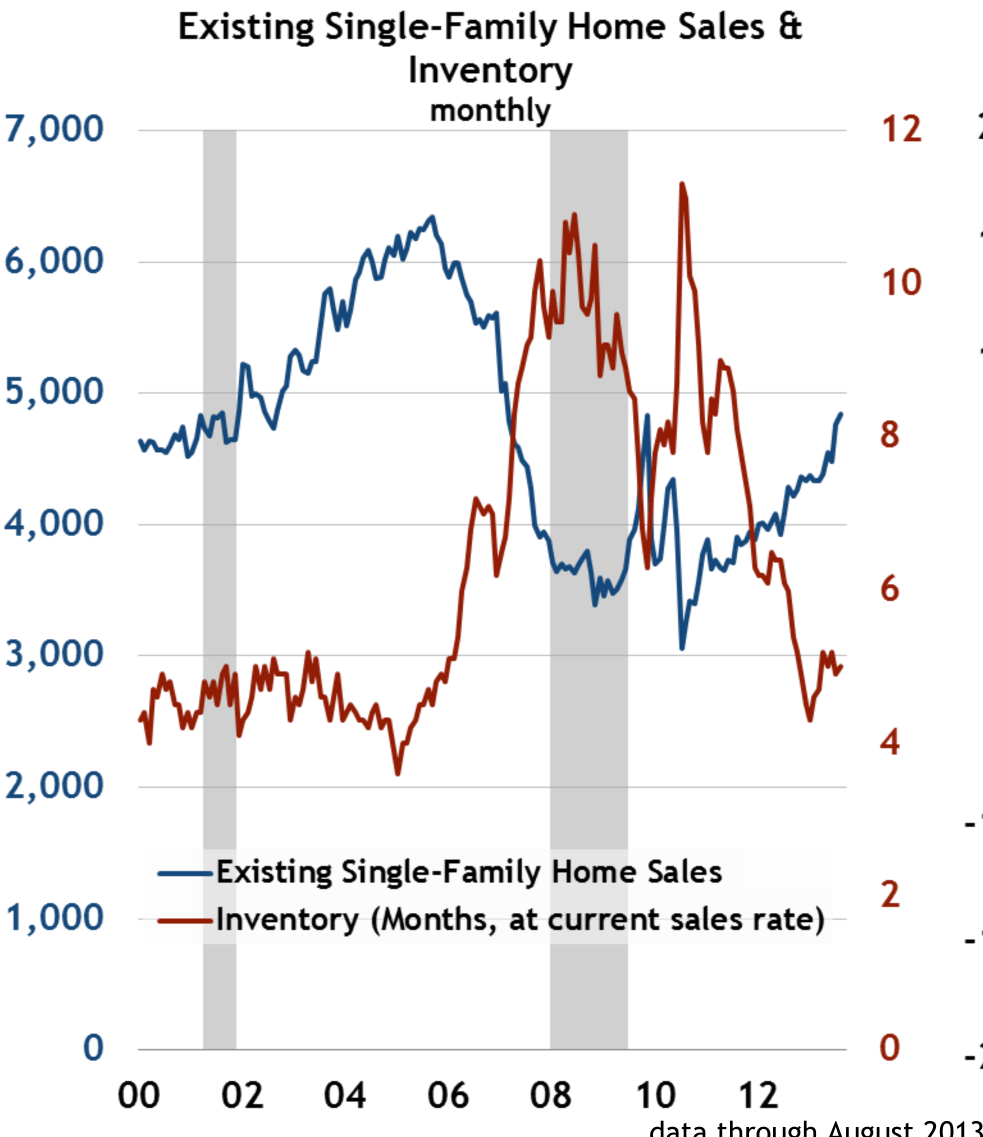
Taking into account the extent of federal fiscal retrenchment over the past year, the Committee sees the improvement in economic activity and labor market conditions since it began its asset purchase program as consistent with growing underlying strength in the broader economy. However, the Committee decided to await more evidence that progress will be sustained before adjusting the pace of its purchases.

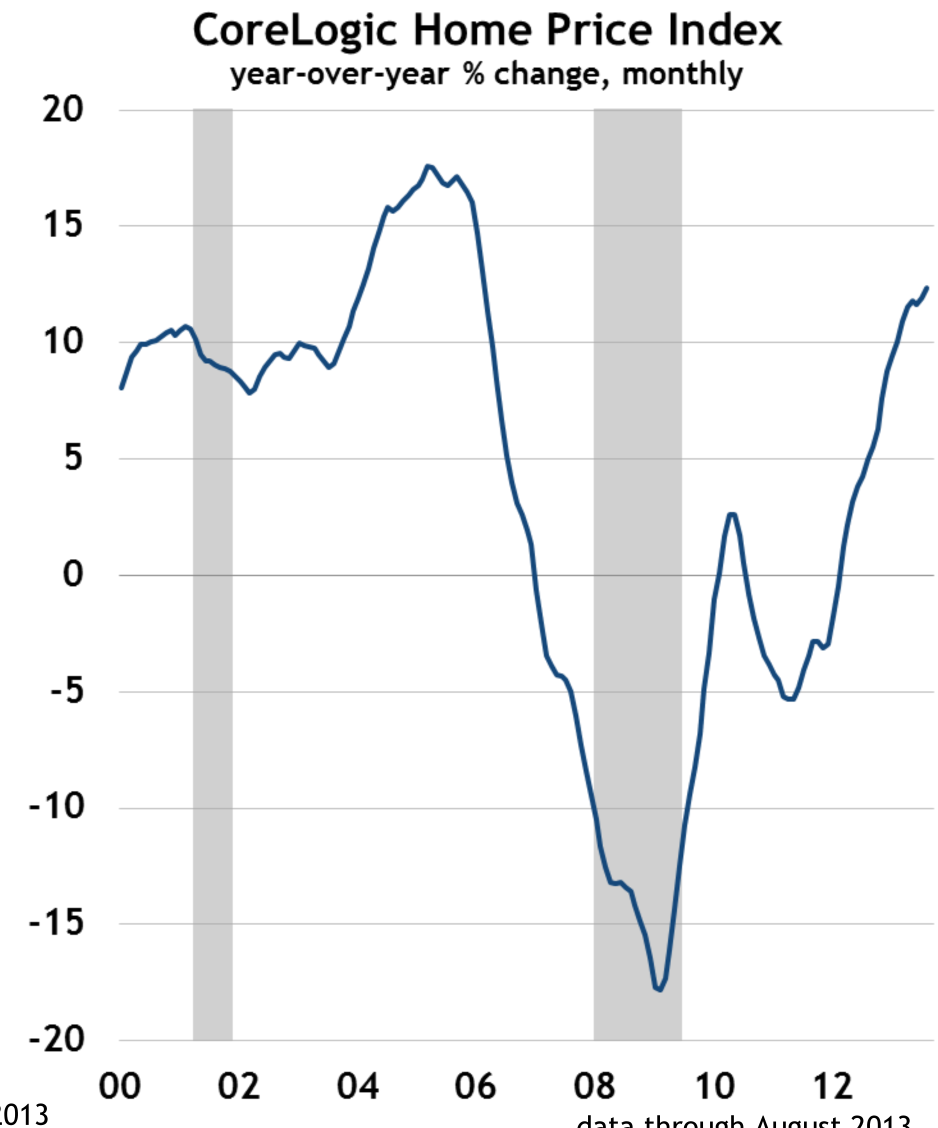
FOMC statement, October 30, 2013

Indeed, if we discount the spending cuts occurring in the government sector, resulting "private" GDP growth is ½ to 1 percentage point stronger. But should we discount the government spending cuts?



Want some good news? Housing is still (mostly) hot. The single-family home market showed continued strength in August. Home prices are up about 12 percent on a year-to-year basis.





Sources: National Association of Realtors; CoreLogic

How certain are you of your growth prediction?

I would say I am 90 percent confident that real growth next year will be somewhere in the range of…

a. 2 to 3 percent
b. 1 to 4 percent
c. 0 to 5 percent
d. -1 to 6 percent
e. None of the above

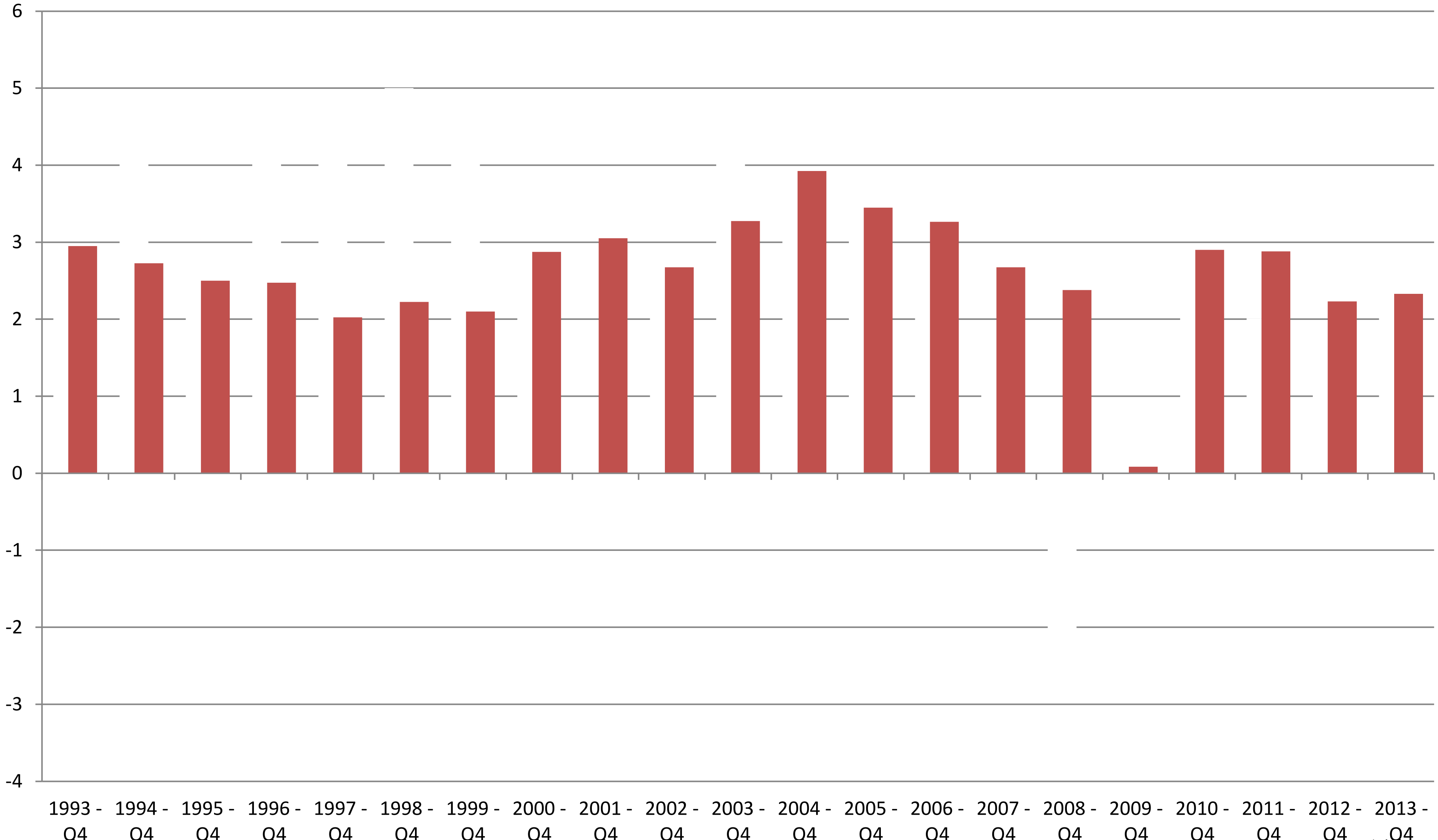
Don’t Ever Trust Someone who tells you they can see the future

The Fortune Teller (De La Tour)

Don’t Ever Trust Someone who tells you they can see the future

The Fortune Teller (De La Tour)

Let's check the track record of economic forecasters. Here is what they said would happen to the economy one year ahead.



Source: Bryan and Molloy (2007)

And here is how it turned out.

RMSE of a one-year ahead forecast is about 1.7%

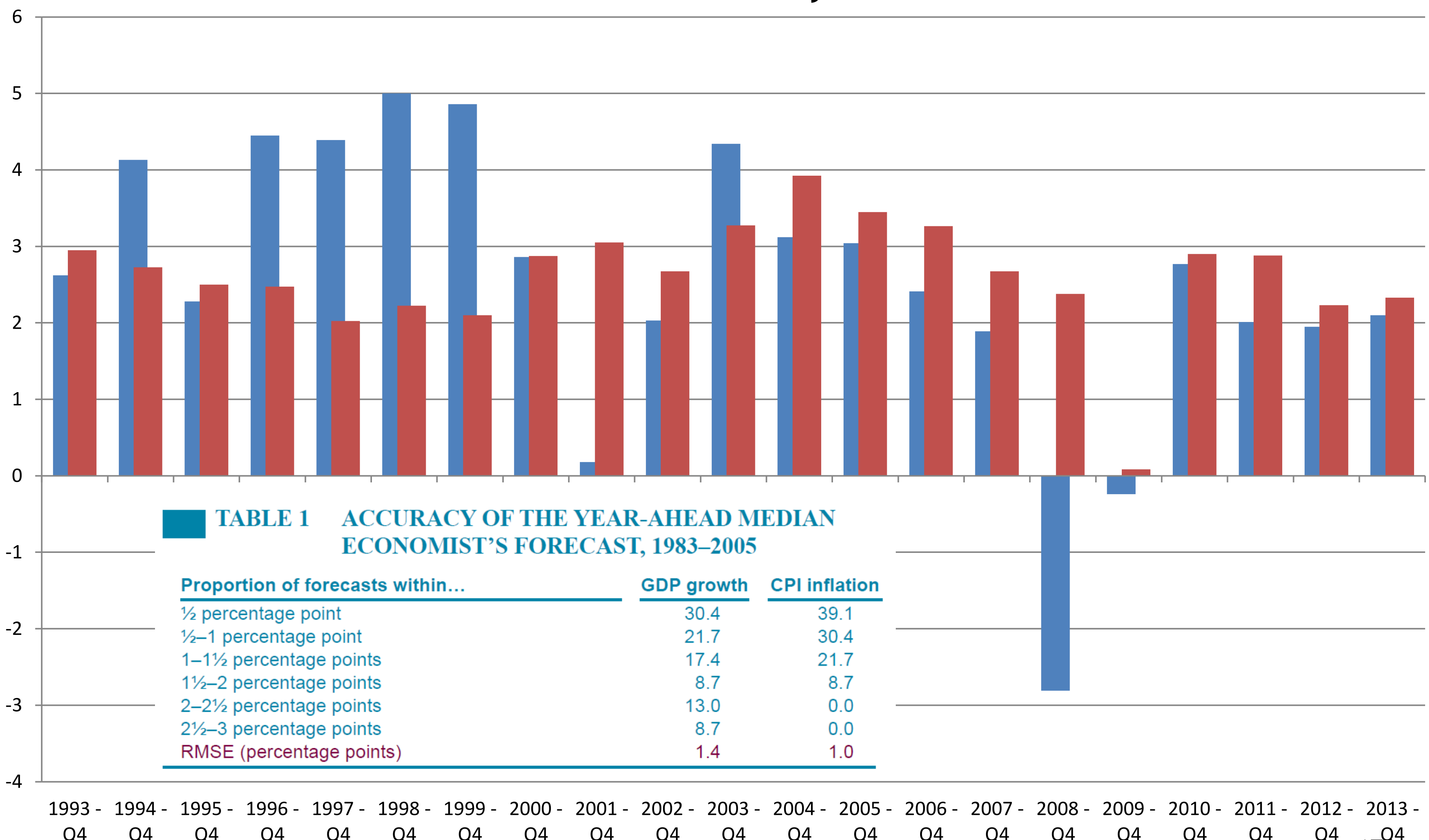


TABLE 1 ACCURACY OF THE YEAR-AHEAD MEDIAN ECONOMIST'S FORECAST, 1983–2005

Proportion of forecasts within...	GDP growth	CPI inflation
½ percentage point	30.4	39.1
½–1 percentage point	21.7	30.4
1–1½ percentage points	17.4	21.7
1½–2 percentage points	8.7	8.7
2–2½ percentage points	13.0	0.0
2½–3 percentage points	8.7	0.0
RMSE (percentage points)	1.4	1.0

Source: Bryan and Molloy (2007)

Oh, but not your favorite forecaster you say? Think again.

TABLE 2 PROBABILITY OF REPEATING AS A GOOD FORECASTER

GDP GROWTH

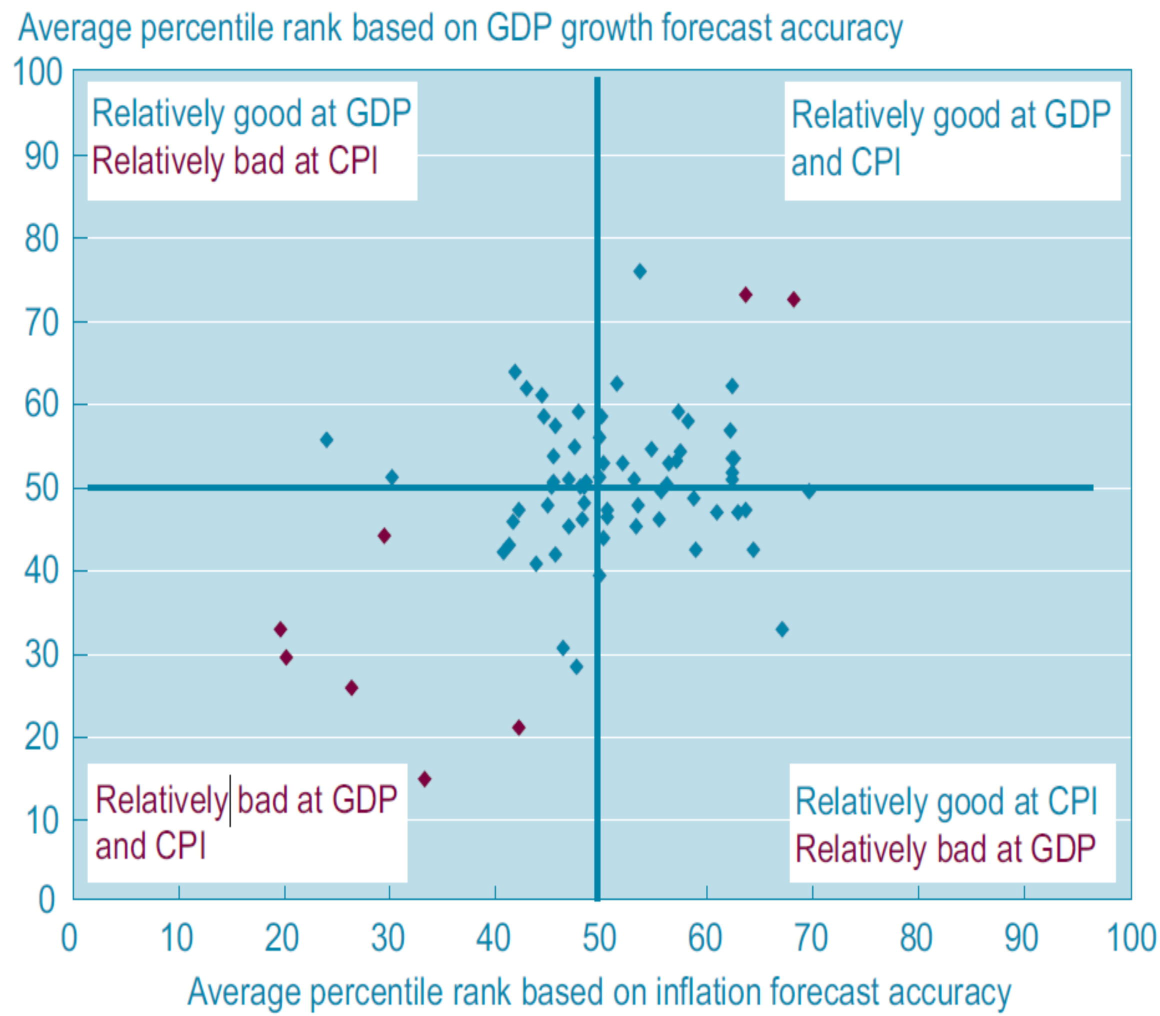
Probability of remaining successful (ABOVE the median) after...	Observed	Expected*
One success	46.8%	49.3%
Two successes	43.5%	49.0%
Three successes	45.9%	48.7%
Four successes	35.3%	48.6%

INFLATION

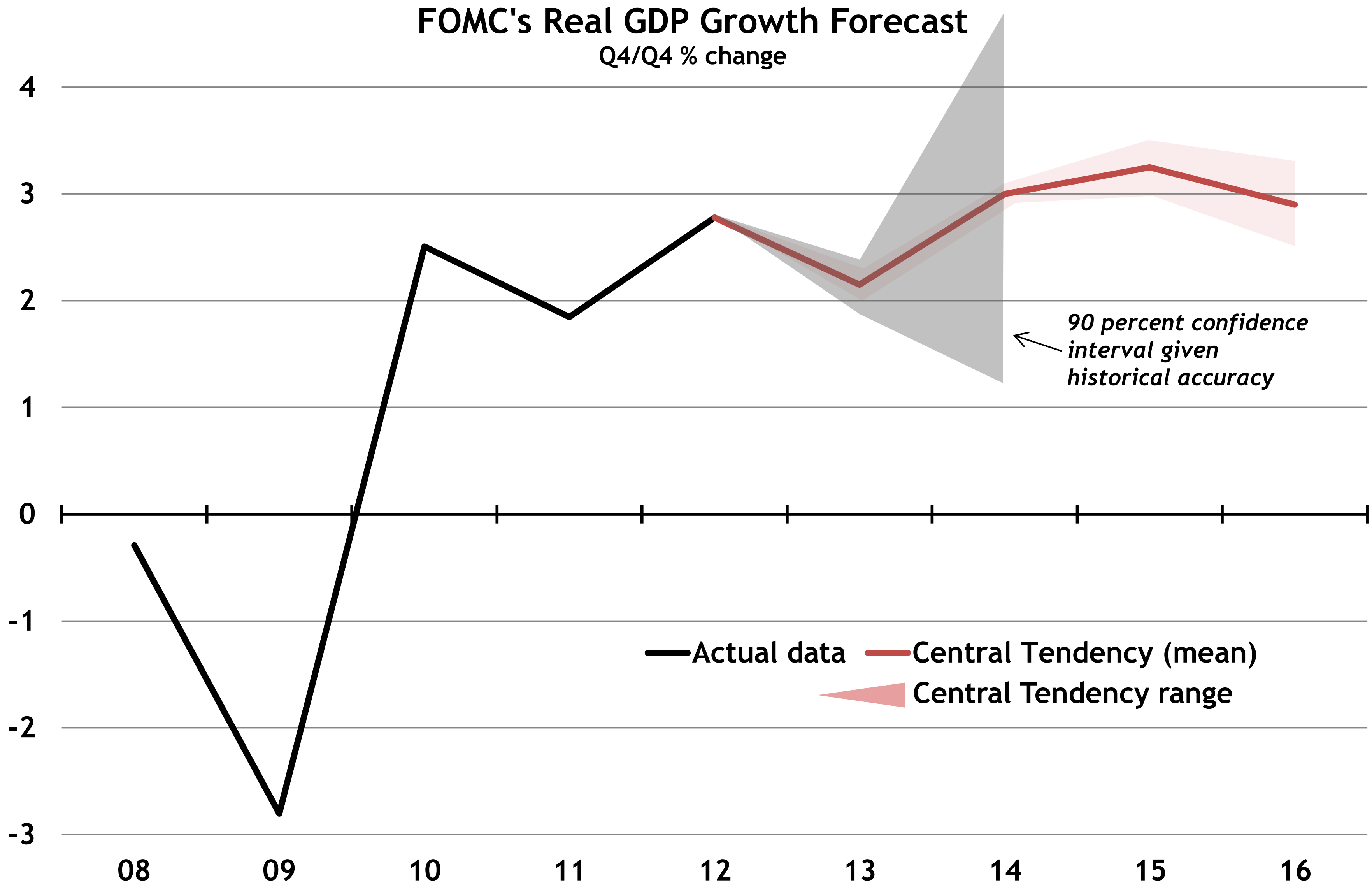
Probability of remaining successful (ABOVE the median) after...	Observed	Expected*
One success	48.7%	49.4%
Two successes	44.4%	49.4%
Three successes	38.7%	48.6%
Four successes	27.6%	48.9%

*Proportion expected assuming random chance.

FIGURE 3 FORECASTER ACCURACY†



So, here is the confidence interval around the FOMC’s year ahead growth projection. Yeah, it’s huge.

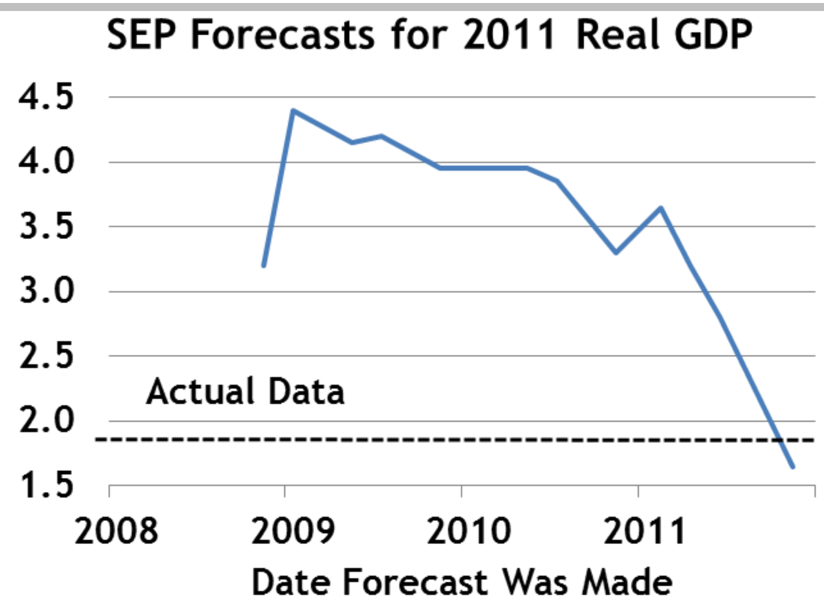


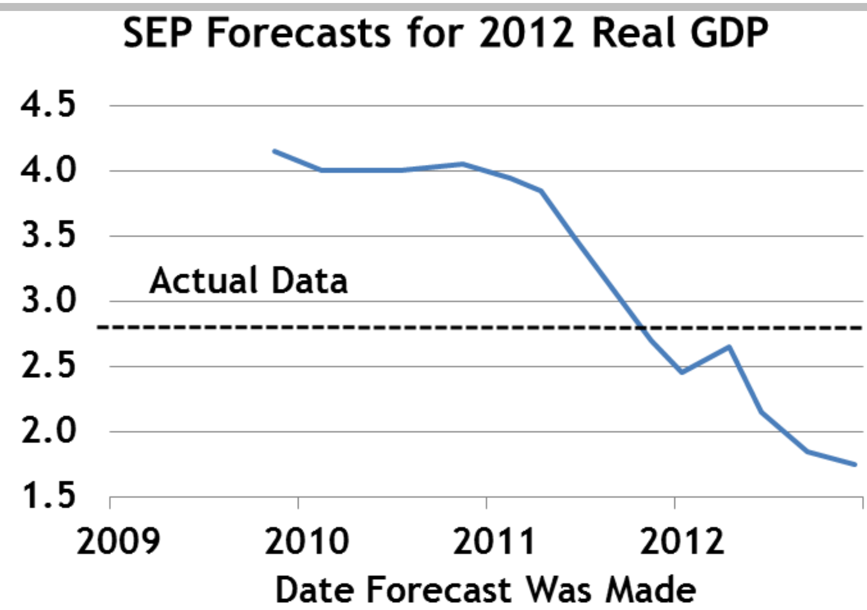
How would you assess the risks to your 2014 growth outlook?

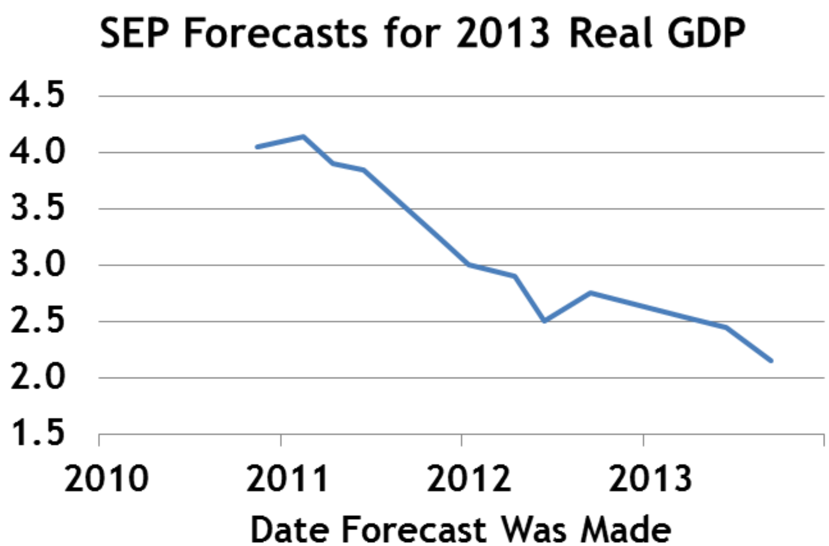
I judge the risks to growth next year as…

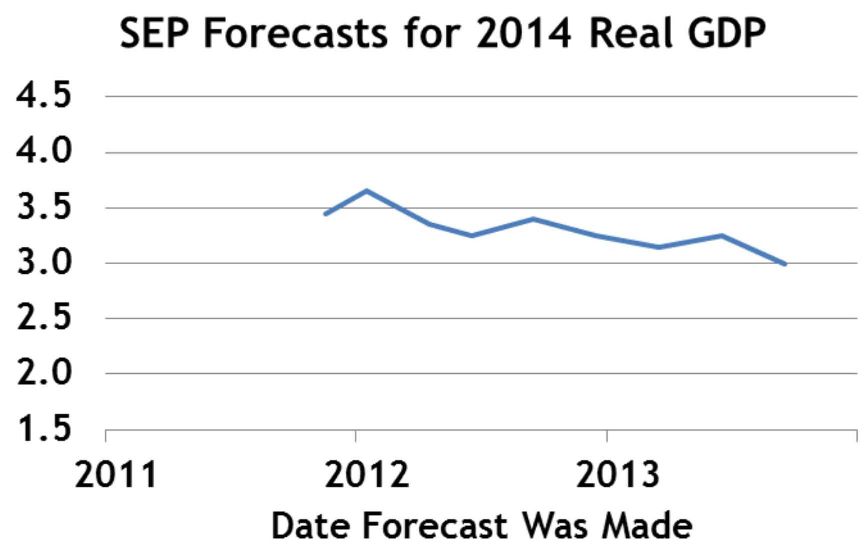
a. Broadly balanced between upside and downside potential
b. Mostly weighted to the downside
c. Mostly weighted to the upside

So is all this "growth acceleration" stuff wishful thinking? An evaluation of the evolution of SEP (midpoint) growth forecasts indicates a clear, recent tendency to overestimate growth over the medium term. Real GDP growth projections for 2011, 2012, and 2013 were originally put near 4% when FOMC participants were looking out one to two years.

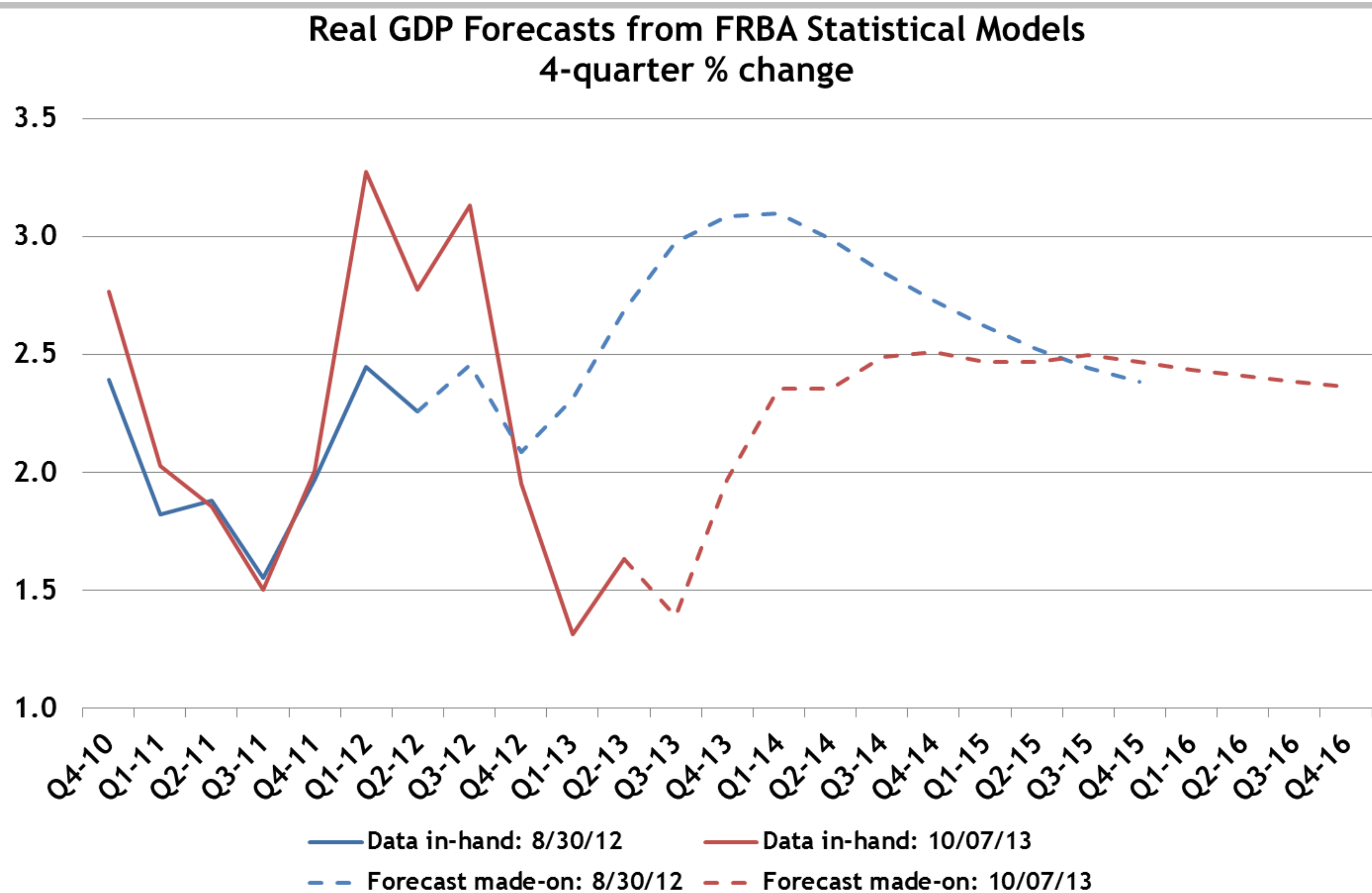




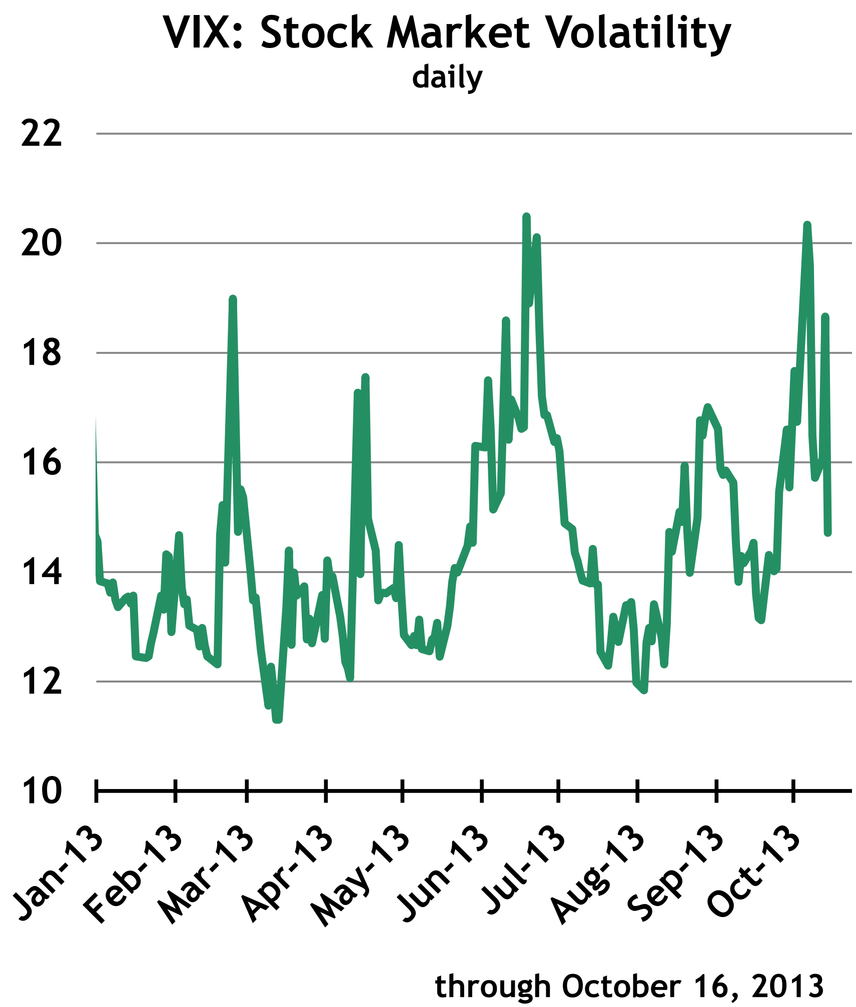


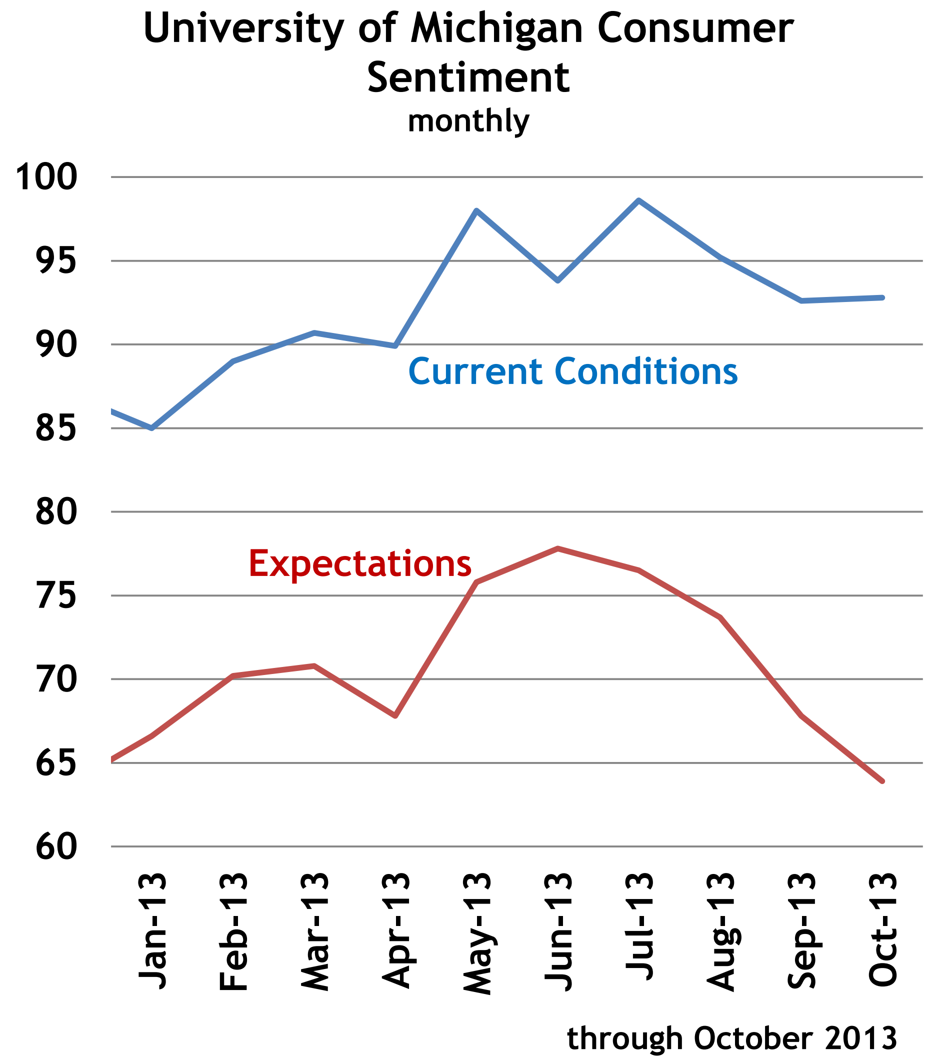


The data seem to think so. Our statistical models, which project the economy's most likely course on the basis of the incoming data, have become increasingly pessimistic that the economy will show a significant acceleration from its recent trend.



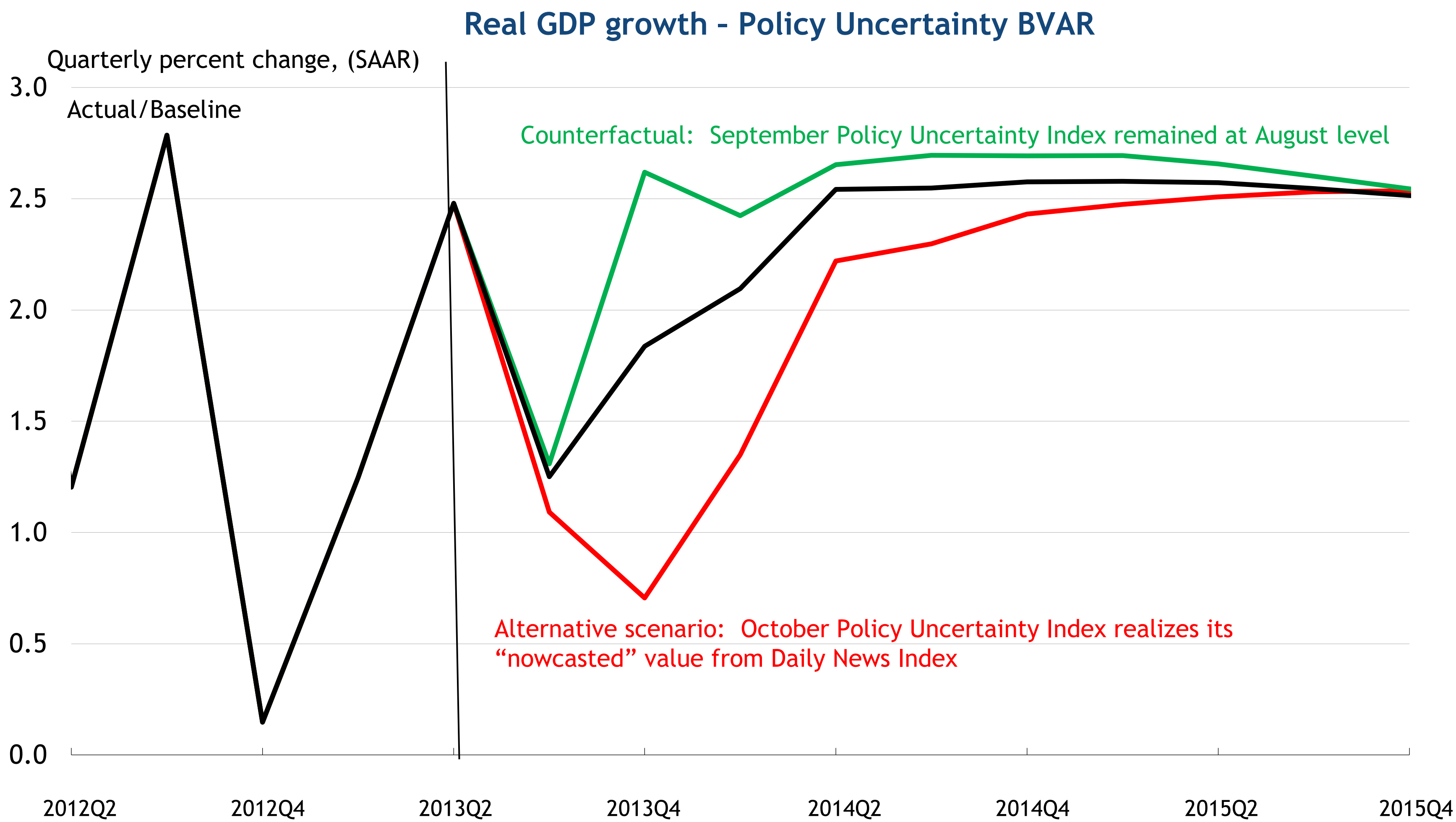
So let's refocus on the risk scenarios. Confidence in the economy clearly deteriorated during the recent government shutdown and debt ceiling debate. Household surveys of current economic conditions held steady in early October, while expectations over the next six months fell. Financial markets have been relatively volatile in recent weeks. And financial markets remain on edge.



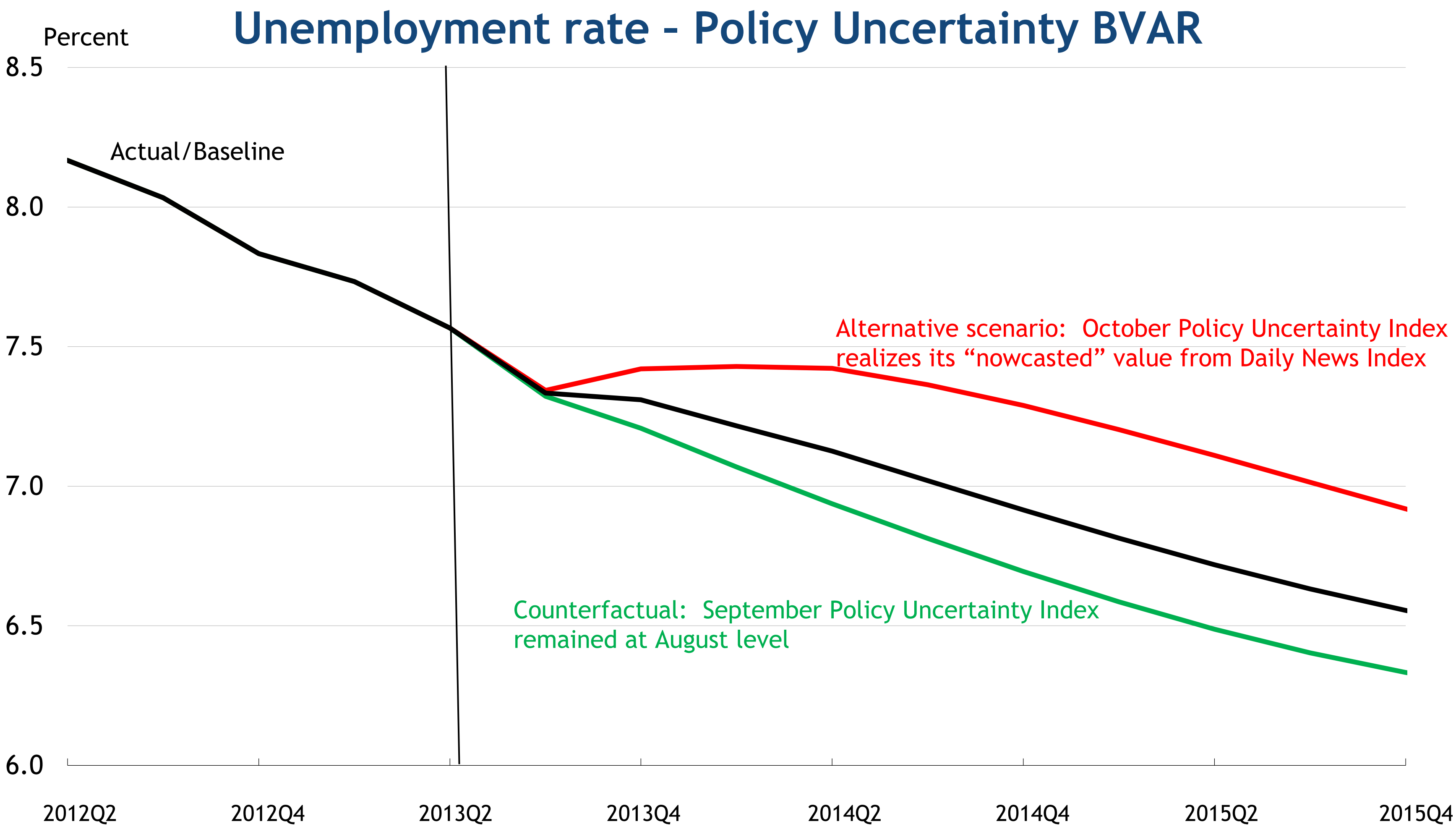


Source: University of Michigan; Bloomberg

So here's an experiment that is kind of important to the forecast team at the Atlanta Fed. What if uncertainty remains high? Elevated uncertainty would sap about ½ percentage point from GDP growth from the baseline over the next six quarters. A quick return to only modest uncertainty would have a similar positive benefit.



And those alternative growth scenarios would have a material influence on the pace of the downward trajectory of unemployment over the forecast horizon, according to our estimates.

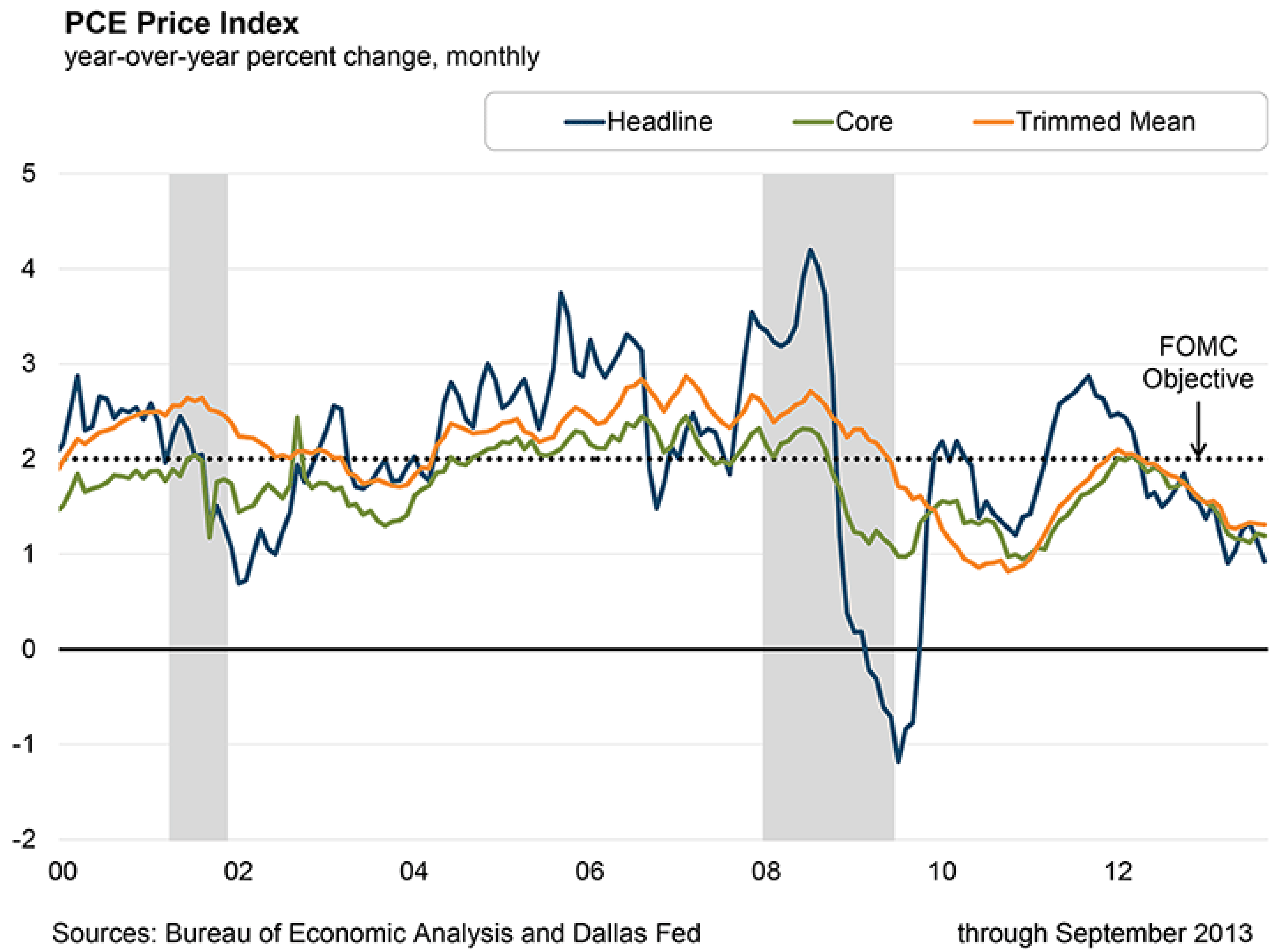


Remember, we have a "dual mandate". So what's your inflation outlook?

I think inflation will return to its 2% longer-term objective sometime in…

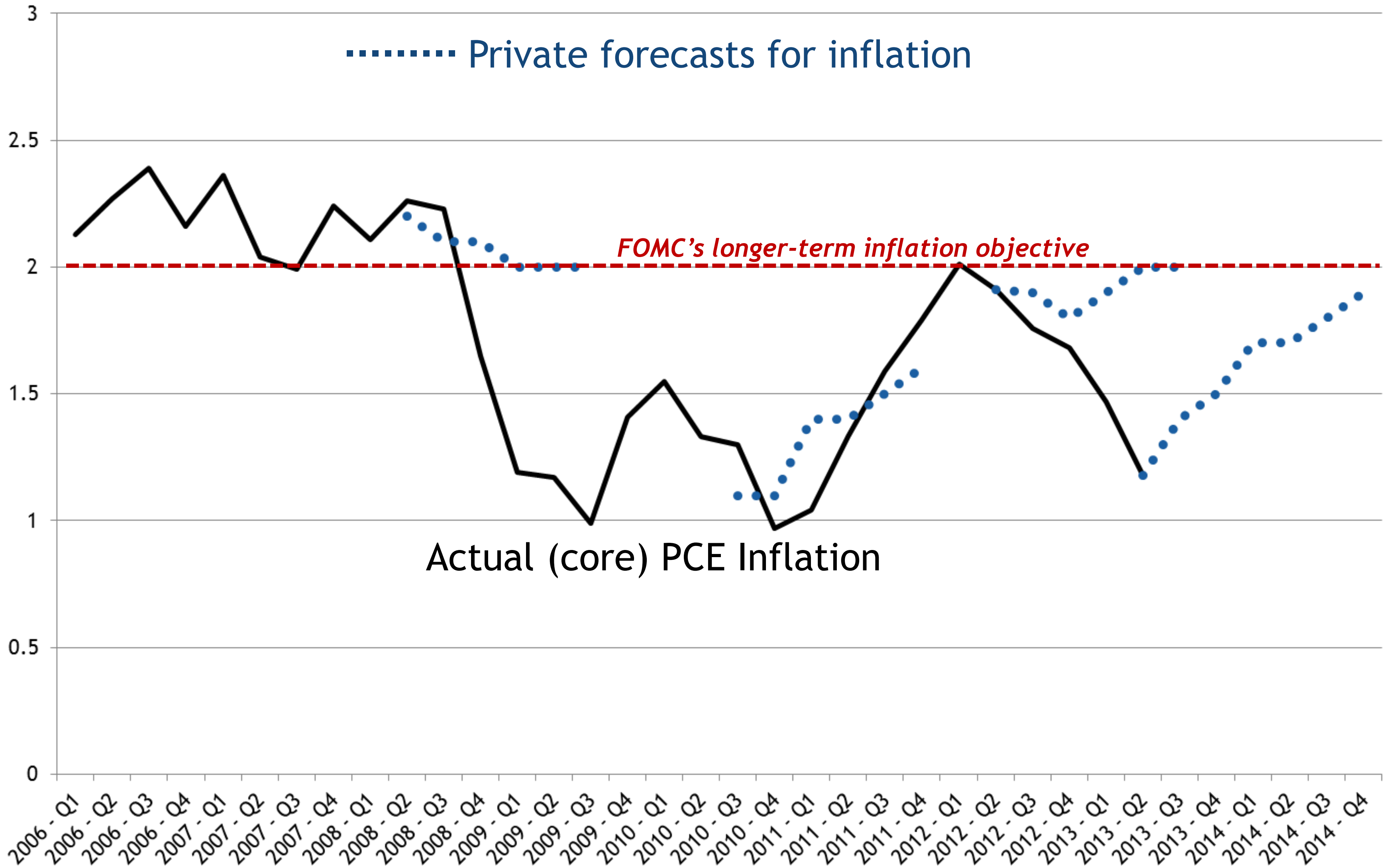
a. 2014
b. 2015
c. 2016
d. 2017
e. When the Browns win the super bowl

The incoming retail price data are still quite soft, and provide little evidence of inflation moving back toward the FOMC's longer-term objective.

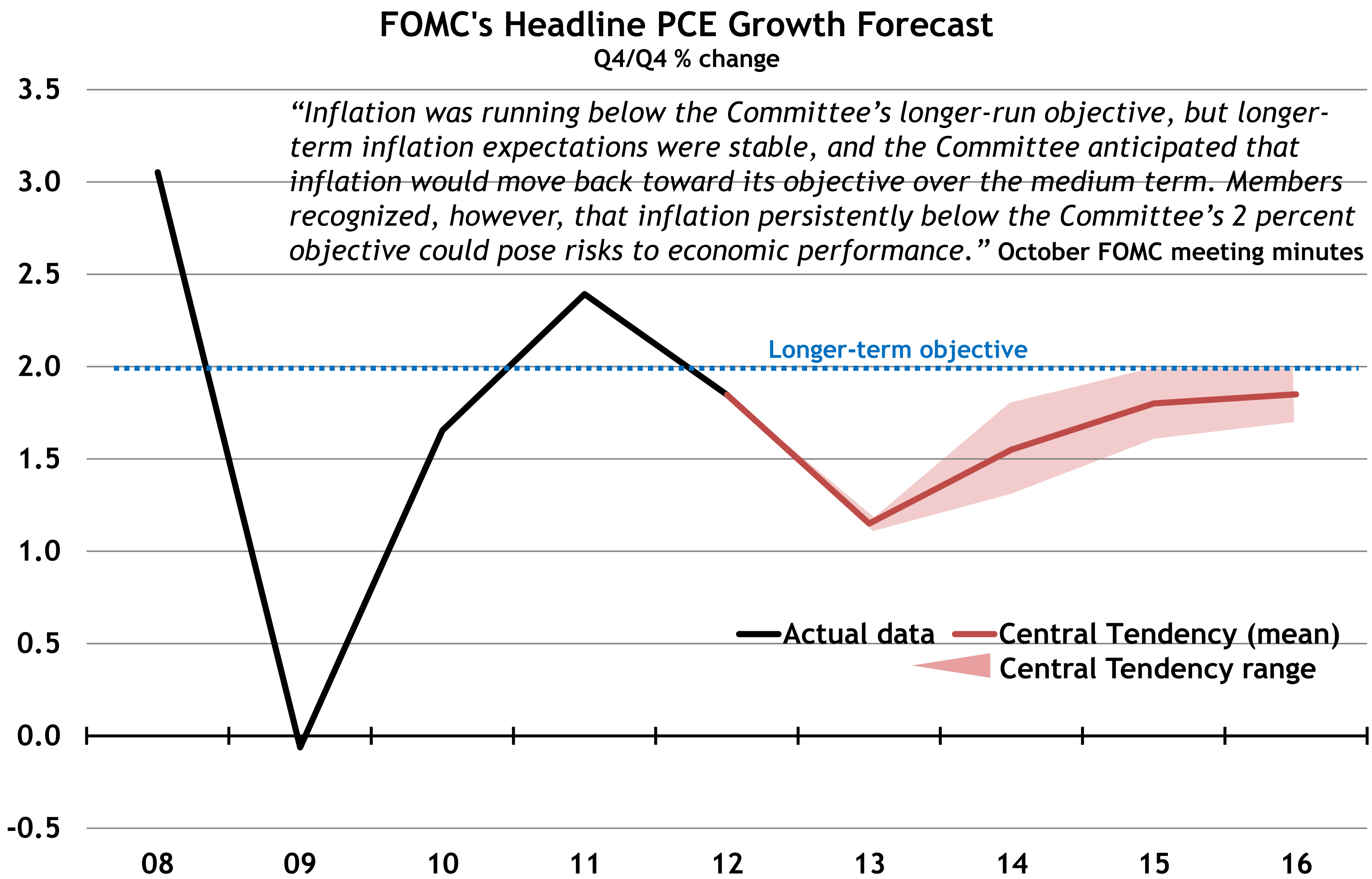


Sources: BLS; Dallas Fed

Regarding inflation, here too, hope seems to spring eternal. Inflation expectations are holding firm, and forecasts show inflation gradually returning to its objective…



In September, the FOMC consensus showed a gradual pick-up in price pressure, reaching the 2 percent longer-term objective by late 2015 or early 2016. But they acknowledge downside risks.



What's your assessment of the inflation risks?

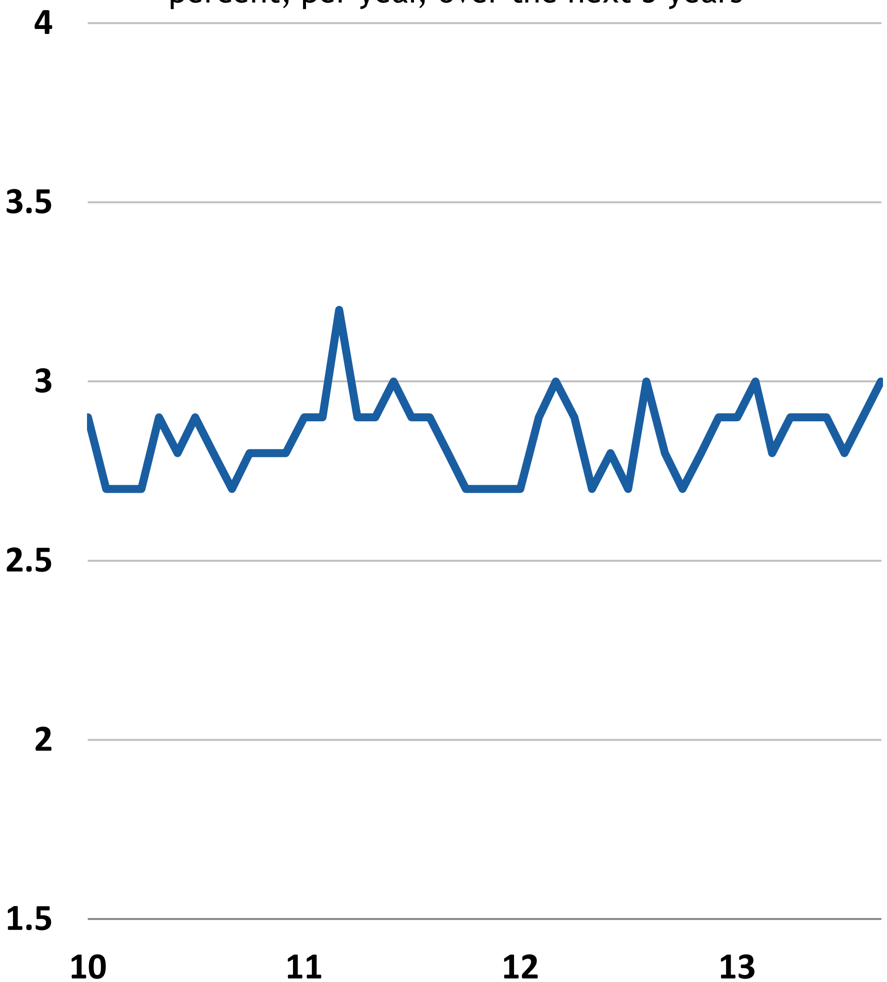
I think the risks to inflation over the medium to longer-term are…

a. Broadly balanced around the 2% objective
b. Weighted to the downside of the 2% objective
c. Weighted to the upside of the 2% objective

"Apart from fluctuations due to changes in energy prices, inflation has been running below the Committee's longer-run objective, but longer-term inflation expectations have remained stable." October FOMC statement

Long-Term Inflation Expectations of Consumers

percent, per year, over the next 5 years

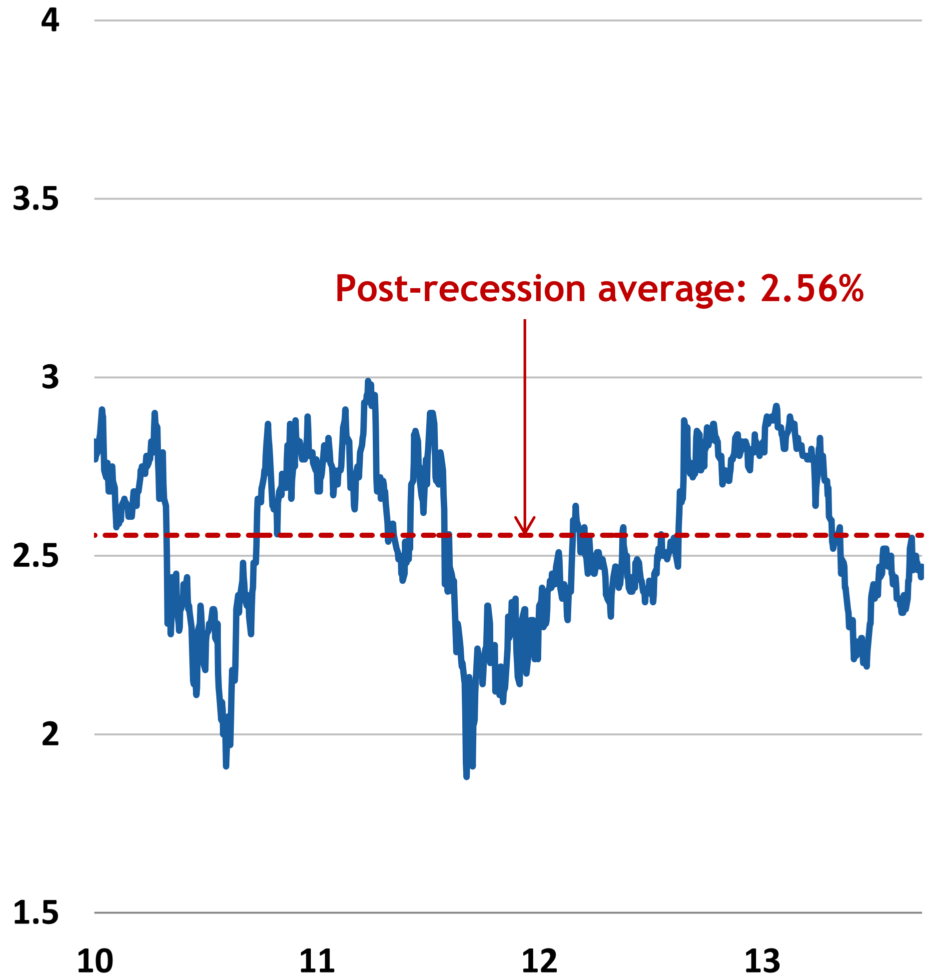


data through September 2013

Source: University of Michigan Survey of Consumers

Barclays 5-year/5-year Forward Breakeven Inflation Rate

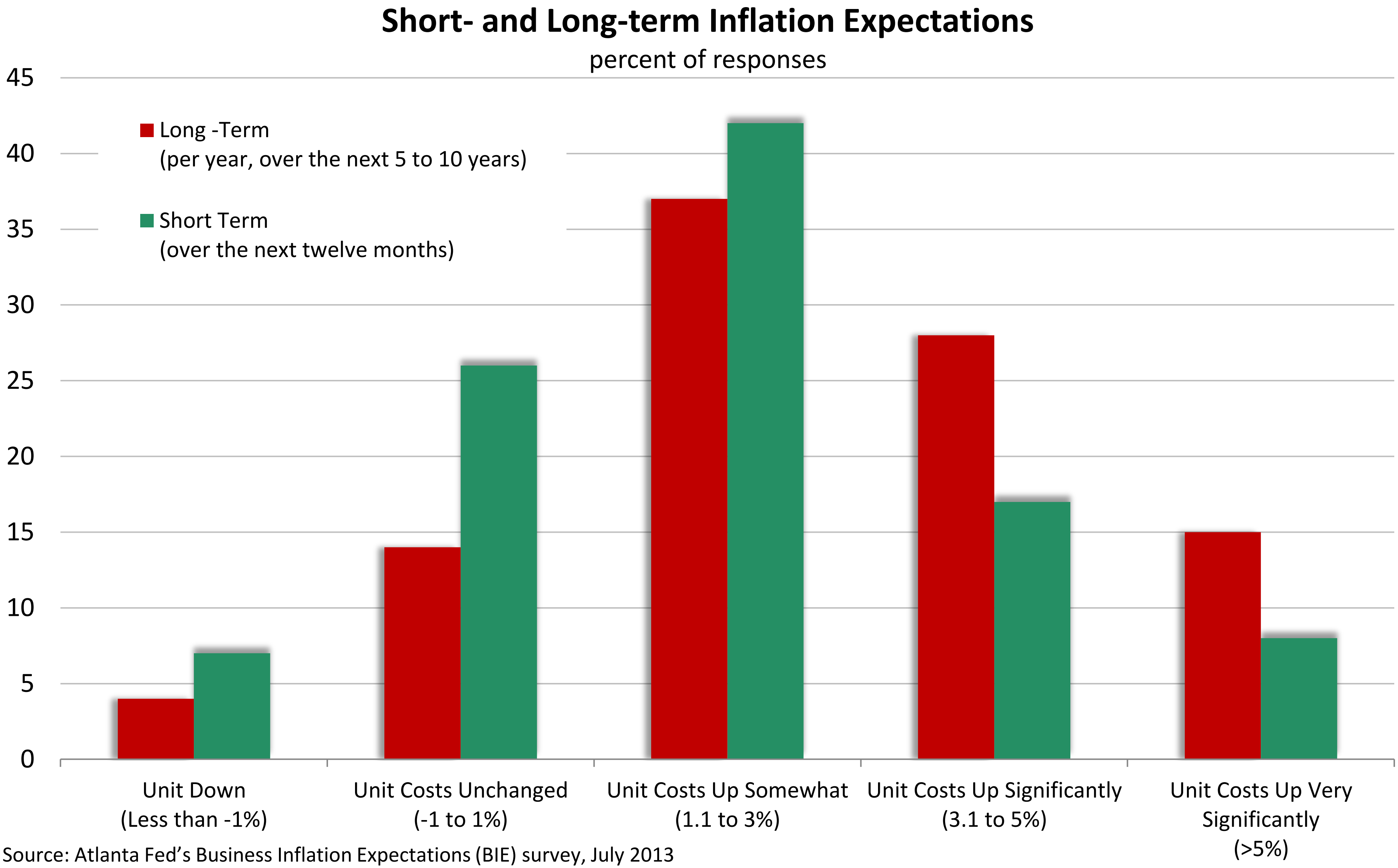
percent



data through October 9, 2013

Source: Bloomberg

Our panel of businesses appear to be of mixed mind when it comes to the assessment of inflation risks. Why the upside pessimism over the longer-term?



Source: Atlanta Fed's Business Inflation Expectations (BIE) survey, July 2013

The Atlanta Fed provides a "dashboard" of these major inflationary forces, scaled by what is statistically typical when inflation has been tracking near its 2 percent longer-term objective. Other than money growth, it signals no inflationary concerns.

Inflation Dashboard

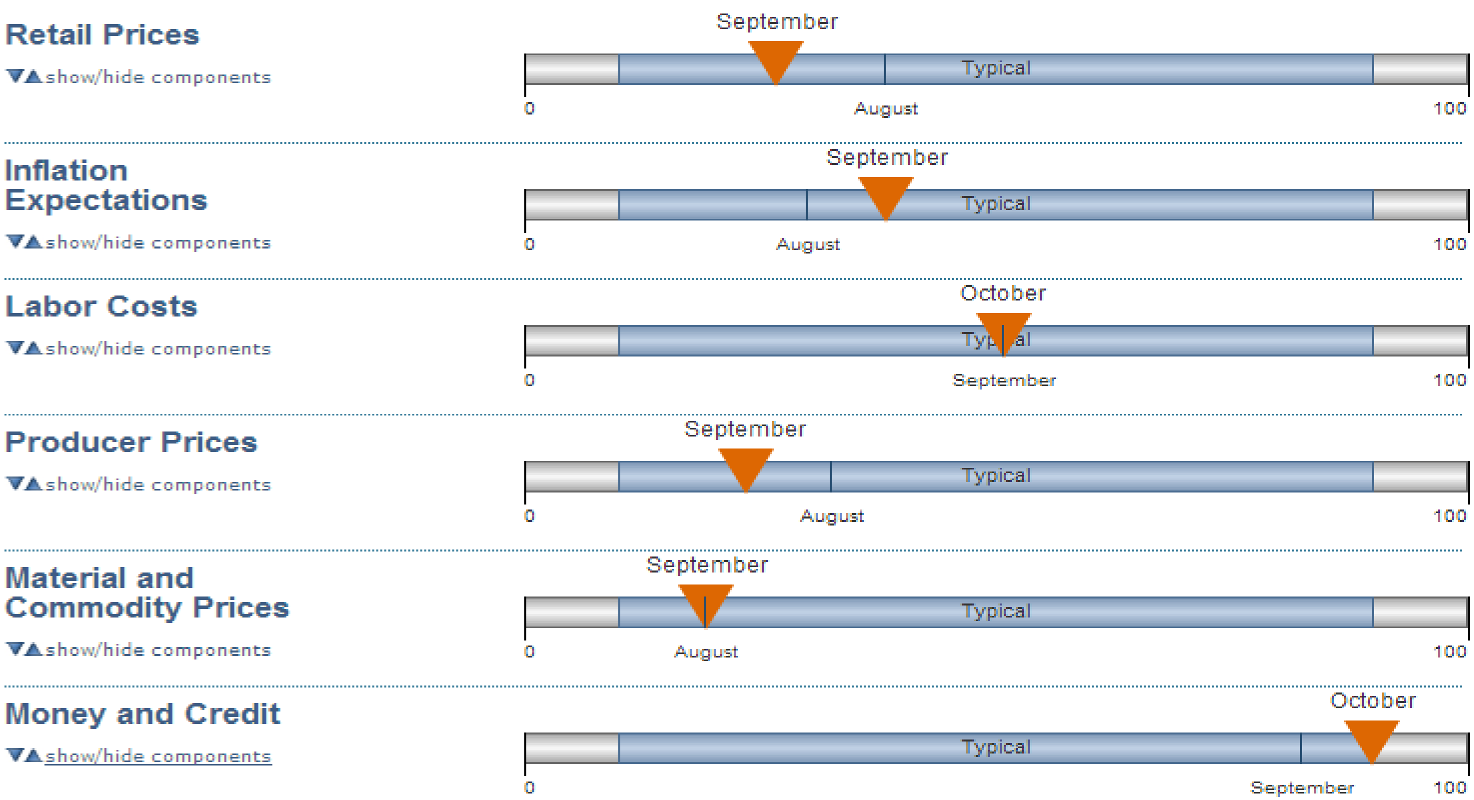
Updated November 18, 2013

The Inflation Dashboard acts as a platform for visualizing recent inflation measures in the context of longer-term trends. The dashboard's 30 data series capture inflation movements from various perspectives. To provide a snapshot of the current inflation picture, each of the 30 series has been grouped into six broader categories: retail prices, inflation expectations, labor costs, producer prices, material and commodity prices, and money and credit. For more information, see frequently asked questions (FAQ).

Percentile of the 3-month common trend of the underlying series — Direction of 3-month trend

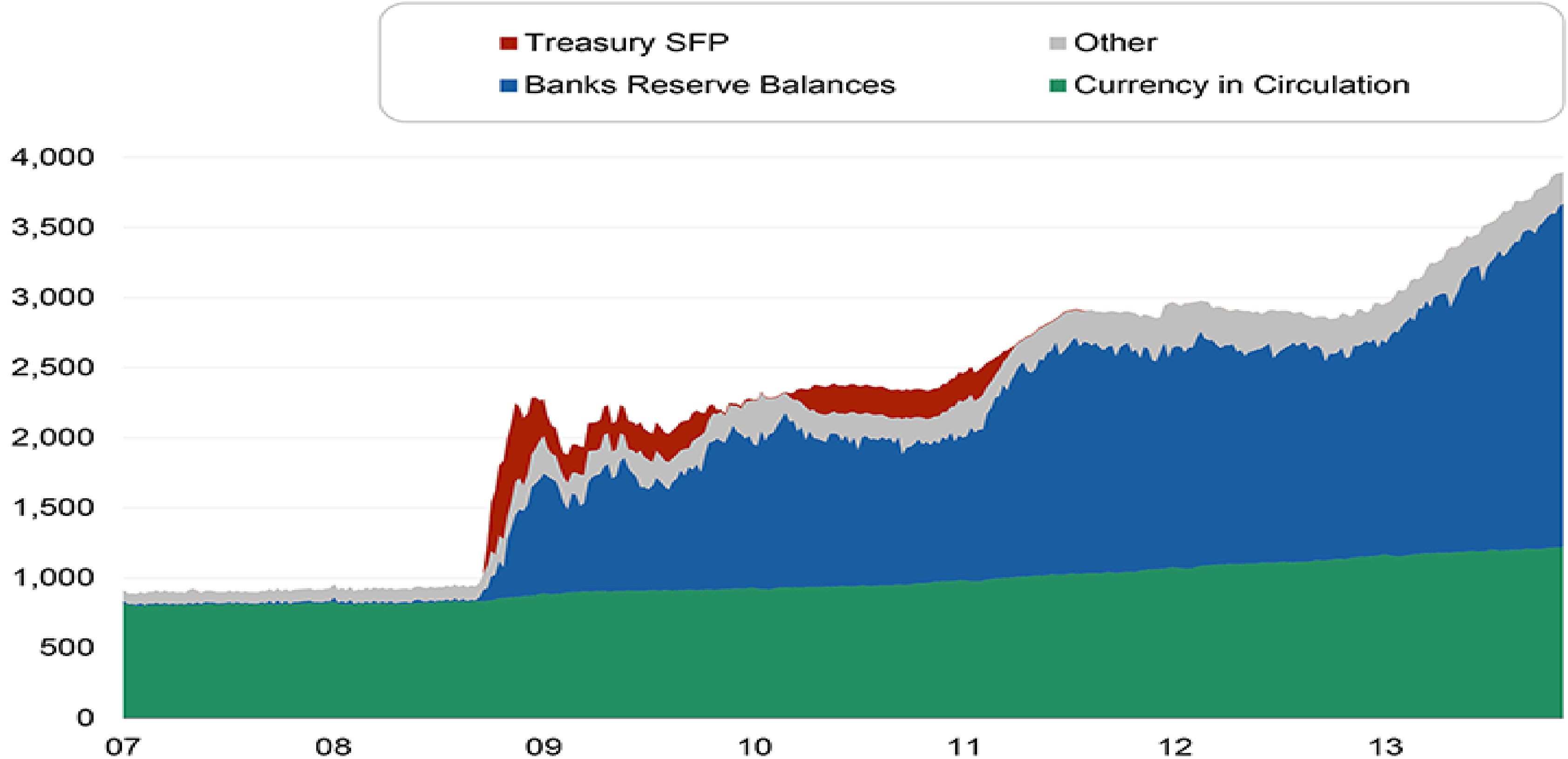
3-month trend — Typical range — Extreme range — Previous percentile

Click to view descriptions of each data series to see links to underlying data and sources.



But let me guess this is why businesses (and you in all likelihood) still have a lingering concern over upside inflation potential. As of October 23rd, the Federal Reserve's balance sheet shows total liabilities of $3.8 trillion. The reserves we have been "adding" to the financial sector appear to be sitting in people's pockets (held by banks, corporations, and households as cash.) It isn't circulating in the economy as one might expect.

Federal Reserve Liabilities (Sources of Funds)
$ billions

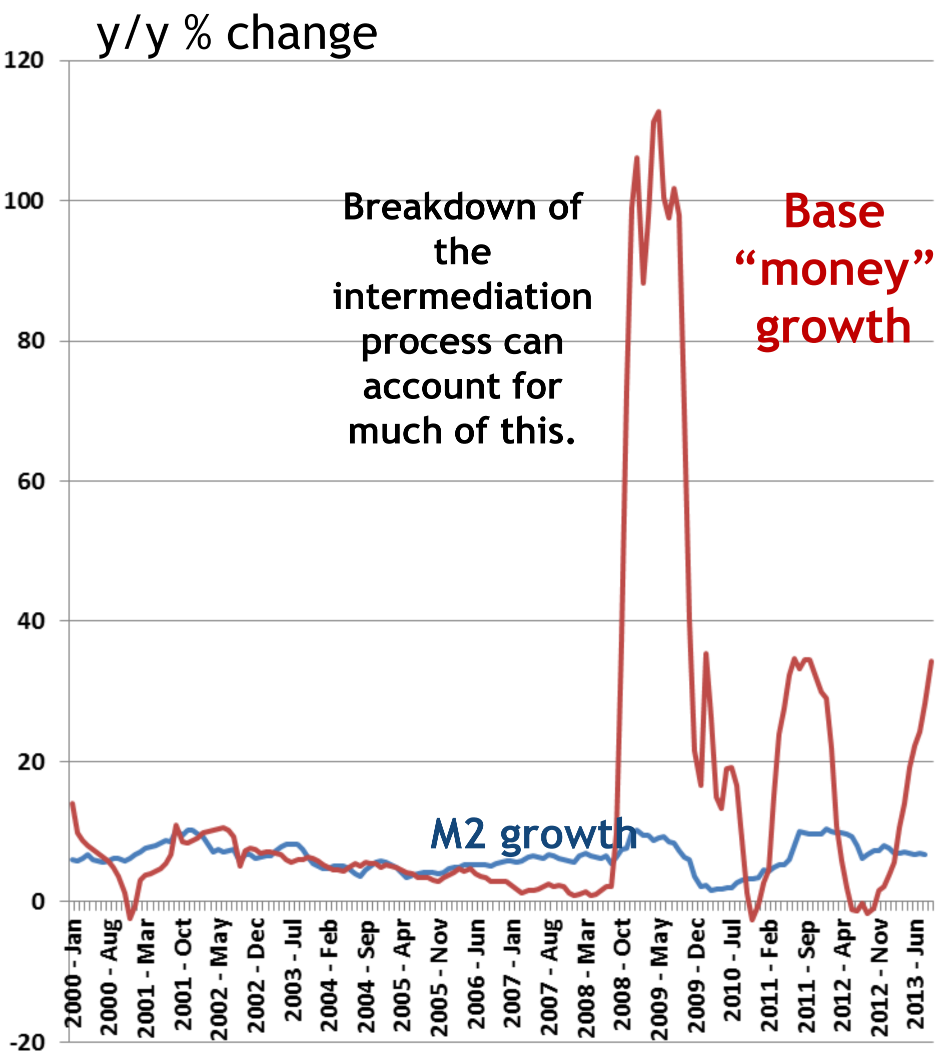


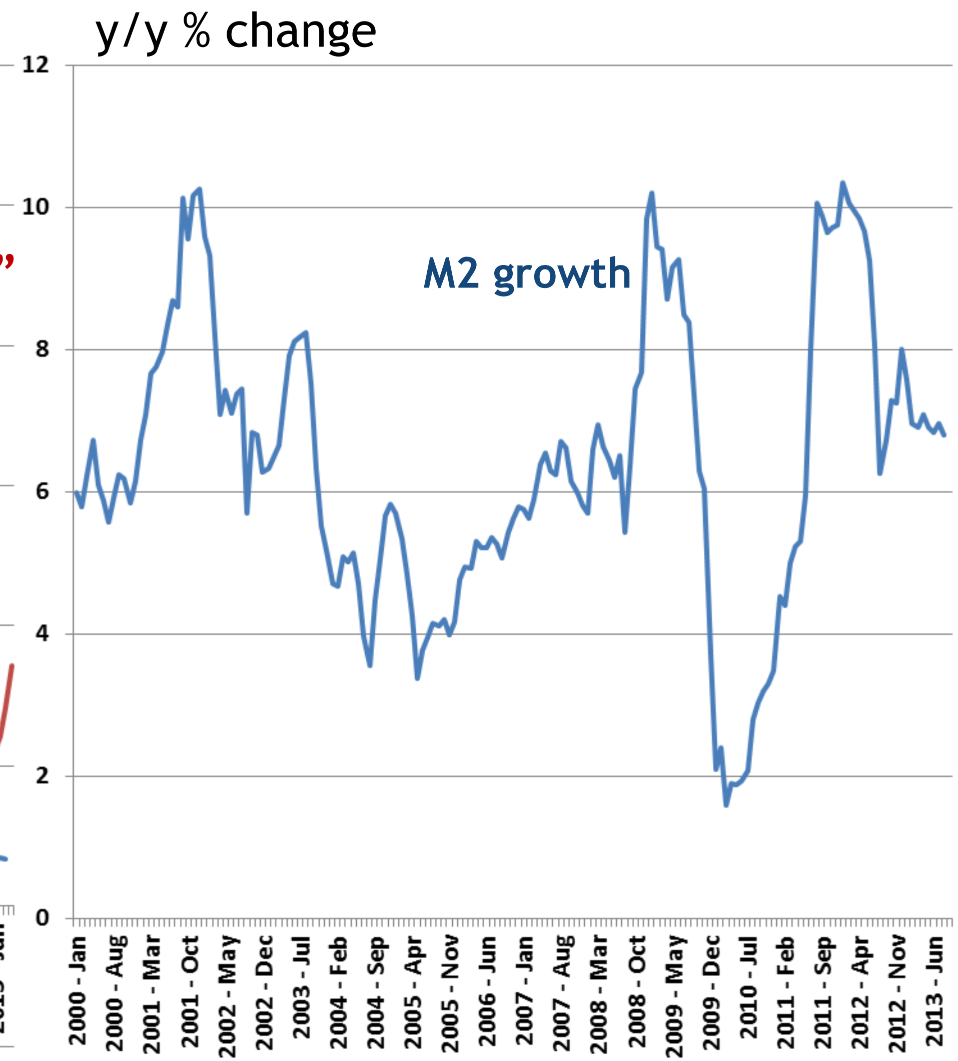
Source: Federal Reserve Board of Governors; Table 1: Factors Affecting Balances of Depository Institutions of the H.4.1 release.

through November 06, 2013

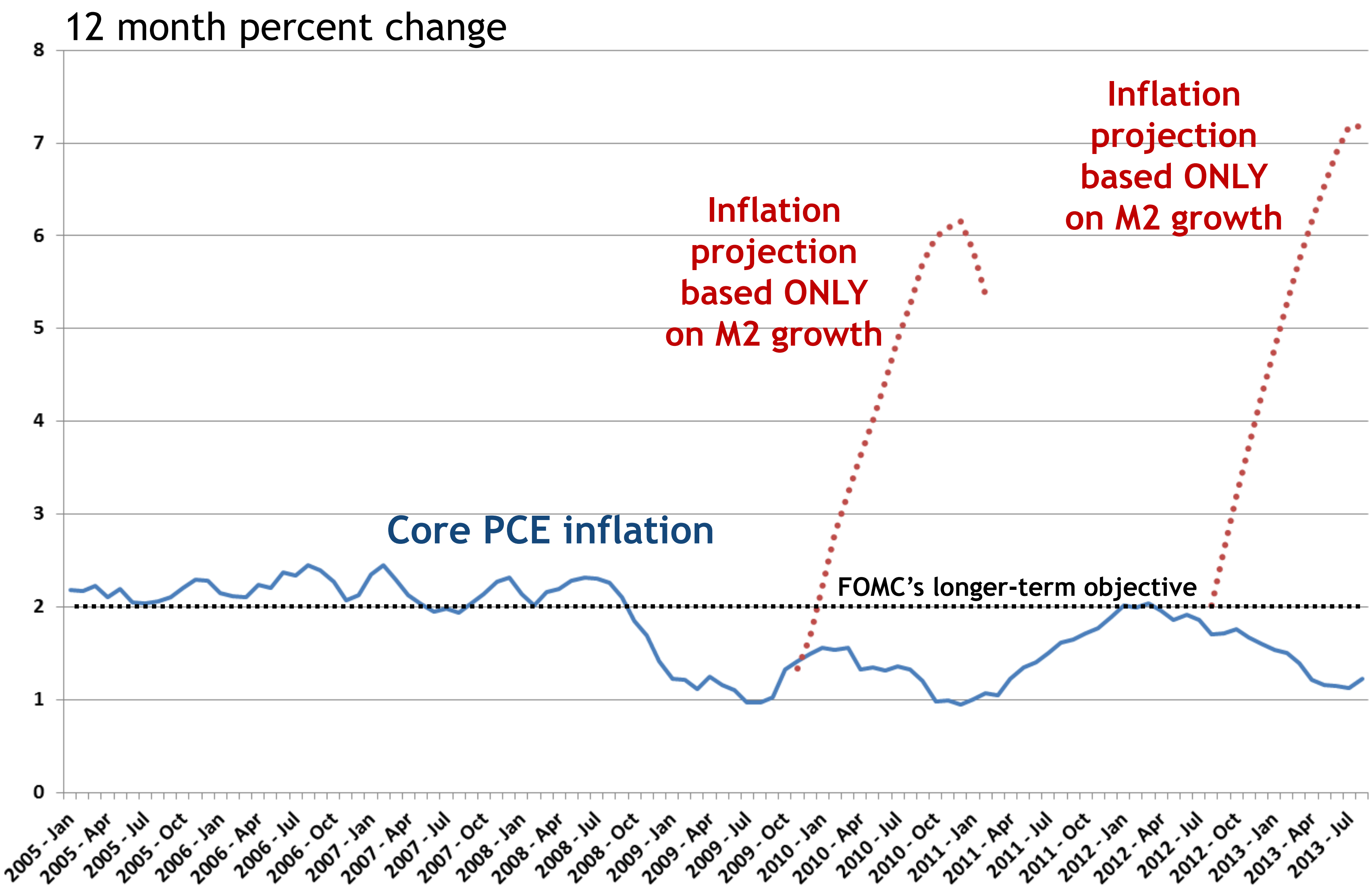
Note: "Other" = Other liabilities & capital, REPOs, Treas. cash holdings, and Deposits with FRB.

Since most agree that "inflation is always and everywhere a monetary phenomenon", does it strike anyone else as curious that we can't seem to get upward pressure on the inflation measures?





Here is what the inflation forecast based on M2 growth looks like at the onset of the last two QEs (with QE known and assuming historical relationships were to hold.) We should have seen a significant inflation in 2010—in fact, prices disinflated. Likewise, M2 growth earlier last year would have put inflation at over 7%. Do not take these forecasts seriously (I have kind of cooked them up).

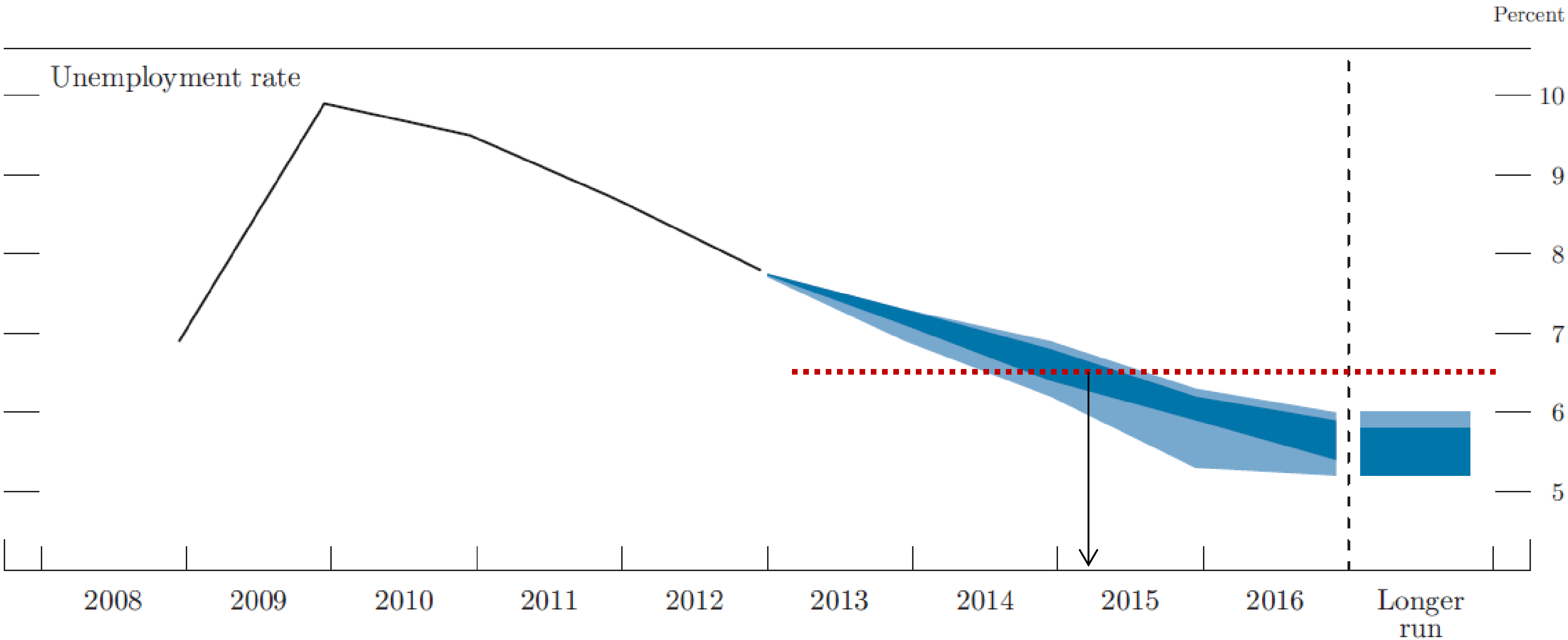


And finally, your policy advice would be…?

If I was advising Dennis Lockhart, I'd say…

a. You gotta stop this QE program. What, are you guys are insane?
b. You have to keep this program going to keep growth on a sustainable path. What, are you guys insane to consider tapering?
c. You guys are insane, I'm just not sure why.

QE will continue "until the outlook for the labor market has improved substantially in a context of price stability" and the fed funds rate will remain at near-zero "for a considerable time after the asset purchase program ends and the economic recovery strengthens (…at least as long as the unemployment rate remains above 6-1/2 percent, inflation between one and two years ahead is projected to be no more than a half percentage point above the Committee's 2 percent longer-run goal…"



At which upcoming FOMC meeting will the Fed announce the FIRST reduction in the size of its monthly large-scale asset purchase program?

(Percent of those responding)

December 17-18	January 28-29	March 18-19	April 29-30	June 17-18 or later
11.8%	33.3%	47.1%	7.8%	0.0%

In what quarter do you think the FOMC will FIRST raise its fed funds rate target from the current level of 0%-0.25%?

(percent of those responding)

Q4 2014	Q1 2015	Q2 2015	Q3 2015	Q4 2015	Q1 2016 or later
3.9%	9.8%	25.5%	25.5%	21.6%	13.7%

Important things to remember

1. Things are about to get better. This time we really mean it.

2. Then again, maybe not. There are some key risk factors still in front of us (re: the fiscal situation).

3. Even the uncertainty of those factors can be growth inhibiting.

4. Inflation will firm as the economy firms—but don’t hold your breath.

5. Invite me back next year and I’ll tell you how it all turned out and why we were right.

FEDERAL RESERVE BANK of ATLANTA

Economic and Policy Environment

Atlanta Economics Club Luncheon

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