



# **Economic Insights:** Conversations with the Dallas Fed Series

**"2014 Economic Update"**  
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# 2014 Economic and Policy Prospects

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The views expressed are those of the speaker and should not necessarily be attributed to the Federal Reserve Bank of Dallas or the Federal Reserve System.

# Overview

- Forecasting strategy
- Unemployment rate: declines to continue
- Inflation: moving higher, but still below target
- GDP growth to stay strong in 2014
- Monetary policy in transition

# Fundamentals Driving the Forecast

- Outlook for other “advanced economies” has generally improved
- Energy prices have been tame
- Drags from fiscal policy and regulatory uncertainty fading
- Growing need for replacement investment
- Monetary policy remains accommodative

# Forecasting Strategy

- Many indicators are informative for current-quarter GDP, unemployment, and inflation.
- Professional forecasters are adept at exploiting this information.
- But policy is properly geared to what happens *beyond* the current quarter.
- At these longer horizons, professionals do no better than simple extrapolation.
- With proper treatment of data revisions, one can beat the professionals at the horizons that matter.

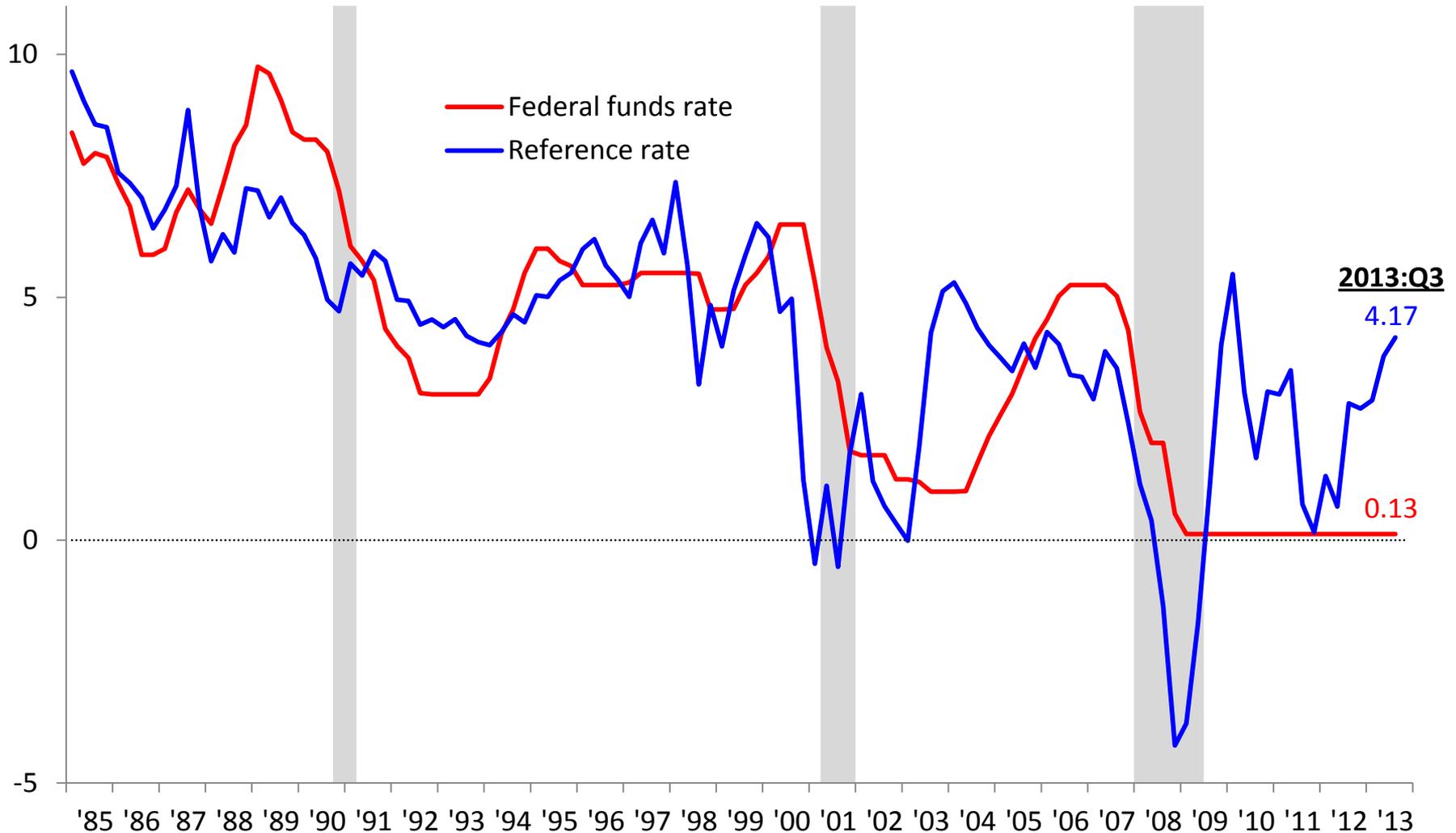
# Forecasting Unemployment

- Unemployment responds, with a lag, to monetary-policy accommodation.
- Monetary policy is tighter, the higher are short-term rates relative to long-term rates and asset appreciation.
- Caveat/concern: The model abstracts from a lot of the complexity of the real world.

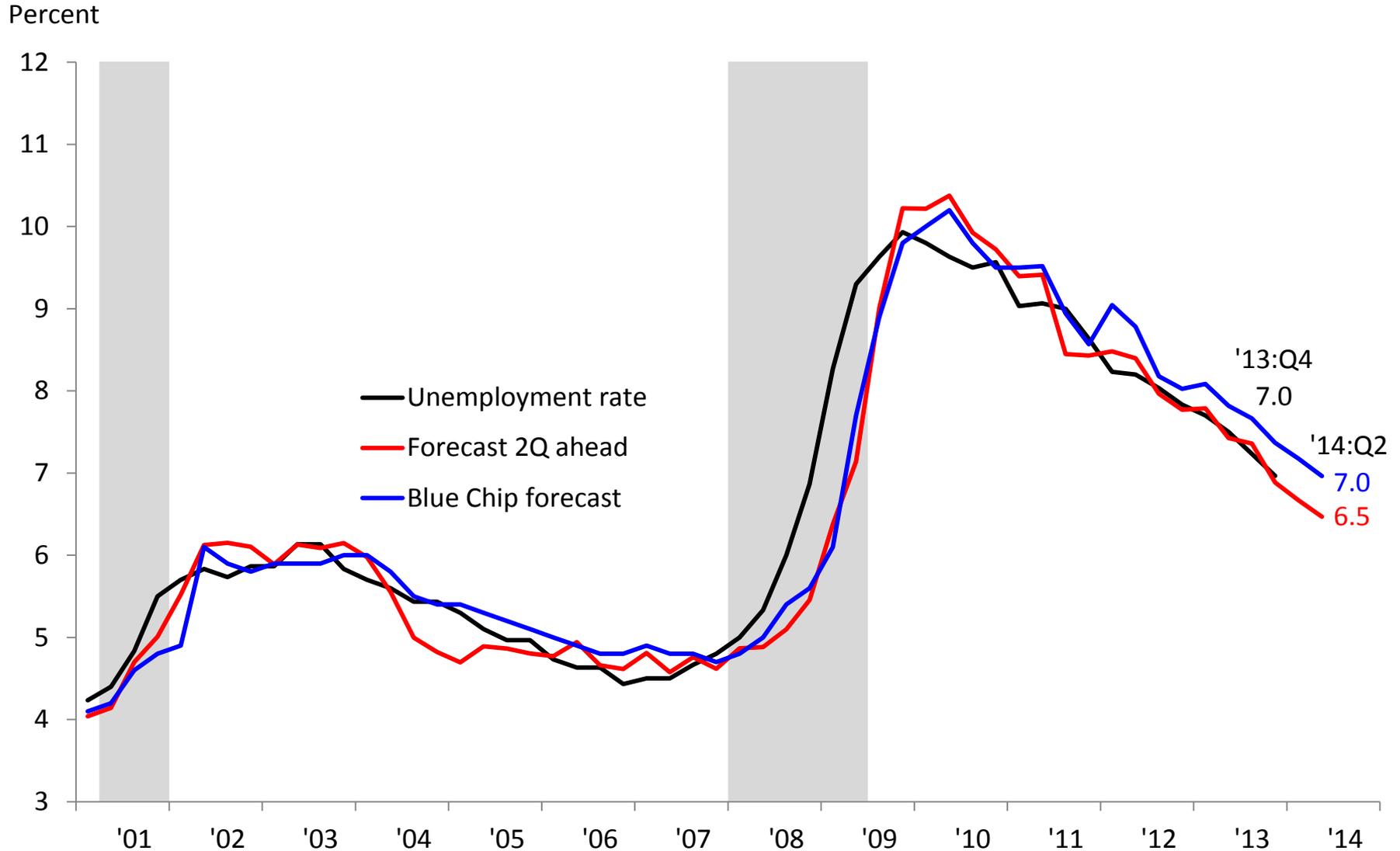
# Recessions are preceded by tight monetary policy, and recoveries are accompanied by easy policy

[Reference rate =  $0.7 \times (\text{long-forward rate}) + 0.3 \times (\text{wealth growth}) - 1.94$ ]

Percentage points

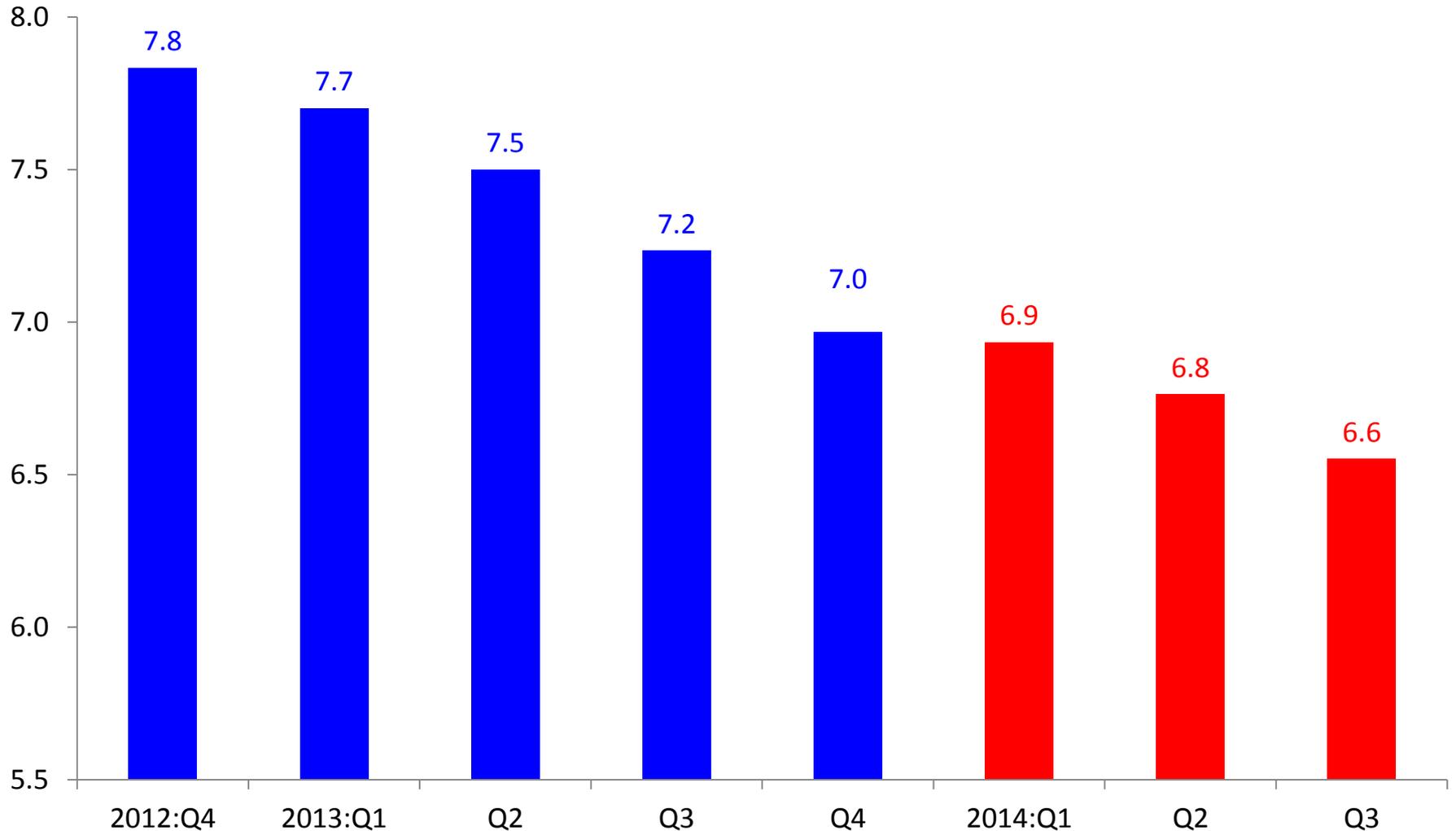


# Blue Chip professionals forecast 7.0-percent unemployment in 2014:Q2



# Blended forecast calls for the unemployment rate to decline 0.4 percentage points over 3 quarters

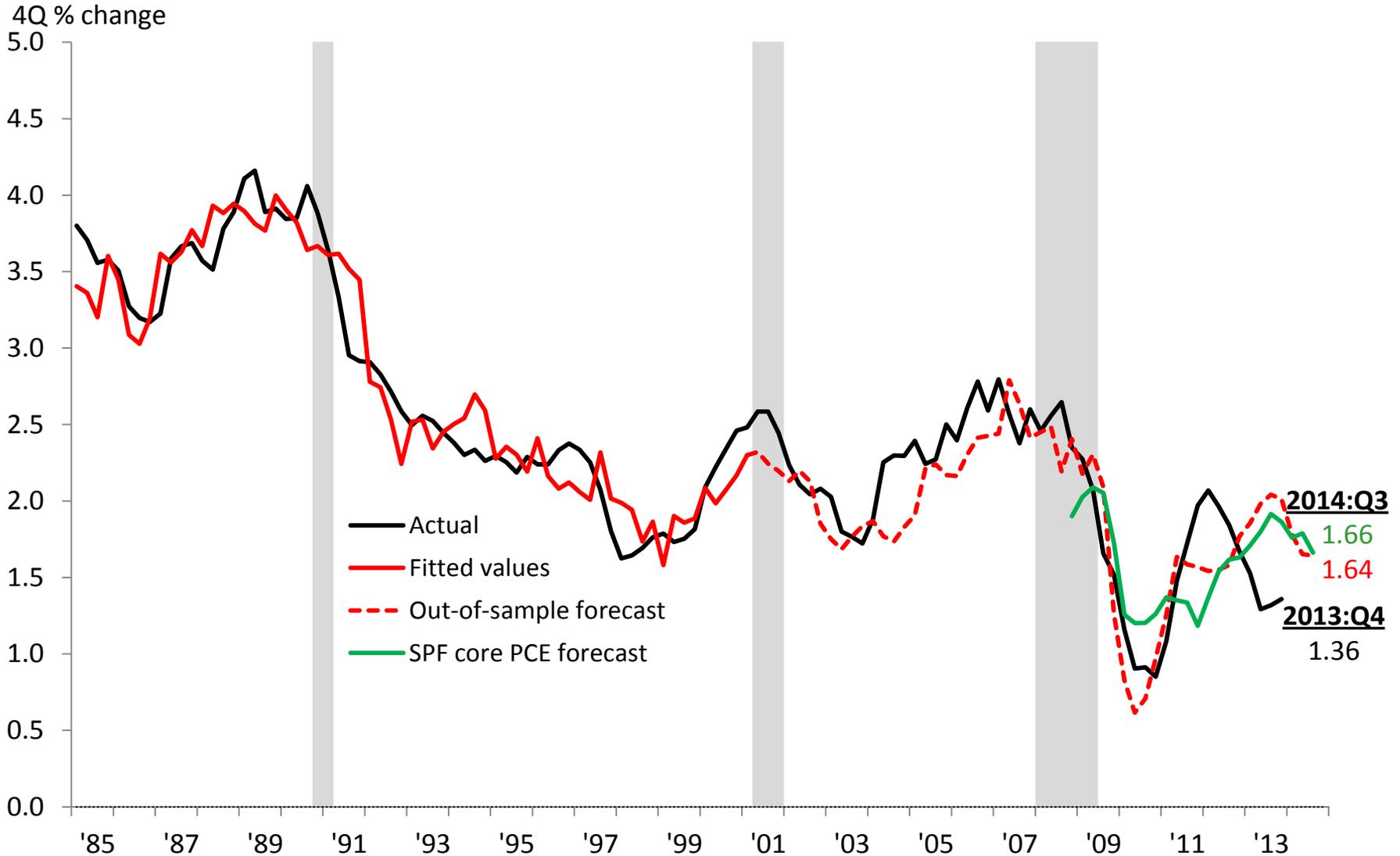
Percent



# Forecasting Inflation

- Focus on forecasting trimmed-mean inflation over the next four quarters.
- Deviations of the headline rate from the trimmed mean can't be forecasted.
- Long-run inflation expectations are assumed to remain anchored.
- Deviations of the trimmed mean from long-run expectations are predicted using the level and the change in the unemployment rate.
- Caveat/concern: long-run expectations might de-anchor.

# The professional consensus is currently quite close to the Dallas forecast

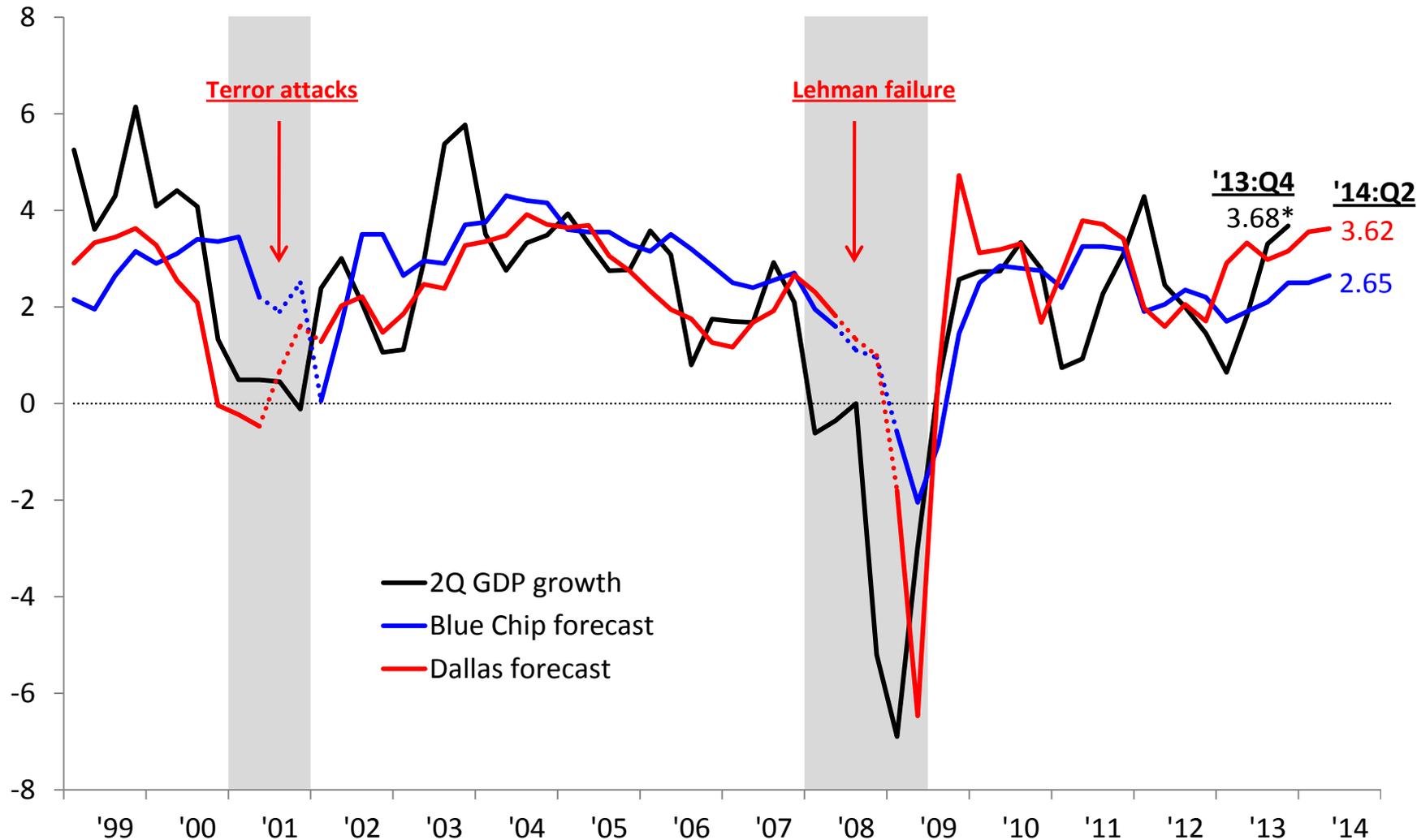


# Forecasting GDP Growth

- Focus on the 2 quarters starting 1 quarter hence
- Rely on a handful of market indicators that aren't subject to revision:
  - stock prices
  - junk-bond spread
  - term spread
  - oil-price increases not due to stronger U.S demand
- Caveats and concerns:
  - timing sometimes off
  - may miss some effects of fiscal/regulatory policy
  - may miss some effects of the zero bound and QE

# Blue Chip professionals forecast 2.65-percent growth over the same period

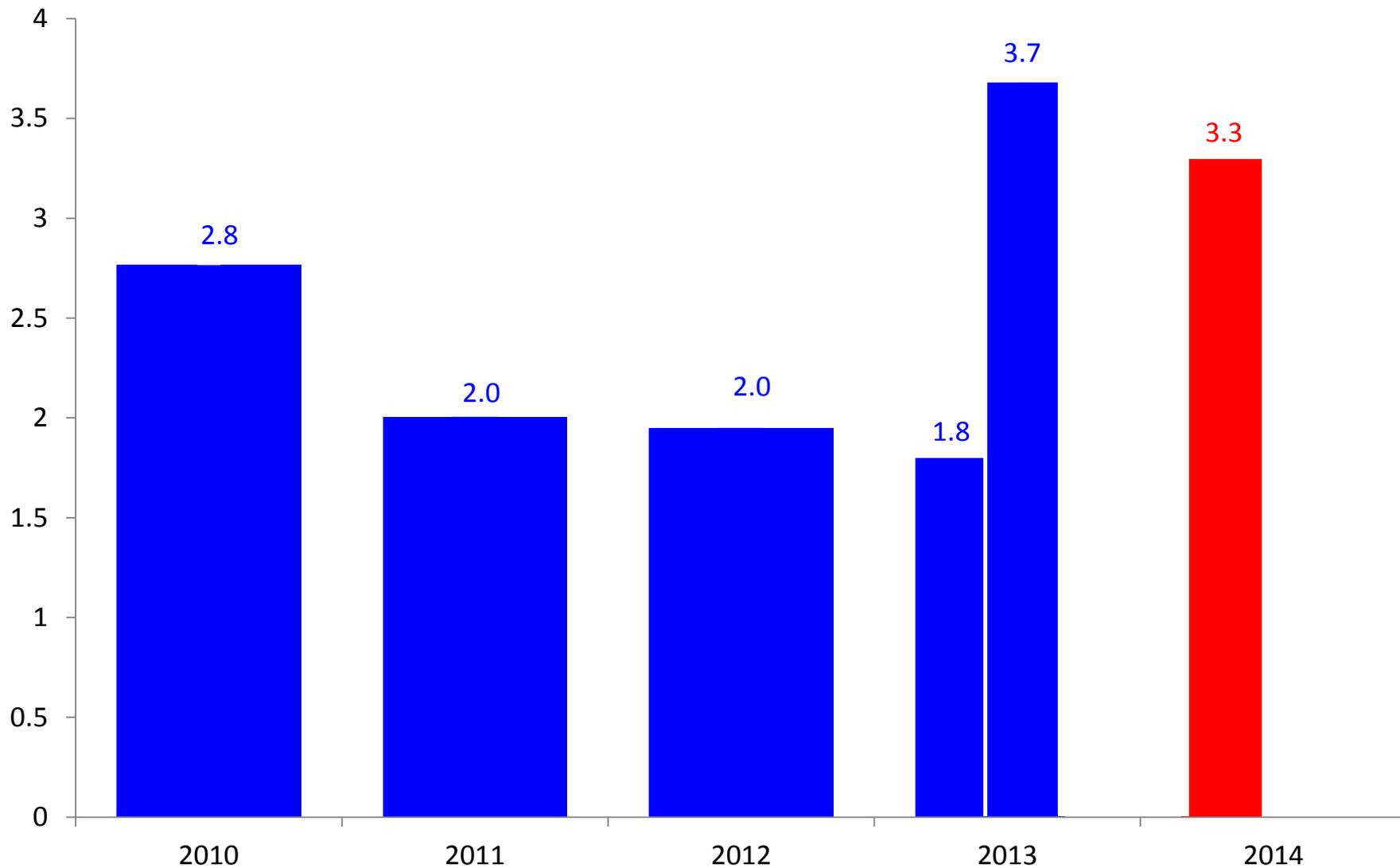
Percent/yr.



\*First-release estimate

# Blended forecast calls for 3.3-percent GDP growth

Percent change, annualized

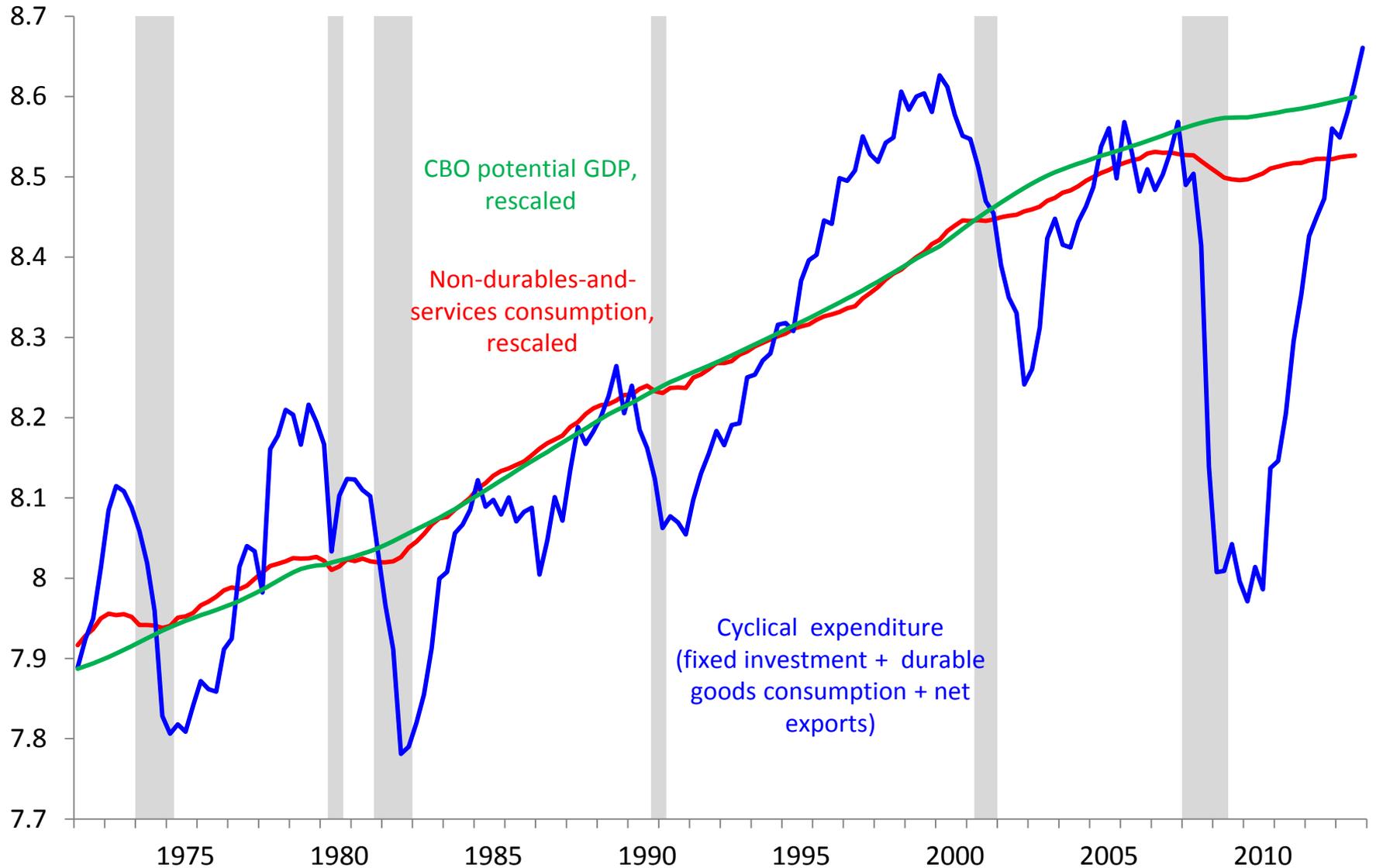


# Longer-horizon GDP Forecasts

- Focus on year/year growth 4 and 8 quarters hence
- Based on separate forecasts of cyclical component of GDP (durables consumption + fixed investment + net exports) and trend component (consumption of non-durables & services)
- Trend growth depends on monetary-policy stance
- Growth in cyclical component depends on:
  - gap between cyclical and trend components
  - monetary-policy stance

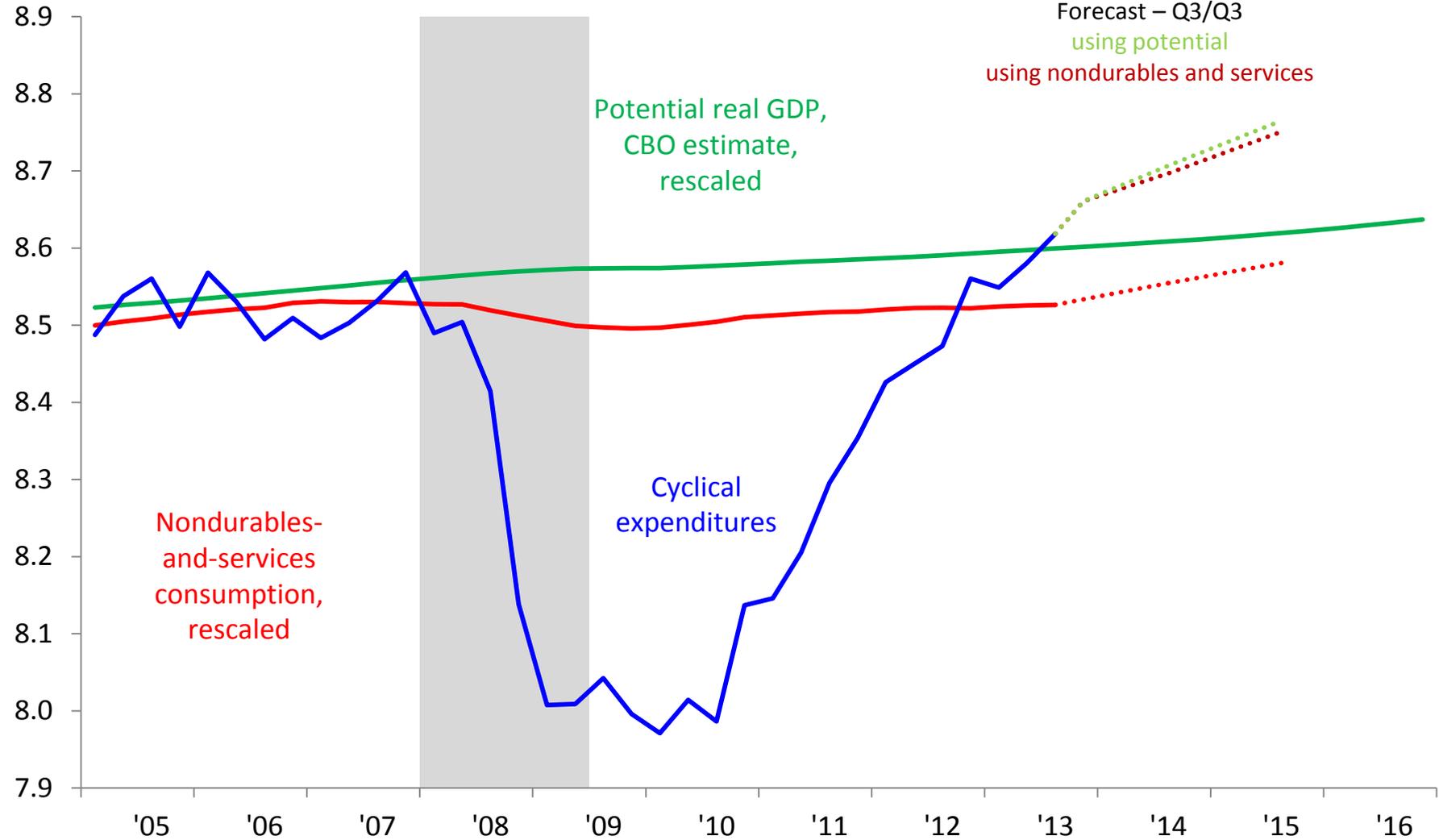
# Cyclical and trend components of GDP

Log scale, 2009\$ per capita



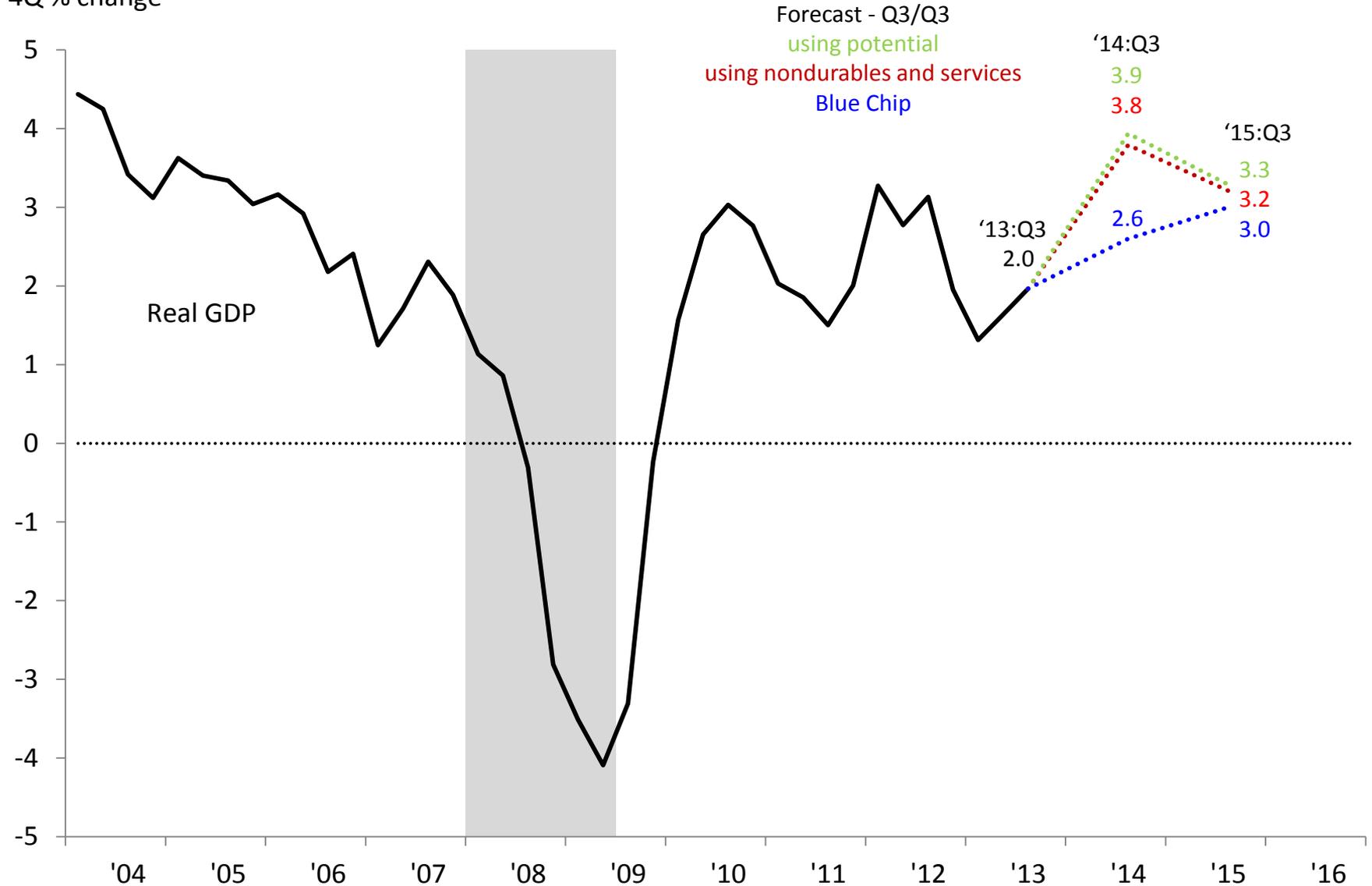
# Forecasts of cyclical and trend GDP components

Log scale, 2009\$ per capita



# The implication: Strong 2014 GDP growth

4Q % change



# Economic Outlook Summary

- Unemployment rate likely to hit the FOMC's 6.5% liftoff threshold sometime between 2014:Q2 and 2014:Q4
- The falling unemployment rate will push inflation toward (but not to) the FOMC's 2% long-run target
- Strong GDP growth in 2014

# Monetary Policy in Transition

- A transition to a new policy-leadership team
- A transition away from asset purchases and toward alternative forms of monetary policy accommodation, such as forward guidance
- A transition toward *reduced* policy accommodation if, as hoped, the recovery and inflation pick up steam
- A transition to new methods and tools for implementing post-liftoff monetary policy

# New policy leadership

- New Board and FOMC chair: Janet Yellen
- New governors: Stanley Fischer, Lael Brainard, ???
- New FRB Cleveland president: ???
- New FOMC voters:

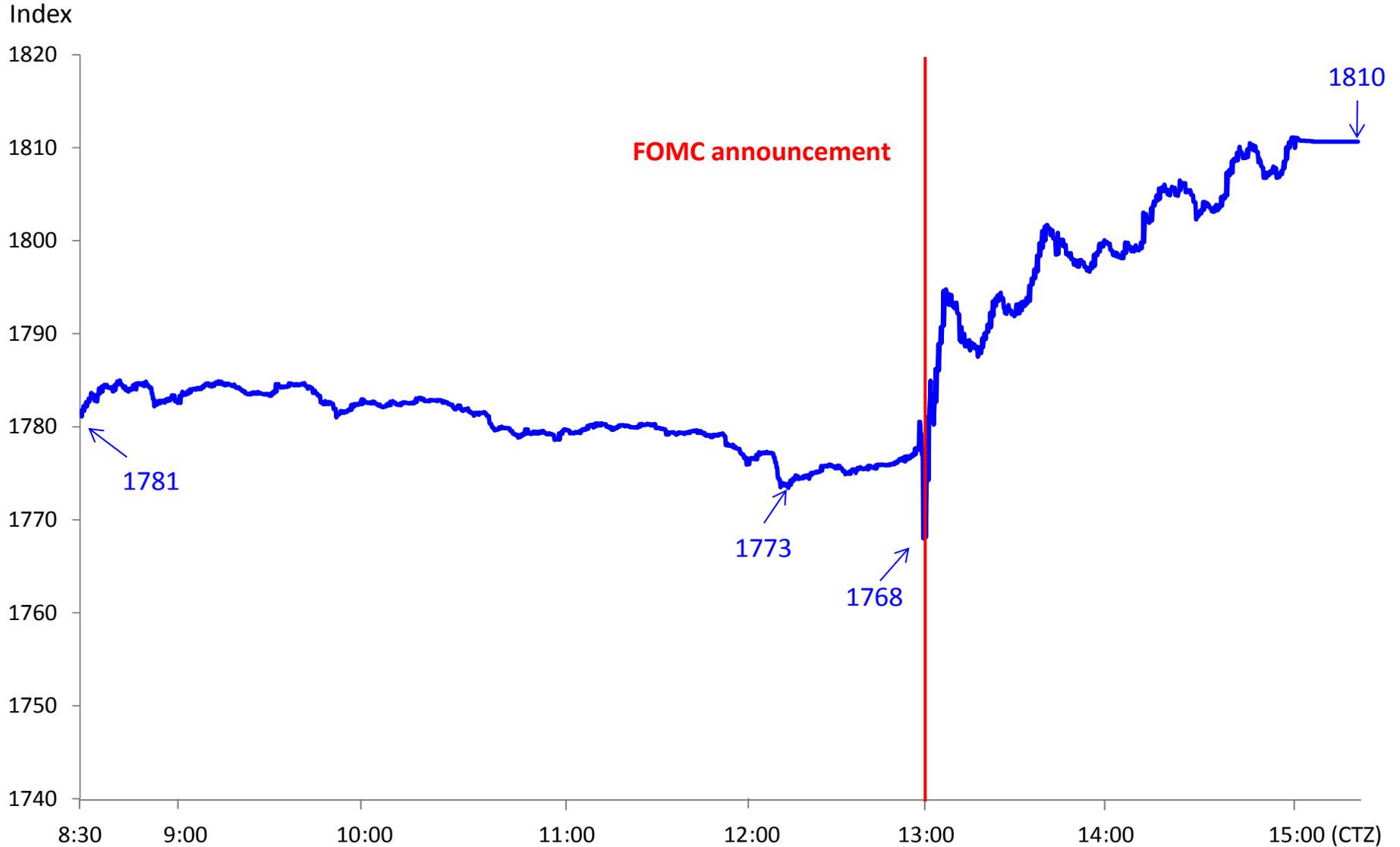
Voting	Replaces
Fisher (Dallas)	Bullard (St. Louis)
Kocherlakota (Minneapolis)	George (Kansas City)
??? (Cleveland)	Evans (Chicago)
Plosser (Philadelphia)	Rosengren (Boston)

# December FOMC: Let the taper begin!

- **A surprisingly early start:** “[T]he Committee decided to modestly reduce the pace of its asset purchases.”
  - Net monthly purchases of Treasury notes and bonds cut from \$45 billion to \$40 billion, and purchases of MBS cut from \$40 billion to \$35 billion
- **But a more-drawn-out taper than had been expected:** “[T]he Committee will likely reduce the pace of asset purchases in further measured steps at future meetings.”
  - With a \$10 billion reduction at each FOMC meeting, QE3 would end in 2014:Q4
- **And the Committee is in no hurry to raise rates:** “The Committee now anticipates...that it will be appropriate to maintain the current target range for the federal funds rate well past the time that the unemployment rate declines below 6-1/2 percent, especially if projected inflation continues to run below the Committee’s 2 percent longer-run goal.”

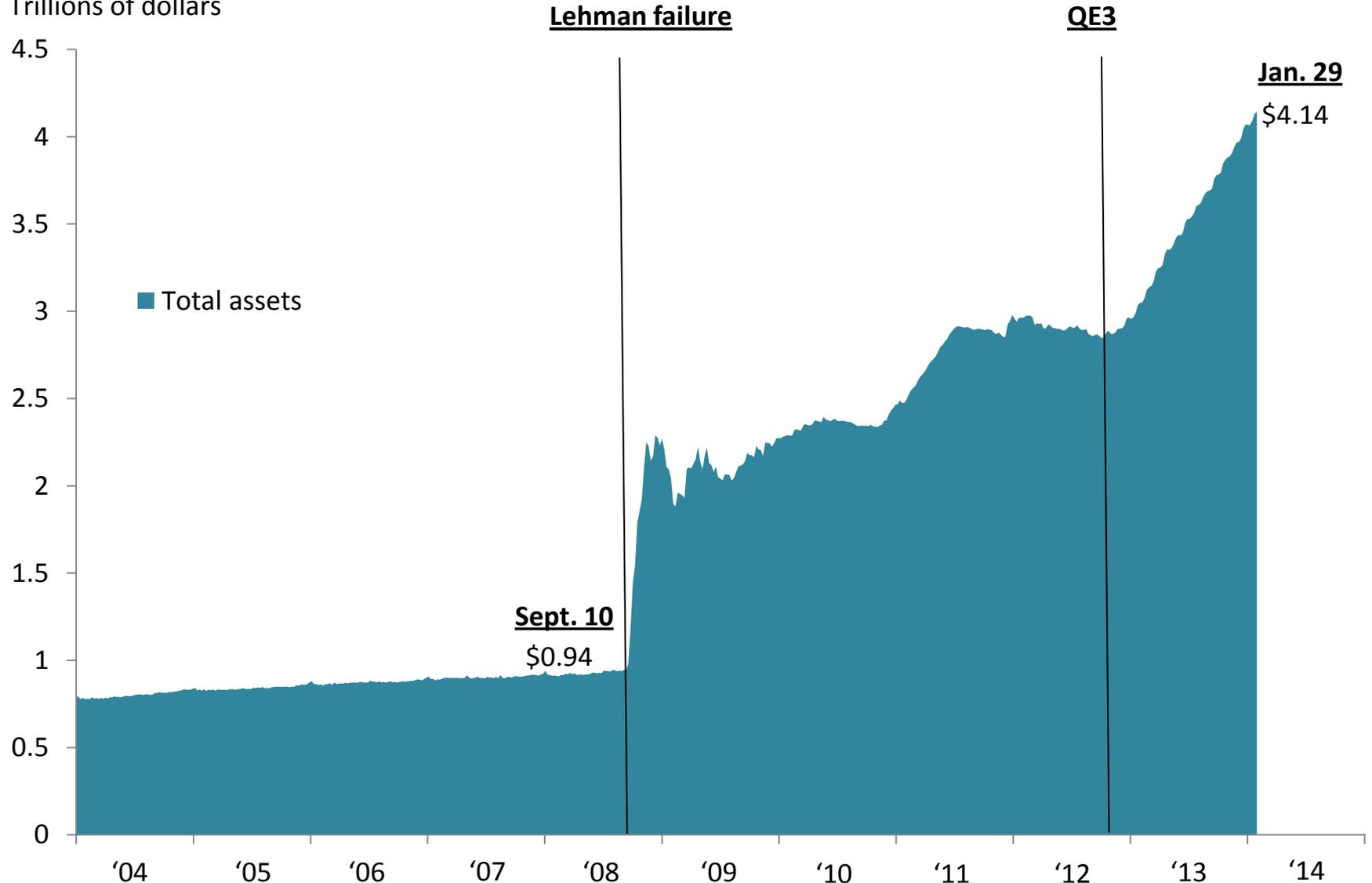
# Stock market reacts positively

(S&P 500 Composite Index, December 18, 2013)



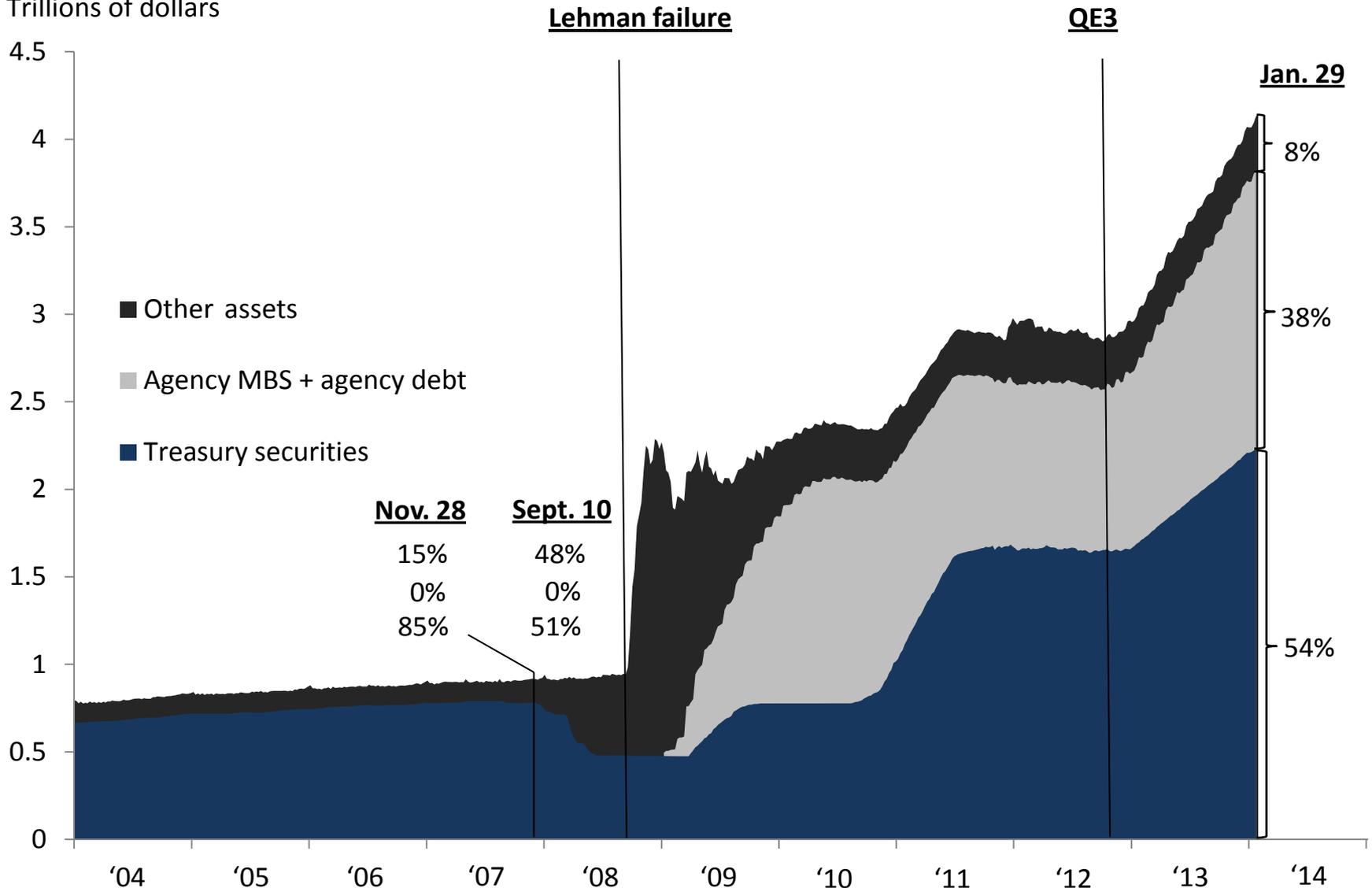
# Policy Backdrop: The Fed's balance sheet has quadrupled in size...

Trillions of dollars



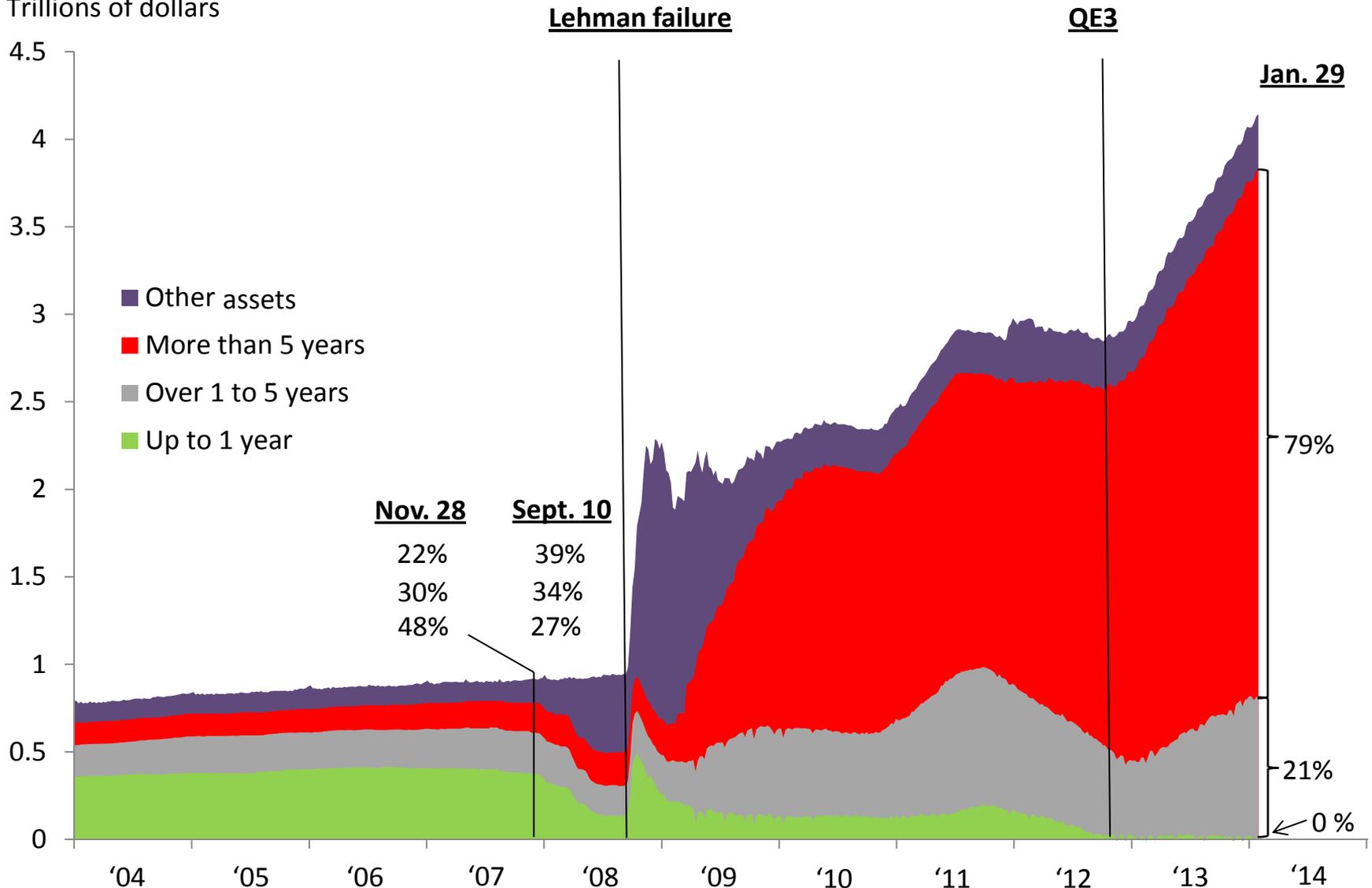
# Now includes large holdings of agency debt and agency MBS...

Trillions of dollars



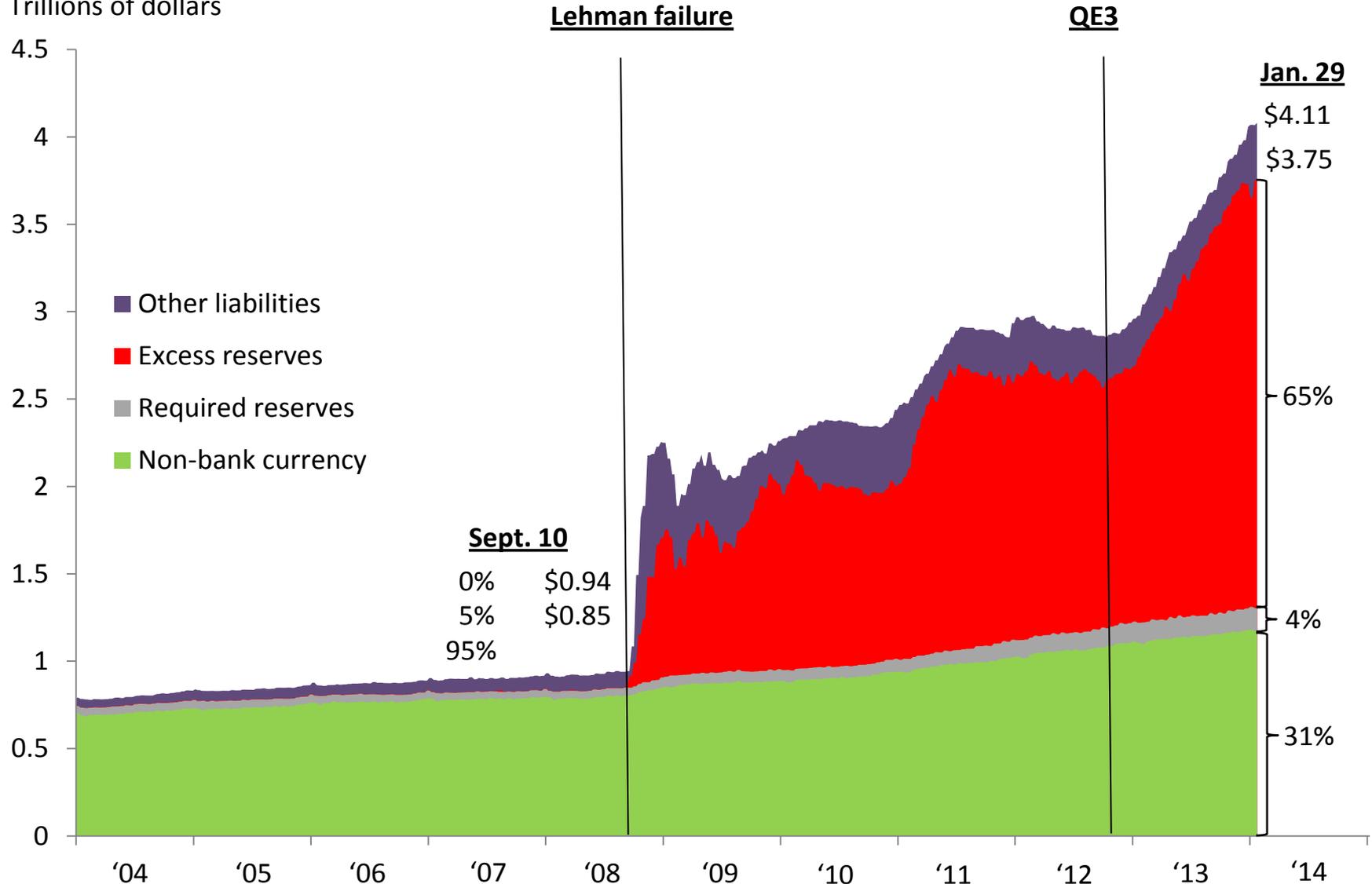
# And is weighted heavily toward securities and loans with long terms to maturity

Trillions of dollars



# The newly created money has flowed mostly into excess bank reserves

Trillions of dollars



# Post-liftoff policy challenges

- To prevent a too-rapid expansion of lending, the Fed will have to either:
  - compete for banks' liquid funds
  - absorb reserves by selling securities
- Practical concerns:
  - we have no experience with using large-scale reverse repos and the IOER to compete for liquid funds
  - rapid asset sales could impair market functioning (especially in MBS market)
- Political/public relations concerns:
  - large interest payments to banks/others
  - capital losses on asset sales
  - low Treasury remittances

# Grand Summary

- The recovery has likely shifted into a higher gear
- Inflation will begin rising toward target
- Interesting times ahead for monetary policymakers: new people, a new direction, new circumstances, and unfamiliar tools



# Texas Economic Update

Mine Yücel  
Senior Vice President and  
Director of Research

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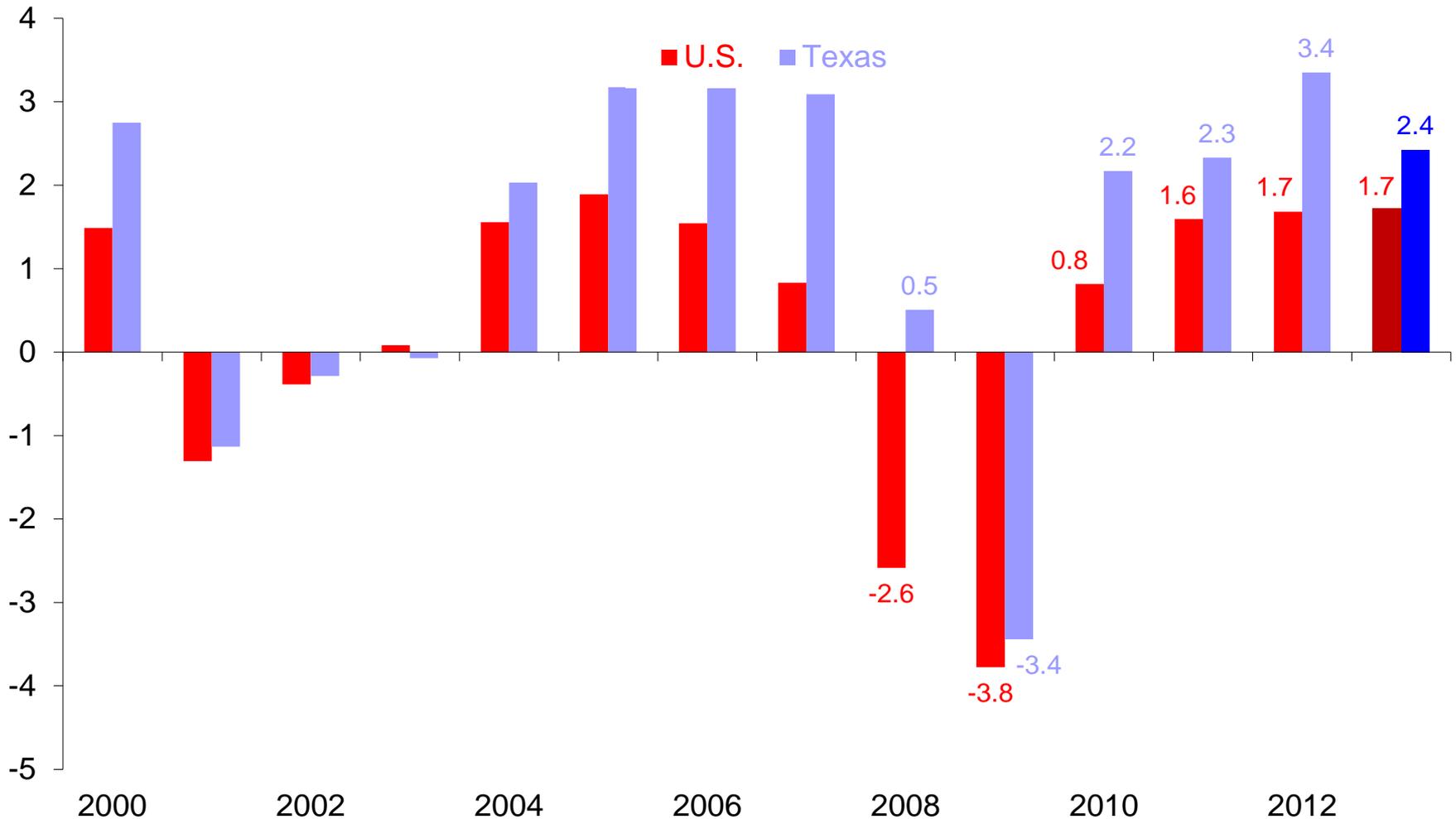
# Texas Economic Update

- The Texas economy grew 2.4% in 2013
  - Added 268,000 jobs
- Growth trends uneven
  - Manufacturing and exports strengthened
  - Energy, single-family housing softened
- Expect 3% job growth for the year



# Texas' employment growth bests nation's

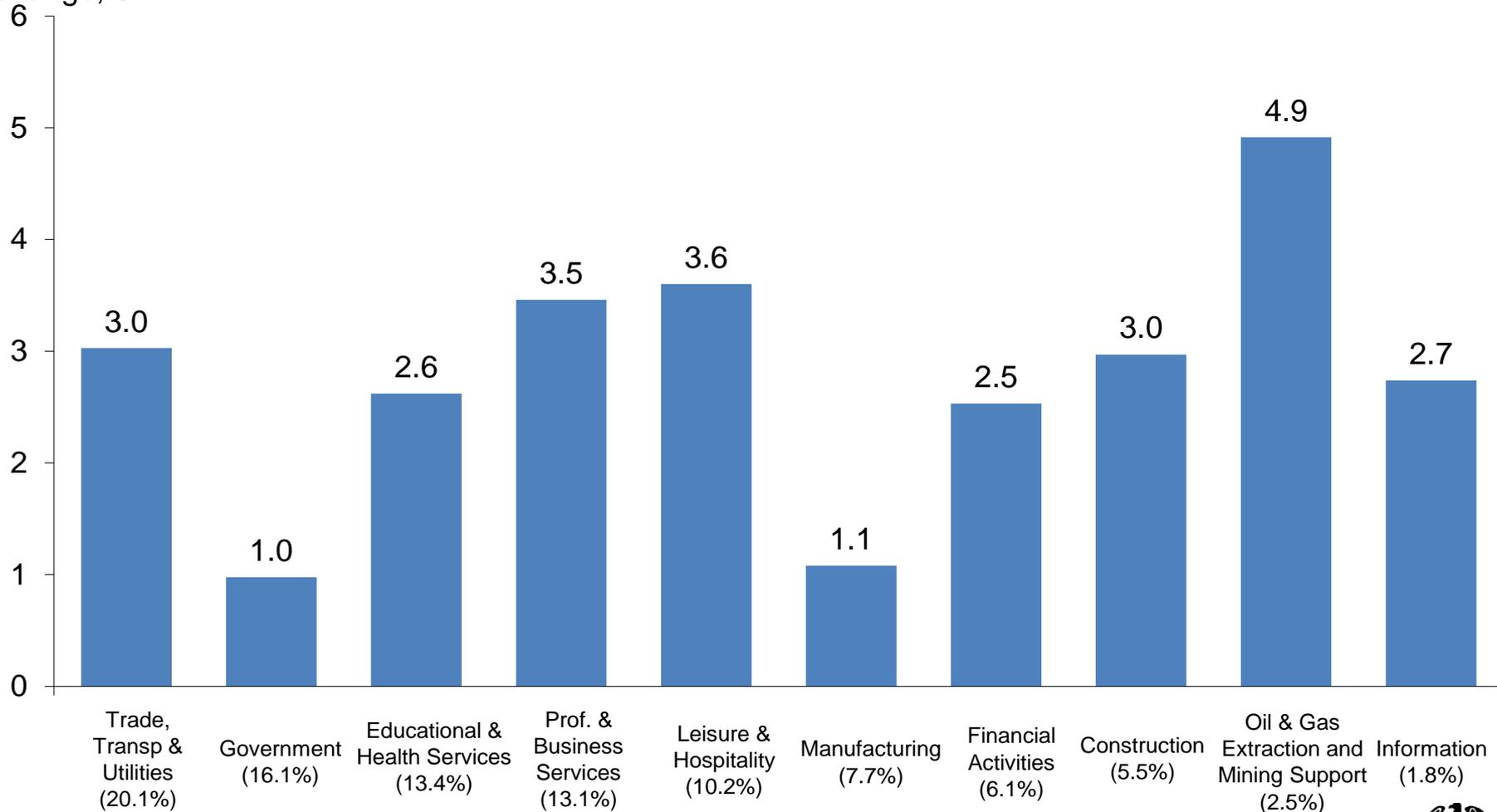
Dec/Dec,  
SAAR



# Employment growth by sector

(NAICS Super Sectors, SA by FRB Dallas)

YTD percent  
change, SAAR



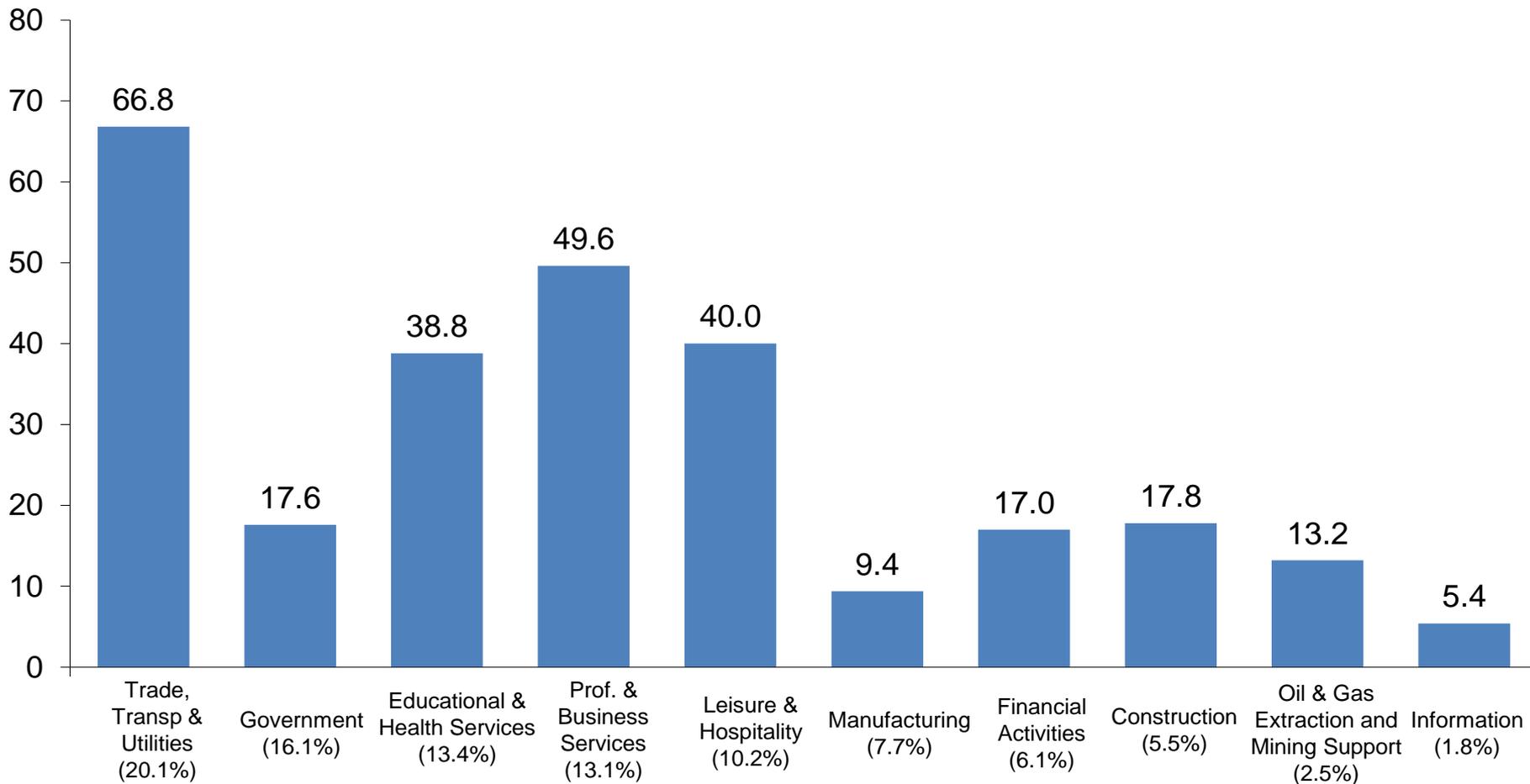
Federal Reserve Bank of Dallas



# Employment growth by sector

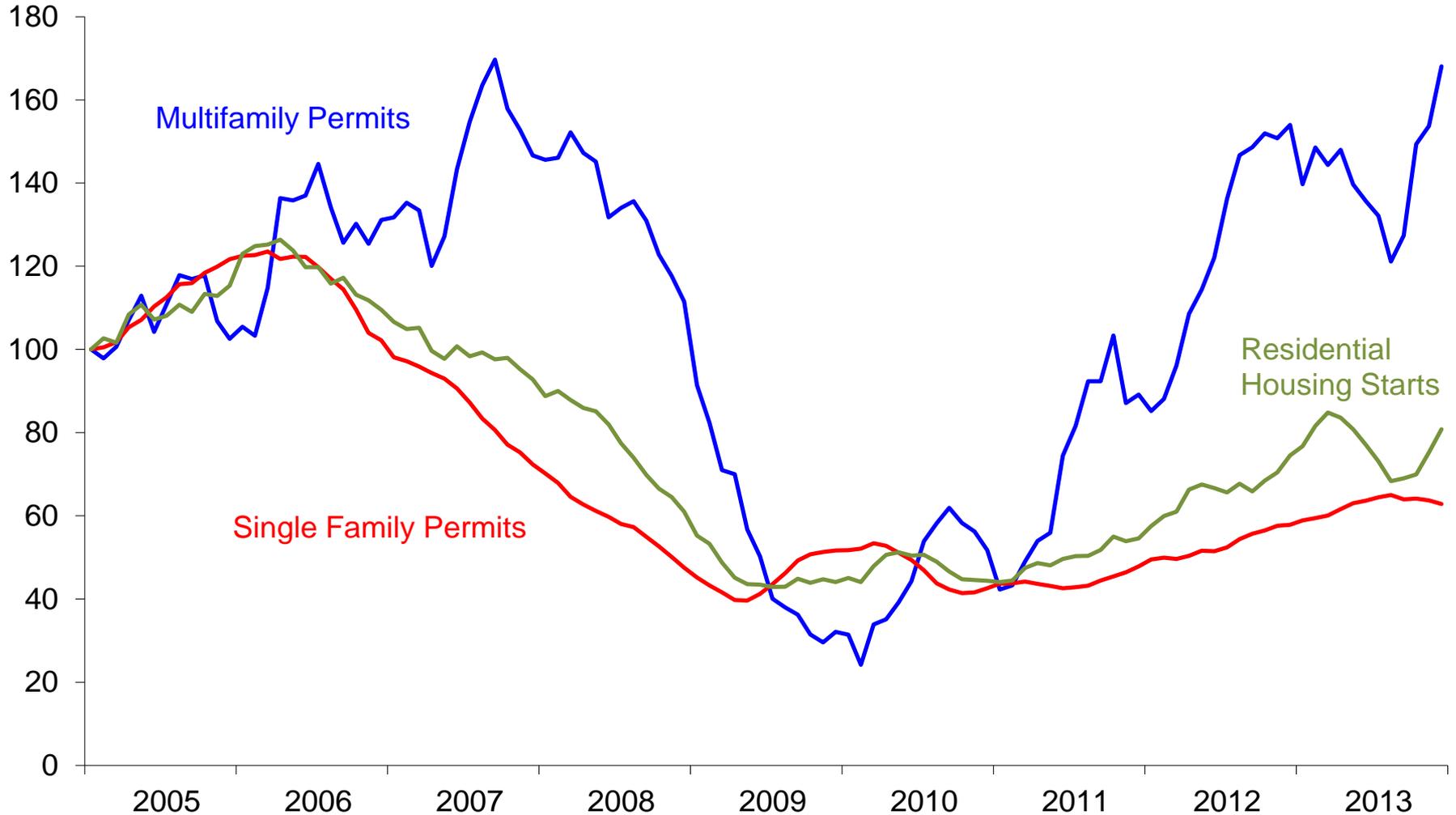
(NAICS Super Sectors, SA by FRB Dallas)

Thousands of jobs



# Multi-family home construction robust

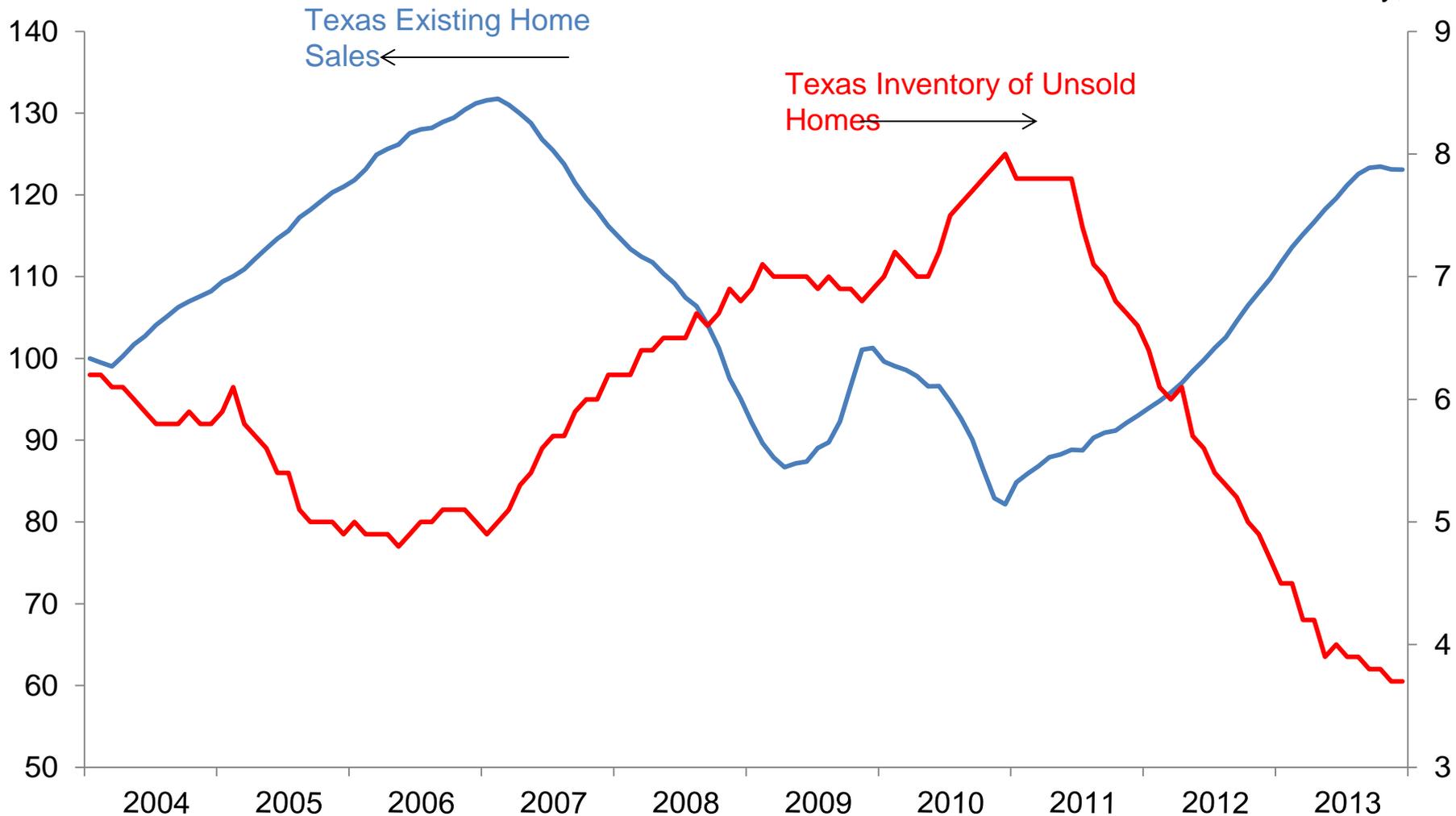
Index, SA, 5MMA  
Jan 2008=100



# Home market tight

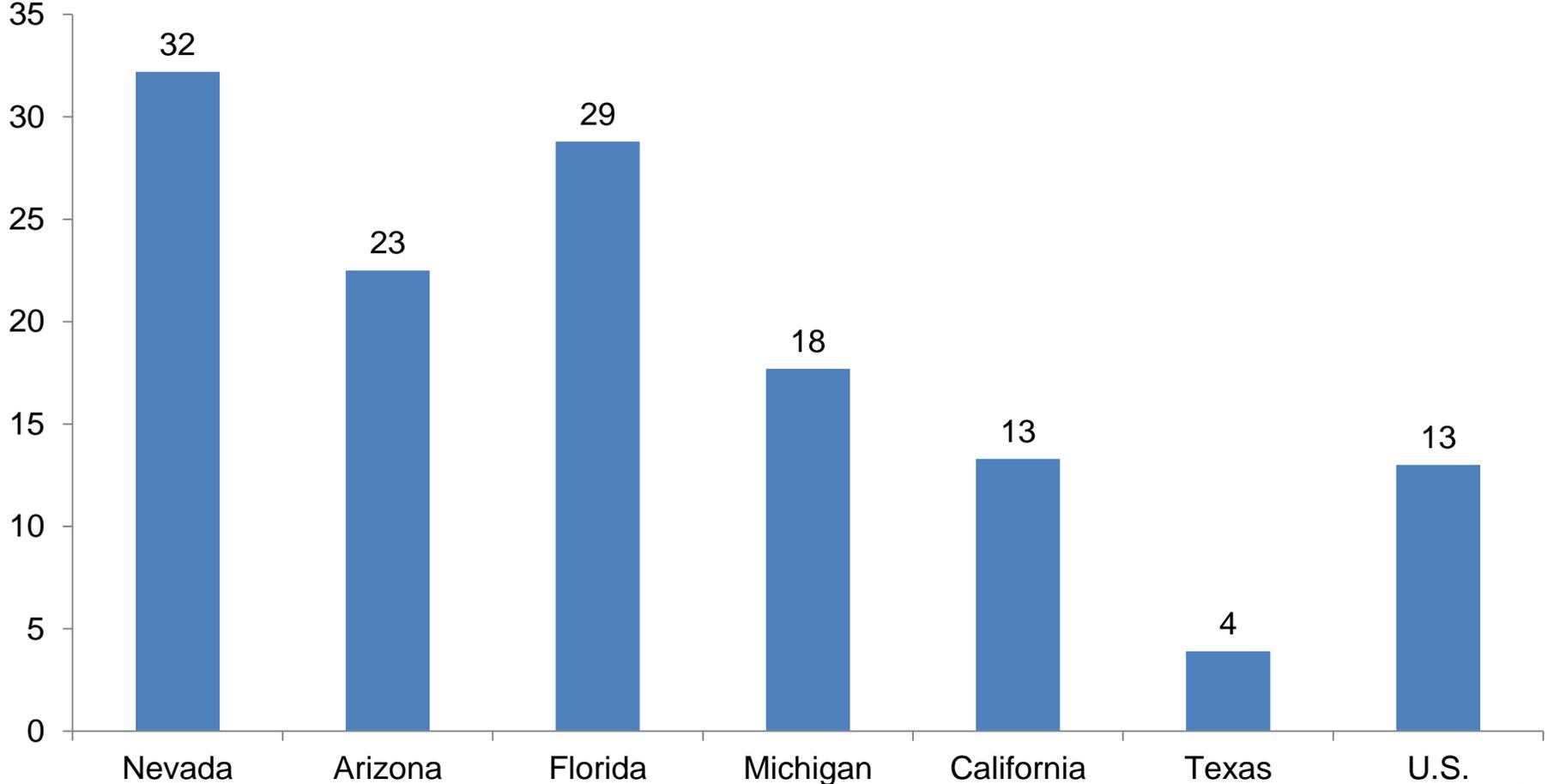
Index, Jan. 2004=100,  
SA, 6MMA

Months in  
Inventory, SA



# Texas has much lower share of underwater mortgages

Percent of mortgages with balance > home value, 2013Q3



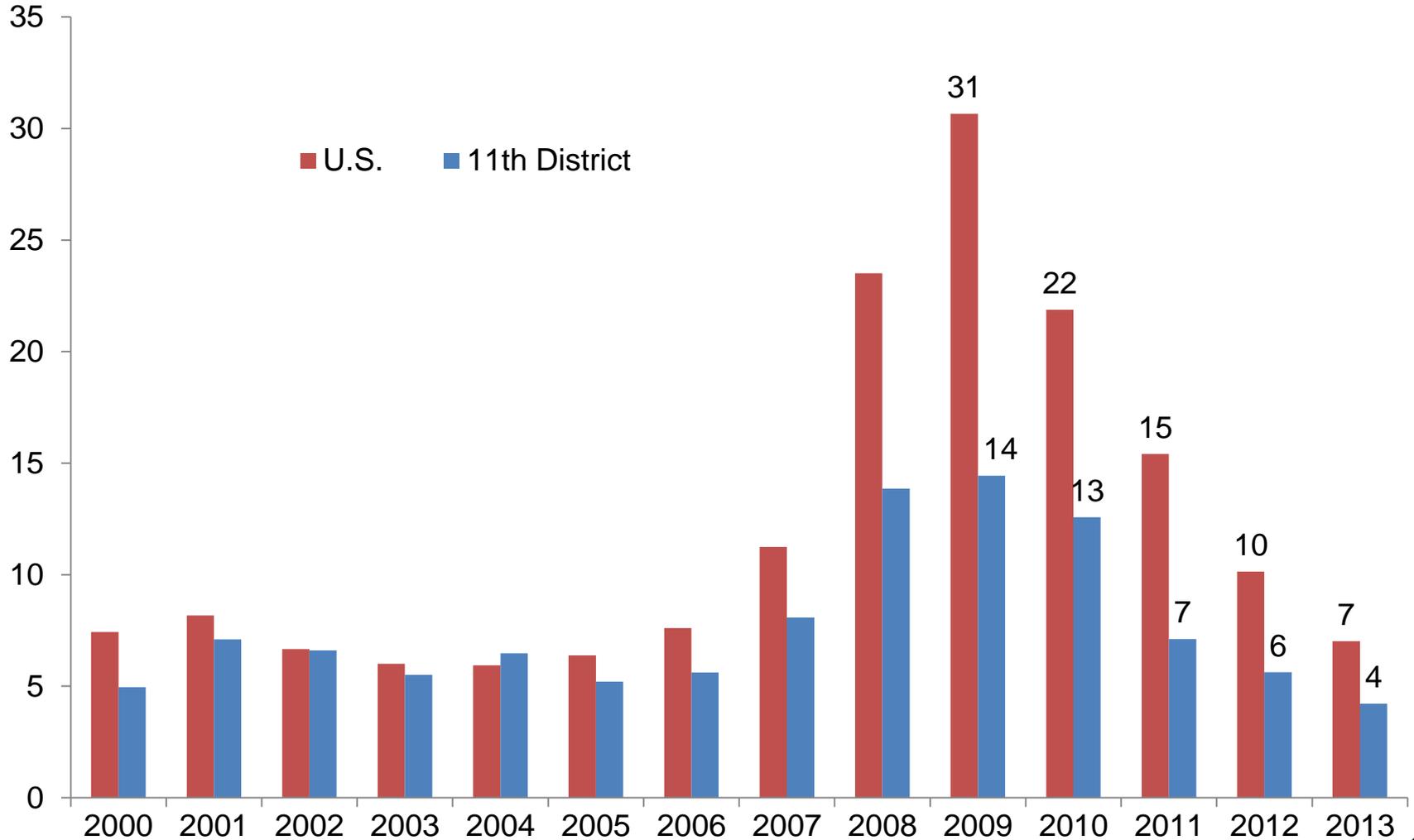
Source: CoreLogic

Federal Reserve Bank of Dallas



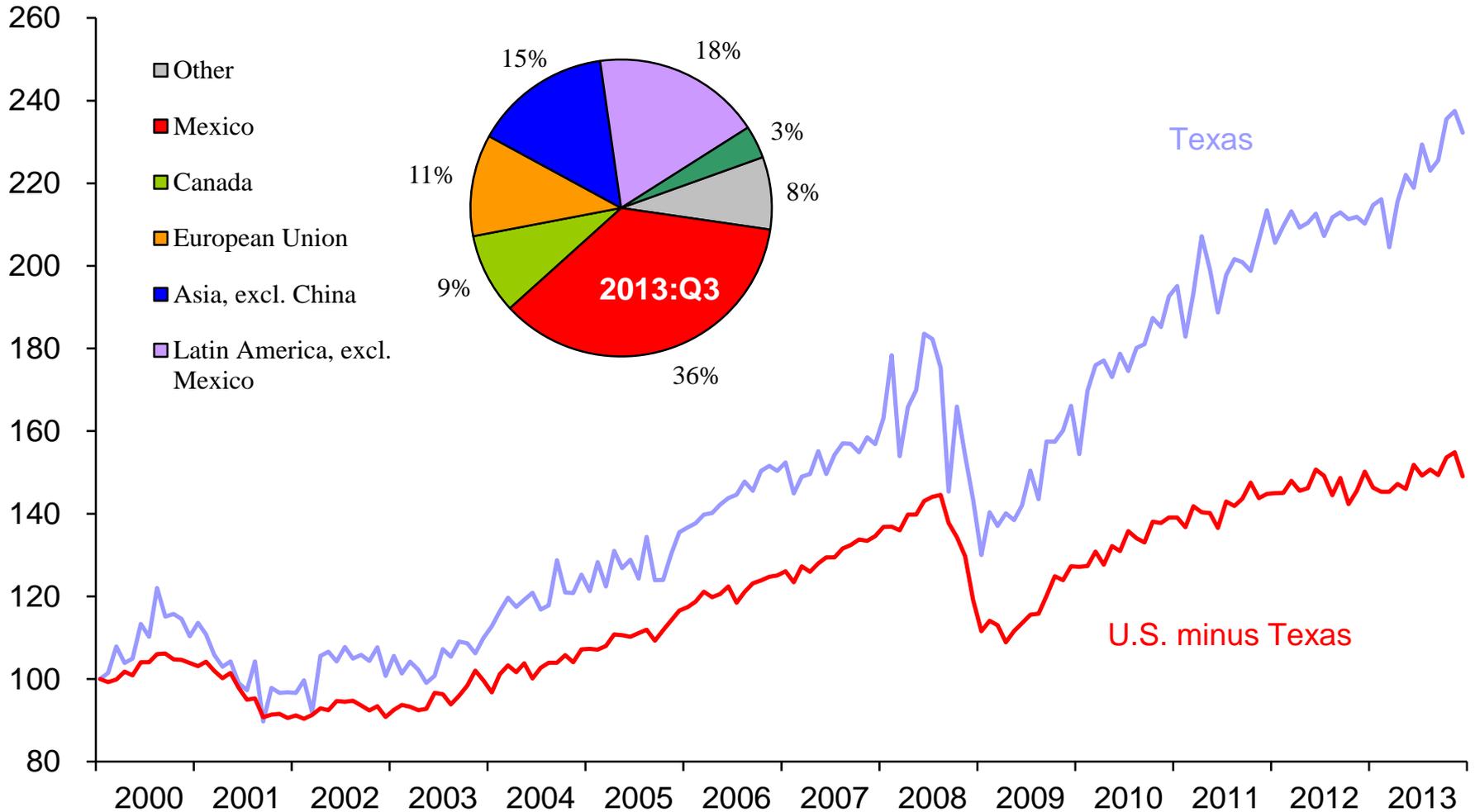
# Share of unprofitable banks

Percent of Banks Reporting a Net Loss



# Export growth weakens slightly

Index, SA Real  
Jan. 2000=100



# Energy major driver of Texas economy

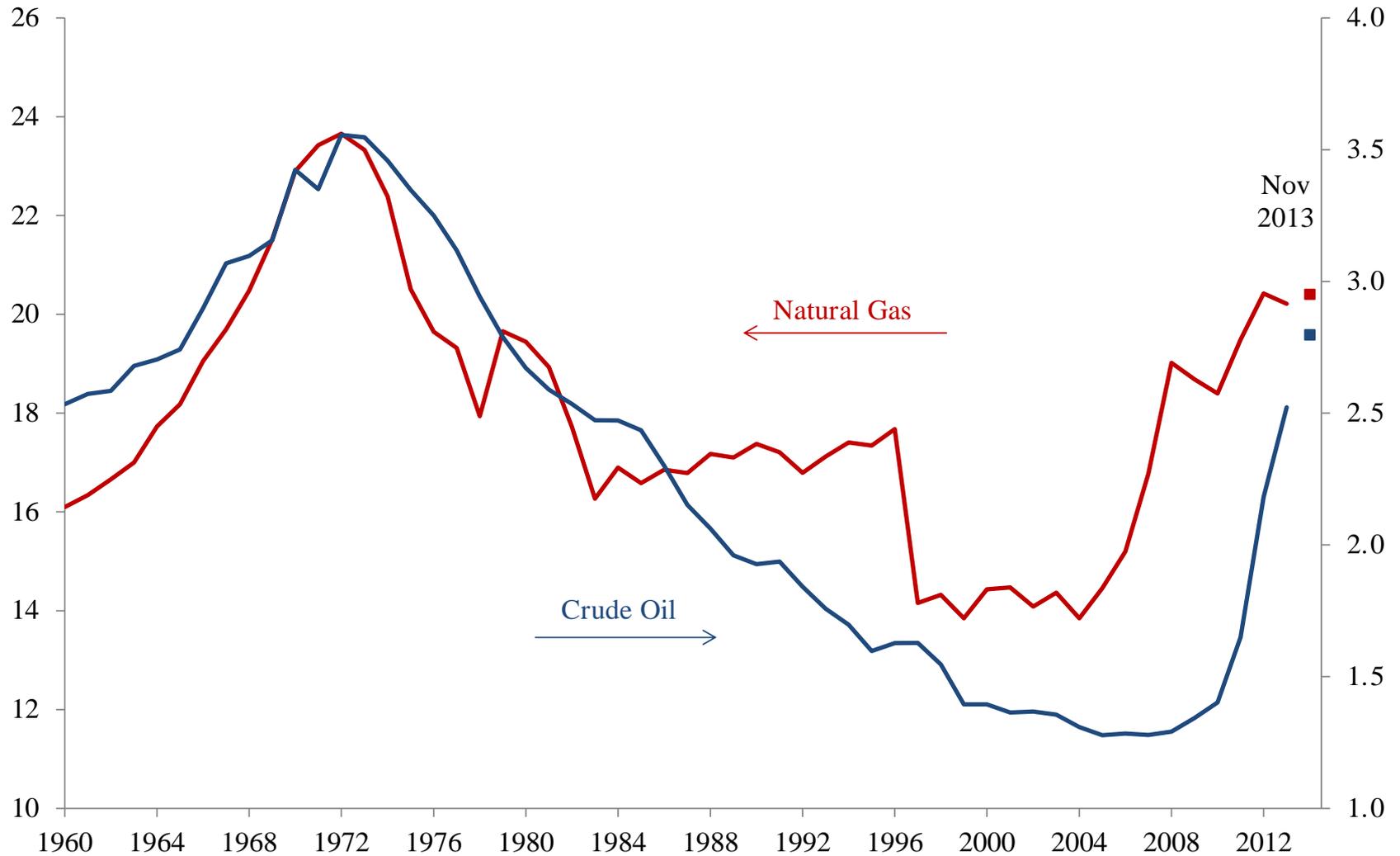
- Texas #1 producer of oil and gas in the nation
- Texas provides oil services to nation and rest of world.
- 25% of U.S. refinery capacity and 60% of U.S. petrochemical production is in Texas
- Higher energy prices benefit Texas, on net.



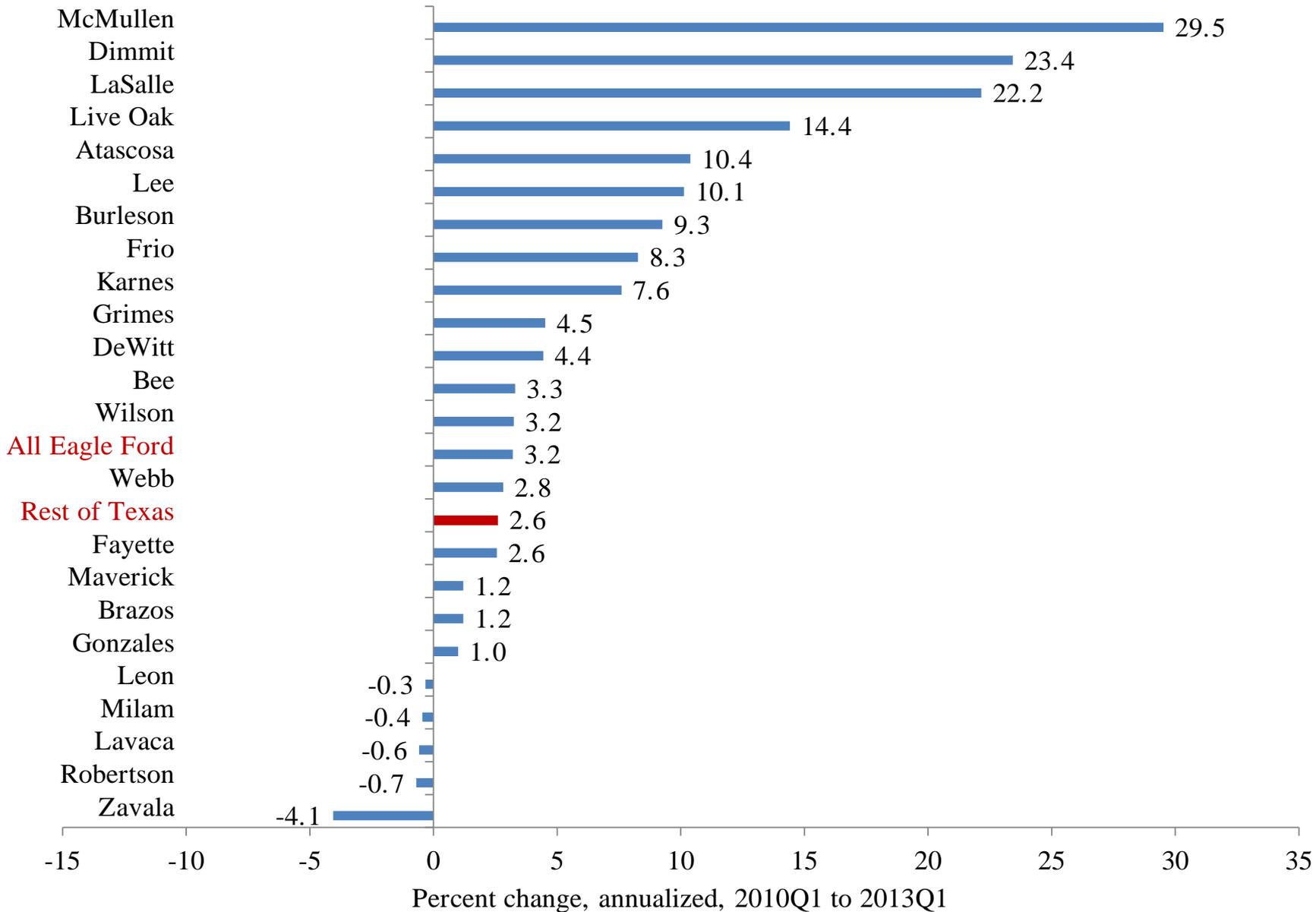
# Texas oil production up strongly

Billion cubic feet per day

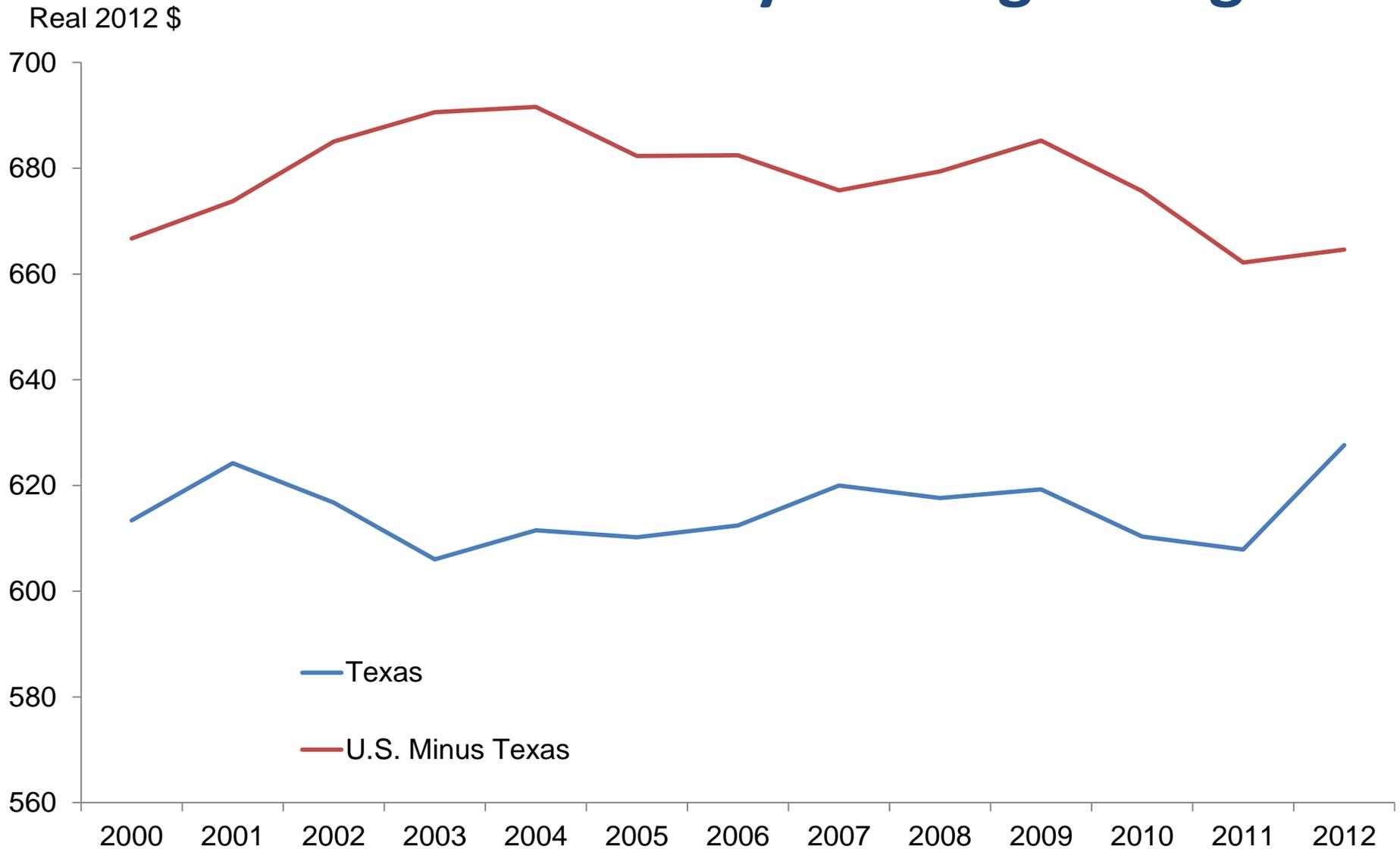
Million barrels per day



# Eagle Ford Employment Growth



# Texas median weekly earnings rising



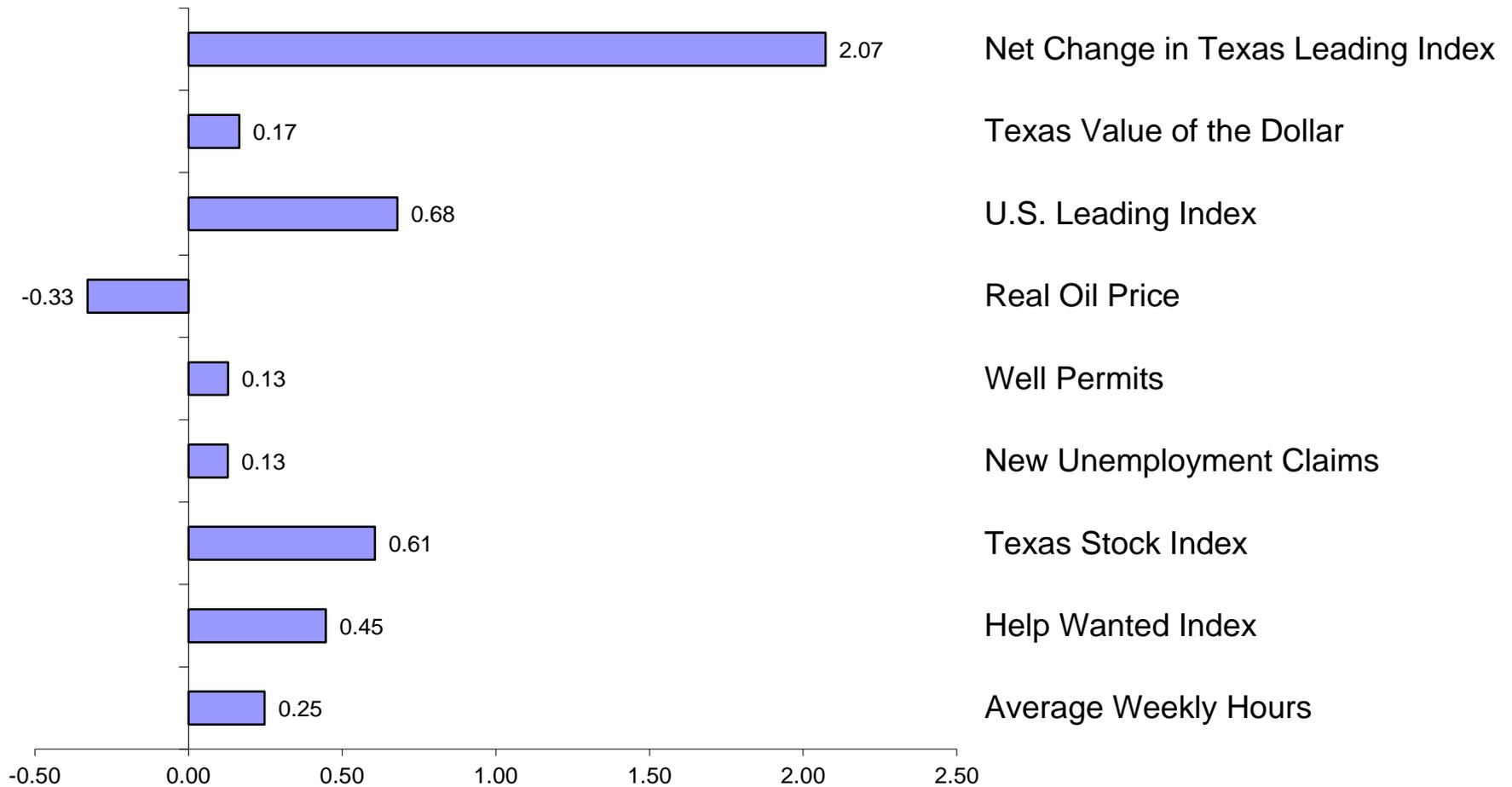
# Severance taxes fill state coffers

- 2013 oil and gas tax revenues in TX
  - \$4.5 billion
  - 10.7 % of total state tax revenues
  - 45% increase from a year ago
- Oil severance taxes: \$3.0 billion
- Natural Gas severance taxes: \$1.5 billion



# Texas Leading Index: Positive growth ahead

## Texas Leading Index Components, 3 month change (September -November)



# Summary

- Texas jobs grew 2.4% in 2013
  - 268,000 jobs
- 2013 growth has been mixed
  - Manufacturing and exports picked up at year-end
  - Although at high levels, energy and single-family construction growth weakened
  - Outlooks optimistic
- Expect 3% job growth for the year
  - 340,000 jobs
- Texas will outpace nation again in 2014





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