Rose Oswald Poels:

Good morning everyone and welcome to the Midwest Economic Forecast Forum. We're really delighted to have over 450 people coming from mainly the central part of the United States, and then some reporters, of course who are coming from all over the world. So, excited to have everyone here today and looking forward to our conversation and hearing from two very knowledgeable speakers on their economic forecast for 2023. I want to welcome all of the bankers who are joining us today from Wisconsin, as well as the many other states who are partnering with us today to offer this event. Really excited to have the associations from Arkansas, Illinois, Kentucky, Michigan, Minnesota, Missouri, and South Dakota all joining us today. So I know in addition to my colleagues from those other states, we have many bankers joining us as well and many of them have invited their business customers into the bank to hear the presentations today.

So we're very excited about that. As President and CEO of the Wisconsin Bankers Association, it is my honor today to be moderating the conversation with Fed President James Bullard and I will introduce him in a moment. I do want to also thank our sponsors for today's event, which include BOK Financial Capital Markets, Wisconsin REALTORS Association, and Whitley LLP. Today's the format for the first half of our forecast forum will be with Fed President James Bullard and in a moment I will introduce his bio. If you have questions, please do share them in the chat. This is meant to be very informative. So Fed President Bullard will have about 10 minutes of some comments and remarks with his thoughts for the economy this year and then we will open it up to questions and again, I will moderate those as well.

So it is my pleasure to welcome Fed President Bullard to this Midwest Economic Forecast Forum. Wisconsin used to do this in person in Madison before COVID and we were honored to have his presence here in the state back then as well. So welcome again to our Economic Forecast Forum this time. Fed President Bullard in his role as the Federal Reserve Bank of St. Louis President. He is a participant on the Federal Reserve's Federal Open Market Committee, which meets regularly to set the direction of US monetary policy. He also oversees the Fed's Eighth District, including activities at the St. Louis headquarters and its branches in Little Rock, Arkansas, Louisville, Kentucky, and Memphis, Tennessee. A noted economist and policymaker, President Bullard makes Fed transparency and dialogue a priority on the international and national stage as well as on Main Street. He serves on the board of directors of Concordance Academy of Leadership and he is a past board chair of the United Way USA.

He is an executive committee member of the Greater St. Louis Inc.'s chair's council. In addition, President Bullard is co-editor of the Journal of Economic Dynamics and Control, a member of the editorial advisory board of the National Institute of Economic Review and a member of the Central Bank Research Association senior council. He is an honorary professor of economics at Washington University in St. Louis, where he also sits on the advisory council of the economics department and the advisory board of the Center for Dynamic Economists. A native of Forest Lake, Minnesota, Bullard received his doctorate in economics from Indiana University in Bloomington. So with that Fed President Bullard, I will turn the table over to you and come back on when it is time for the Q and A.

James Bullard:

Great, thanks very much, and thanks for having me today. I'm looking forward to robust discussion of the many things that are going on in the US economy and the global economy and monetary policy associated with that. It's always fun to talk to this group and I'm sure we'll have a great discussion today. So I thought I'd start with just a few comments about the general way I'm looking at the US economy and then we can go from there with the Q and A. To start off, I think that over the holiday season here, the main piece of news in my mind was that fourth quarter GDP growth in the US is looking better than previously expected. You might recall that only a few months ago, some were predicting that the fourth

quarter would be a negative quarter for the US economy in part due to aggressive monetary policy by the Fed.

That's turning out not to be the case. We don't have the fourth quarter GDP number right now, but the Atlanta Fed's GDP tracker is up around 4% at an annual rate of growth for the fourth quarter. So other forecasters have now revised up their forecasts and so I would just generally say that it looks like we had an above trend rate of growth for the US economy in the fourth quarter. The reason I think this is especially important here is that, that's combined with a third quarter real GDP growth rate for the US at an annual rate above the longer run trend of 2%. And so when you combine the third and fourth quarter together, both of those look now like they'll be above trend and so you had a whole second half of 2022 of above trend GDP growth.

So this, I think puts the GDP numbers more in line with the labor market data that we've been seeing and I'll come to labor markets in just a moment and sort of resolves a puzzle that had previously been vexing many of you and me as well because the first half of 2022 according to the official data, still shows negative real GDP growth in the first half of 2022 last year. And I thought that might get revised away. It didn't get revised away and it's been a bit of a puzzle as to why that was so weak in the first half when the labor market was so strong in the first half of last year. So now that we have labor market data that's still strong, but GDP growth which is positive and above trend, this is all making a lot more sense.

And so I think that that's a bullish factor going into 2023. Some other bullish factors I would say for 2023 are that households still remain flush. Bank deposits, for instance, many institutions are still relatively high and that I think is partly because households have not completely spent the COVID dollars that they got during the response to the COVID crisis. So they're spending that down, but they certainly have a cushion that should support consumption spending going forward through the first half and all of 2023. Also, state and local governments seem to be relatively flush with cash both from COVID dollars and from tax receipts, especially from 2021. I don't think those entities have been able to spend the resources that they have and have gotten a lot of comments from many of you probably in that direction. I think we still have a very high wealth to disposable income ratio in the US, it's true. The wealth to disposable income ratio includes equity pricing and house prices. Both of those have come off their highs.

But if you look at the history of that metric, still at a very high level compared to where it was historically or even compared to where it was in many of the years pre-pandemic. So that also suggests that households feel relatively comfortable and should cushion consumption spending during 2023. And finally that we have better global prospects than we had just a few weeks ago. For Europe, it looks like there's less possibility of recession and that the worst of the winter worries about energy prices have faded. For China, we have an abrupt change in their COVID policy and China reopening going forward. So that seems to indicate that the global... those are two very large economies in concert with the US economy, seems to indicate that global growth prospects have brightened just in the last few weeks here.

So as I was saying that the GDP data now matches the labor market data, which has continued to be very strong. We've had jobs reports that showed non-farm payroll employment growing well above the long run trend pays for the US economy. We still have 1.7 job openings for every unemployed worker in the US. It's hard to see how unemployment is going to go up if there are that many job openings for a worker that gets disrupted, it seems like they would have many opportunities to get back into a job fairly quickly. Unemployment insurance claims accordingly are very low and lower than they were in the pre-pandemic era when adjusted for seasonal factors. Quits rates remain quite high. Workers feel confident that they can quit their jobs and go to another job. Unemployment rate ticked down to 3.5%, one of the lowest unemployment rates of the recent decades in the US economy.

So labor market continues to look very strong going into 2023. Inflation remains extremely high. Core CPI inflation even after today's data, measured over 12-month interval is 5.7%, still well above the Fed's inflation target of 2%. But inflation is moderating in response to front-loaded and aggressive monetary policy in 2022. I would cite evidence on inflation expectations, which I think have been kept in check as we've tried to deal with this inflation shock by the aggressive monetary policy that we've employed.

If you look at the inflation swaps, inflation compensation over two years, five years or the five-year, five-year forward, those numbers in January 2021 were all slightly above 2%. At that point, we had no inflation and no one was predicting any inflation at that point in the first quarter of 2021. Then over the ensuing two years until today, of course we had lots of bad inflation data and a big change in monetary policy, but today those same inflation compensation data are all in the low 2% range, whereas during the intervening time period they had risen up to higher levels.

So that shows that the Fed's policy has been able to keep inflation expectations under control and has returned inflation expectations to levels consistent with the 2% inflation target. And I'm now expecting actual inflation to follow behind and move down toward 2% as we go forward in the US economy. So I think that the Fed's policy has been the right one, especially the front-loading aspect to get the policy rate to the right level to return inflation to 2% on a consistent basis. By front-loading transparently and forthrightly in communicating with markets, we can avoid the 1970s outcome with similar inflation rates to what we have today. In the 1970s, the problem was that inflation seemed to move down but then kept coming back and rising to even higher levels as we went forward and we ended up messing around with an inflation problem for over 15 years, culminating in the 1980-82 recession with unemployment at 10.8%.

So we don't want to replay the 1970s. We want to make sure that we're moving inflation clearly back to 2%, and that means that the Fed is going to have to maintain rates at high enough levels to make sure that inflation is moving down and staying down on a consistent basis. So that brings me to the last point I wanted to make in my opening comments here which is the level of the sufficiently restrictive policy rate that the Fed should be using to try to keep inflation under control and return inflation to the 2% target. And I've done a Taylor-type rule calculation, which you can check out on my webpage in previous talks, and that calculation was made with generous assumptions. So even if you're willing, you do a calculation like that, you have to make a lot of assumptions, but I made the most generous ones that I could.

That is the ones that would suggest a lower level of the policy rate rather than a higher level of the policy rate. And even with those generous assumptions, you get something north of 5% as being the lowest level of the policy rate that you could use to credibly restrict inflation and to return it to the 2% inflation target. And indeed, in the Summary of Economic Projections that the committee put out in December, the committee suggested that the median person on the committee, I'm not sure what that is really, but the median dot said that the policy rate would be somewhat above 5% at the end of 2023. So that's consistent with the generous policy rule assumption that I did... analysis that I did in previous speeches. So my preference would be, if that's the appropriate level of the policy rate that we want to shoot for, then I think it would be appropriate to get there as soon as possible and get the benefit of downward pressure on inflation from the higher policy rate.

Although I would say the tactics around that probably don't matter that much in macroeconomic terms, it certainly matters a lot to all of you as participants in financial markets, but in macroeconomic terms, whether that's done at one meeting or another is probably not as important. I think the risk here is that inflation, while it is moderating, does not moderate as quickly as markets are currently expecting and that we're all hoping for. It could be that inflation starts to go in the other direction again and then the Fed would have to react to that. I don't think there's enough pricing being put on that possibility. There's

probably too much optimism that inflation's easily going to come back to 2%. That is not the history of inflation, but we can all still be hopeful. And again, I do think that our policy so far has been successful. So, so far so good. We're moving inflation in the right direction. And my bottom line for 2023 is that it will be a year of disinflation. So let me stop there and open it up to questions. Thanks very much.

Rose Oswald Poels:

All right, well thank you very much for those great opening comments and I am certainly happy to hear that you're very bullish about 2023. I think that's certainly very good news and good to see that some of the indicators are starting to show some positive signs that your policies and tightening have been working. So let's dive into some questions here. First of all, what is your guiding view on inflation? Numbers in October and November came in better than expected. In December though, as I think you mentioned, inflation forecast went up. We did see some positive news today though on the CPI. What is really guiding your view on inflation?

James Bullard:

Yeah, it's true that the Summary of Economic Projections had a revision upward to inflation for 2023, but that was relative to September, the previous round of forecast made by the committee. So I think what happened was that at the September meeting, I can't speak for my colleagues, but my guess is that they expected that the inflation numbers for the last part of 2022 would be more moderate than they turned out to be, and because of that they had to ratchet up their inflation forecast for 2023. I think we certainly look at all kinds of information when we're trying to forecast inflation. It's notoriously difficult to forecast, and there are obviously many factors at play. I think the decline in energy prices has obviously impacted the headline number. However, if you look at some of the other measures of inflation, the core PCE, which throws out the food and energy component, or the core CP I, it came out today, those have moderated but not as much as the headline figure.

And if you look at other measures of the price change, and one of the favorites of mine is the Dallas Fed Trim Mean. So what the Dallas Fed Trim Mean does is it takes the whole distribution of price changes, throws out the ones that have gone down the most and throws out the ones that have gone up the most and just looks at the center of the price change distribution. And that's been running around four and a half percent and it's barely budged on the downward side. So I think that gives you some indication of how hard it's going to be to make sure that inflation by measure like that is going to come down to 2% in a reasonable timeframe. So I think we've got a lot of work to do as a Fed in order to make sure that we get inflation lower going forward. But it is encouraging that we got some information today that went in the right direction.

Rose Oswald Poels:

Right. Yeah, hard to know sometimes how long your policies take to actually work through the system, right?

James Bullard:

Yeah.

Rose Oswald Poels:

All right. We have several questions coming in from the audience, which is great. So I'll read the first one to you. Would you address the impact of the ongoing quantitative tightening on the mid-maturities of

the treasury curve? Given the trillions of supply to come into the markets, should we be worried about mid-maturity yields to increase as QT continues?

James Bullard:

Well, I was pleased that we were able to get the quantitative tightening program started in the second quarter of 2022, way ahead of what we had previously thought and previously scheduled. And I would say to everyone in the audience here that a mystery around US monetary policy is how much tightening are we actually getting from that part of the policy as opposed to the rates part of the policy. The committee has wanted to, and the chair has said that we want to make the policy rate be the main tool and have the balance sheet policy certainly in motion, but not having that be the adjustments that are being made to try to address inflation. So I was pleased to get that in place. It has been up and running at its presumed or its targeted level since about September. So my preference is to let this continue to operate as we're making our adjustments to the policy rate and kind of see where we are maybe in the second half of 2023.

As far as the exact impact on rates, I don't think anybody knows exactly what these are. If you look at the empirical evidence in the literature, it has a very wide range, distressingly wide range of estimates about what the true effects are. For those that want to argue that the policy rate does not to need to go as high, they might point to the quantitative tightening policy as a supplemental tightening policy that might be helping us. Others might say that the effects coming through that channel are relatively weak and therefore we have to do more with the policy rate and that's definitely a live area for policy debate.

Rose Oswald Poels:

The next question is related to supply chain issues. Certainly we saw many of those over the last three years, although they are certainly improving in the Midwest. I know there do still seem to be some supply chain issues in certain sectors. How are we to measure supply chain constraints, and can we predict the impact that those are having on inflation as they start to improve?

James Bullard:

Yeah, I think it's been an era of distressingly big supply chain issues. I think you're exactly right that the measurements that we have based on looking at particular markets are indicating substantial improvement. One of the ones that you often see charts on is the cost of shipping from China to the US that went up dramatically during the pandemic and stayed high, but now has come down just as dramatically. And so I would say that's a sort of poster child for a mitigation of these supply chain issues. Also, I think American businesses are very astute and very agile, and to the extent they're having problems, they find workarounds, they find ways to address the problem or even change their product maybe so that they aren't as reliant on particular materials or particular parts from a certain area. It's become a cliché that we're moving away from just in time and toward just in case.

But I think that Business 101 says that you should be diversifying your supply lines and making sure that you're not overly reliant on a particular situation. I think the Russian invasion of Ukraine has also sensitized businesses all around the world at how much geopolitical risk is really out there. And also to the idea that the world may be less globalized going forward than we would've previously thought. And so you can't rely necessarily on these global supply chains the way you might have in the previous decades. So I think all of these lessons are being learned and that's mitigating the problems that we've had on this dimension.

Rose Oswald Poels:

Well, certainly COVID, and as you mentioned, some of the other geopolitical factors going on right now prove the adaptability and resiliency of Americans and businesses here in this country for sure. The next question, if inflation persists at a lower level but higher than the 2% Fed target, would you suspect the Fed to hold rates steady versus hiking further? Would you see the Fed using the balance sheet as a policy tool versus continuing to just use the Fed funds rate?

James Bullard:

Yeah, I think the most likely scenario is in fact that core PCE inflation, Dallas Fed Trim Mean inflation, core CPI inflation, those kinds of numbers will remain above 2%, and that means that the policy rate will have to be higher for longer in order to continue to put downward pressure on those types of measures of inflation. So we would very much like all of those to be at 2%, and hopefully we can get there, but they're going to be slower to adjust. And so I think we're really moving into an era of higher nominal interest rates for quite a while going forward as we try to continue to put downward pressure.

If you think about the 1990s, you had inflation maybe in the low 2% range or fluctuating around between 3% and 2%, and you had higher levels of the whole nominal rate structure, and that helped us to get and keep inflation at 2% even when the economy boomed in the second half of the 1990s. So that kind of vision for what will happen going forward, I think is the right one that you'd have this era now of higher policy rates and higher rates generally than you're used to from the pre-pandemic era, and that inflation would be above target, but moving toward target from the high side and that that's kind of the world that we're going to live in over the next several years. And that seems like a likely outcome as far as I can tell.

Rose Oswald Poels:

Okay. We talked a little bit about the war in Ukraine and the effect that it may be having on supply chain issues. This person is wondering, to what extent, maybe beyond that, does the war in Ukraine affect inflation in the United States?

James Bullard:

Well, it was certainly a shock in terms of commodity prices. Russia is a major producer of oil and also of natural gas for Europe, which has been the main point of contention. So there's just no question that it had a very large impact. And when we think about energy prices and commodity prices, they do feed through to other aspects of pricing globally. So it's not always as easy to disentangle the energy prices from other types of prices because of the input-output matrix and how all goods and services are related. But I do think that or hope that we can reach some kind of resolution in the Russia-Ukraine conflict. I know the commentary that I read on this is not very optimistic about that. But we've seen wars in the world before that have ground on for a long time, and I think markets do adjust to that risk and do take that into account and settle into an equilibrium even though there's a war going on.

And I think that has happened to some degree during 2022 and will continue in 2023. However, it remains an extremely dangerous situation. You have a conflict between a nuclear power and NATO through a proxy and Ukraine, and that's not a good situation. We'd very much like to see that get resolved. There is some upside. If it does get resolved somehow, I think that would be very positive from a macroeconomic point of view. And so that's a possibility. But as far as I can tell, military analysts and foreign policy analysts seem to think that the chances of that are very remote at this point. So it seems like we will be living with conflict in between Russia and Ukraine for quite some time.

Rose Oswald Poels:

Yeah, sadly, I have read the same thing. So that is very unfortunate. Staying a little bit in the political realm, how much attention, if any, does the Federal Reserve Board pay to the current administration in Washington?

James Bullard:

Well, I like to say that we're not independent. We're at arm's length from politics because of the design of the Federal Reserve Act. And this allows our political class to criticize the Fed, but without having to make the decisions on a day-to-day basis. And that seems to have worked pretty well historically, and I think that it will continue to work well going forward. As Chair Powell said just the other day in a speech on central bank independence, we have to have the ability to make difficult decisions that would be hard to do if you tried to make them directly in the Congress. I would say I've been pleased though, during 2022 and coming into 2023 with our program of raising interest rates because I think we were able to, and the chair was able to explain that, "Hey, we need to do this to get inflation under control. We'll be better off if we get inflation under control sooner rather than later."

And I think financial markets, by and large signed on to that and agreed with that. Certainly there's always debate about monetary policy, but generally speaking, everyone said, "Oh yeah, we have a lot of inflation. We're going to have to raise the policy rate in order to contain inflation." And because of that and because of the transparency around our policy, I don't think we've had as much financial instability as you might have expected given that we raise a policy rate some 400 plus basis points during 2022.

So I've been pleased with that so far. If you look at measures of financial stress like the St. Louis Fed's Financial Stress Index, financial stress remains at relatively low levels. It was at a very high level in March and April 2020, but has returned back to normal levels and been there ever since. So even though we took extraordinary policy actions, we did it in a way that didn't cause, at least so far, didn't cause undue financial stress and allowed everyone to make the adjustments to the new interest rate situation. So, so far so good on that. We're always monitoring that very carefully, however.

Rose Oswald Poels:

Sure, of course. So there's a lot of talk, of course, about a recession coming in 2023. What sectors do you think would be under the greatest recessionary pressure and which would be under the least?

James Bullard:

Well, the sector that we've seen the most impact immediately from the rate increases has been housing. And I think one comment I would have on that is that the housing sector didn't wait for us to actually get the policy rate higher. They started reacting even in the spring of 2022, even before we had barely done anything in terms of actual policy moves. So this shows you that markets do anticipate policy and this has real effects on the ground way before we actually make the policy move. So I think that's interesting.

As far as recession risks, I would say they have diminished some over the last 90 days or so as it's become apparent that the fourth quarter was stronger than expected. And as we've got jobs reports that have been relatively strong, and the unemployment rate has stayed at a very low level and indeed ticked down instead of up. And so these are suggesting that the economy's more resilient than we previously thought, and that the prospects for a soft landing have improved. If you really believe markets, markets think that inflation's going to come down very rapidly during 2023, and the GDP data and the labor market data seems to suggest that the economy has plenty of cushion to remain relatively resilient as inflation is coming down. So, so far so good, and let's hope that that's the outcome for 2023.

Rose Oswald Poels:

Yeah, I would certainly hope so as well. Tying back to your bullish comments in the beginning, you mentioned earlier that you believe rates are going to have to stay pretty elevated, maybe even more than what the market is currently predicting. Can you give us a sense based on history, I know you talked a little bit about comparing it back to the 1970s when I was very much alive and living through that time as well, is that sort of the marker you're using to compare what we learned from the seventies until the mid-eighties to feed in or guide your comments around having to keep rates elevated and keep the pressure going so we don't keep having what we experienced in the past of the back and forth, or do you think today's situation maybe is vastly different from all of the factors that were going on back during that historical time?

James Bullard:

Yeah, the problem with the 1970s wasn't just the inflation. You had high and variable inflation, but you also had four recessions in 13 years culminating in 1980 and then in 1981-82. And so it wasn't just that, "Oh, we have to put up with some inflation" as that real economy was quite volatile and unemployment eventually peaked at 10.8% in 1982. So I think the lesson was that the inflation messed up the price signals and the whole economy. People aren't sure what the prices really mean because they're bouncing around so much, and then that means that you get the wrong sorts of decisions made around investments, and this affects workers. People get laid off and then they get rapidly hired back. And you had this very volatile economy. Once we brought inflation under control after Volcker in the 1980s, you got a very different outcome. You had very long boom in the 1980s during the Reagan era.

You had a mild recession in 1990-91, and then another long boom period in the 1990s, and especially the second half of the 1990s, which had the most rapid real GDP growth that we've seen in the post-war era. Then again, another mild recession continued on up to the financial crisis. So benefits of price stability really showed themselves during that era. And that's why I think it's imperative to go back to that sort of policy and allow the boom to occur by getting inflation under control and keeping it close to 2%. So I think we have learned the lessons from the seventies, but it does mean that we'll have to stay higher for longer. We'll have to make sure that inflation's not coming back. I'm sure that the disinflation that we're expecting during 2023 won't occur in a smooth line.

There'll be sometimes, some reports like today are very encouraging, but there'll probably be other reports that are not as encouraging or even going the wrong direction entirely. And for that reason, I think we're going to have to remain vigilant to make sure that inflation continues to go in the right direction. And we have a long way to go. Even today, core CPI measured from one year ago, 5.7%. Gosh, that's a lot of inflation, way more than we're used to, and that's throwing up food and energy. So we need that to come back down close to 2%. So hopefully we can get that to happen. I do think we have the right policy in place to get that to happen during 2023, but it won't be a straight line back to 2%.

Rose Oswald Poels:

All right. We have about five minutes left, so I'll try to get in two more questions here. Related to this conversation about rates and given your desire, and I'm sure the full board's desire to get back to 2% as soon as possible, does that mean that you are more supportive of continued large rate hikes upfront, or are you open to maybe backing down to more of a 25-basis point rate hike?

James Bullard:

Yeah, I've liked the front-loading policy. I think if we want to get to the low 5% range, we should go ahead and move to that level, then we get the disinflationary impact of that now as opposed to some

point in the future. So I think the front-loading policy has served us well and would continue to serve us well going forward. I don't really see any purpose in dragging things out through 2023. That doesn't really seem to help us if the idea is to get to the right level of the policy rate and then allow that to put the downward pressure on inflation that we need.

So that would be my judgment. But as I also said during these remarks here, in macroeconomic terms, it's probably not totally critical exactly how this occurs. Markets do anticipate, to some degree. The committee has already said that we expect the policy rate to be above 5% at the end of this year. So I think a lot of that's probably been priced into markets already. So to me, it is like we should just follow through and get to the right level of the policy rate, and then after that we can see how the data rolls in and make adjustments appropriately.

Rose Oswald Poels:

Okay. And then our last question is, what is your expectation for the M2 money supply and the possible impact to bank deposits in 2023?

James Bullard:

Yeah, of course, I'm a monetarist at heart and the St. Louis Fed has been a monetarist institution. And I do think that this has been a good test for M2 as a predictor of inflation. M2 growth exploded during the pandemic to very high levels, some of the highest that we've seen, and indeed inflation followed right behind. Now M2 growth has collapsed and gone to zero or even negative, and that would seem to bode well for our disinflation prospects in 2023. I will say though, that for the few monetarists are still left out there, that the direct correlations between money growth and inflation are not strong enough to rely on a day-to-day policymaking basis. I do think it's a good indicative sign of disinflation, but we can't just go by the M2 growth because it's just not correlated strongly enough with inflation.

Rose Oswald Poels:

Sure. Right. Well, thank you again very much for your time today, President Bullard. I appreciate reconnecting with you again and very much appreciate your bullish outlook on 2023, all of your thoughtful comments today, and appreciate the work you do as part of the Fed's Open Market Committee. So thank you again for your time, and I wish you all the best this year.

James Bullard:

Great. Thanks for having me. Always a great group. Happy New Year everyone.

Rose Oswald Poels:

Yep.