The 2017 Outlook for U.S. Monetary Policy

James Bullard

President and CEO, FRB-St. Louis

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Washington University in St. Louis

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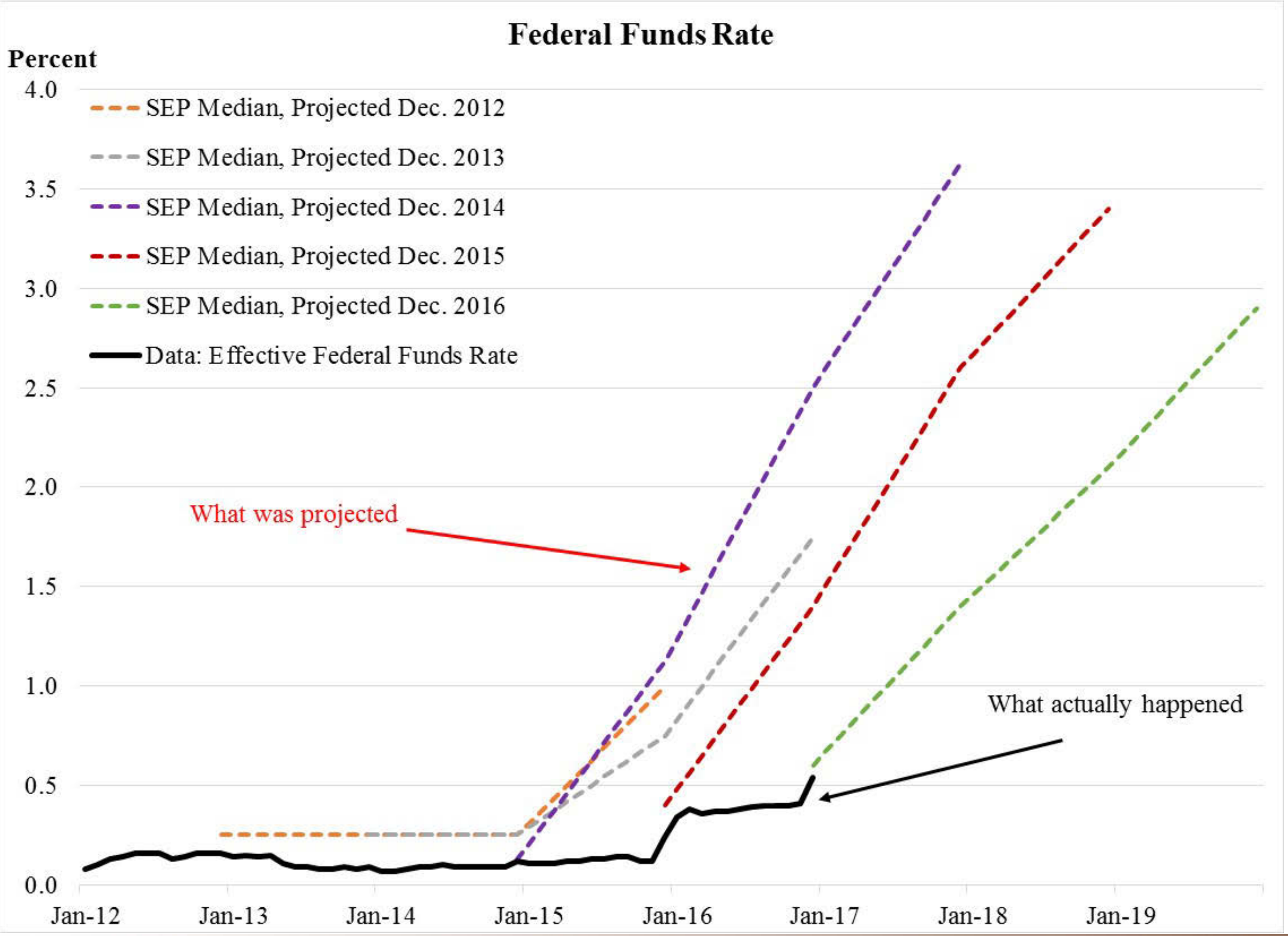
A Problem with Federal Open Market Committee Projections

The FOMC policy rate projections versus reality



Source: Federal Reserve Board and author's calculations. Last observation: December 2016.

A questionable model

- In 2016, we at the St. Louis Fed concluded that the model behind this type of projection was questionable.
  - The June announcement and several remarks I gave in the following months covering various aspects of the St. Louis Fed's new regime-based approach to near-term projections are available on my webpage under "Key Policy Papers."

What is the core issue?

- Today's policy rate, at just 63 basis points, appears to be too low when casually compared to past historical experience.
  - In the past, when unemployment was relatively low and inflation was close to target, the policy rate was much higher.
- We at the St. Louis Fed concluded that what is different today is that the safe real interest rate is better thought of as being in a "low regime."
- Moreover, we think the low-safe-real-rate regime is unlikely to change in the near term.
- This means the policy rate can also remain relatively low over the forecast horizon.

This talk

- Will the low-safe-real-rate regime go away naturally in 2017?
- Will the new administration's policies drive the safe real interest rate higher in 2017?
- Will the U.S. economy overheat in 2017?
- Is the Fed's normalization program limited to increases in the policy rate?

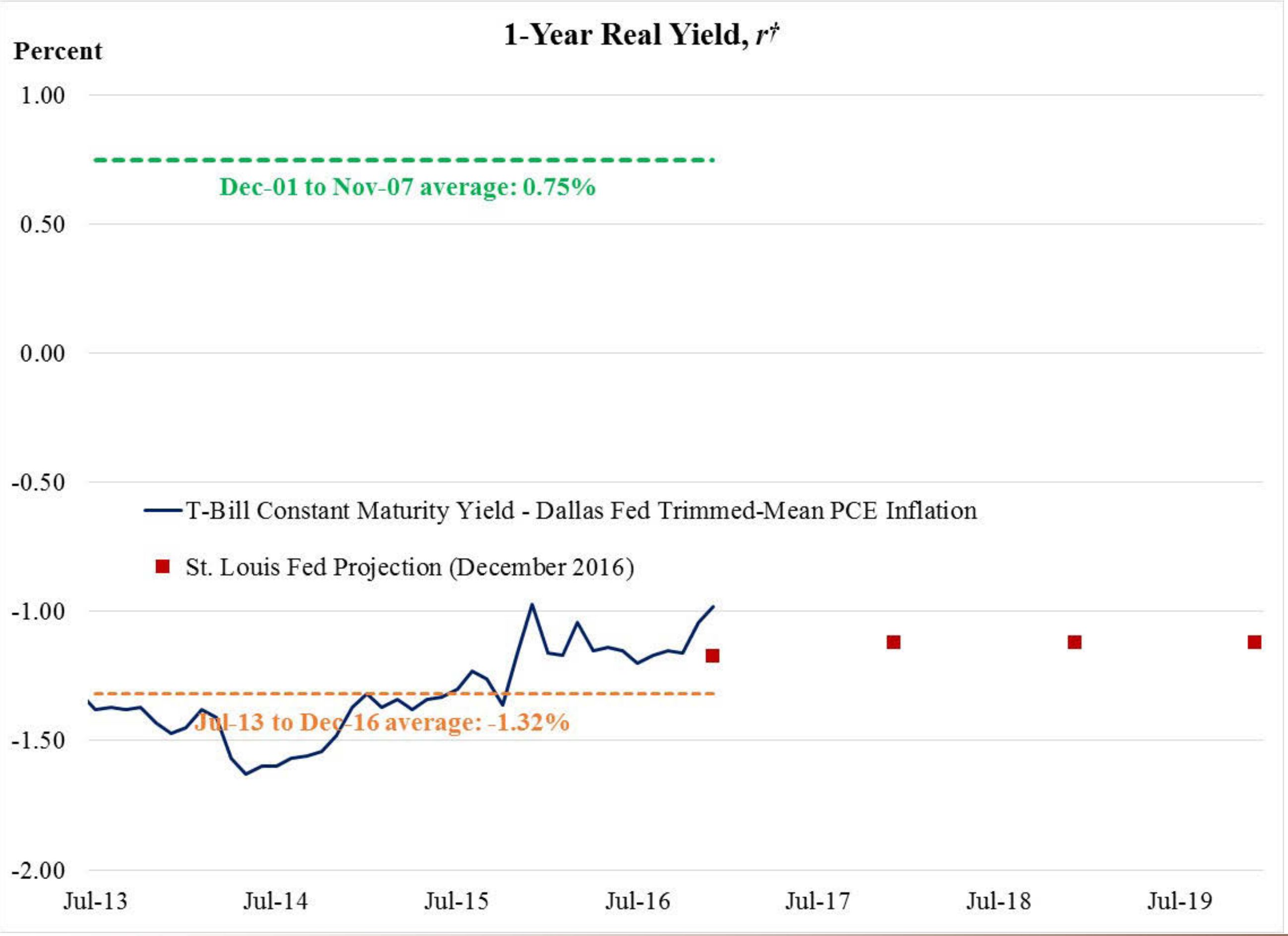
- The answer to all of these questions is "no."

Will the Low-Rate Regime Go Away Naturally in 2017?

Will the low-rate regime go away naturally in 2017?

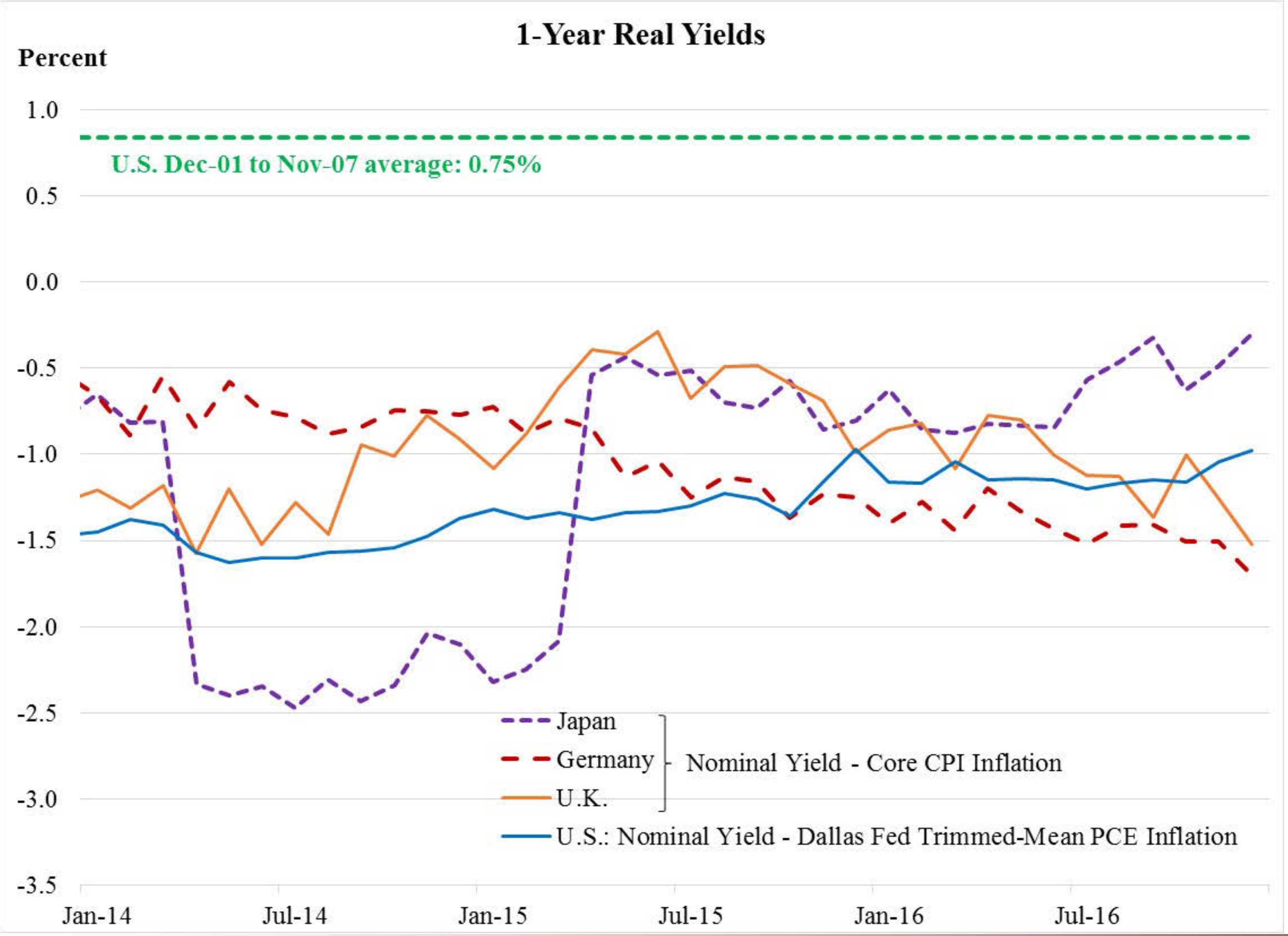
- Some considerations on this question:
  - The low-real-rate regime is a global phenomenon.
  - The low-real-rate regime has been many years in the making and is unlikely to turn around quickly.
- This suggests that the regime will not go away naturally– therefore, a relatively low policy rate will remain appropriate.

The low- and high-real-rate regimes in the U.S.



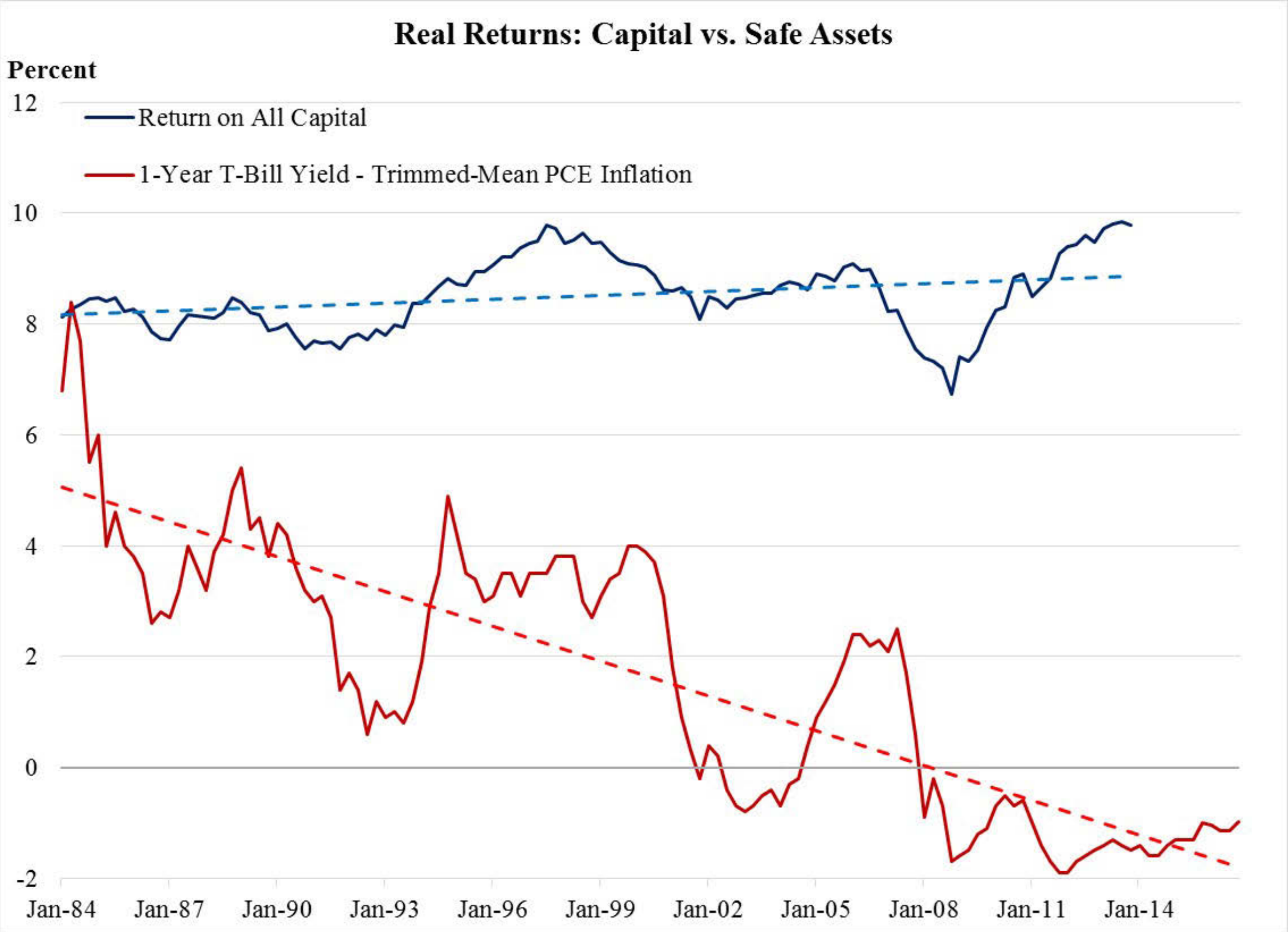
Source: Federal Reserve Board, FRB of Dallas and author's calculations. Last observation: December 2016.

One-year ex-post real yields are low globally



Source: Haver Analytics and author's calculations. Last observation: December 2016.

Low safe real rates have been developing over decades



Source: P. Gomme, B. Ravikumar and P. Rupert. "Secular Stagnation and Returns on Capital," FRB of St. Louis Economic Synopses No. 19, 2015; Federal Reserve Board, FRB of Dallas and author's calculations.

The low-safe-rate regime

- Real rates of return on government paper are exceptionally low in the current global macroeconomic environment.
- This has led to a lot of theorizing about a possible shortage of safe assets globally.
- Regardless of the theory, empirically it seems unwise to predict that the forces driving safe real rates to such low levels are likely to reverse any time soon.

Will the New Administration's Policies Drive the Safe Real Interest Rate Higher in 2017?

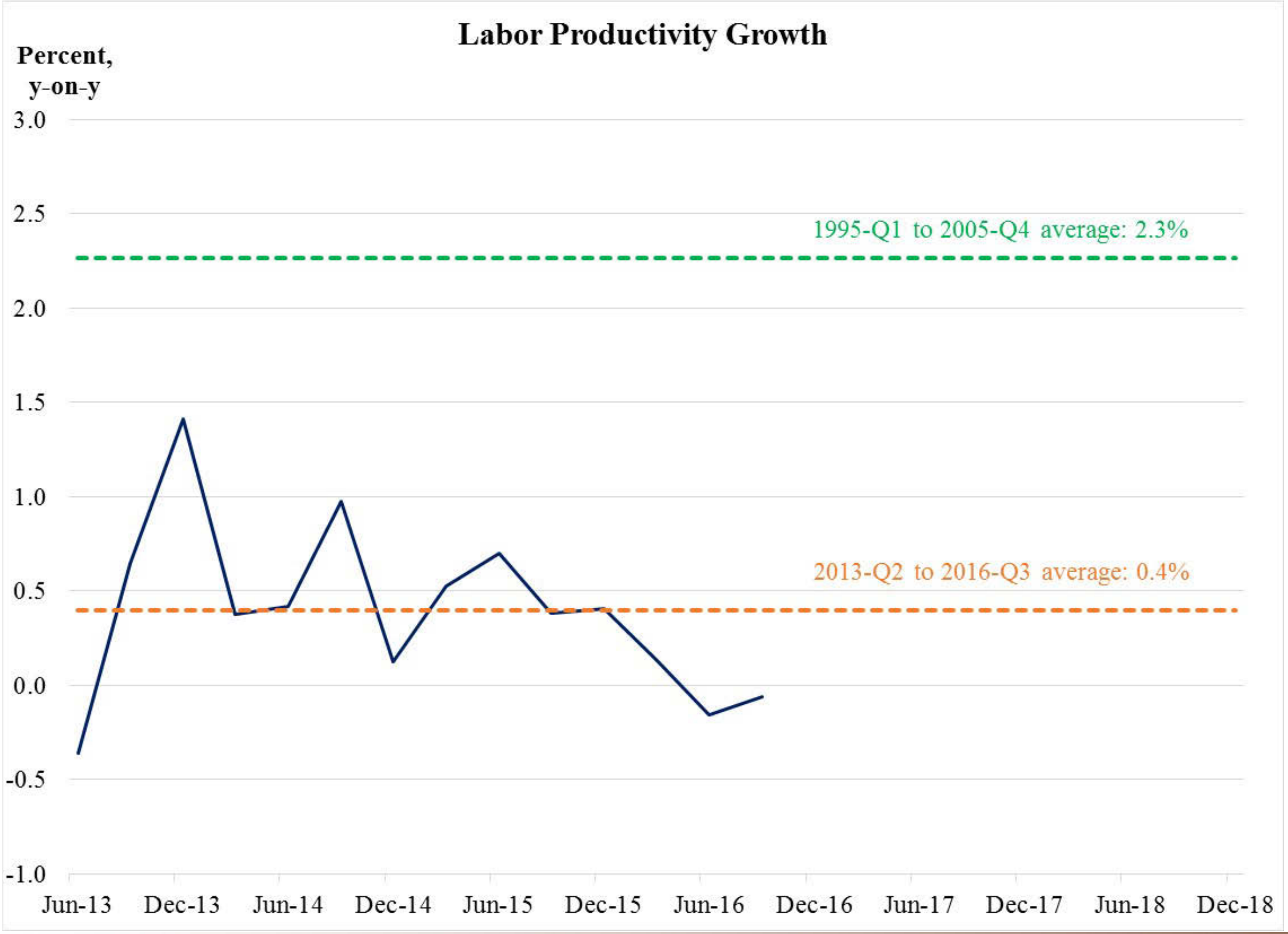
The impact of new policies on the real rate

- Will the new administration's policies move the U.S. out of the low-real-interest-rate regime?
- Here are two considerations:
  - The economy is not in recession today, so these policies should not be viewed as countercyclical measures. This is a source of great confusion.
  - U.S. productivity growth is low and could be improved considerably. This could increase the safe real rate.

Impact of new policies on productivity

- Whether the new administration's policies represent a "regime shift" depends on whether these policies will have a sustained impact on productivity.
- Three policy changes may have an impact in 2018 and 2019:
  - Deregulation: To the extent that some areas of regulation are excessive, this could improve productivity.
  - Infrastructure: Putting the right public capital in place could improve productivity.
  - Tax reform: Tax changes that encourage investment in the U.S. could improve productivity.

The high- and low-productivity-growth regimes



Source: Bureau of Labor Statistics, Bureau of Economic Analysis and author's calculations.
Last observation: 2016-Q3.

Longer-term policies

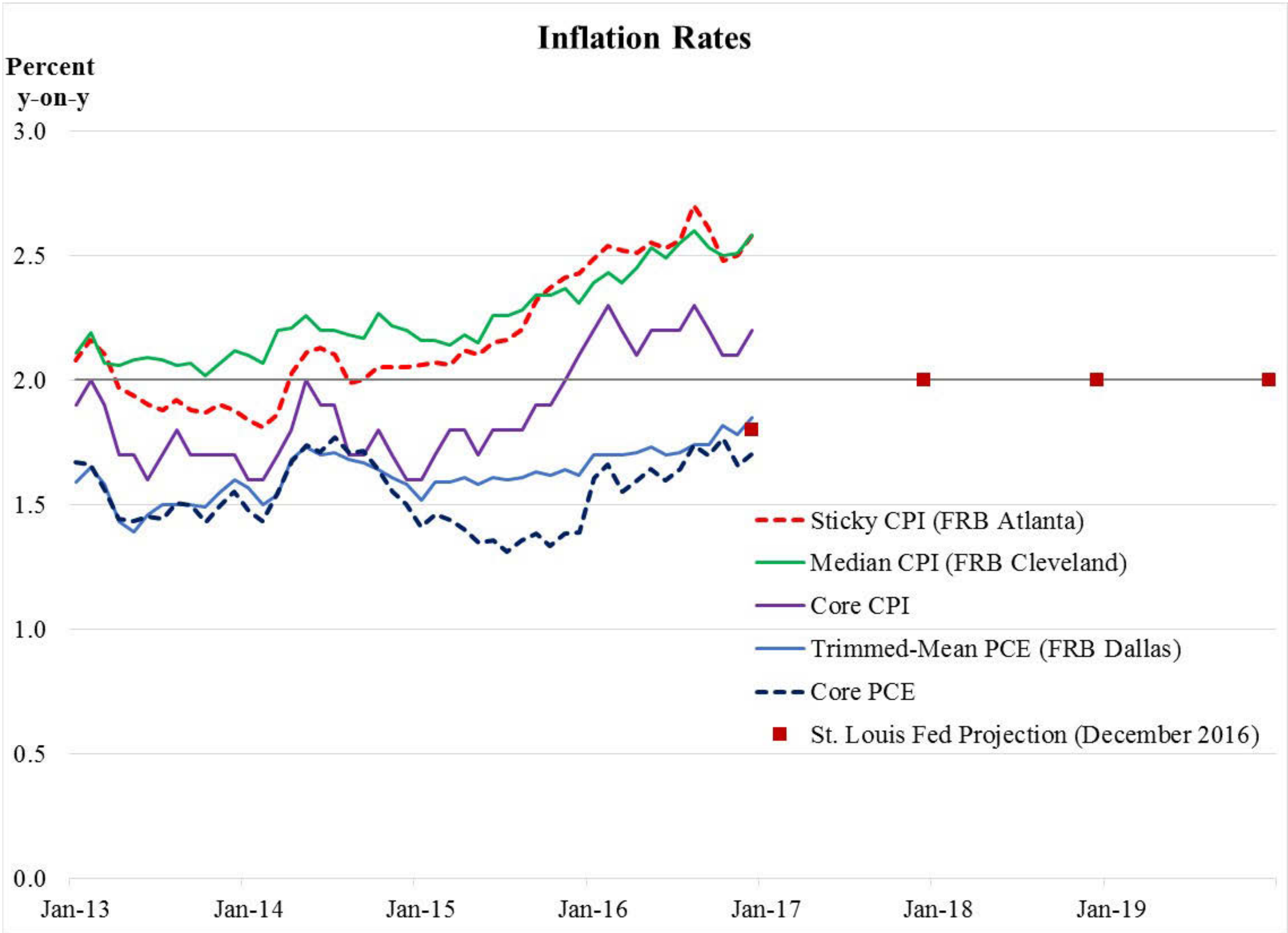
- Other macroeconomic issues include trade and immigration.
- Trade negotiations tend to be slow-moving relative to monetary policy.
- Trade arrangements can have important macroeconomic effects, but over the longer term.
- Similarly, immigration reform would likely have important effects on the macroeconomy, but over a longer horizon.

Will the U.S. Economy Overheat in 2017?

Inflation close to target

- Inflation has been below target in recent years, due in part to commodity-price effects.
- However, net of commodity-price effects, inflation is close to target, and headline inflation is expected to return closer to target in the quarters ahead.

Smoothed measures of U.S. inflation are close to 2 percent

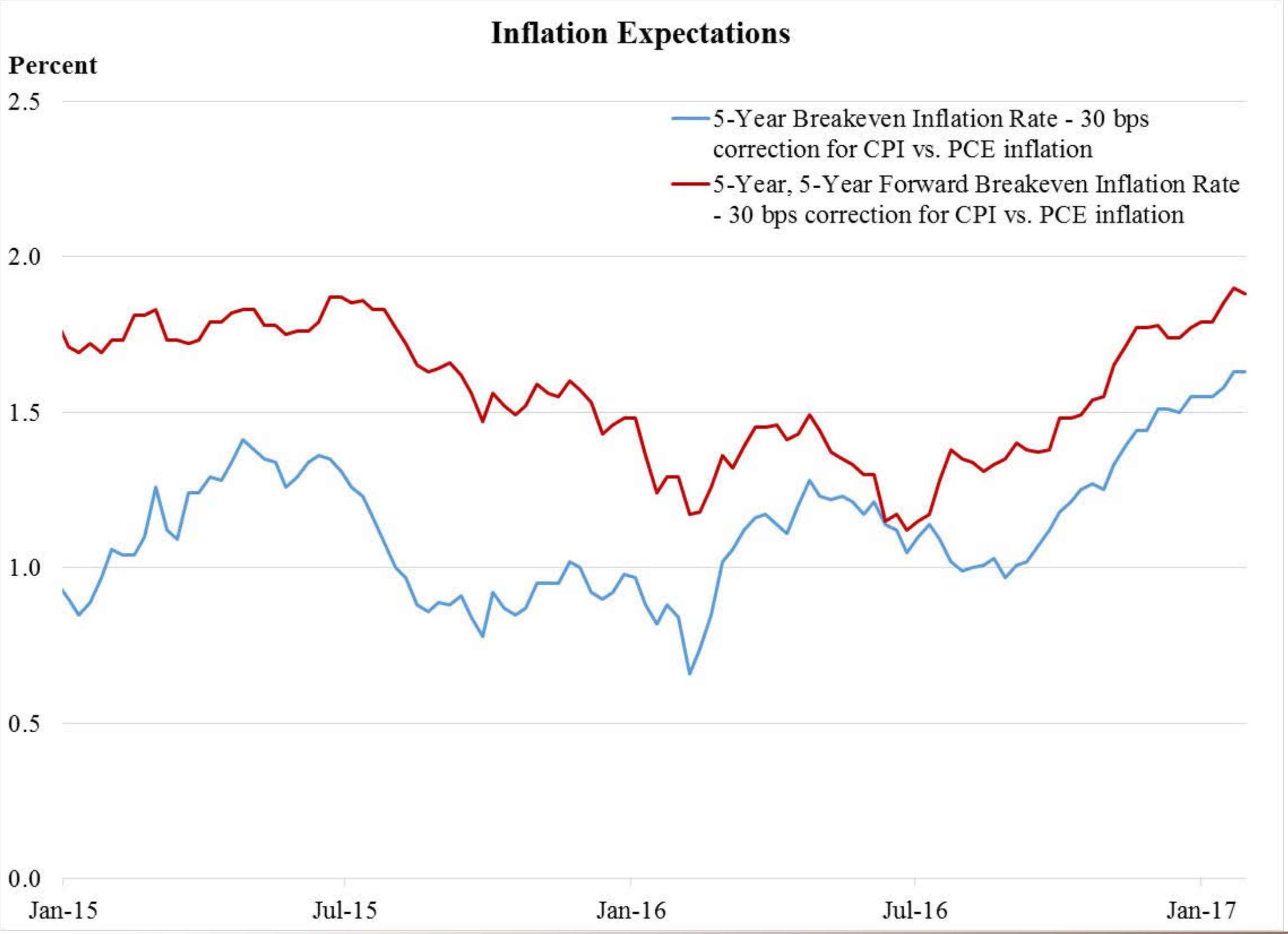


Source: Bureau of Labor Statistics, FRB Cleveland, FRB Atlanta, Bureau of Economic Analysis, FRB Dallas and author's calculations. Last observations: December 2016.

Inflation expectations remain low

- Inflation movements are often attributed to movements in unemployment relative to a reference level (Phillips curve effects) or to movements in inflation expectations.
- Phillips curve effects have generally been empirically weak in recent years.
- Market-based measures of inflation expectations, corrected for differences between CPI and PCE inflation, remain somewhat low.
- Consequently, it does not appear that undue inflationary pressure is building so far.

Inflation expectations remain somewhat low

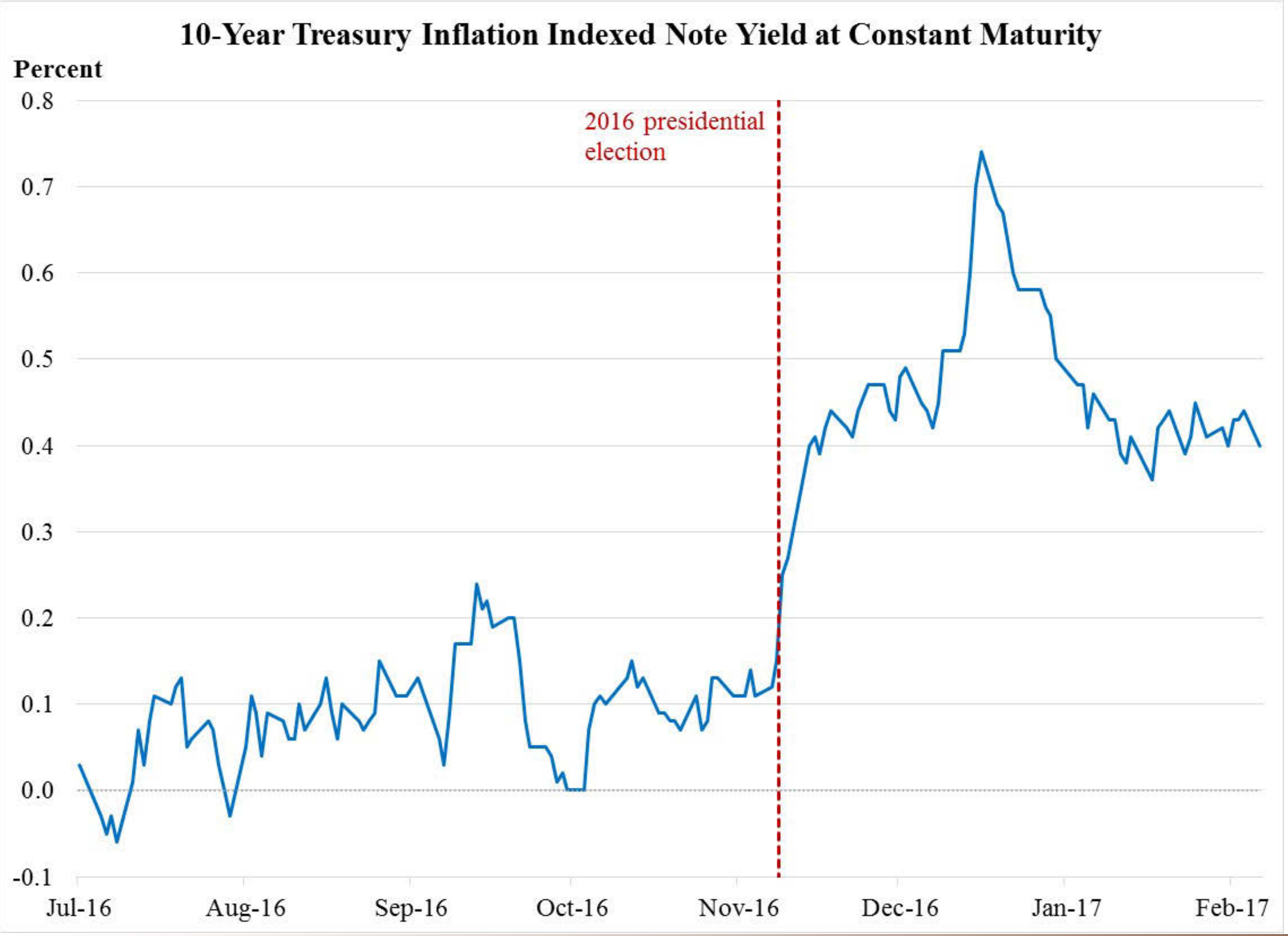


Source: Federal Reserve Board. Last observation: week of Feb. 3, 2017.

A meaningfully higher policy rate in 2017?

- Any effects from the new administration's policies are only likely to be observed in 2018 and 2019.
- The prerequisites for meaningfully higher inflation do not seem to have materialized so far.
- Short-term safe real rates of return seem likely to remain low globally in 2017.
  - Real yields did increase following the election, and we have taken that into account in our policy rate recommendation.
- These considerations suggest that the policy rate can remain fairly low in 2017.

Real yields increased following the election



Source: Federal Reserve Board. Last observation: Feb. 6, 2017.

Is the FOMC's Normalization Program Limited to Changes in the Policy Rate?

Fed balance sheet could begin normalization

- The Fed's balance sheet has been an important monetary policy tool during the period of near-zero policy rates.
- The Committee has not set a timetable for ending the current reinvestment policy.
- Now that the policy rate has been increased, the Committee may be in a better position to allow reinvestment to end or to otherwise reduce the size of the balance sheet.
- Adjustments to balance sheet policy might be viewed as a way to normalize Fed policy without relying exclusively on a higher policy rate path.

Current policy is distorting the yield curve

- The current FOMC policy is putting some upward pressure on the short end of the yield curve through actual and projected movements in the policy rate.
- At the same time, current policy is putting downward pressure on other portions of the yield curve by maintaining a $4.45 trillion balance sheet.
- This type of "twist operation" does not appear to have a theoretical basis.
- A more natural normalization process would allow the entire yield curve to adjust appropriately as normalization proceeds.

Conclusion

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- Safe real rates of return are exceptionally low and are not expected to rise soon, a "low-safe-real-rate regime."
  - This, in turn, means that the policy rate may be expected to remain exceptionally low over the forecast horizon.
- The new administration's policies may have some impact on the low-safe-real-rate regime if they are directed toward improving medium-term U.S. productivity growth.
- Ending balance sheet reinvestment may allow for a more natural adjustment of rates across the yield curve as normalization proceeds.

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