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Changing Imperatives for U.S. Monetary Policy Normalization

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Any opinions expressed here are my own and do not necessarily reflect those of the Federal Open Market Committee.

Introduction

Main idea

- The case for monetary policy normalization in 2015 rested on some key assumptions.
- Two important aspects of this case have changed in 2016:
 - Inflation expectations have fallen further.
 - The risk of asset price bubbles over the medium term appears to have diminished.
- These data-based developments have given the Fed more leeway in its normalization program.

Themes in this talk

- Have inflation expectations fallen too far for comfort?
- Has the global sell-off in equity markets reduced the risk of asset price bubbles over the medium term?
- U.S. growth and labor market prospects remain reasonable.
 - Lower long-term rates are an automatic stabilizer that should support growth.
 - “Phillips curve” effects on inflation are small relative to effects due to declining inflation expectations.
- Monetary policy needs to be more clearly data dependent.
 - Should the Fed rethink the Summary of Economic Projections (SEP)?

Inflation Expectations Declining

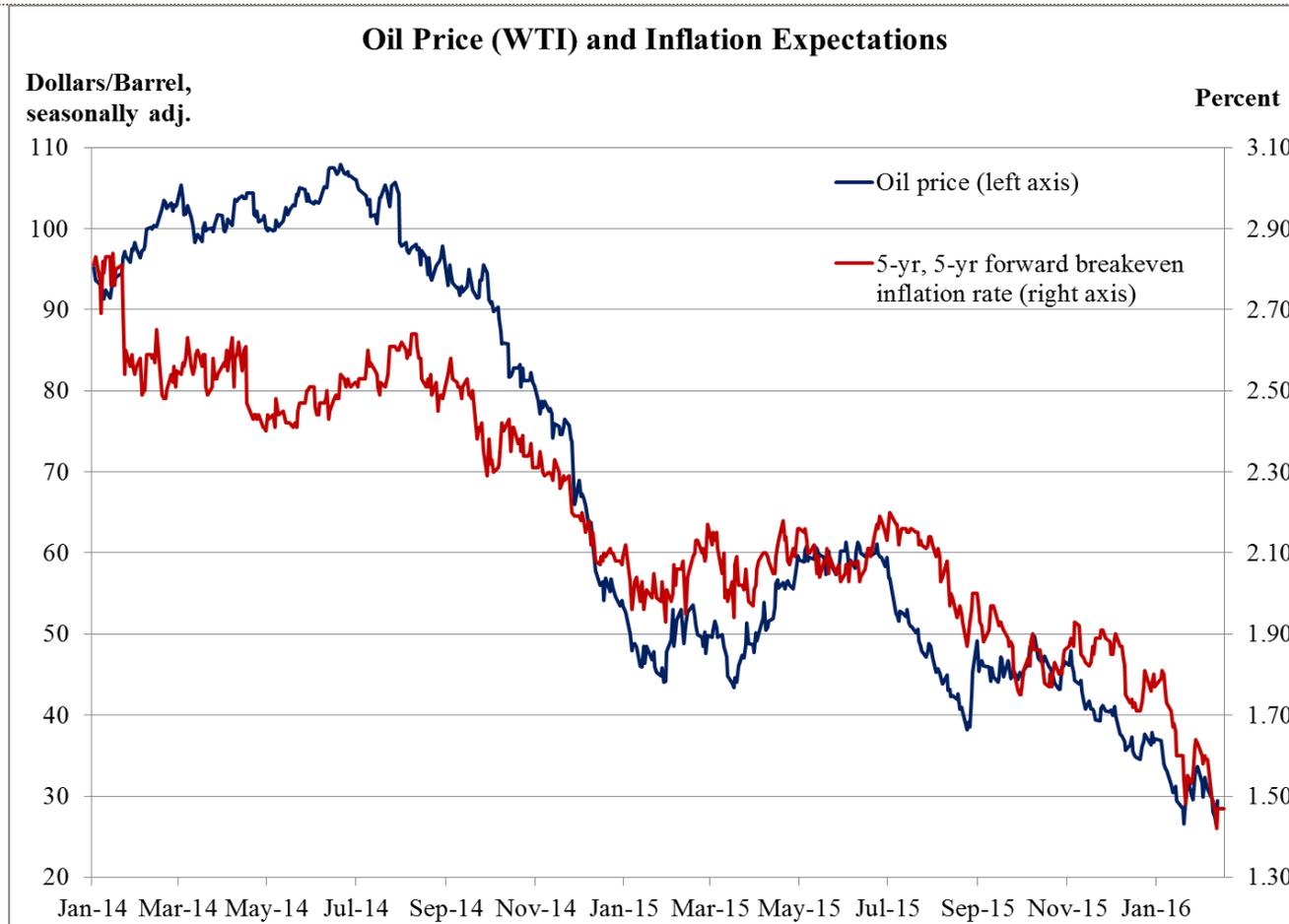
Normalization and data developments

- The case for normalization in the U.S. during 2015 rested on several pillars:
 1. Stable inflation expectations.
 2. Fully recovered labor markets.
 3. Further gains in labor markets putting upward pressure on inflation over the medium term and returning inflation to target.
 4. Remaining at a zero policy rate with increasingly tight labor markets risks fueling destabilizing asset price bubbles.
- Actual macroeconomic developments during 2016 are calling 1 and 4 into question.

Inflation expectations

- Modern theory suggests that inflation expectations are a more important determinant of actual inflation than traditional “Phillips curve” effects.*
- Market-based measures of inflation expectations have been declining in the U.S. since the summer of 2014.
- The decline has been highly correlated with the decline in oil prices.
 - I suggested during 2015 that inflation expectations would return to previous levels once oil prices stabilized.
- Now I think inflation expectations have declined too far for comfort, the oil price correlation notwithstanding.

Crude oil price and expected inflation



Declining inflation expectations

	July 1, 2014	February 12, 2016	Difference
2-year *	188	104	- 84
5-year **	200	103	- 97
10-year **	226	125	- 101
5-year forward **	252	147	- 105

* Inflation compensation: continuously compounded zero-coupon yields (basis points).

** Breakeven inflation rates (basis points).

Inflation expectations need to stabilize

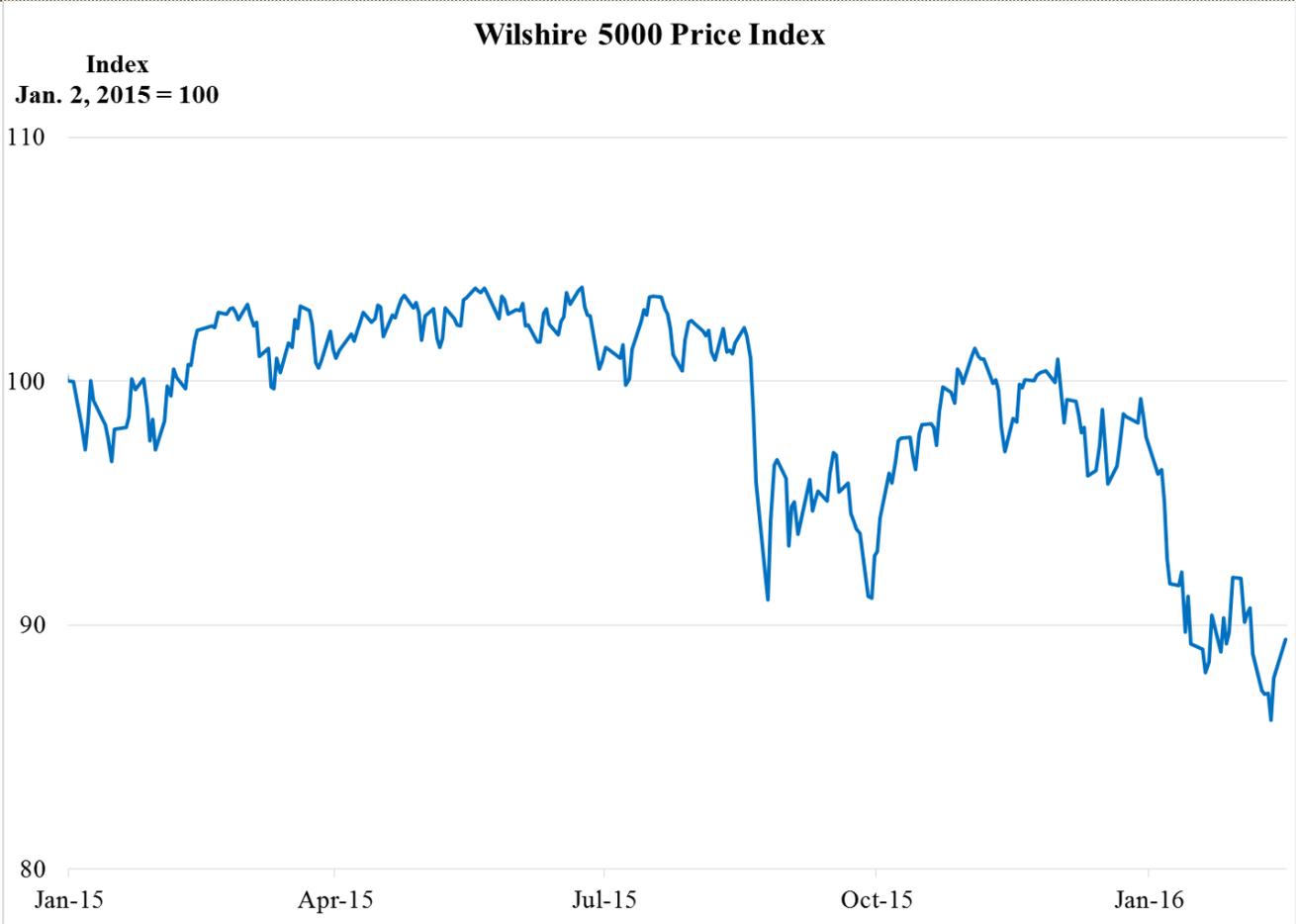
- The FOMC's normalization strategy is predicated on an environment of stable inflation expectations.
- Renewed downward pressure on market-based measures of inflation expectations during 2016 has called this assumption into question.
- I regard it as unwise to continue a normalization strategy in an environment of declining market-based inflation expectations.
 - I find arguments that these measures have declined due to changing risk premia or related factors unpersuasive because those analyses are too sensitive to the underlying assumptions.

Asset Price Bubbles

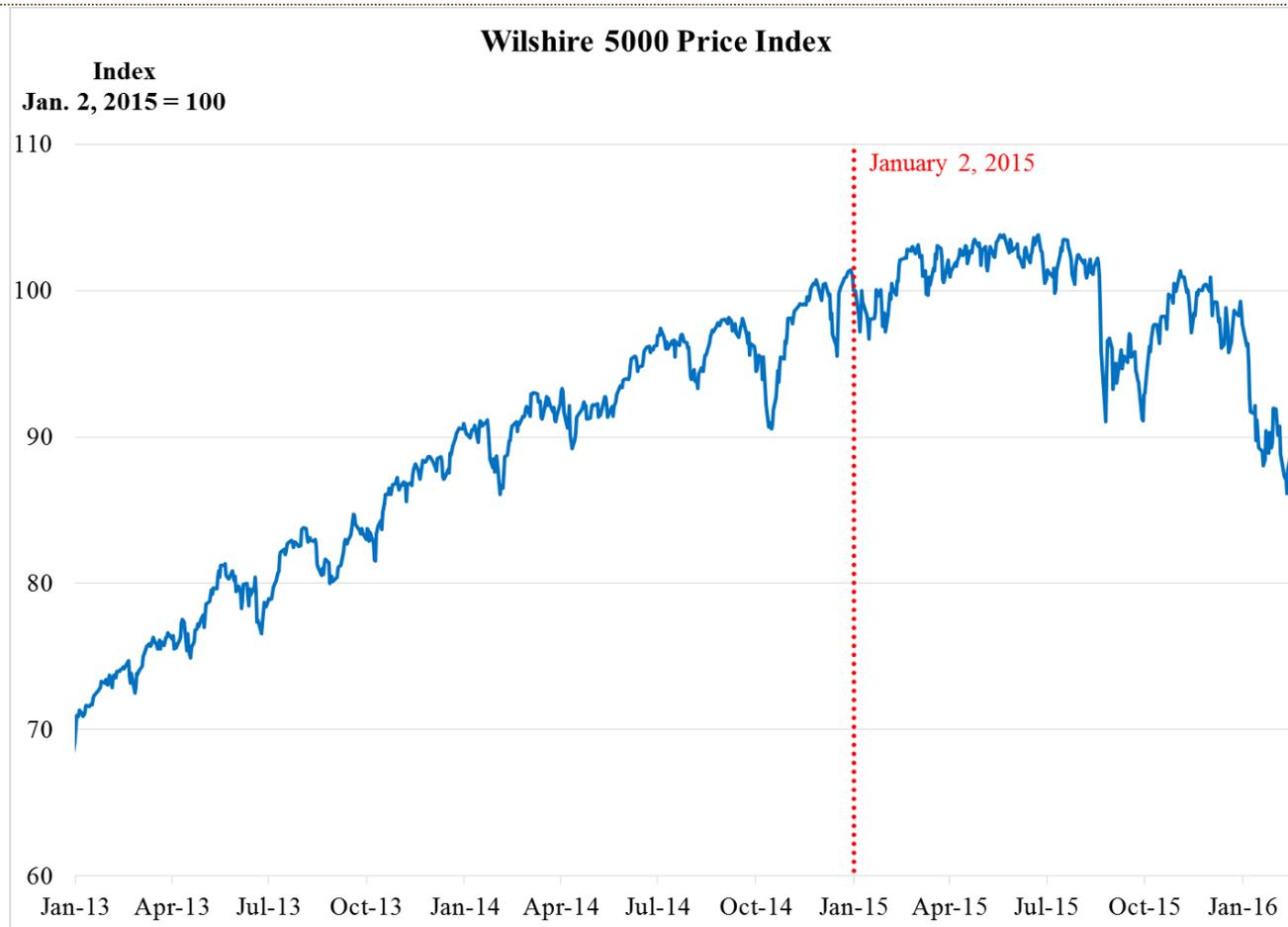
The specter of asset price bubbles

- Asset price bubbles have plagued the U.S. economy over the last two decades.
- Steps toward normalization of U.S. monetary policy help to lessen the risk that very low interest rates might feed into a third major asset price bubble in the U.S.
- The recent sell-off in global equity markets, along with increases in risk spreads in corporate bond markets, may have made this risk less of a concern over the medium term.

Recent declines in equity prices



Some recent historical context on equity prices

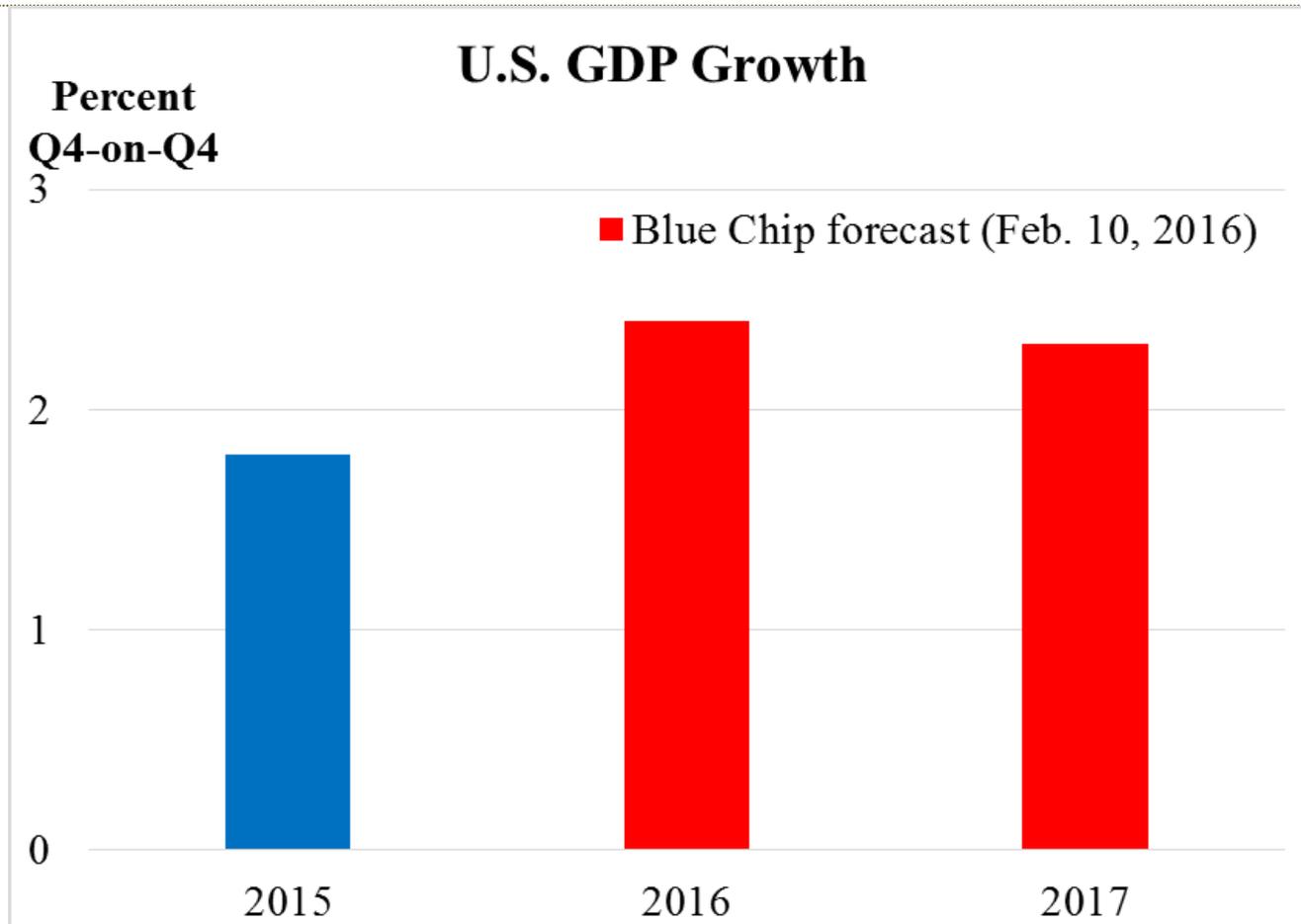


U.S. Growth and Labor Market Prospects

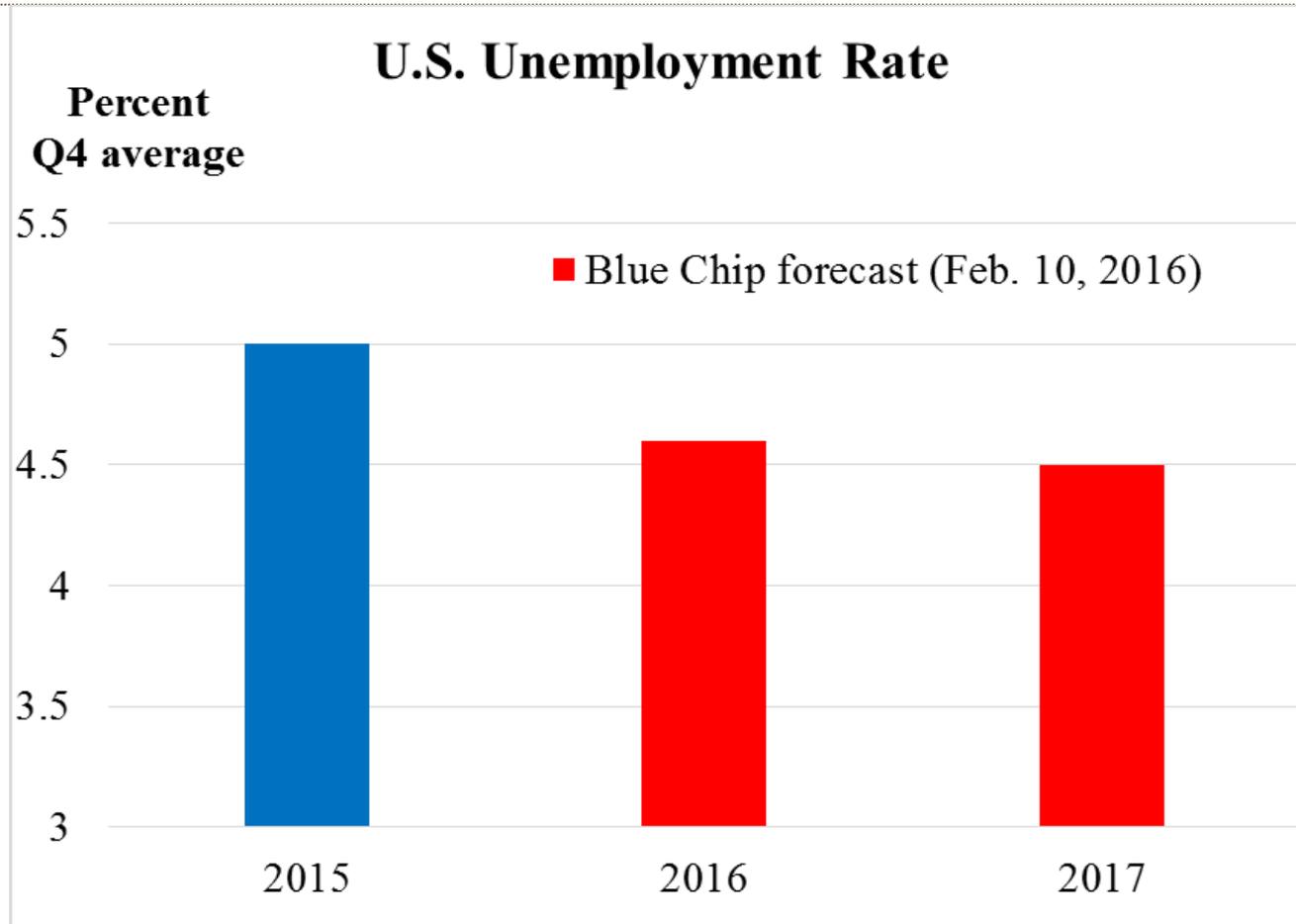
U.S. growth and labor market prospects

- My arguments related to inflation expectations and asset price developments are not predicated on a particularly weak U.S. economic outlook.
- I expect 2016 U.S. economic growth to be stronger than last year, and I expect U.S. labor markets to continue to improve.
- I also expect global growth to be stronger in 2016 than it was last year.

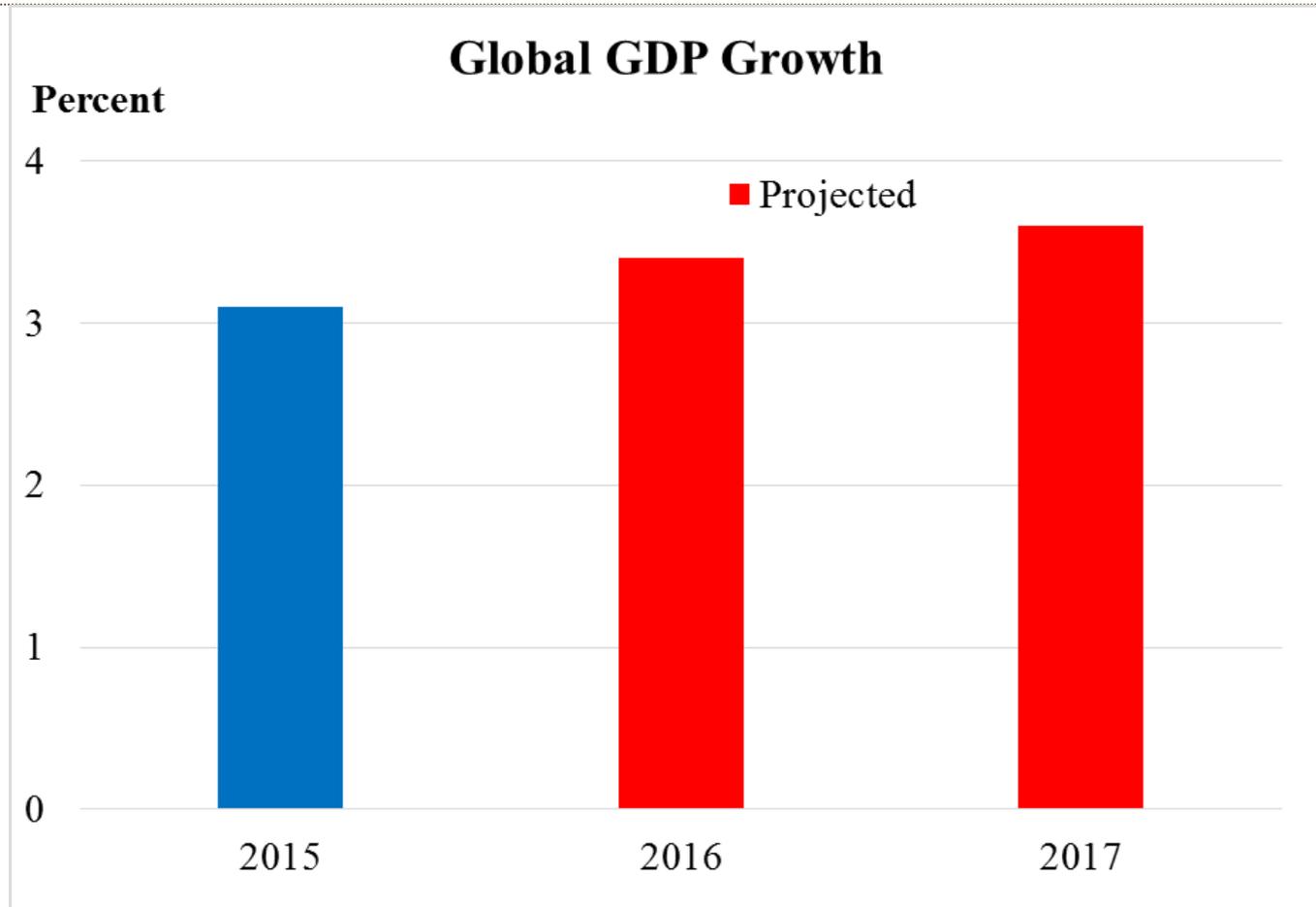
U.S. GDP growth



U.S. unemployment



Global GDP growth according to the IMF



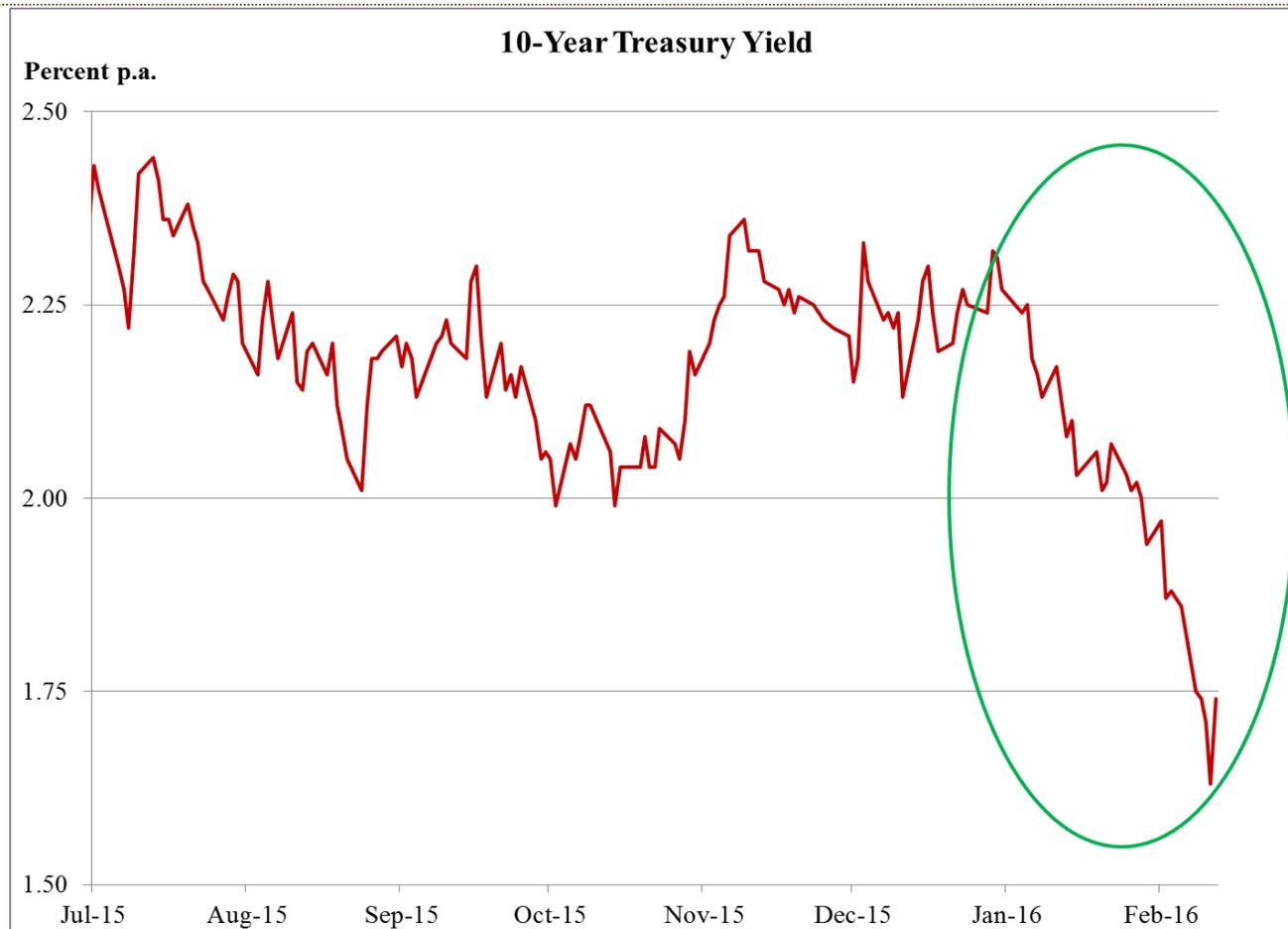
Financial market turmoil and automatic stabilizers

- Financial market turmoil has been pronounced during the last two months.
- One aspect of this turmoil is that U.S. longer-term interest rates have fallen.
- This is a bullish factor for the U.S. during 2016.

Financial stress index nearing a recovery high ...



... but this has also driven U.S. longer-term rates lower

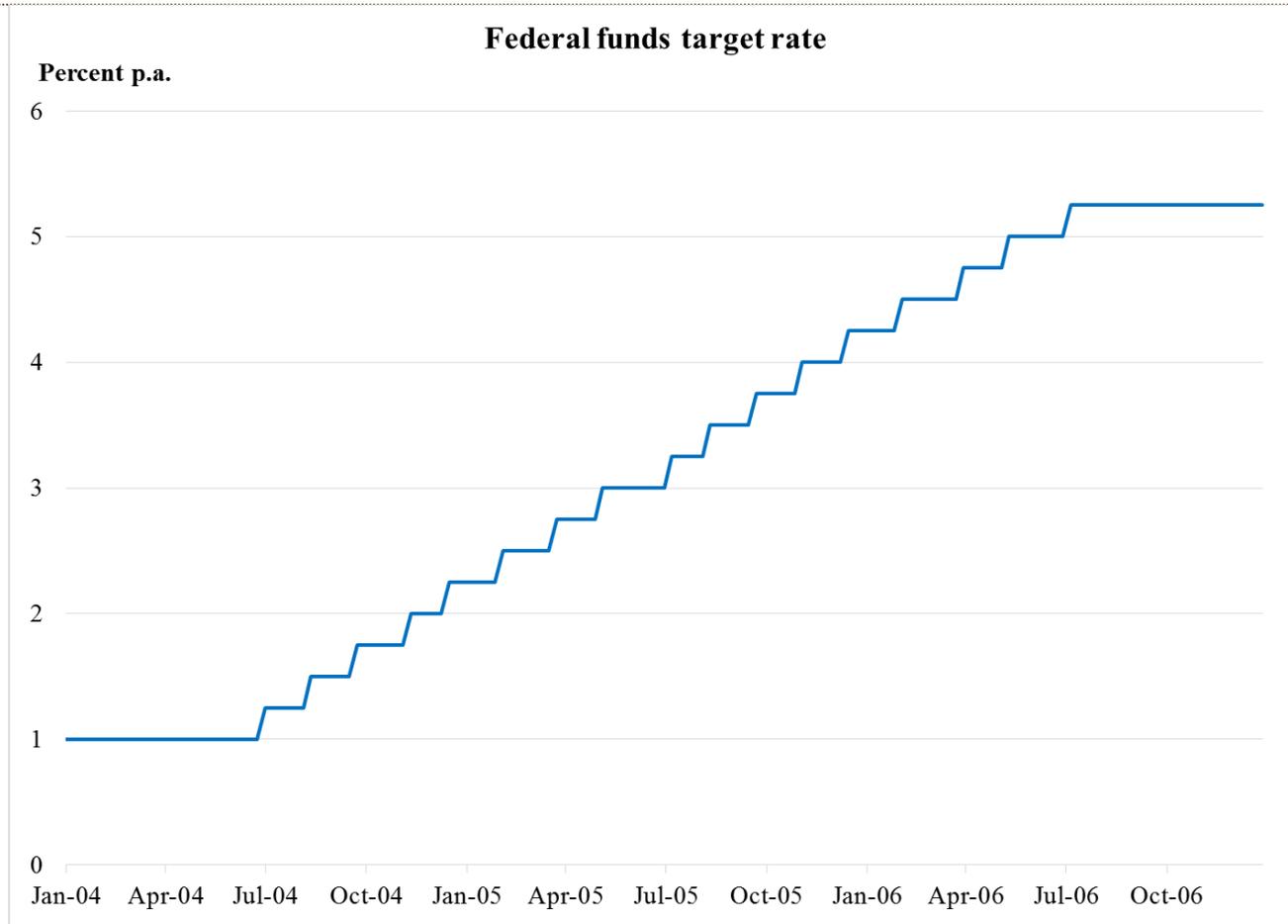


The FOMC and Data Dependence

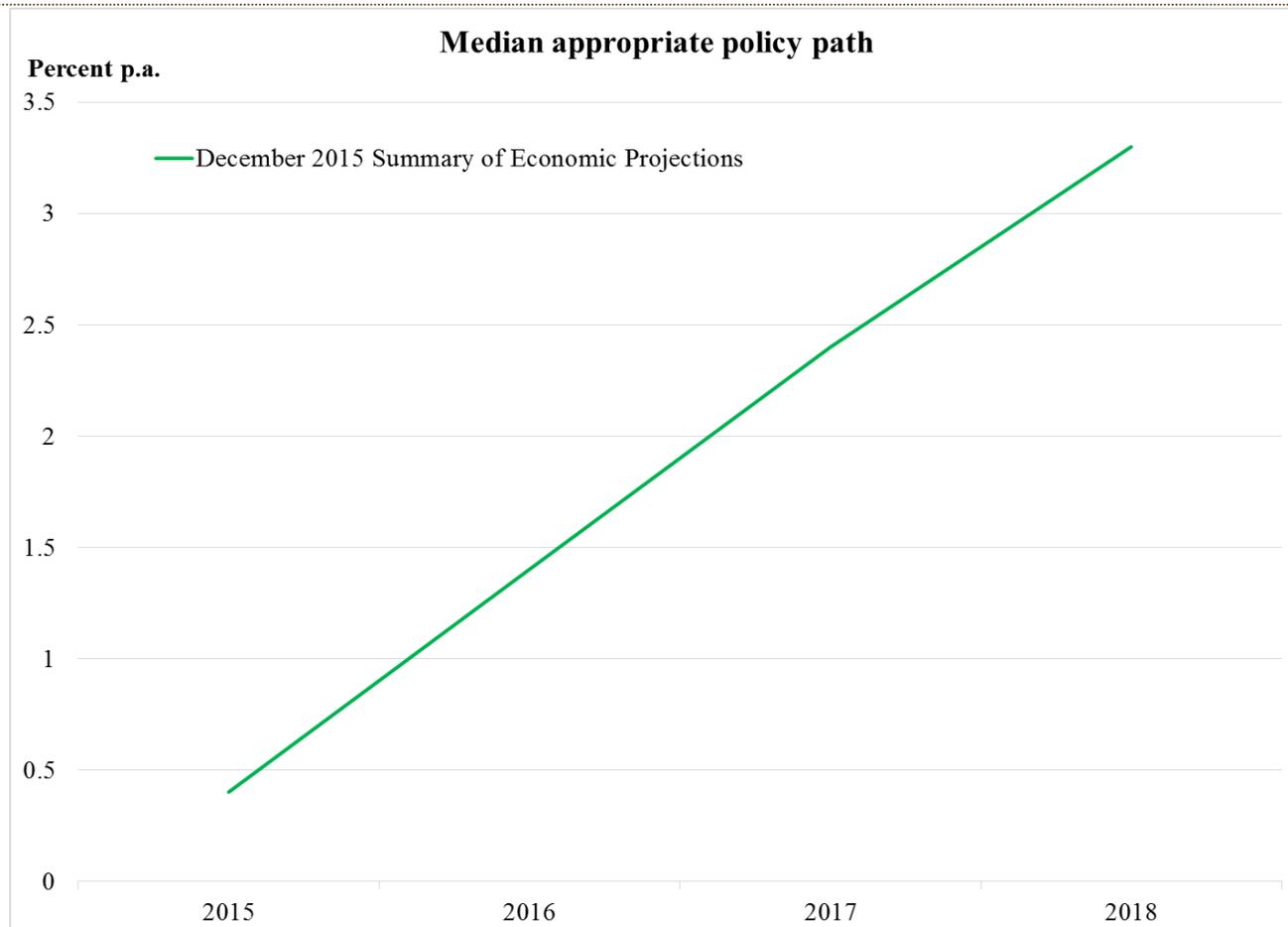
The FOMC and data dependence

- The FOMC has repeatedly stated in official communication and in public commentary that future policy adjustments are data dependent.
- Do financial markets believe the data dependence clause?
- Based on the following two observations, it is possible to make a case that they do not:
 - The 2004-2006 normalization cycle appeared to be mechanical.
 - The Committee's SEP may be unintentionally communicating a version of the 2004-2006 normalization cycle.

The FOMC policy rate 2004-2006



The median appropriate policy rate in the SEP



The SEP as an inadvertent commitment

- Financial markets might be forgiven if they see similarities in these two pictures, and therefore essentially expect a repeat of the 2004-2006 calendar-based normalization cycle.
- The policy rate component of the SEP was perhaps more useful when the policy rate was near zero, and the Committee wished to commit to the idea that the policy rate was likely to remain near zero for some period into the future.
- But now, post liftoff, communicating a path for the policy rate via the median of the SEP could be viewed as an inadvertent calendar-based commitment to increase rates.

Possible changes to the SEP?

- The FOMC cannot alter history and change what happened in 2004-2006.
- However, the FOMC could change its approach to the SEP in a way that would cease giving such explicit guidance on the likely path of the policy rate going forward.
- Such a change might help better align the Committee with financial markets on the idea that policy is data dependent and does not follow a predetermined path.
- This is an important issue for the Committee to consider.

Summary

Summary

- Two important pillars of the 2015 case for U.S. monetary policy normalization have changed.
- These changes are that market-based inflation expectations have fallen further and that the risk of asset price bubbles appears to have diminished.
- These data-dependent changes likely give the FOMC more leeway in its normalization program.
- The Committee may wish to consider changes to the way it approaches the policy rate projections in the SEP to better align market expectations of future policy moves.



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