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A Successful Normalization of Monetary Policy in the U.S.

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

Introduction

Key themes

- The Federal Open Market Committee (FOMC) has ended its monetary policy normalization program in the U.S.
- The program has been successful in that U.S. real economic performance has been very good during the normalization.
- The Committee has likely chosen an appropriate stopping point for normalization.
- U.S. monetary policy going forward will adjust appropriately to changing economic conditions.

A Successful Normalization

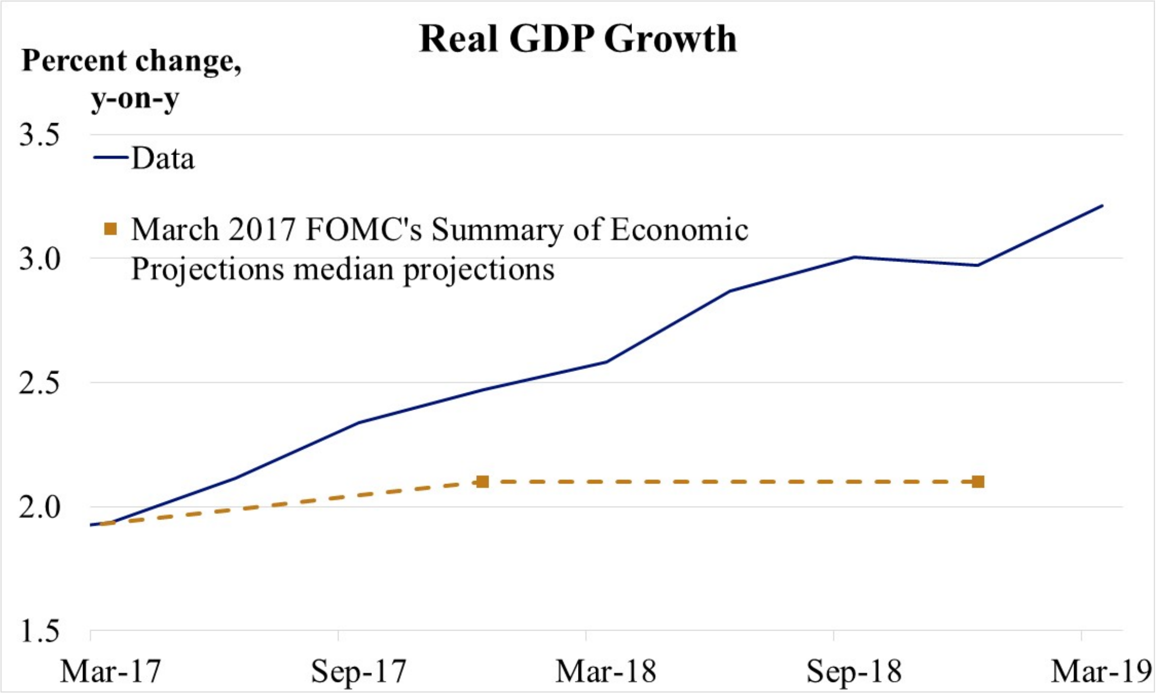
The normalization program ends

- The FOMC indicated recently that, if the economy evolves about as expected, the current level of the policy rate—the federal funds rate target range—will be appropriate through 2019.
- The FOMC also indicated that the Fed's balance sheet reduction program will end this autumn.
- These events mark the end of monetary policy normalization in the U.S.

A successful normalization

- The normalization campaign has been largely successful:
  - The policy rate has been raised about 225 basis points, from near-zero levels to a target range of 225 to 250 basis points today.
  - The size of the Fed’s balance sheet has been reduced, with reserves in the banking system declining by about 45 percent since July 2014.
  - As the normalization continued, the real side of the U.S. economy has surprised to the upside during 2017 and 2018, and so far in 2019 as well.

U.S. real economy during normalization



Sources: Bureau of Economic Analysis and Federal Reserve Board. Last observation: 2019-Q1.

An Appropriate Stopping Point

An appropriate stopping point

- The normalization program has ended with interest rates still low by U.S. postwar standards and the balance sheet still relatively large compared to pre-crisis levels.
- However, current rates in the U.S. are relatively high compared with those in Europe and Japan, where negative rates remain the norm.
- The Fed's balance sheet cannot return to its pre-crisis level because of developments in currency demand, the Treasury General Account and reserve demand driven by Dodd-Frank regulatory requirements.
- Given these considerations, the FOMC's recent judgment to end the normalization program is likely appropriate.

U.S. interest rates are relatively high

	U.S.	Germany	Japan
Two-year government bond yield	2.20%	-0.66%	-0.17%
Five-year government bond yield	2.17%	-0.52%	-0.18%
10-year government bond yield	2.39%	-0.11%	-0.07%

Source: Bloomberg. Observation: May 17, 2019.

The Fed's changing balance sheet

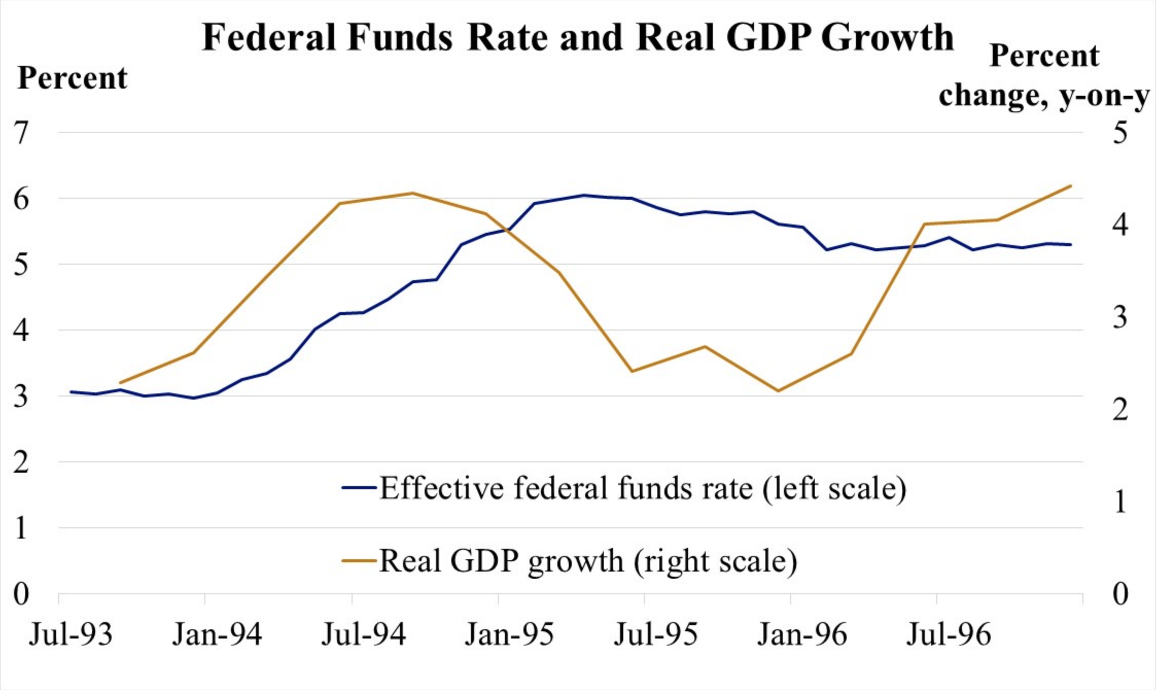
Selected liabilities of the Federal Reserve	Estimated values	
	Pre-crisis	Today
Demand for currency	765	1,750
Treasury General Account	5	250
Demand for reserves	30	1,200
Total	**800**	**3,200**

Author's calculations based on data from the Federal Reserve Board. All values are in billions of dollars.

An analogy to 1995

- The FOMC successfully normalized U.S. monetary policy during the mid-1990s.
- The policy rate was increased 300 basis points between early 1994 and early 1995.
- The FOMC then ended the normalization program and later lowered rates somewhat.
- The economy did not enter a recession but instead boomed during the second half of the 1990s.
- This example shows that policy rate normalization can be accomplished without damaging the prospects for an extended period of growth.

Normalization and real GDP growth in the mid-1990s



Sources: Federal Reserve Board and Bureau of Economic Analysis. Last observations: December 1996 and 1996-Q4.

Challenges Ahead

U.S. monetary policy going forward

- While the FOMC’s normalization program has come to an end, the conduct of monetary policy itself has not.
- The FOMC may elect to adjust monetary policy going forward, but any such adjustments would be in response to incoming macroeconomic data and not part of an ongoing normalization strategy.

Challenges ahead

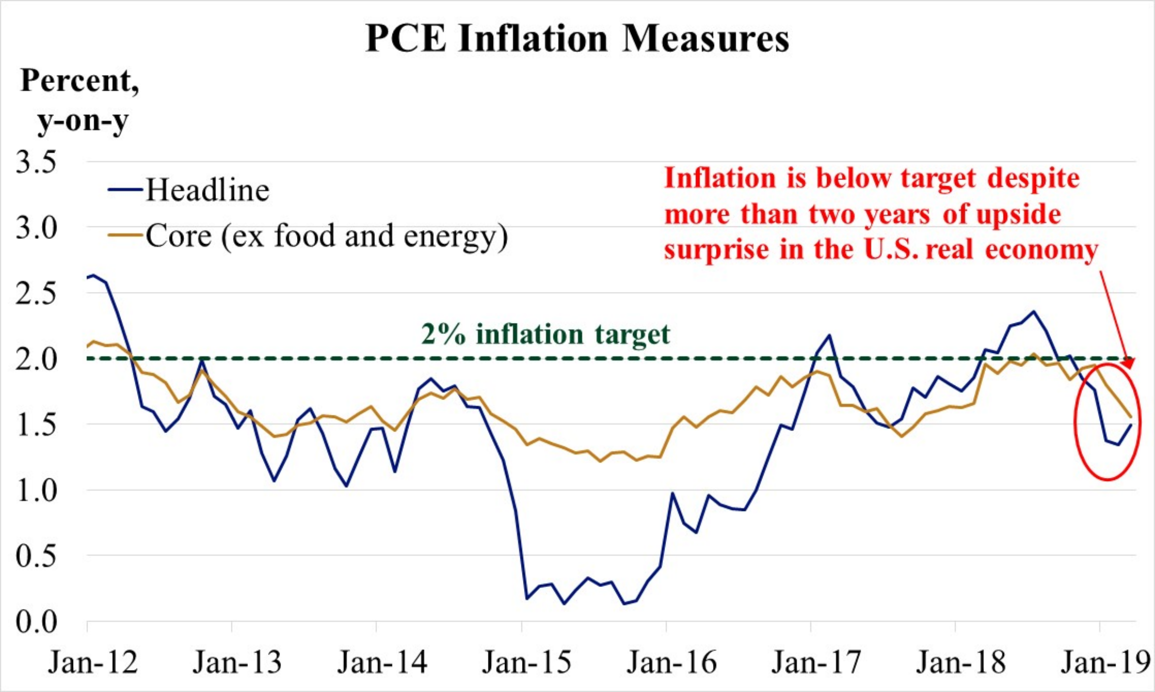
- I will mention just two of many macroeconomic challenges facing the FOMC:
  - First, current trade disputes could become entrenched, altering global trading patterns over the medium term. This could occur if no agreements are reached in the near term and substantial trade barriers are erected and maintained.
    - My baseline case is that agreements will be reached in the near term.
  - Second, the FOMC may miss its inflation target on the low side in 2019 based on current readings of market-based inflation expectations, following seven years of inflation mostly below target.
    - My baseline case here is leaning toward another low-side miss, so let me focus on this challenge.

Both actual inflation and inflation expectations remain low

- The FOMC has a stated inflation target of 2 percent.
  - The inflation target is in terms of the annual change in the price index for personal consumption expenditures (PCE).
- Actual inflation as measured by the FOMC’s preferred method is below target.
- Market-based inflation expectations are also below target.*
- This is occurring despite more than two years of upside surprise in the U.S. real economy.
- This is clearly concerning for the credibility of the inflation target.

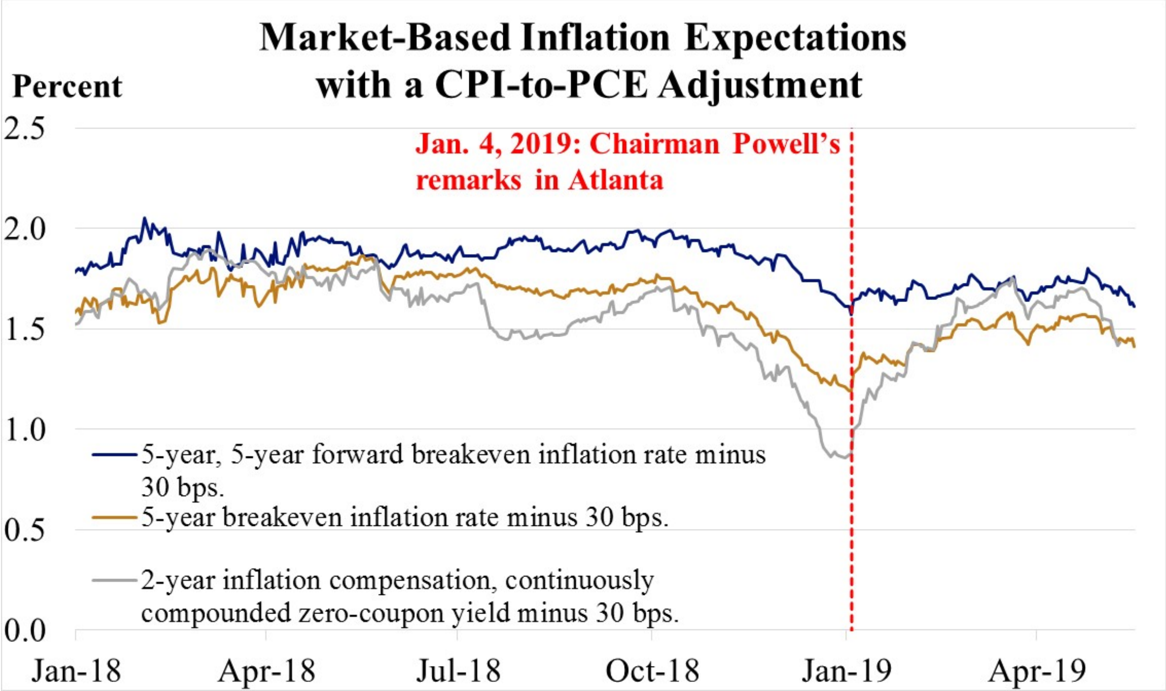
** Inflation-protected securities trade based on consumer price index (CPI) inflation. I subtract 30 basis points from market-based measures of inflation expectations to roughly translate to a PCE inflation basis.*

Actual inflation is low



Source: Bureau of Economic Analysis. Last observation: March 2019.

Real-time inflation expectations are low



Sources: Federal Reserve Board and author's calculations. Last observations: May 17 and May 10, 2019.

A potential policy response to low inflation

- The FOMC may want to consider ways to re-center inflation and inflation expectations at the 2 percent target.
- A downward policy rate adjustment even with relatively good real economic performance may help maintain the credibility of the FOMC's inflation target going forward.
- A policy rate move of this sort may become a more attractive option if inflation data continue to disappoint.

Conclusion

Conclusion

- The FOMC's normalization program has come to a close at an appropriate point.
- Going forward, the FOMC may adjust monetary policy, but any changes would be in response to incoming macroeconomic data and not part of an ongoing normalization strategy.
- The FOMC faces many macroeconomic challenges going forward, including unresolved trade disputes and below-target inflation.
- These challenges suggest that the FOMC needs to tread carefully in order to help sustain the economic expansion.

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