



CENTRAL
to
AMERICA'S
ECONOMY™

Five Macroeconomic Questions for 2017

James Bullard

President and CEO, FRB-St. Louis

Forecasters Club of New York

Jan. 12, 2017

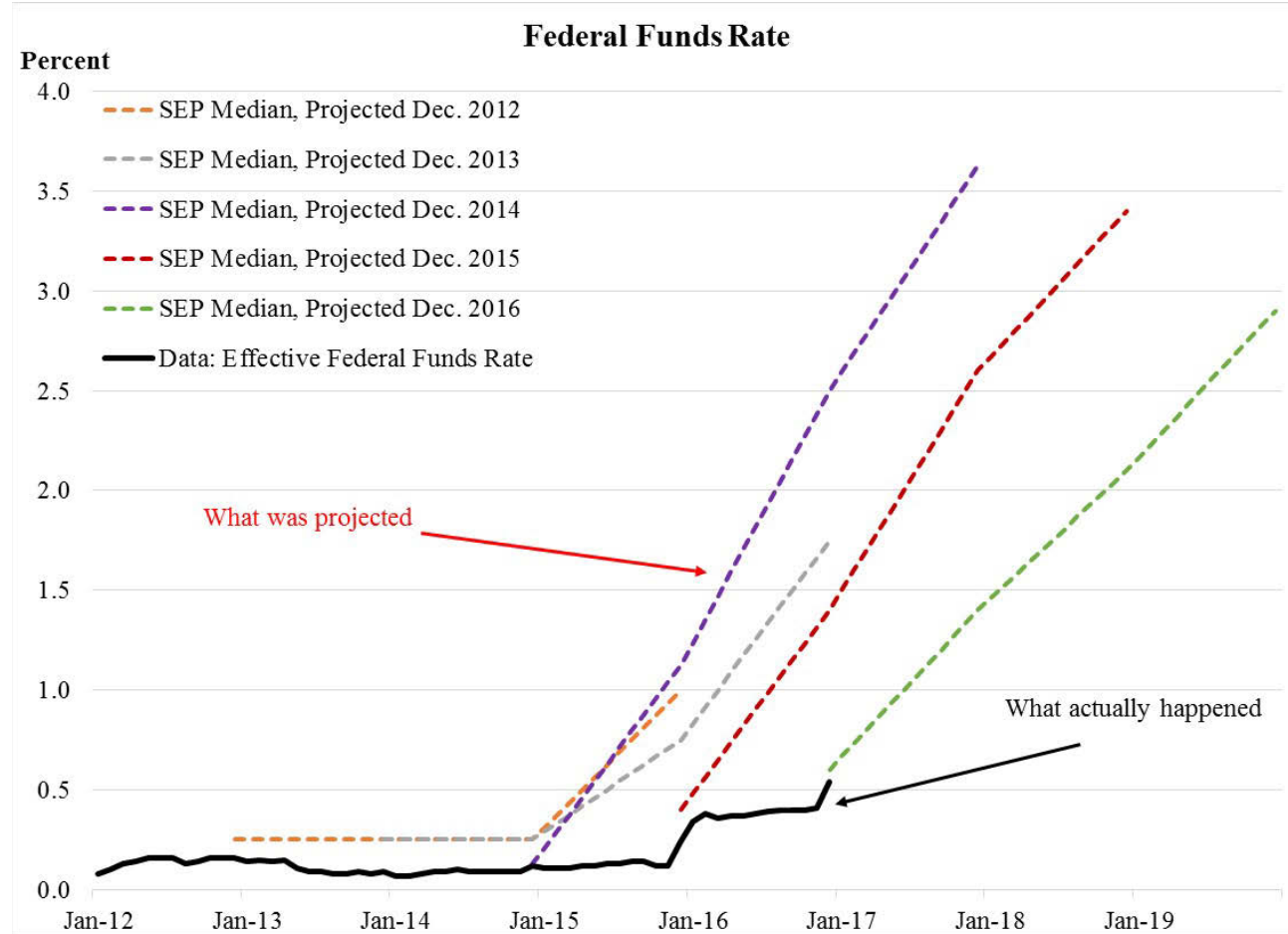
New York, N.Y.

Fed Projections Should Challenge Your Thinking

The FOMC policy rate projections

- In 2016, the St. Louis Fed changed its approach to near-term U.S. macroeconomic and monetary policy projections.
- In part, this was a reaction to continual FOMC projections (including St. Louis Fed projections) of a meaningfully rising policy rate environment since 2012, which did not materialize in subsequent years.
- In effect, the Committee kept the policy rate lower than had previously been expected, and yet there was no detectable increase in inflation or additional economic growth.

The FOMC policy rate projections versus reality



The FOMC policy rate projections

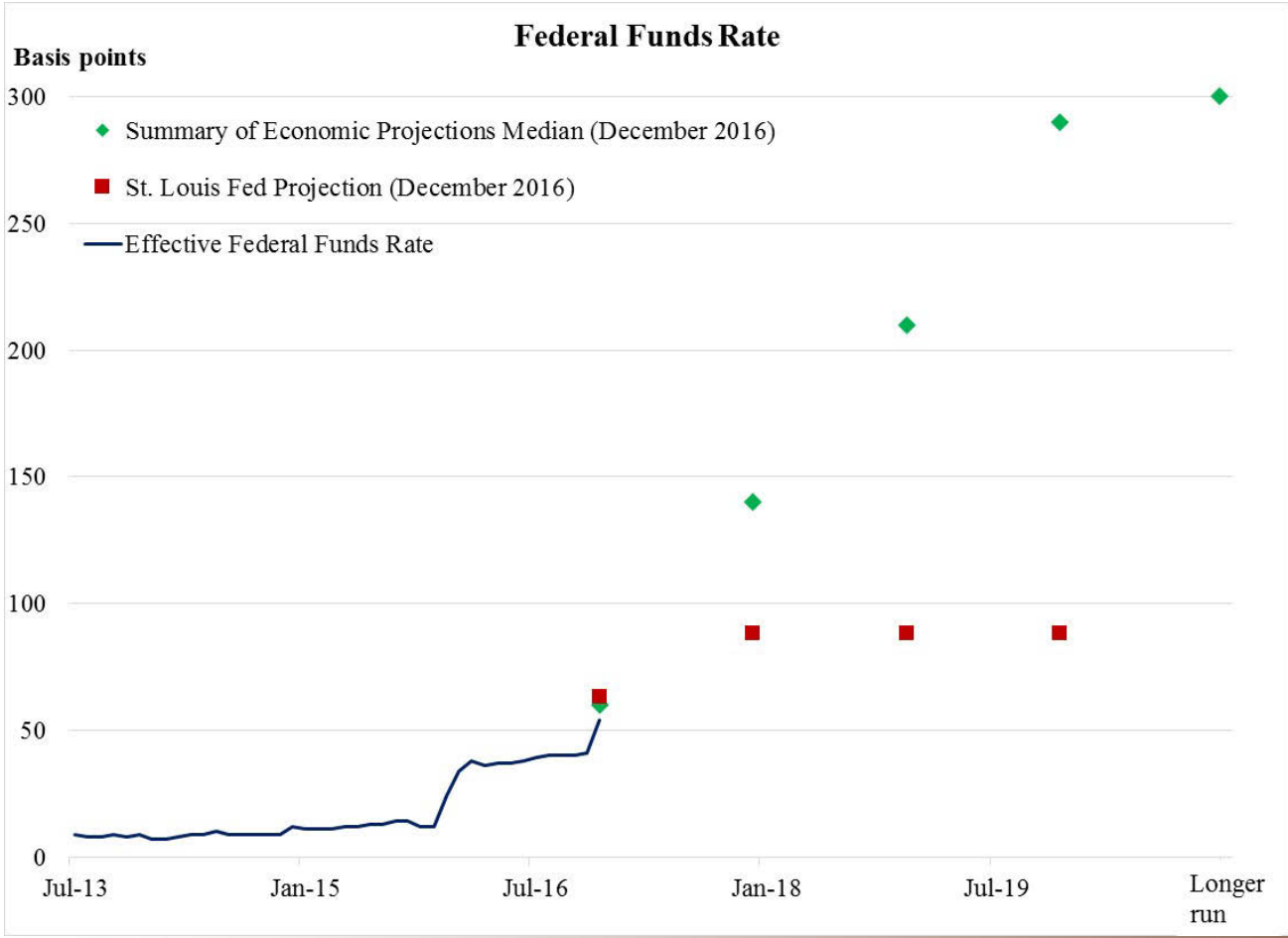
- As an example, the December 2014 SEP projection suggested that the current level of the policy rate would be approximately 200 basis points higher than it actually is today.
- In 2016, we at the St. Louis Fed concluded that the model behind this type of projection was questionable.

A Regime-Based Approach

A regime-based approach

- We argued that a better view of the current U.S. macroeconomic environment is as a “low-safe-real-interest-rate regime.”
 - The “regime” nomenclature is due to Hamilton (1989).*
- Monetary policy can then be viewed as a Taylor-type interest rate rule conditional on this low-rate regime.
- Because unemployment and inflation are close to target, there is presently little reason to change the policy rate given the regime.
- Therefore, we have projected only a little movement in the policy rate over the forecast horizon.

The policy rate path dichotomy



More details on the regime-based approach

- For more details, see
 - J. Bullard, “The St. Louis Fed’s New Characterization of the Outlook for the U.S. Economy,” announcement, June 17, 2016.
 - The announcement and several remarks I gave in the following months covering various aspects of the St. Louis Fed’s new approach are available on my webpage under “[Key Policy Papers.](#)”

Questions for This Talk

Is a regime change afoot for the U.S. economy?

- Since the U.S. presidential election concluded in November, we have entertained many questions on the regime-based view.
- In this talk, I will list some of these questions and provide some tentative answers.

Five questions

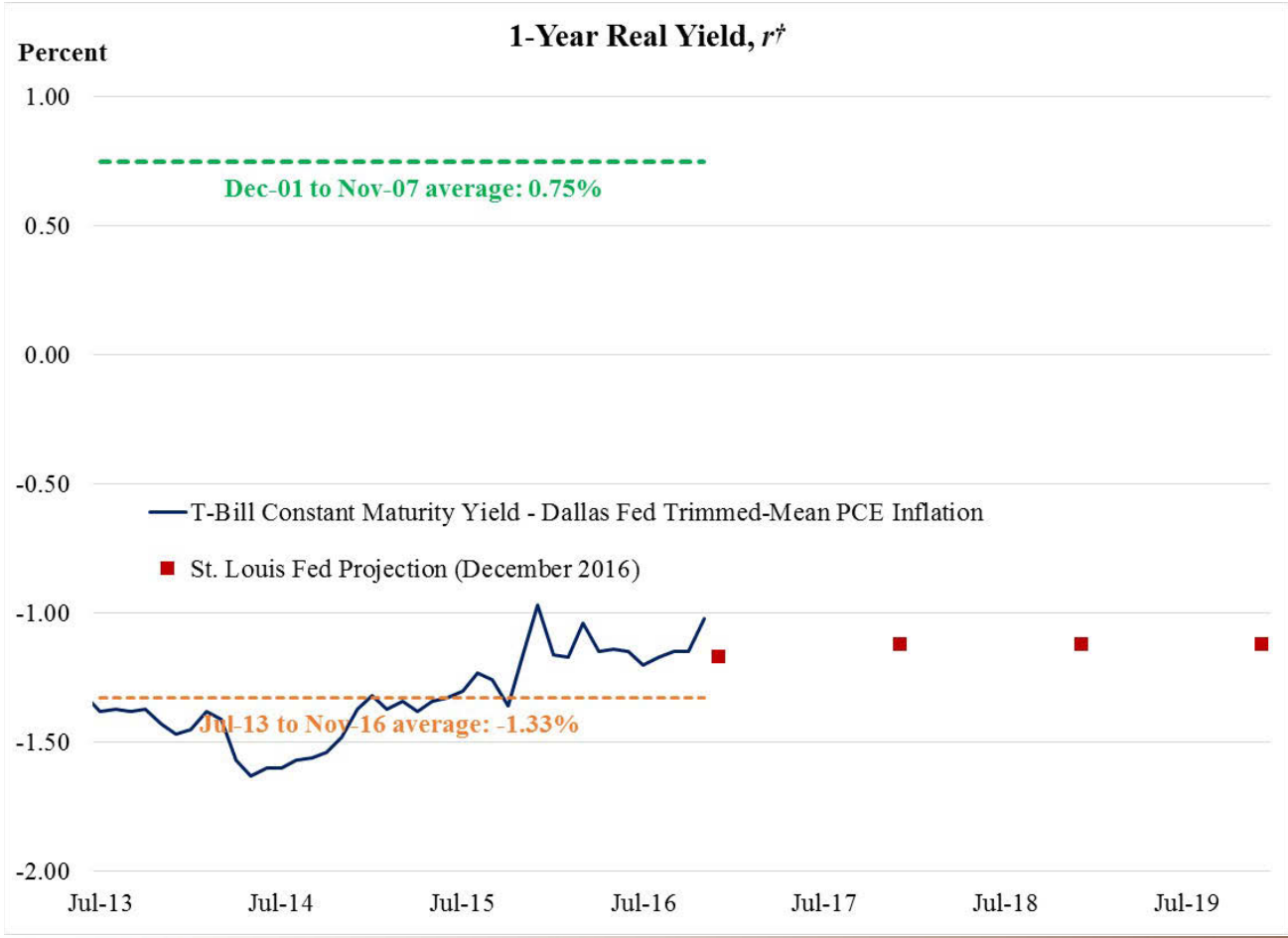
1. Will the low-real-rate regime give way to a high-real-rate regime in the U.S. in 2017?
2. Will the new administration's policies drive the U.S. real GDP growth rate higher?
3. Is U.S. inflation about to move higher?
4. Does the U.S. policy rate need to move higher to keep inflation near target and unemployment at current levels?
5. Could the Fed's balance sheet now be allowed to shrink?

1. Will the Low-Rate Regime Switch to a High-Rate Regime in 2017?

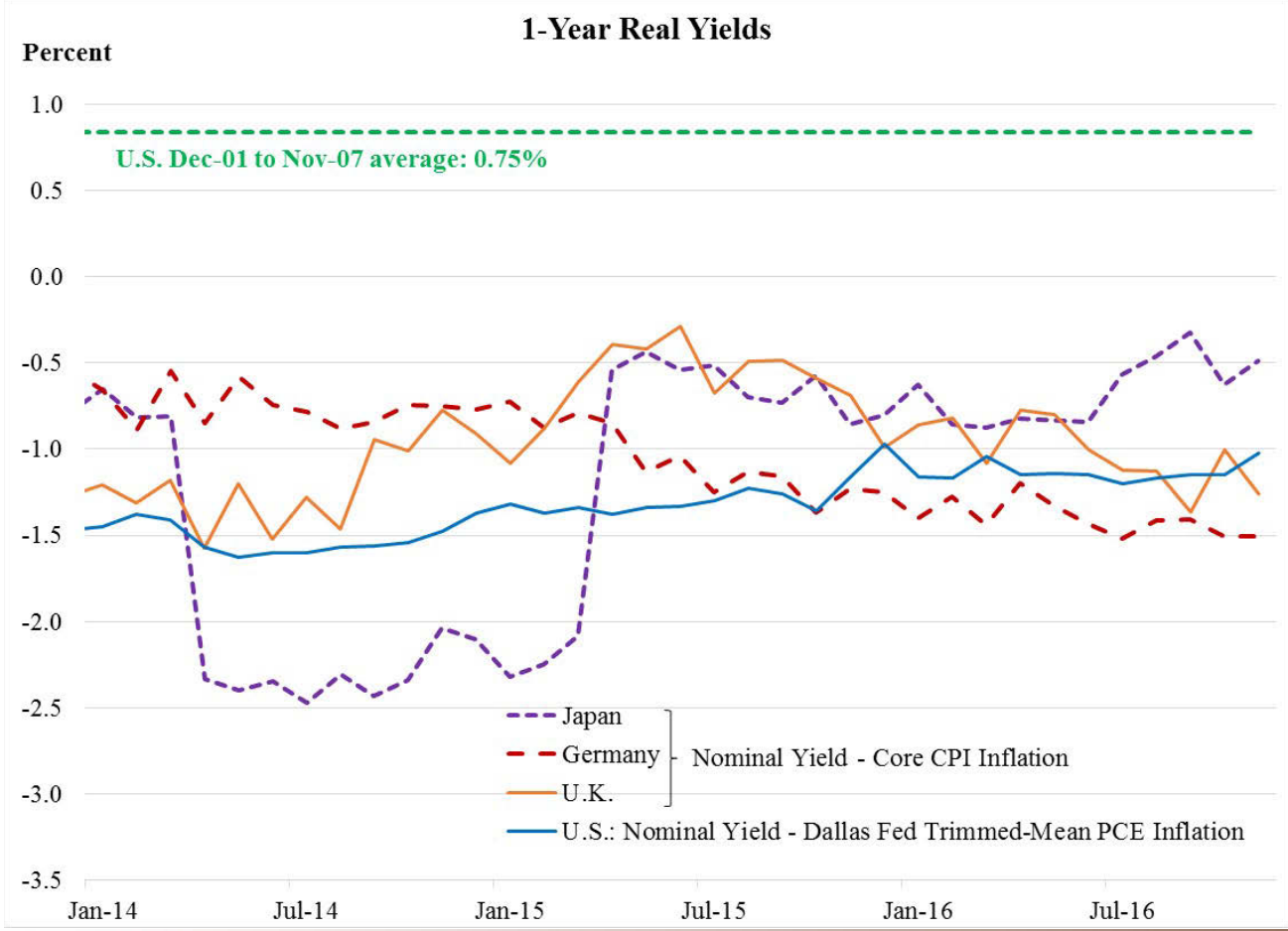
Will there be a switch in 2017 on real interest rates?

- We can think in terms of two real-interest-rate regimes:
 - A high-real-rate regime that prevailed during the 1980s, 1990s, and into the 2000s.
 - A low-real-rate regime that prevails today.
- Are we now likely to switch back to the high-real-interest-rate regime in 2017?
- Probably not. Why?
 - 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.

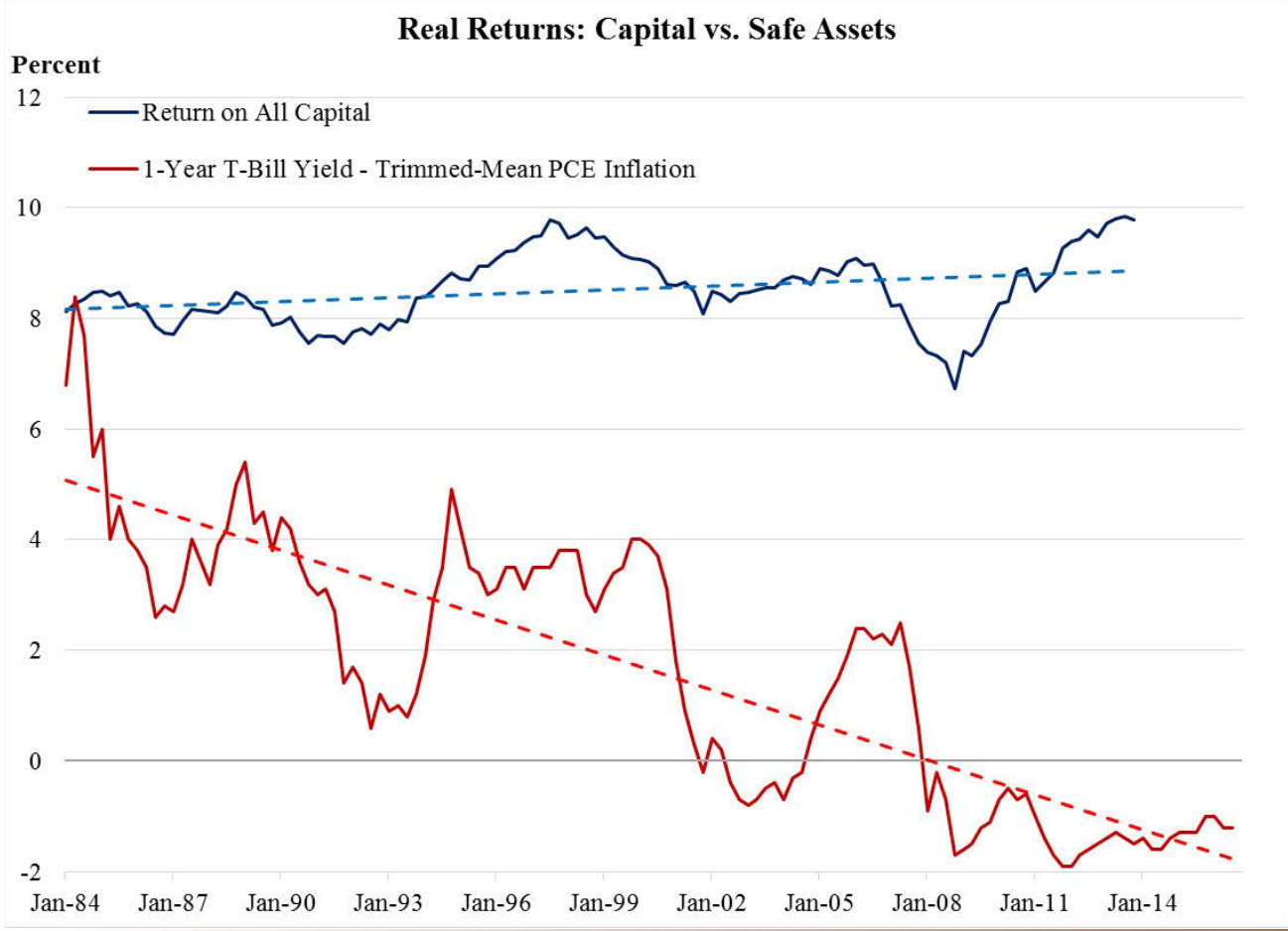
The low- and high-real-rate regimes in the U.S.



One-year ex-post real yields are low globally



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.

2. Will the New Administration's Policies Drive the U.S. Real GDP Growth Rate Higher?

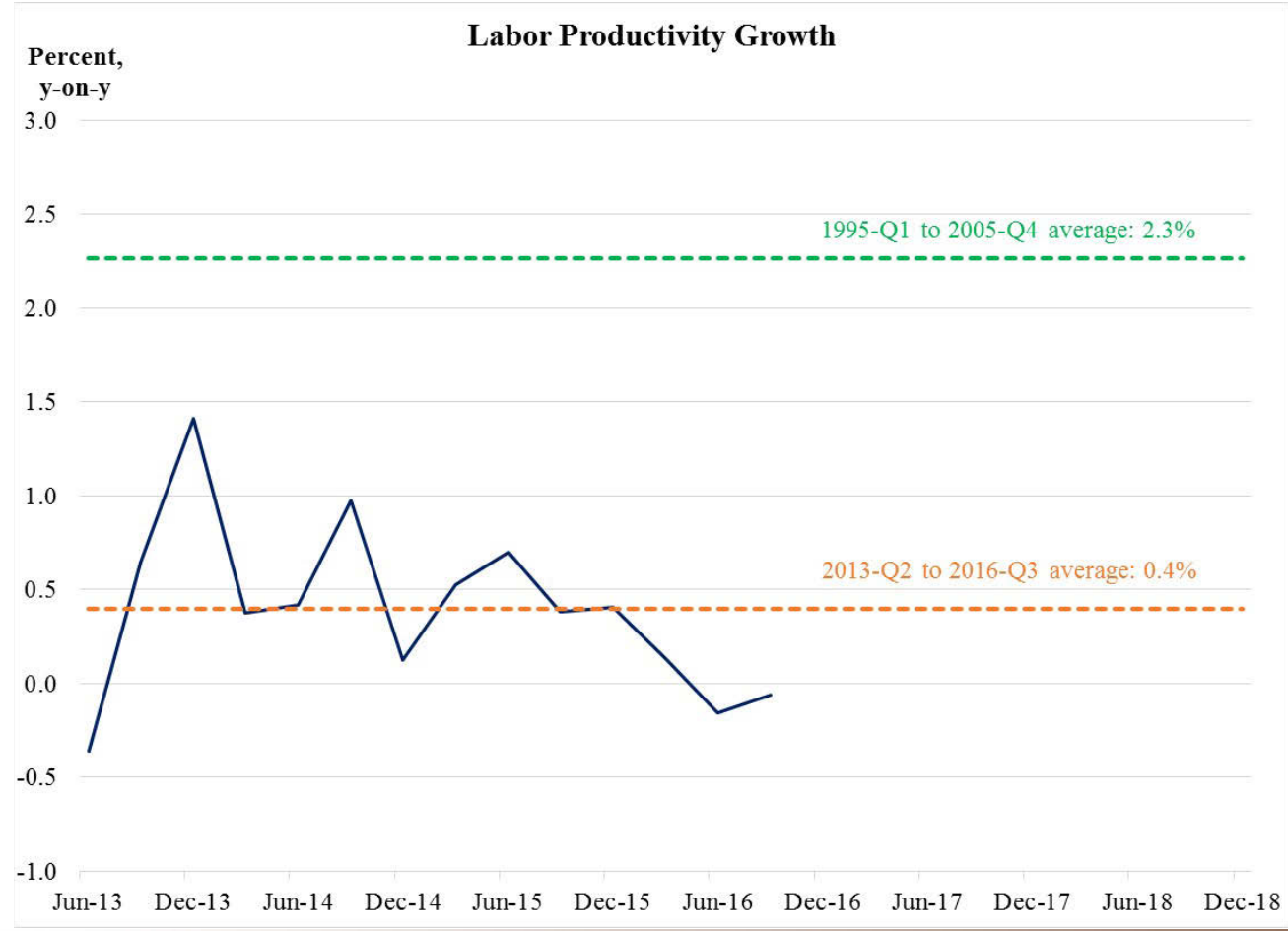
The impact of new policies on the real rate

- Can 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.
 - U.S. productivity growth is low and could conceivably be improved considerably. This could increase the safe real rate.

Impact of new policies on the real GDP growth rate

- 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 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



Longer-term policies

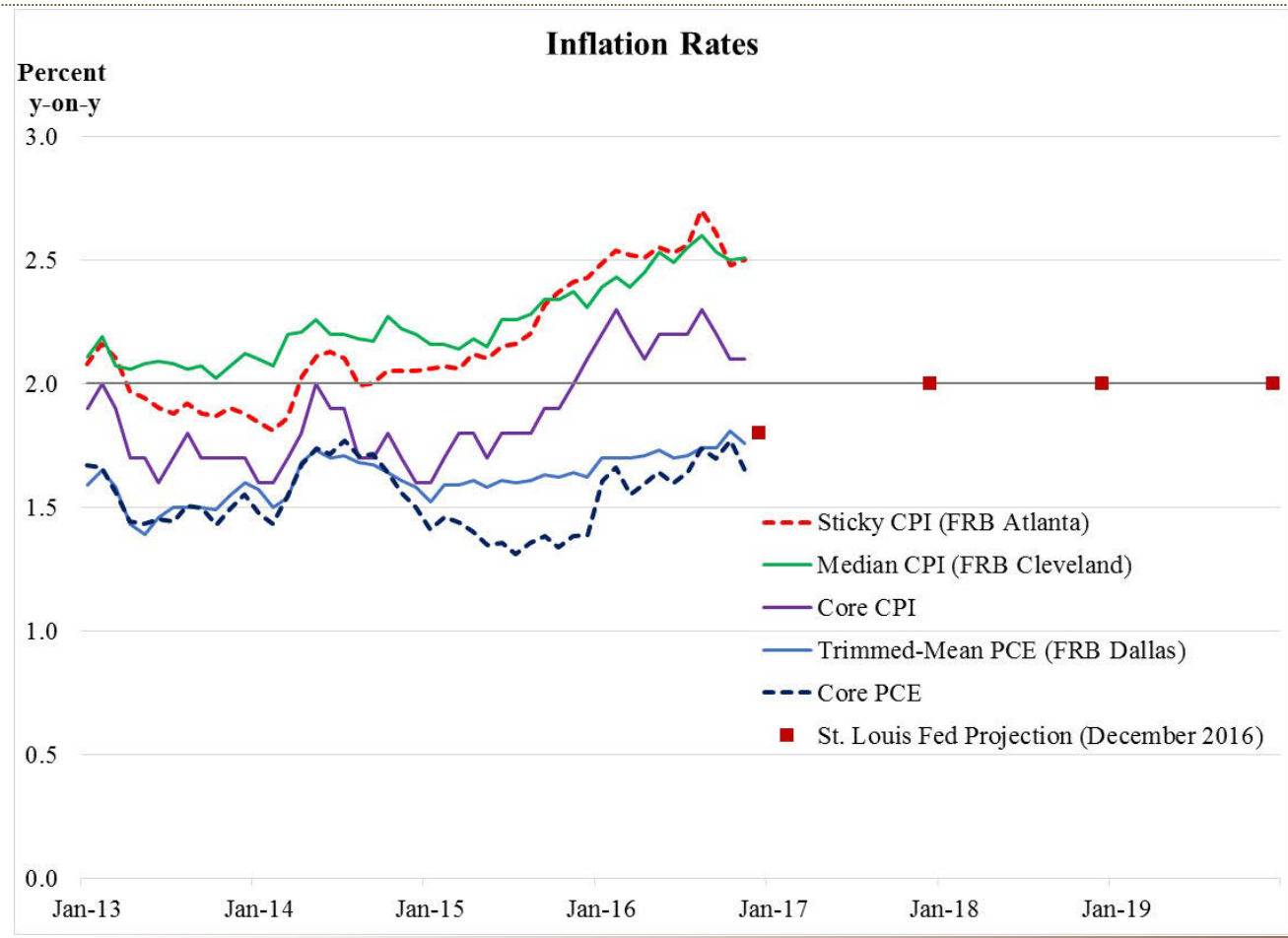
- Other macroeconomic issues were perhaps of more pressing concern during the recent presidential campaign, including trade and immigration.
- Trade negotiations tend to be slow-moving relative to monetary policy.
- Trade arrangements can have important macroeconomic effects, but over the longer term.
- Similarly, immigration reform would likely have important effects on the macroeconomy, but over a longer horizon.

3. Will Inflation Move Higher 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

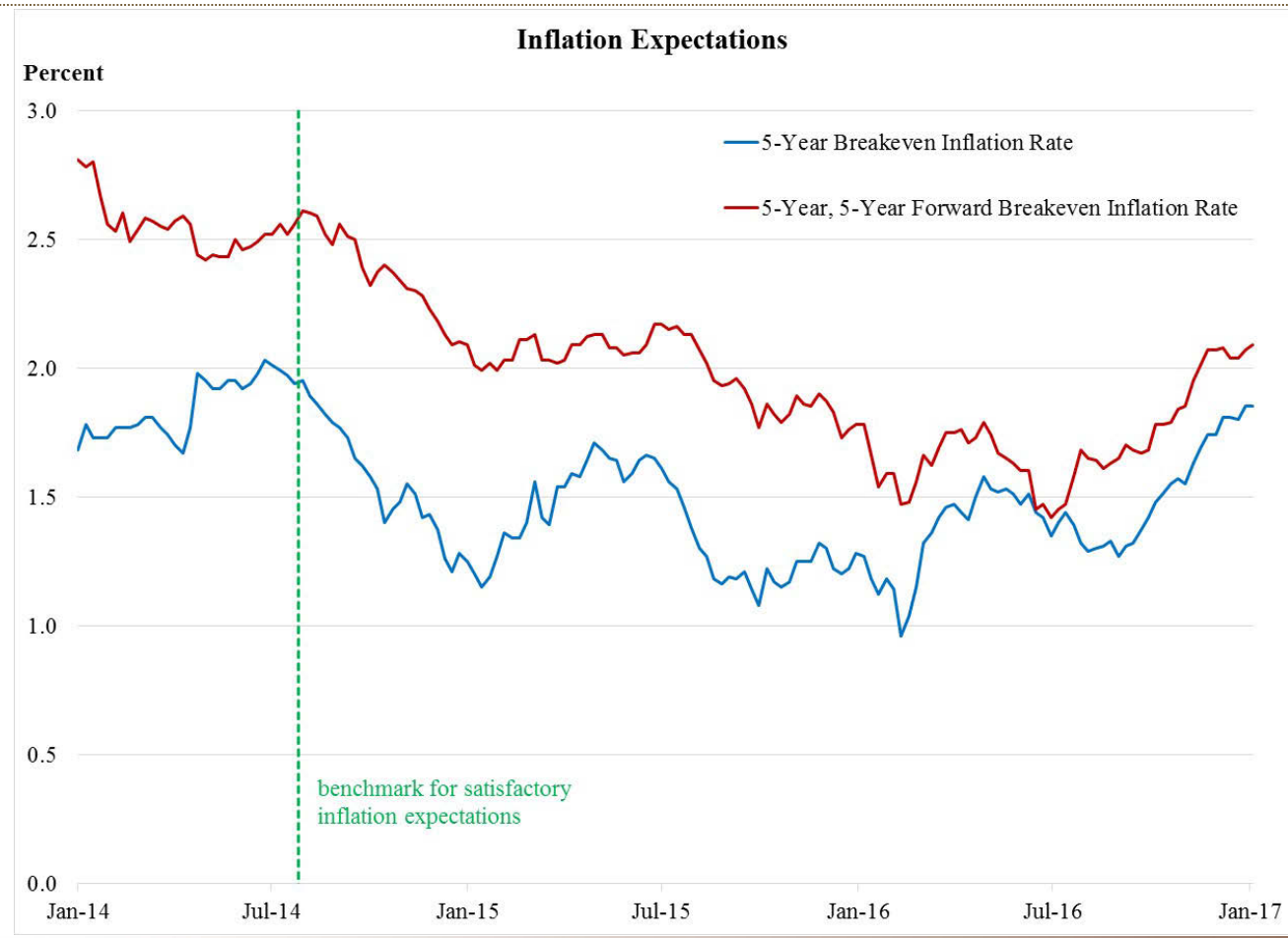


Source: Bureau of Labor Statistics, FRB Cleveland, FRB Atlanta, Bureau of Economic Analysis, FRB Dallas and author's calculations. Last observations: November 2016.

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 remain somewhat low relative to the mid-2014 benchmark, when they were at satisfactory levels.
- Consequently, it does not appear that undue inflationary pressure is building so far.

Inflation expectations remain somewhat low

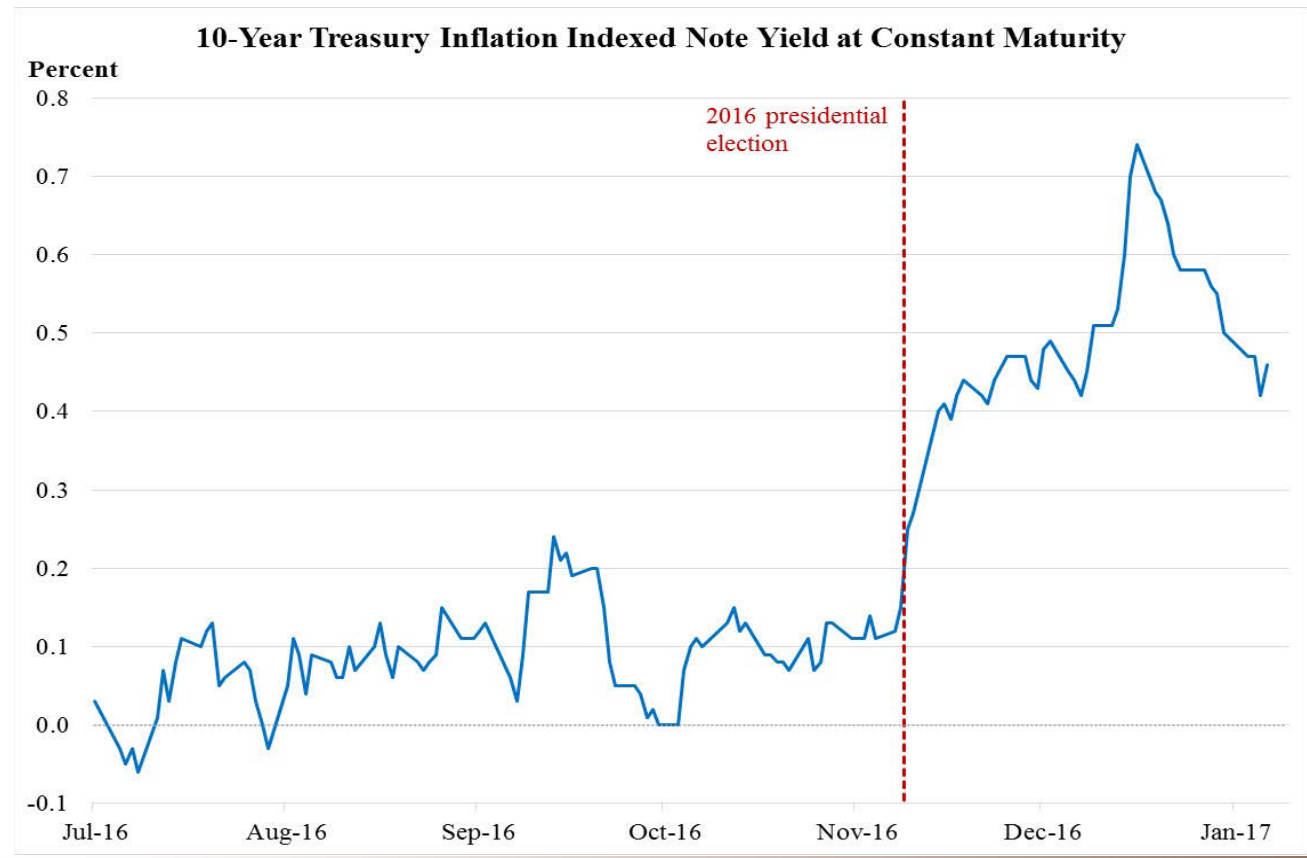


4. Should the U.S. Policy Rate Move Meaningfully Higher in 2017?

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 rates 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



5. Could the Fed's Balance Sheet Begin to Shrink?

Fed balance sheet policy has been on hold

- 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 putting exclusive emphasis on a higher policy rate path.

Conclusion

Conclusion

- The St. Louis Fed's recommended policy rate depends mostly on the safe real rate of return.
- Safe real rates of return are exceptionally low and are not expected to rise soon, a “low-safe-real-rate regime.”
- This means, in turn, that the policy rate should 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.



CENTRAL
to
AMERICA'S
ECONOMY™

Federal Reserve Bank of St. Louis
stlouisfed.org

Follow us on Twitter
twitter.com/stlouisfed

Federal Reserve Economic Data (FRED)
fred.stlouisfed.org

James Bullard
stlouisfed.org/from-the-president