Central Bank and Monetary Policy Outlook

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Central Bank and Monetary Policy Outlook

I. US monetary policy has passed its turning point, other major countries will follow

II. Definition, scope and timing of monetary policy normalization are uncertain

III. Central banking will not return to the old normal
Part I: Policy is at Turning Point

Global growth is again projected to pick up

<table>
<thead>
<tr>
<th></th>
<th>2016</th>
<th>2017</th>
<th>2018</th>
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</thead>
<tbody>
<tr>
<td>Real GDP Growth (Y/Y)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Global Output Growth (PPP weights)</td>
<td>3.0</td>
<td>3.5</td>
<td>3.7</td>
</tr>
<tr>
<td>US: a bump in growth</td>
<td>1.6</td>
<td>2.2</td>
<td>2.2</td>
</tr>
<tr>
<td>Euro Area: modest improvement</td>
<td>1.7</td>
<td>1.8</td>
<td>1.8</td>
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<tr>
<td>Japan: more of the same</td>
<td>1.0</td>
<td>1.3</td>
<td>1.0</td>
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<tr>
<td>UK: slower growth ahead</td>
<td>1.8</td>
<td>1.7</td>
<td>1.3</td>
</tr>
<tr>
<td>China: gradual slowdown still most likely</td>
<td>6.7</td>
<td>6.5</td>
<td>6.2</td>
</tr>
<tr>
<td>India: expansion on track</td>
<td>7.4</td>
<td>7.3</td>
<td>7.6</td>
</tr>
<tr>
<td>Russia: modest upturn</td>
<td>-0.5</td>
<td>1.2</td>
<td>1.3</td>
</tr>
<tr>
<td>Brazil: bottoming out at best</td>
<td>-3.6</td>
<td>0.1</td>
<td>1.4</td>
</tr>
</tbody>
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Source: David J. Stockton, PIIE

This time sustained global expansion may be for real--even if modest
US Growth Will not Be this Rosy

Forecasts' Long-term Growth Outlook

Real GDP growth over next 10 years

Source: Survey of Professional Forecasters
The US Growth Challenge

Powerful supply-side factors explain why growth has been tepid relative to the 70s, 80s, 90s

• Women are no longer surging into the workforce
• Baby boomers are starting to retire
• Slow productivity growth

A sustained higher pace of growth requires boosting the supply-side determinants of output

• Fiscal expansion and tax and financial reforms won’t be enough
• Immigration policy could well be a big negative

Source: Karen Dynan, PIIE
The Federal Reserve’s Tightening Cycle Is Underway

Increase in federal funds rate from low point

<table>
<thead>
<tr>
<th>Months of tightening after</th>
<th>Apr 77</th>
<th>Mar 87</th>
<th>Jan 94</th>
<th>Jun 04</th>
<th>Nov 15</th>
</tr>
</thead>
<tbody>
<tr>
<td>Percentage points</td>
<td></td>
<td></td>
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</tbody>
</table>

Source: Joseph Gagnon, PIIE
Long and Short Rates Are Rising

10-Year and Federal Funds Rates

Months since November 2015

Source: FRED
After Half a Decade of Revised Expectations

10-year treasury rate

July 2012 to March 2017

Source: FRED
Global Divergence/Convergence: Unemployment

Unemployment Rates

Source: David Stockton, PIIE
Global Divergence/Convergence: Inflation

Core Consumer Price Inflation

12-month percent change

Source: David Stockton
Part II: Monetary Policy Normalization

• The United States has started monetary policy normalization
  – What is normal?
  – What will be the processes?
  – How long will it take?
We Likely Face a New Normal of Low Rates?

• Secular stagnation
• Low population growth
• Retirement saving
• Low productivity growth
• Global saving glut/FX policies
• Demand for safe assets
FOMC Participants “Forecasts” of Long-run Federal Funds Rate

Median = 4.25

January 2012

Median = 3.00

March 2017

Source: Federal Reserve Board and Joseph Gagnon, PIIE
US Monetary Policy Forecast

Source: David Stockton, PIIE
What is Normal?

If “normal” for the Federal Reserve is a funds rate at 3 percent

• The Fed may take three years to get there
• In the meantime, US monetary policy will remain accommodative
• The scope for overshooting on both inflation and employment is considerable
Part III: Central Banking Will NOT Return to Normal

- Central bank mandates have been expanded de facto and de jure
- Markets will expect central banks to keep their powder dry but available
- Central banks and their critics will not be able to put the genie back into the bottle
Central Banks Will Not Focus on Inflation Alone

- Central banks appropriately have regained a role in promoting financial sector stability
- Macro-prudential policies are largely untested in AEs, but are expected to play a role
- Unfortunately, some tools of crisis management have been taken away
Central Bank Balance Sheets Are Said to be Bloated

Source: FRED and author’s calculations
Case for a Rapid Shrinking of Balance Sheets Is Weak

• The Federal Reserve is committed to normalizing the stance of monetary policy, starting with the funds rate
• Shrinking the Fed’s balance sheet is a secondary objective
  – It already has started
  – It will and should trail the normalization of the federal funds rate
  – The case for a return to “normal” rests on considerations of market efficiency with the funds rate as the primary instrument of policy in normal times
  – The anti-inflation argument has been discredited by the events of the past decade
My Three Points

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III. Central banking will not return to the old normal
Thank you