St. Louis Fed's Bullard Discusses New Approach to Monetary Policy Normalization

8/17/2016

ST. LOUIS – Federal Reserve Bank of St. Louis President James Bullard discussed "Normalization: A New Approach" on Wednesday during the Wealth and Asset Management Research Conference at the Olin Business School at Washington University in St. Louis. In particular, he explained how the St. Louis Fed's approach to near-term U.S. macroeconomic and monetary policy projections recently changed, and how the St. Louis Fed came to adopt this new narrative.[1]

Bullard explained that the new approach delivers a simple forecast of U.S. macroeconomic outcomes over the next two and a half years. He said that the St. Louis Fed's forecast is for real gross domestic product (GDP) growth of 2 percent, an unemployment rate of 4.7 percent and a Dallas Fed trimmed-mean personal consumption expenditures (PCE) inflation rate of 2 percent. The target federal funds rate (i.e., the policy rate) is projected to be 0.63 percent over the forecast horizon.

Overview of the Two Narratives

In developing a new approach, Bullard said, the St. Louis Fed wanted to replace certainty about where the economy is headed with a manageable expression of the uncertainty surrounding medium- and longer-term outcomes.

He said the St. Louis Fed's previous narrative assumed that the economy is converging to a unique, long-run steady state and that values for key macroeconomic variables are essentially tending toward an average of their past values. With inflation and unemployment gaps near zero, he noted, business cycle dynamics appear to be over. Therefore, the implication under the old narrative is that "the policy rate would likely rise over the forecast horizon to be consistent with its steady-state value."

However, Bullard explained, "In the new narrative, the concept of a single, long-run steady state is abandoned. Instead, there is a set of possible 'regimes' that the economy may visit." He added that regimes are generally viewed as persistent and that switches between regimes, while possible, are not forecastable. He said that the current regime appears to be characterized by slow growth, low real rates of return on safe assets and no recession.

In terms of monetary policy, which is regime-dependent, the implication is that "the policy rate will likely remain essentially flat over the forecast horizon to remain consistent with the current regime."

The Previous Narrative and the End of Its Usefulness

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James Bullard
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James Bullard is president and chief executive officer of the Federal Reserve Bank of St. Louis. In these roles, he participates in the Federal Open Market Committee (FOMC) and directs the activities of the Federal Reserve's Eighth District.

- President's Website
- Speeches & Presentations
- Video Appearances
- Media Interviews
- Research Papers

Bullard said that during the past several years, the St. Louis Fed's typical medium-term forecast under the old narrative was for output to grow at an above-trend pace, for unemployment to decline, for inflation (net of commodity-price effects) to overshoot 2 percent, and for policy rate increases to be consistent with the unique steady state. Under this old narrative, the extremely low policy rate was seen as stimulating, which is what was driving inflation above target, output growth above trend and a decline in unemployment.

He noted that from the second half of 2013 to the first half of 2015, output growth and unemployment data supported the previous narrative. However, inflation did not overshoot 2 percent during that period.

Now, Bullard explained, output growth has arguably slowed to a rate below a 2 percent trend, unemployment may not fall much below its current values, and trimmed-mean PCE inflation is close to 2 percent but not rising rapidly.

"If there are no major shocks to the economy, this situation could be sustained over a forecasting horizon of two and a half years," he said. "These facts suggest that it may be time to quit using the old narrative."

The New Narrative Based on Regimes

In describing the new narrative, Bullard discussed three important fundamental factors that determine the nature of the regimes that the economy may visit: productivity growth, which can be high or low; the real interest rate on short-term government debt, which can also be high or low; and the state of the business cycle, which can be expansion or recession. "The 'regime' can refer to any of these states or to the combination of all three," he explained.

Bullard said that while recession is a risk, "we have no reason to forecast a recession given the current state of the U.S. economy." Therefore, this is viewed as a "no-recession regime." Regarding labor productivity growth, he noted that it has been low on average at least since 2011. Hence, this is viewed as a "low-productivity-growth regime." Turning to the real rate of return on short-term government debt, Bullard noted that it has been exceptionally low by recent historical standards. This is viewed as a "low-real-rate regime."

"We think of low real rates of return on government paper (safe assets) as reflecting an unusually high liquidity premium on government debt," he said. While not all real returns in the economy are unusually low, he noted that the real returns on safe assets are the ones that are most closely linked to monetary policy.

He acknowledged that there are some risks associated with the projected policy rate, including the fact that these fundamental factors could switch into new regimes. Overall, he said that the risks are likely to the upside.

Bullard concluded, "If a regime switch does occur, the policy rate path would have to change appropriately—it remains data-dependent."

[1] For more discussion of the St. Louis Fed's new approach, see Bullard's webpage at www.stlouisfed.org/from-the-president/key-policy-papers.