JAMES BULLARD'S NEW NARRATIVE FOR MONETARY POLICY

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Last Friday, Jeremy Siegel and I sat down with James Bullard, President of the Federal Reserve Bank of St. Louis. Our discussion focused on Bullard's new prescription and narrative for monetary policy and its implications for interest rates. Bullard is known for challenging conventional thinking and adapting views based on economic conditions—and he certainly has lived up to that hallmark with his new narrative for the economy. Setting the stage: One year ago, we spoke with President Bullard, who was fairly hawkish, wanting to hike interest rates sooner than most other Fed officials. Bullard's models saw economic growth in the U.S. averaging in excess of 3% in 2016. With the Fed not hiking rates as quickly as Bullard desired, we should have seen high inflation. Neither growth of 3% nor inflation transpired. Economic growth—always viewed as right around the corner—disappointed at below-trend levels of just 1.2%; inflation also disappointed. As a result, Bullard sought a new model to describe what was happening in the economy. ***Introducing his new narrative:*** The old narrative, with a long-run steady state common to macroeconomic models, suggests everything converges to its long-run value. Yet today, the distance between the output gap in the economy is close to zero, and inflation is essentially close to target. The old narrative would suggest that the policy rate should rise (hence the Fed's rising dot plot). But Bullard thinks this no longer applies. In his new narrative, there is no steady state. Instead there is a regime-based world ("regime" comes from the econometrics literature). These regimes are persistent, and once in them, you want to make the best monetary policy possible. Policy is therefore regime based. The current regime is characterized by low growth, low productivity and especially low real rates of return on sovereign debt. Another important element is that the cyclical dynamics of the economy are over. This new narrative wasn't appropriate three years ago when the unemployment rate was far higher. To summarize, Bullard sees growth at 2% for the next 2.5 years, unemployment at 4.7%, inflation at 2% and the policy rate at 63 basis points. ***Why the neutral rate for monetary policy has come down so precipitously:*** Bullard emphasizes that he's focused on a neutral rate he calls "R-dagger"—a short-term equilibrium real interest rate and not the long-run policy rate. He says if you look at the ex post real return on 1-Year U.S. Treasuries and subtract the Dallas Fed trimmed mean personal consumption expenditure (PCE) inflation rate over the last three years, you would get -140 basis points (R-dagger), and that is a level that hasn't changed much in recent years. Bullard therefore thinks we should just accept this rate as an input to monetary policy. One way he justifies his recommendation of 63 basis points (bps) uses this -140-bps real return on short-term debt combined with a "Taylor Rule". With the output gap and inflation gap staying close to zero, adding the R-dagger (-140 basis points) to the inflation target of 2% is how he got close to 63 basis points as a policy recommendation. ***Many people assume the long-run Fed target rate is close to 4%. If one subtracts 1% to 2% for slower economic growth, why has Bullard brought down his policy target more dramatically? Bullard's view:*** There is a very large liquidity premium on government paper with negative nominal rates on global government debt. He's taking this as "exogenous" or unknown for the model, and it is a very large influence that he does not see changing anytime soon. Bullard distinguishes his view on this liquidity premium: Just because he sees a large liquidity premium for government debt and resulting low interest rates, it does not mean there should be lower returns on other forms of capital. ***On whether we need to see inflation hit 2% before the next hike in interest rates, Bullard said:*** The way the St. Louis Fed prescribes policy, it is not urgent to move rates today, and Bullard would like to increase rates following good news for the economy. If growth picks up and jobs continue to grow, it would be good time to move. But that hike would still take us to a neutral rate with no upward or downward pressures on inflation. Bullard would not make the next hike contingent on inflation being either 1.9% or 2.0% or 2.1% because he does not believe we measure inflation that well. In macroeconomics, Bullard believes that if we have 1.7%, 1.8% or 1.9% inflation levels, those are all close to the Fed's 2% target. *Bullard's forecast for interest rates is much closer to market expectations for Fed policy. The Fed Funds Futures for the furthest-out contract—July 2019—shows an implied interest rate of 79 basis points,[1] not so different from Bullard's 63 basis points and only one hike.*

Bullard has moved closer to the market's views. ***On why productivity growth has disappointed and contributed to slow growth:*** Bullard does not believe there is one clear answer for why productivity growth has slowed. But from his perspective, the Fed cannot influence productivity and has to take that as an input. That means gross domestic product (GDP) is likely to grow slowly. But the good news is this: In the mid- to late '90s, there was a productivity boom, and GDP grew 4% a year when we were talking about paying off the national debt. Technology could start to diffuse into the economy and help take us to a new regime, but we have just not seen that over the last five years. For forecasting purposes, we should assume that we are going to stay in a low-productivity regime until evidence says otherwise. ***On the political season and how to get us out of a slow-growth regime:*** Bullard thinks the nation needs a medium-term growth agenda. Better human capital development would be helpful. Immigration would be helpful. He sees the problem as a supply-side phenomenon and not a demand-side issue. The campaigns are focusing on infrastructure—that could be effective, but we cannot build bridges to nowhere. He sees the need to build public capital that will improve productivity in the economy. Interest rates are low, making it possible to borrow to build infrastructure. But this is not a new idea. Congress has not voted for these packages unless there was "a Christmas tree-like bill with pork-barrel spending for everyone." So he sees difficulty in actually getting these things done. ***On global factors impacting the U.S.:*** Bullard thinks much of the global uncertainty leads to a stronger dollar. But he cautions that the U.S. dollar has been overemphasized as a drag on U.S. growth. We had 20% growth in the trade-weighted U.S. dollar from the second half 2014 into 2015—with not much change in the last year. We've had a period in which the U.S. dollar could have impacted GDP, but if you look at net exports' contribution, there was an outsized contribution in late 2014 and early 2015, but in the last five quarters, the net export contribution to GDP has been close to zero. ***In closing, Bullard emphasized:*** While we talked about the regime-based approach, he noted some upside risks to the economy. He has said 63 basis points over the next 2 to 2.5 years, but he knows where the other productivity growth regime is, and it is higher. There have been times in the past when investors have not been as fond of government paper as they are now. If they do switch, they are likely to switch higher, and then we'd have to react appropriately. The recession risks are quite low at the moment. We always live with recession risk, but it is unlikely in the near term.

[1]Source: Bloomberg, with data as of 8/12/16.

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Hawkish : Description used when worries about inflation are the primary concerns in setting monetary policy decisions.

Long-run steady state : a period where a set of conditions within a system like an economy enter an environment characterized by stability and lack of expectations of immediate, large change.

Output gap : The difference between actual GDP or actual output and potential GDP or potential output.

Dot Plot : a chart based on the economic projections of the Federal Reserve board members that illustrates their views on the appropriate pace of policy firming and provides a target range or target level for the federal funds rat.

Econometrics : The study of economics that heavily emphasizes data and mathematics in order to prove, create or support different theories about what is more or less important within an economic system.

Productivity : Measure of efficiency that details how much output is obtained per unit of input.

Real interest rate : Interest rate accounting for the impact of inflation. From the nominal interest rate, which does not account for the impact of inflation, the rate of inflation is subtracted to get to the real interest rate.

Sovereign Debt : Bonds issued by a national government in a foreign currency, in order to finance the issuing country's growth.

Ex post real return : ex post refers to actual results rather than forecasts. Real return refers to return after inflation. So in total, this is the return after inflation that actually happen.

Trimmed mean : a mean is an average, so a trimmed mean is an average that takes out some of the more extreme values within a designated framewor.

Personal Consumption Expenditure (PCE) Price Index : measure of price changes in consumer goods and services in the U.S. economy.

"Taylor Rule" : approach to determining an appropriate level of the Federal Funds rate based on economic inputs developed by Professor John B. Taylor of Stanford University.

Inflation gap : A measure in economics that seeks to quantify the difference between a theoretical "full-employment" level of gross domestic product growth—meaning the capability of the economic system where it is not over extending its productive capacity—and the actual level of gross domestic product growth when there is a positive difference, meaning the economy is growing beyond the theoretical full-employment level. A recessionary gap is when this difference is negative.

Liquidity premium : activity amongst investors that indicates a demand to be able to buy and sell particular assets quickly in any quantity needed. The current demand for government-issued bonds, signified by very low interest rates, is one such example.

Nominal interest rate : Interest rate that does not account for the impact of inflation.

Fed Fund Futures : A financial instrument that let's market participants determine the future value of the Federal Funds Rate.

Gross domestic product (GDP) : The sum total of all goods and services produced across an economy.

Human capital : measure of the skills of the labor force within an economy, as well as their experience. A large number of people with high skills and experience relevant to what is needed within the economic system indicates a high level of human capital.

Public capital : refers to a pool of government owned assets that are used for private productivit.

Pork-barrel spending : portions of different legislation that relate to smaller spending initiatives within constituencies of different government representatives, thought to entice those representatives to vote in favor of passing the larger legislative action.

Trade-weighted currency : multilateral exchange rate with the weight of each foreign country equal to its share in trade.

Net exports : a component of gross domestic product that refers to the quantity or value of exports minus imports for an economy. A positive number means greater value of exports than imports and a positive contribution to overall GDP.

Recession : two consecutive quarters of negative GDP growth, characterized generally by a slowing economy and higher unemploymen.