Are Low Monetary Policy Rates the New Normal?

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I. In the late 1990s, Paul Krugman analyzed the Japanese economy's early experience with deflationary forces, and concluded that the Bank of Japan should provide extraordinary amounts of monetary accommodation in order to push inflation several percentage points above its perceived inflation objective.

A. Krugman's policy prescription was bold, but it was a straightforward and sensible consequence of his mainstream analysis.
B. A bit unfortunately, his clever rhetoric describing the optimal policy response was distracting: He described it as the central bank "credibly promis[ing] to be irresponsible."[1] I suspect this characterization didn't sit well with many monetary policy analysts.

II. Why do I bring this up now? Well, several years ago, Larry Summers described the global economic environment of low growth and low interest rates. He speculated that we were likely experiencing what he dubbed "secular stagnation."[2]

A. Many critics have maligned Summers' perceptive analysis because of this provocative terminology. Secular stagnation calls to mind a *permanently* lower state of growth and decay into the indefinite future. Why should we think the world has *permanently fallen* into such a rut?
B. Well, similar to Krugman's analysis about Japan, Summers' analysis is standing the test of time. Today, the world economy is still in a low-growth, low-market-interest-rate regime. And more and more economists see the essential characteristics of this state as likely persisting for some time to come, as shown in their analytical perspectives and baseline forecasts.

III. As a mainstream, time-series oriented macroeconomic researcher, I know all of the baggage that comes with terms like "secular" and "permanent."

A. But I don't think we should get hung up over technical details related to I(0) vs. I(1) behavior.
B. Whether the current weakness is a permanent new regime or a very persistent deviation from the norm is not the point.
C. The task of identifying changes in fundamentals and the persistence of those changes is indeed formidable.
    1. Remember back to the late 1990s. Quite some time was required before the productivity surge was commonly recognized as something sufficiently long-lasting to be incorporated into baseline economic projections.

[1] Krugman (1998).
[2] Summers (2014).

2. OK? And now think how difficult it has been recently to digest the persistence in the decline in productivity that has occurred since the mid-2000s.

D. But whether we are talking about I(0) or I(1) processes here isn't key; stationary but highly persistent behavior is enough to make the stagnation hypothesis a serious issue for analysts and policymakers.

E. And more and more do seem to be taking this persistence on board. Many economic forecasters have notably downgraded their estimates of long-run growth over the past several years.
   1. For example, between March 2010 and March 2016 the *Blue Chip* consensus forecast for long-run gross domestic product (GDP) growth in the U.S. fell half a percentage point, from 2.6 to 2.1 percent.
   2. Clearly, mainstream analysts think something fundamental is going on.

IV. By now, we should all be aware of the factors contributing to lower long-run growth.

A. Demographics are playing an essential role. In the U.S., growth in the workforce is slowing due to both the movement of the baby-boom cohort into retirement age and lower labor force participation rates, particularly among the youth. Also, a plateauing in educational achievement and the retirement of highly experienced workers mean that improvements in the quality of the work force are already contributing less to productivity growth than they have in the past.

B. Furthermore, the underlying trends in total factor productivity (TFP) growth do not look good. John Fernald at the San Francisco Fed and his co-authors estimate that the current trend in TFP growth is about one-half of 1 percent; that compares with 1-3/4 percent during the heady days of the mid-1990s productivity surge.[3]
   1. Some economists, such as Robert Gordon at Northwestern,[4] think this slowdown is possibly here to stay. They argue that we have already picked the low overhanging fruit, so future transformative technologies will be increasingly more difficult to harvest.
   2. Others disagree, pointing to the huge productivity advances we've seen in medicine and energy production. Such innovations may indeed be "transformative," but have yet to make their way through the pipeline to show up as measurable increases in factor productivity.
   3. We'll have to wait and see. But at least at this point, many are assuming modest TFP growth trends for years to come.

C. Productivity and potential output growth are also influenced by the quantity and quality of the capital stock that workers employ in the production of goods and services.

[3] Byrne, Fernald and Reinsdorf (2016).
[4] Gordon (2012).

1. Business investment in structures, equipment and intellectual property declined sharply during the recession, and has grown only modestly during the recovery. This has left the level of capital spending quite low, and capital deepening has been weak.
2. This reduced pace of capital formation translates directly into lower growth in potential output.
3. I would note that one persistent theme I hear from business executives is that they feel their productive capacity is about right-sized to the current level of demand and their modest baseline expectations for growth in sales. So the sluggish capital spending may itself in large part reflect low expectations for growth over the longer run.

D. In addition to the supply-side factors that I have noted, the secular stagnation argument also typically envisions insufficient aggregate demand support from fiscal and monetary policy.
   1. That is, with weak supply-side factors, low inflation, and little appetite for fiscal expansion, negative demand shocks of all varieties are more likely to bring economies to the effective lower bound on interest rates. And at this bound, monetary policy is less efficient at mitigating headwinds and boosting activity.

V. This setting has strong implications for interest rates and monetary policy. All else being equal, weaker long-run growth fundamentals imply lower equilibrium real interest rates over the longer run. This is a straightforward implication of our standard macroeconomic models.

A. There are other factors that will likely keep market interest rates low for quite a while in the U.S. and other advanced economies as well.

B. High on this list is the enormous worldwide demand for safe assets.
   1. Even before Summers raised the specter of "secular stagnation," former Fed chairs Alan Greenspan and Ben Bernanke pointed to such growing demand as an important factor in their well-known "conundrum" and "global savings glut" speeches.[5]
   2. Greenspan's conundrum commentary explicitly cited these demands as leading to a flattening of the Treasury yield curve.

C. For all of these reasons, the outlook for interest rates is vastly more complicated today. Most analysts have come to expect that both short-run rates that are directly tied to monetary policy and longer-term interest rates will be lower over the long run than they had expected just a few years ago.
   1. With regard to short-term rates, I note that:
      a. In March 2010 the *Blue Chip* consensus thought the three-month Treasury rate would average 4-1/4 percent over the long run; last March, that number was just 3 percent.
      b. Similarly, in the Fed's most recent Summary of Economic Projections, or SEPs, the median long-run fed funds rate projection was down to 3 percent.[6]

[5] Greenspan (2005) and Bernanke (2005).
[6] Federal Open Market Committee (2016).

c. We have also have seen meaningful declines in long-term expectations for future short-term rates from a number of econometric term structure models.

VI. Beyond just economists' consensus forecasts, I have recently heard more commentary that the lower-for-longer interest rate scenario is being built into business plans.

A. I recently had a meeting with a number of executives from the life insurance industry, whose business models rely on investing funds to cover anticipated long-term liabilities.

1. They talked about how they and other real money investors — such as pension funds — are reassessing the yield-curve environment and increasingly coming to the view that persistently slow output growth in the U.S. and abroad may keep real interest rates low for a long period of time; longer than they likely thought one, two or certainly three years ago.
2. As a result, these long-horizon investors are developing strategies to manage their business operations based, in part, on the yields that are currently achievable on longer-term safe fixed-income instruments.
3. I have also heard complementary reports from those on the other side of the market. In particular, issuers of high-quality corporate debt are finding markets receptive to their offerings, and new issues are routinely being oversubscribed.

B. Let me be very clear on why this is important. This comes back to the "secular" component of secular stagnation.

1. We often hear of rates on long-term safe assets being reduced by a temporary flight to quality — that is, by investors running away from riskier investments until the threats recede.
2. And many asset-pricing models estimate that temporary declines in term premia — as opposed to outright permanent declines in expected real rates — have been a major contributor to low long-term interest rates.
   a. As a technical matter, these models' conclusions often turn importantly on an I(0) stationarity modeling assumption for the level factor. Along with other assumptions, this stationarity does not more robustly allow for secular changes in rates.
3. The commentary from the life insurance executives and others I just referred to is different. Their business decisions suggest that an important part of the decline in long-term market rates reflects expectations of lower short-term interest rates over the long run. This is quite different from attributing nearly all of it to transitory movements in difficult-to-explain term premia.

VII. Now, how does this all inform my assessment of the degree of accommodation that U.S. monetary policy is currently providing?

A. In general, a lower equilibrium long-term rate means that current monetary policy is not as accommodative as it might seem by historical standards.

1. On top of that, the view among many Federal Open Market Committee (FOMC) participants is that today the neutral federal funds rate is even lower than its eventual long-run level, implying an even further adjustment to the degree of accommodation in the current stance of policy.

B. These observations strongly suggest that U.S. policy today is less expansionary than what is often calibrated from simple monetary policy rules. These simple rules embed an intercept — which is an average real rate — that is higher than what we are envisioning today. Accordingly, the risk now of overshooting our 2 percent inflation objective is lower — and the likelihood that we actually get to 2 percent is smaller — than what these rules would imply.

C. These observations primarily have first-moment, mean implications for the path of interest rates. But the long-duration investors' comments also help inform questions about future volatility in long-term interest rates.

D. For example, some worry that if the FOMC gets behind the curve and has to raise the funds rate moderately faster than, say, what is in the Fed's most recent SEPs, fixed-income markets will be spooked and we'll see a spike in long-term interest rates that could be detrimental both to growth and to financial stability.
   1. Presumably, these analysts think that a steady pace of fed funds increases would reduce this "spike risk."
   2. Normally, the risks of large spikes in long-term rates are probably intensified by fast-money investors (hedge funds and the like) making carry trade bets on low-term premia. These investors have an eye toward a quick exit when rates begin to rise — behavior that can snowball into something like the taper tantrum we saw in 2013 when long-term rates spiked 100 basis points in response to a sudden change in expectations for the path of Fed asset purchases.
   3. Instead, today I have been talking about the positions of real-money, long-horizon investors. Given their expectations of low-for-long policy rates, they are less likely to think that some unexpected tightening will lead to substantially higher rates over the long term. Rather, such a tightening would likely be seen as simply flattening the yield curve.
      a. Put differently, long-run expectations for policy rates provide an anchor to long-run interest rates. So lower policy rate expectations act as a restraint on how much long-term rates could rise following a surprise over the near-term policy path.
   4. Finally, if inflation or term premium risks rose substantially, the alternative funds rate path for funds rate increases that might accompany a tighter-than-expected policy is still likely to be quite gradual.
      a. In the June SEPs, the median funds rate path envisioned two more 25 basis point rate increases in 2016 followed by three more — totaling 75 basis points a year — in 2017 and again in 2018.
      b. During the normalization of policy between 2004 and 2006, the FOMC increased the funds rate 25 basis points at every meeting — a pace of eight increases, for a total of 200 basis points, a year.

c. No one discusses that 2004–06 pace of tightening as anything but gradual — it was certainly not steep enough to generate financial stability concerns.
d. And while there are important differences in the environment today, this example does lead one to believe that, if necessary, we could normalize policy much faster than currently envisioned and still keep the pace gradual enough to avoid a disorderly change in financial conditions.

VIII. To conclude, let me say:

A. There are many challenges for monetary economists in judging long-run growth prospects and discerning what they mean for financial conditions and the implementation of monetary policy.
B. I see good arguments for believing that we are in for a protracted period of low equilibrium real interest rates. I also think many long-term investors are taking this view as well.
C. We still need to remain on guard for market vulnerabilities in case this analysis is wrong. But the scenario I've outlined today suggests fewer financial stability concerns than if low long-term interest rates were being driven solely by unusual declines in term premia that could leave markets more exposed to sharp swings in risk sentiment or speculative unwinding of carry trades.
D. Still, the low-growth, low-interest-rate world we find ourselves in today is a difficult situation.
    1. Whether we call this secular stagnation or simply a persistent period of low market interest rates is not the point. Both interpretations present strong challenges for policymakers.
    2. Addressing downside shocks near the zero lower bound is much, much harder than if we had a comfortable buffer against the equilibrium real rate. And we must stay attuned to the difficulties in delivering additional monetary policy accommodation if the need ever arises before this environment changes.

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