U.S. Monetary Policy through a Global Lens

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Federal Reserve policy has always had a global dimension

"[I]t is just not credible that the United States can remain an oasis of prosperity unaffected by a world that is experiencing greatly increased stress."

Chairman Alan Greenspan at UC Berkeley, September 4, 1998
Where is the Fed compared with other AEs?

Source: IMF, April 2019 WEO database, and CEIC
Are the Fed’s recent cuts justifiable?

• Why has the Fed cut interest rates even though U.S. growth is projected to remain at or above potential and unemployment is low?
• Wicksell’s principle of price stability: The real policy interest rate (money rate less expected inflation) should move toward $r^*$, the rate that would prevail with flexible prices and full employment.

• But:
  • A prime determinant of $r^*$ is the rate of economic growth.
  • U.S. growth has been (well) above its estimated potential rate of about 1.8%.
  • And aggregate unemployment is very low.
• The Fed has cited weaker growth *abroad*. How to interpret?
Financial integration and global impacts on $r^*$

• The U.S. trades less than other major economies, but is highly financially integrated.

• So its real interest rate depends on capital-market events abroad.

• International bond-market arbitrage ensures a relationship between U.S. and foreign real interest rates.

• Roughly, if the U.S. real return rises above the foreign, the relative real value of dollar investments must be expected to fall through a real dollar depreciation.
AE real rates have all trended downward
Declining real rates: Why? Low for long?


• Multiple global causes.

• Self-insurance by EMs (Bernanke 2005) has waned – but not other factors.

• Demographics: slower population growth and longer lives raise saving.

• Productivity growth: it has slowed. But forever? Is Bob Gordon right?

• Inadequate infrastructure investment, e.g., Germany – has contributed to the rise of the euro area current account surplus.

• Demand for safe assets – in a world with increasing policy, geopolitical, and climate uncertainty.
Global capital-market equilibrium in a PPP world

In a PPP world, the real interest rate in the home country, $r_{H}^* = r_{F}^*$, determines the balance of saving and investment. The Home and Foreign sectors are in equilibrium when the real interest rate equals the autarkic real interest rate, $r_{H}^{\text{aut}} = r_{F}^{\text{aut}}$.

In the Home sector, the supply of saving ($S_{H}$) intersects the demand for investment ($I_{H}$) at the equilibrium real interest rate, resulting in a Deficit.

In the Foreign sector, the supply of saving ($S_{F}$) intersects the demand for investment ($I_{F}$) at the surplus level, indicating an excess of saving over investment.

The relationship between saving and investment in each sector is depicted on the graphs, illustrating the global capital-market equilibrium in a PPP world.
Increase in saving abroad without PPP assumption

\[ r_{H}^{\text{aut}}, r'_{H} \]

\[ r_{F}^{\text{aut}}, r'_{F} \]

\[ S'_{F} \]

\[ E \Delta q \]

Deficit

Surplus
Implications for monetary and fiscal policy

• Why might Fed cut due to a fall in foreign demand that lowers U.S. $r^*$?
• Otherwise, low global demand, currency appreciation, deflationary pressure $\rightarrow$ slump.
• Low for long $r^*$ is a challenge for monetary policy: ELB more frequent.
• In contrast, there would be more fiscal space.
• Automatic stabilizers need strengthening to avoid political gridlock.
• Monetary-fiscal coordination? E.g., Boivin, Fischer, Hildebrand (2019).
• Don’t fight the last war. If a bad recession comes and policy fails to address it, institutional fallout will go far beyond central banks.
• Central-bank independence is a means, not an end.
Prospects for richer-to-poorer capital flows?

- 2010 MGI report: “Farewell to Cheap Capital?” Seemed reasonable then ....
- Real interest rates recovered in EMs.
- There indeed are big opportunities for infrastructure investment.
- It is critical that this be designed to facilitate green growth (Nick Stern).
- Obstacles to capital flow include distorted markets and institutions.
- Addressing these could lead to higher North-South flows and higher global real interest rates and $r^*$s.

Real interest rates in advanced and emerging-market economies