U.S. Monetary Policy through a Global Lens

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Presentation at PIIE Global Economic Prospects Conference

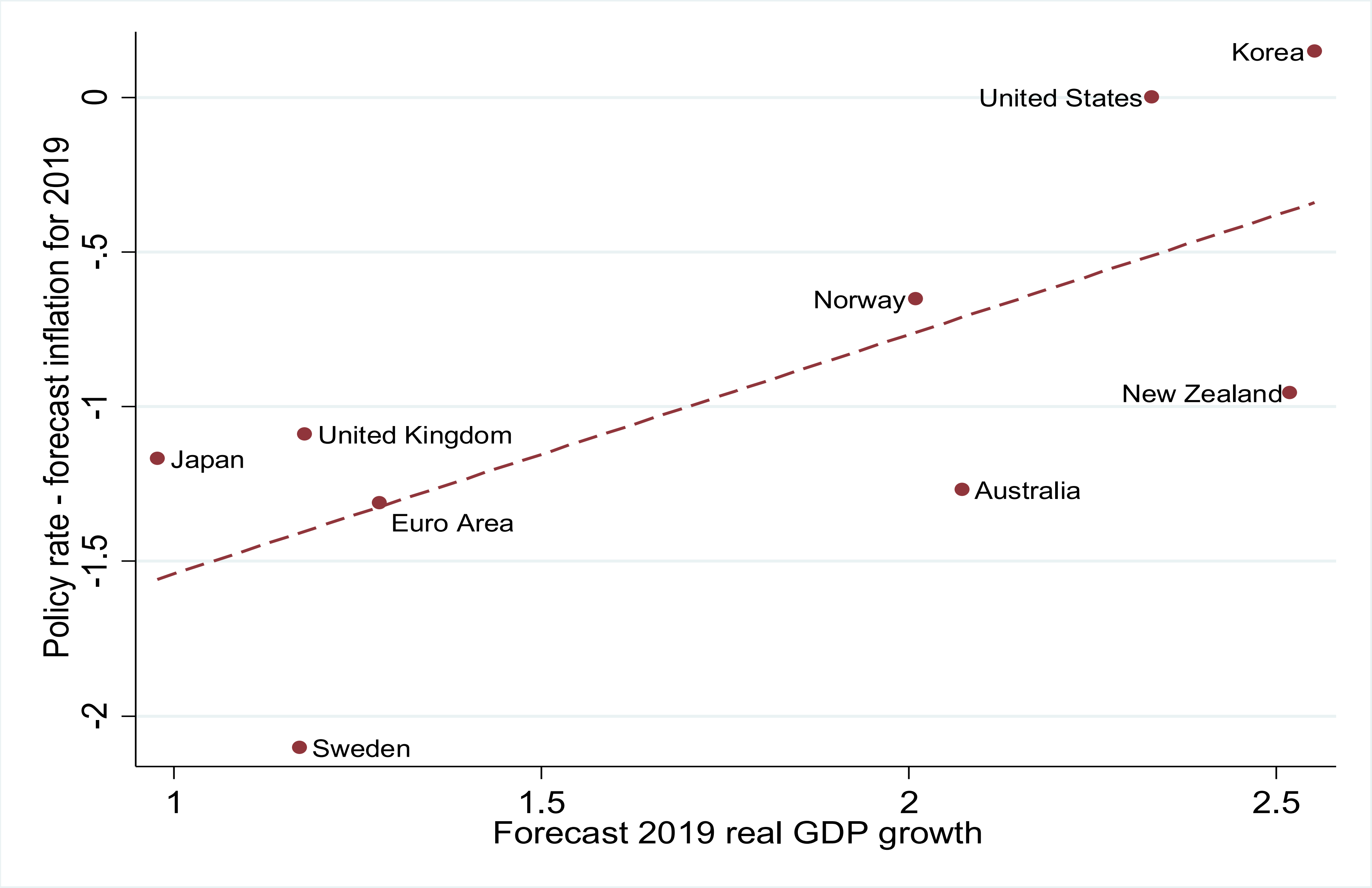
Washington, D.C., October 8, 2019

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?



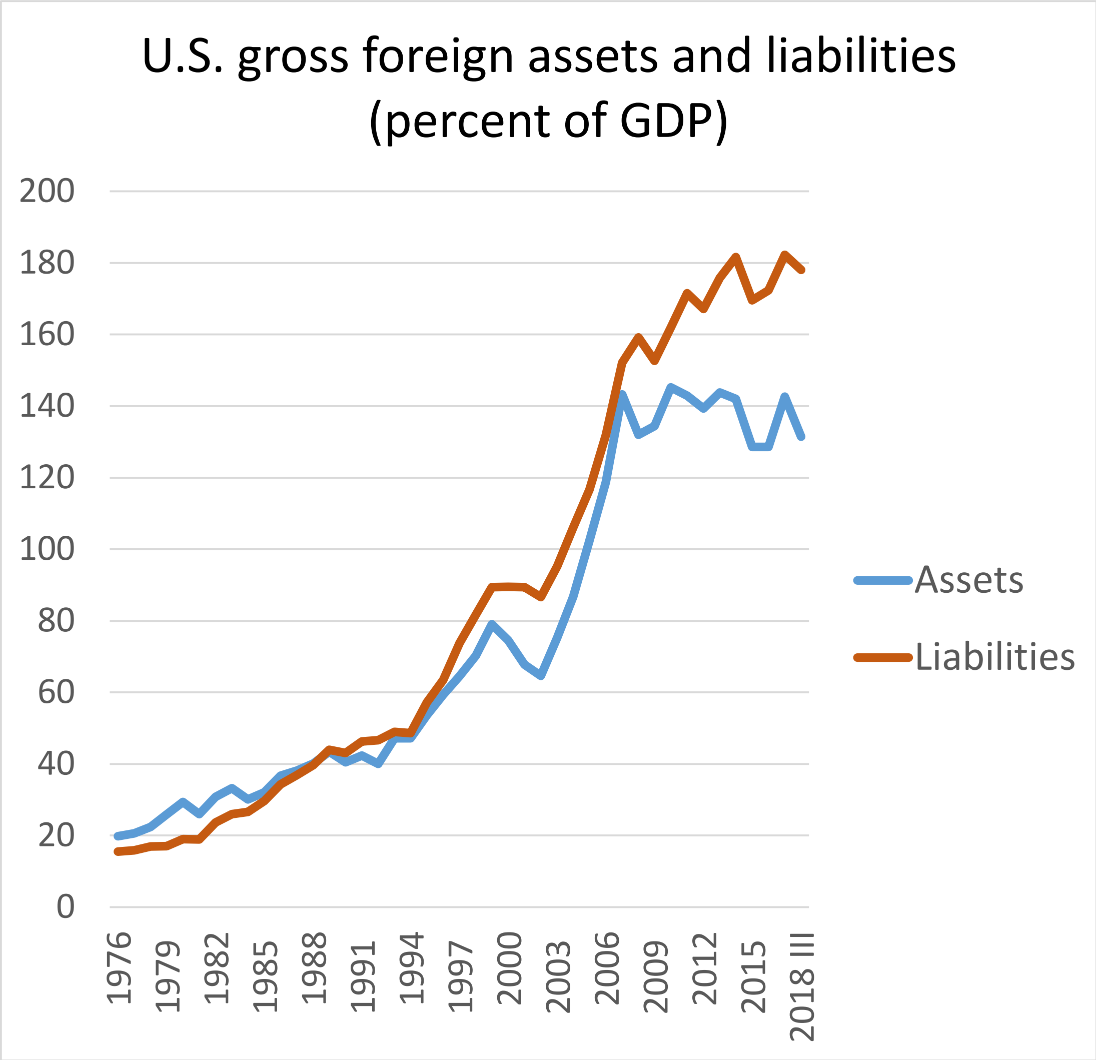
Source: IMF, April 2019 WEO database, and CEIC

Are the Fed's recent cuts justifiable?

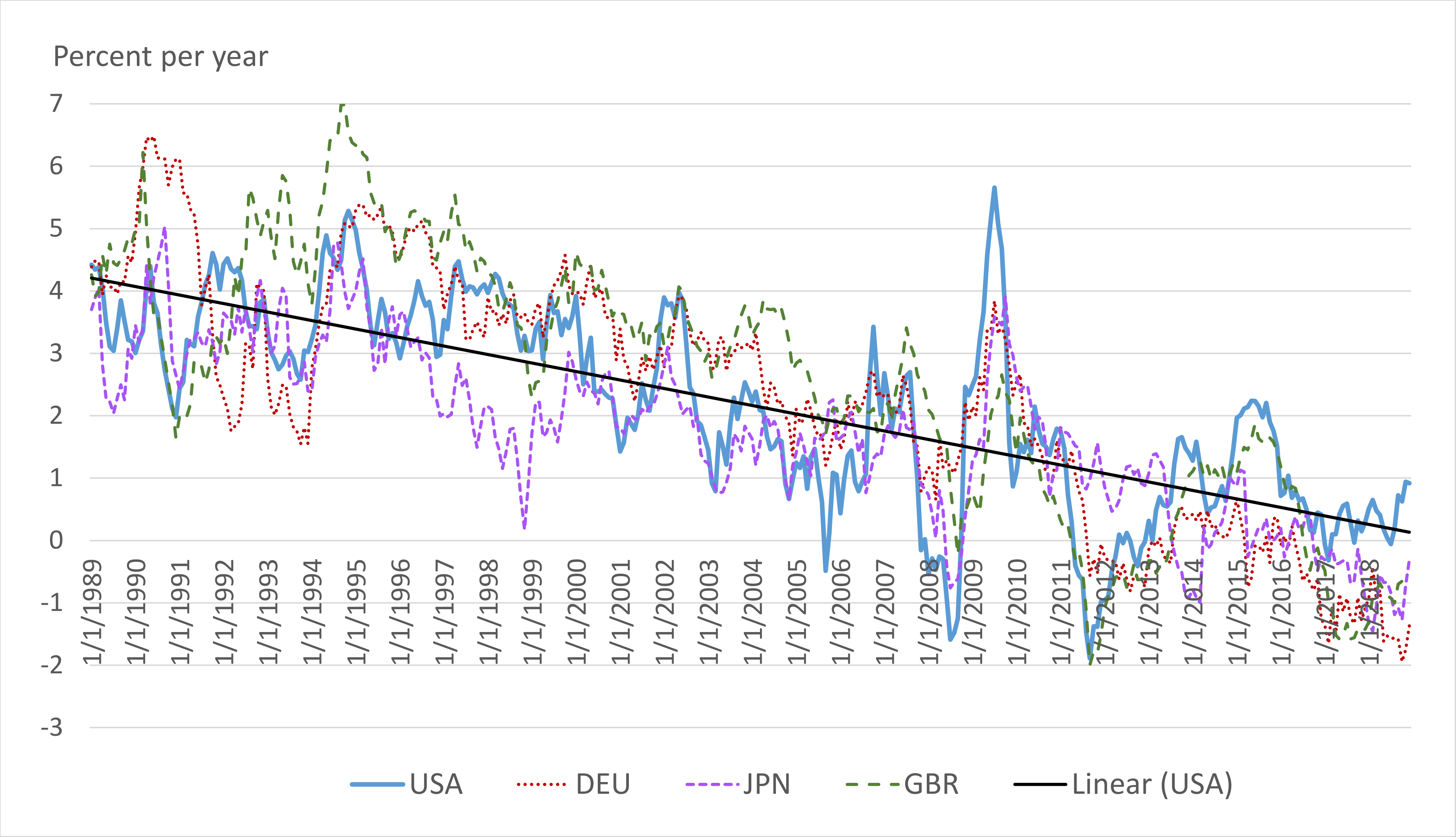
- Why has the Fed cut interest rates even though U.S. growth is projected to remain at or above potential and unemployment is low?
- Wicksell's principle of price stability: The real policy interest rate (money rate less expected inflation) should move toward *r**, the rate that would prevail with flexible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



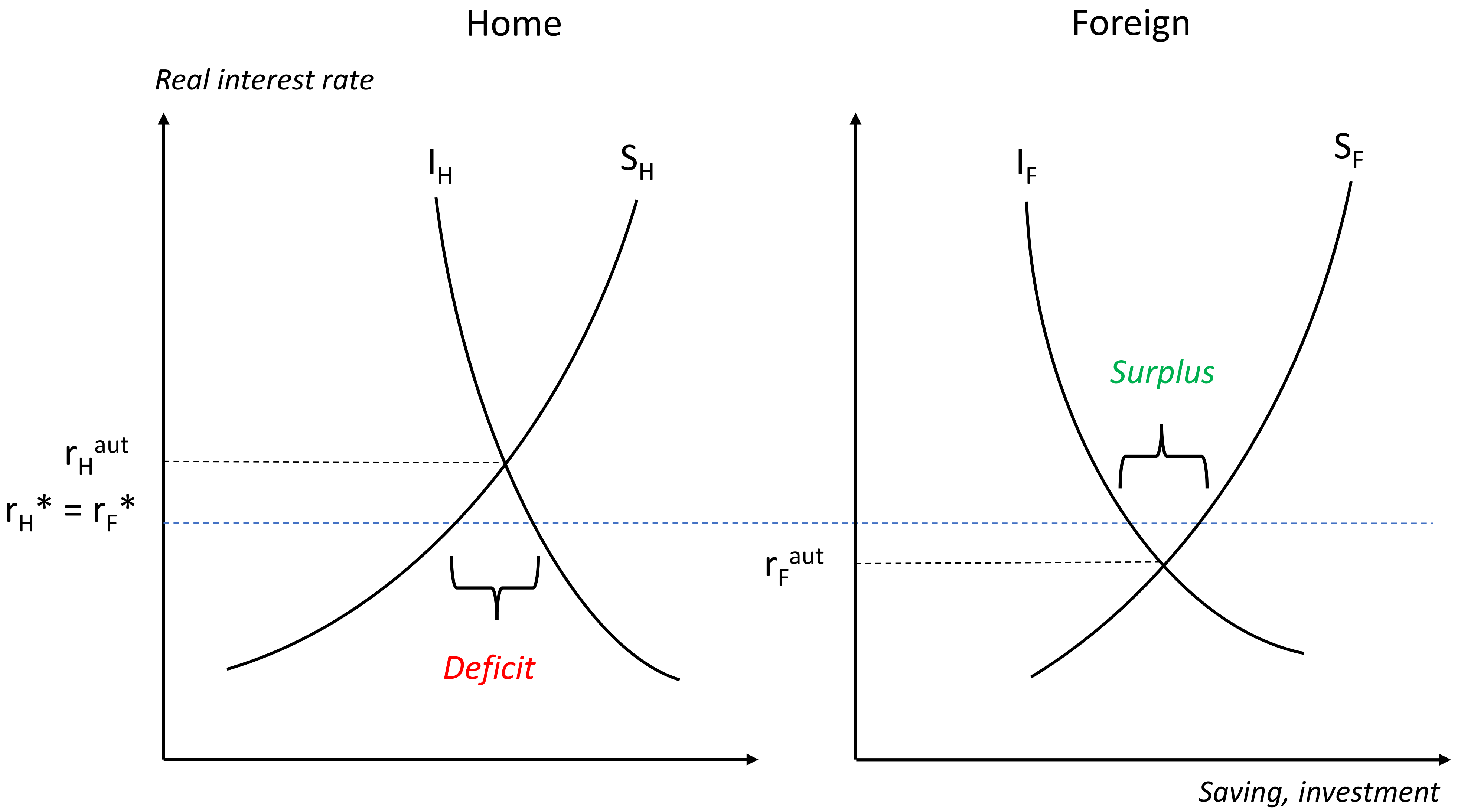
AE real rates have all trended downward



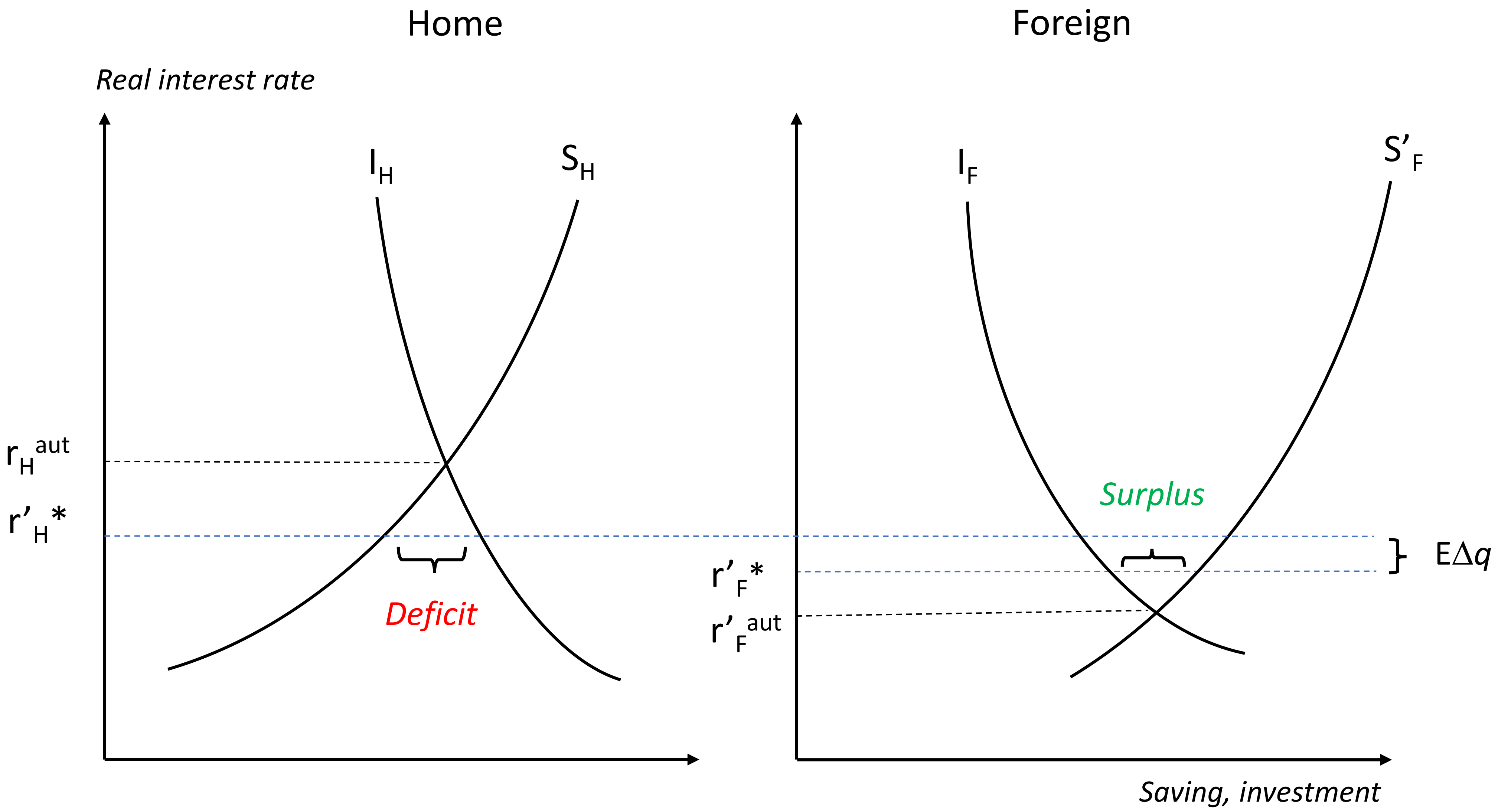
Declining real rates: Why? Low for long?

- Many analyses, including IMF (2014), CEA (2015), Rachel and Smith (2015), Jordà and Taylor (2019), Rachel and Summers (2019).
- 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



Increase in saving abroad without PPP assumption

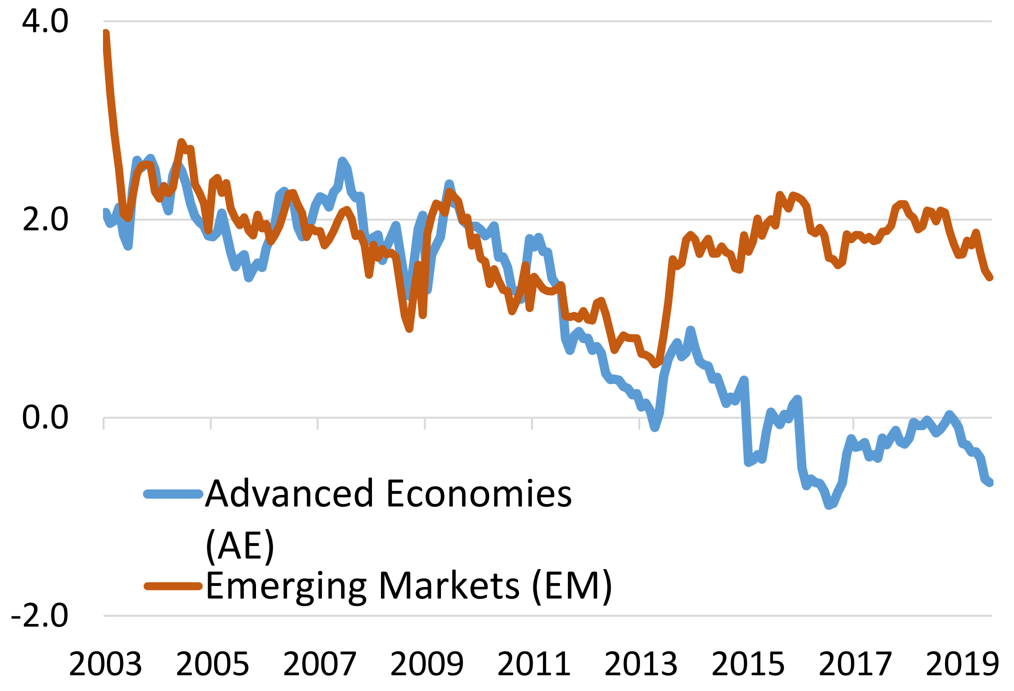


Implications for monetary and fiscal policy

- Why might Fed cut due to a fall in foreign demand that lowers U.S. r^*?
- Otherwise, low global demand, currency appreciation, deflationary pressure → 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?

Real interest rates in advanced and emerging-market economies



GDP-weighted averages, by country group. From Forbes (2019), courtesy Kristin Forbes, updated from Rachel and Smith (2015).

- 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.