

many businesses. To the extent that there has been counterproductive regulation, its partial rollback may be beneficial for U.S. productivity and hence for economic growth.”

Other Policy Changes and Longer-Term Effects

Bullard concluded with a look at some potential policy changes that could have a macroeconomic impact over the longer term. In particular, he briefly discussed trade and immigration. While trade negotiations tend to be slow-moving relative to monetary policy, “trade arrangements can have important macroeconomic effects, but over the longer term,” he said. “Similarly, immigration reform would likely have important effects on the macroeconomy, but perhaps over a longer horizon.”

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Safe Real Interest Rates and Fed Policy

November 10, 2016

Low interest rates are likely to be the norm over the next two to three years, President James Bullard told those attending Commerce Bank’s annual economic breakfast in St. Louis. He also explained the St. Louis Fed's new regime-based approach to near-term U.S. macroeconomic and monetary policy projections. In doing so, he deconstructed an equation to show that an increase of 25 basis points (one-quarter of a percent) in the federal funds rate target over the forecast horizon would be appropriate monetary policy for the current macroeconomic "regime."

St. Louis Fed's Bullard Discusses Safe Real Interest Rates and Fed Policy

ST. LOUIS – Federal Reserve Bank of St. Louis President James Bullard discussed [“Safe Real Interest Rates and Fed Policy”](https://www.stlouisfed.org/-/media/project/frbstl/stlouisfed/files/pdfs/bullard/remarks/bullard_commerce_bank_nov_10_2016.pdf) on Thursday at Commerce Bank’s annual economic breakfast.

Bullard discussed how a single equation can describe much of the state of the current monetary policy debate, and how the St. Louis Fed’s new regime-based approach to near-term U.S. macroeconomic and monetary policy projections, which was adopted in June, fits within this one-equation format.

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“The bottom line: Low interest rates are likely to continue to be the norm over the next two to three years,” he said.

The Policy Rate Path Dichotomy

Bullard noted that the Federal Open Market Committee (FOMC) operates by setting a short-term nominal interest rate (i.e., the federal funds rate target), which is also referred to as the policy rate. It influences all other nominal interest rates. The policy rate setting is currently 38 basis points, which is extraordinarily low by postwar historical standards.

“The FOMC is considering raising the policy rate to a somewhat higher level,” he said, adding, “the St. Louis Fed’s rate path projection is much flatter than those of the rest of the Committee.”

The Short-Term Real Interest Rate

To help illustrate the current situation, Bullard outlined a simple Taylor-type rule that could be used to provide a recommended value for the FOMC’s policy rate. “Because unemployment and inflation are relatively close to

their long-run values, the recommended policy rate from a Taylor-type rule depends mostly on the safe real rate of return,” he said.

Thus, the Taylor-type rule simplifies to the policy rate being the sum of the real interest rate on safe, short-term assets—like short-term government debt—and the FOMC’s inflation target (2 percent, or 200 basis points).

Bullard noted that one way to measure the real return on short-term safe assets is to consider the one-year nominal Treasury security and to subtract a one-year smoothed inflation rate from it, which produces an ex-post one-year real return on a safe asset. “There are other methods of calculation, but this one is simple, model-free, and uses a relatively short maturity that allows use of year-over-year inflation measures,” he explained.

Measured this way, the real rate of return on safe assets has been more than 200 basis points lower in recent years than it was during the 2001-2007 expansion. “This goes a long way toward explaining why the policy rate is low today,” Bullard said. “Furthermore, it seems unlikely that the real rate of return on safe assets will return to its historical level over the next two to three years. At the St. Louis Fed, we call this a ‘low-safe-real-rate regime.’”

From July 2013 to September 2016, this ex-post one-year real rate of return on safe assets averaged -1.34 percent, or -134 basis points. Adding this value to the inflation target leads to a recommended policy rate of 66 basis points. “I conclude that a single 25-basis-point increase in the policy rate—from 38 to 63 basis points—will get us very close to the recommended Taylor rule value over the forecast horizon,” Bullard said.

Regime-Dependent Monetary Policy

Bullard then discussed the St. Louis Fed’s new approach to forecasting and monetary policy. Under this approach, the macroeconomy could visit a set of possible regimes and monetary policy is regime-dependent.

“When the real rate of return on safe assets is relatively high, a Taylor-type rule would recommend relatively high settings for the policy rate. This is one possible regime,” he said. “When the real rate of return on safe assets is

relatively low, as it is now, a Taylor-type rule recommends relatively low settings for the policy rate. This appears to be the current regime.”

Therefore, these two regimes would lead to very different settings for the policy rate, one high and the other low, he said. “But policy is following a Taylor-type rule in both circumstances, meaning that the policy rate can be adjusted for deviations of output and inflation from long-run levels. The monetary policy is ‘equally good’ in each of the regimes,” he explained. “If there is a change of regime, monetary policy would have to adjust to the new circumstance.”

Why Are Real Returns Low?

Bullard stated that the reasons behind the extremely low real rate of return on safe assets have been widely debated. Real rates of return on safe assets have been declining relative to the real return on capital in the U.S. for several decades, he noted, adding that this decline cannot be attributed to monetary policy. “This suggests that there has been an increasing demand for safe assets during this period. We call this the ‘high-liquidity-premium’ regime,” he said.

He then discussed the low productivity growth in the U.S. “The low-productivity-growth regime is feeding into lower rates of real GDP growth and lower rates of consumption growth than would otherwise be the case. This is likely putting downward pressure on safe real rates of return,” he said.

He noted that the high liquidity premium and low productivity growth seem unlikely to change over the forecast horizon.

“Safe real rates of return are exceptionally low and are not expected to rise soon,” Bullard concluded. “This means, in turn, that the policy rate should be expected to remain exceptionally low over the forecast horizon. This can still be viewed as a high-quality monetary policy, as the Taylor rule is followed even though the level of the policy rate is lower.”

¹For more discussion of the St. Louis Fed’s new approach, see Bullard’s