

Slow Real GDP Growth and the Monetary Policy Problem

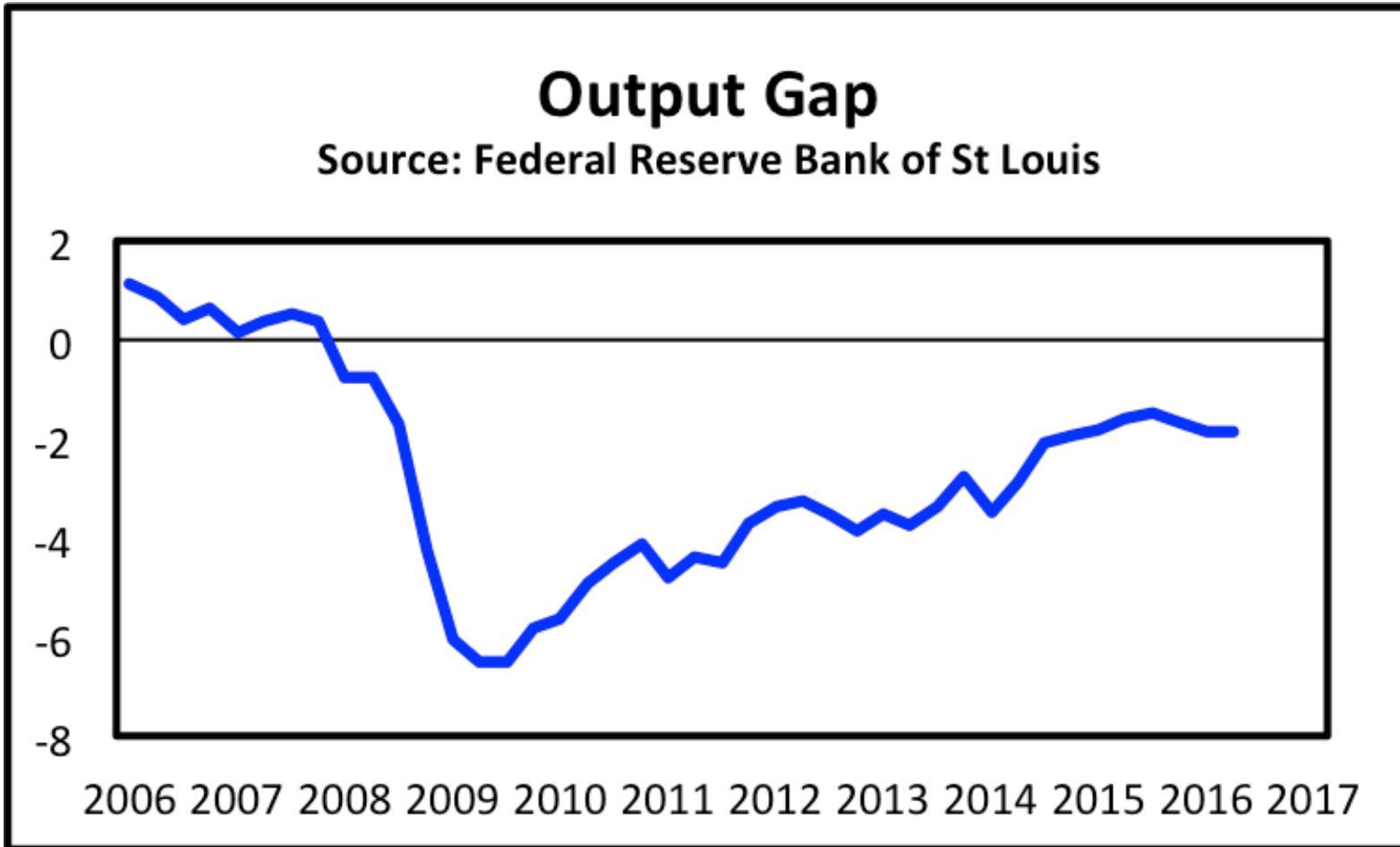
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Federal Reserve Bank of Boston
60th Economic Conference
“The Elusive Great Recovery”
October 14, 2016

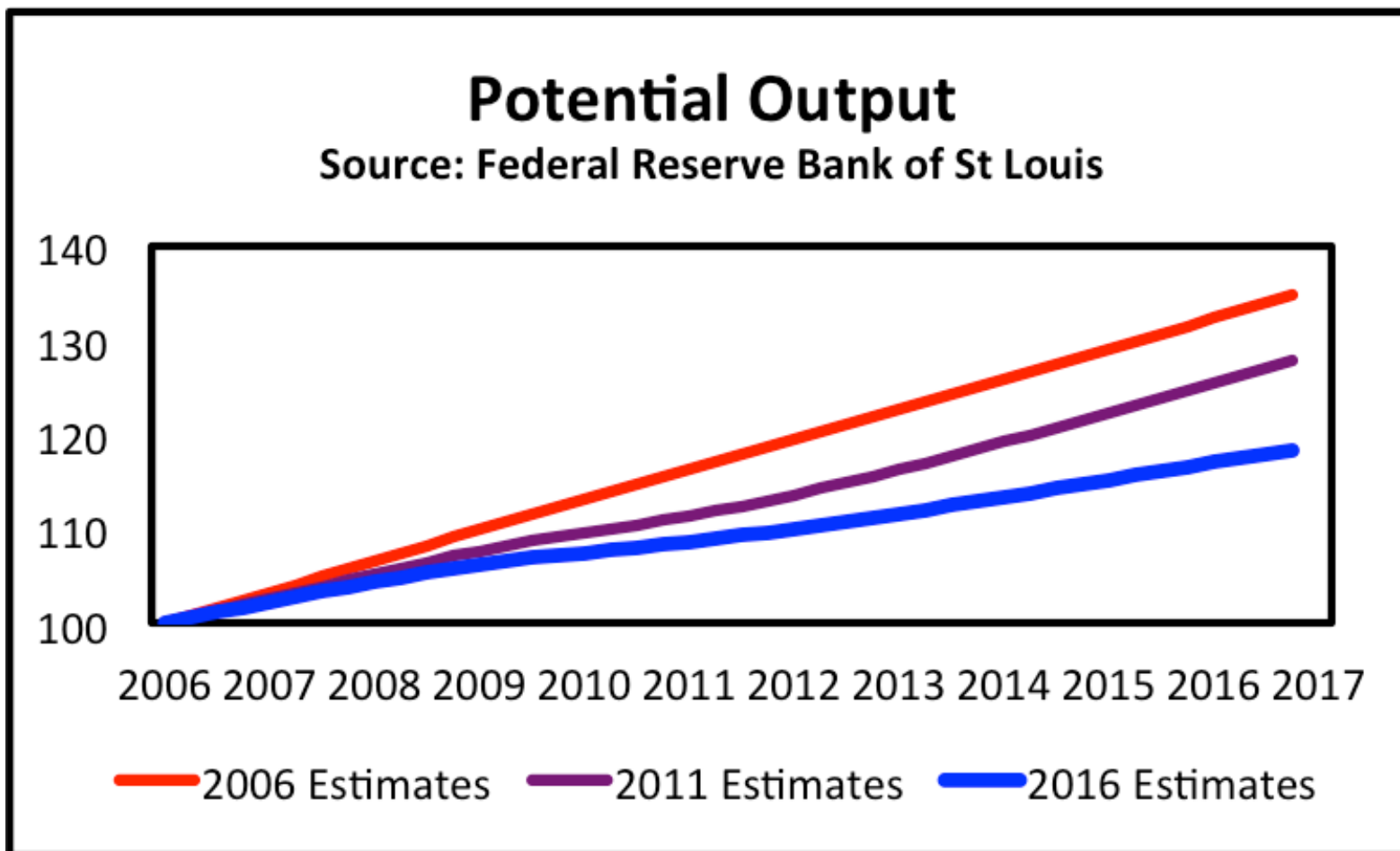
The Monetary Policy Problem

- Should the FOMC raise its federal funds rate target again before the end of the year?
- Is the Fed falling behind the curve or still struggling to provide adequate stimulus?
- Look at the behavior of GDP for clues.

The output gap is almost closed.



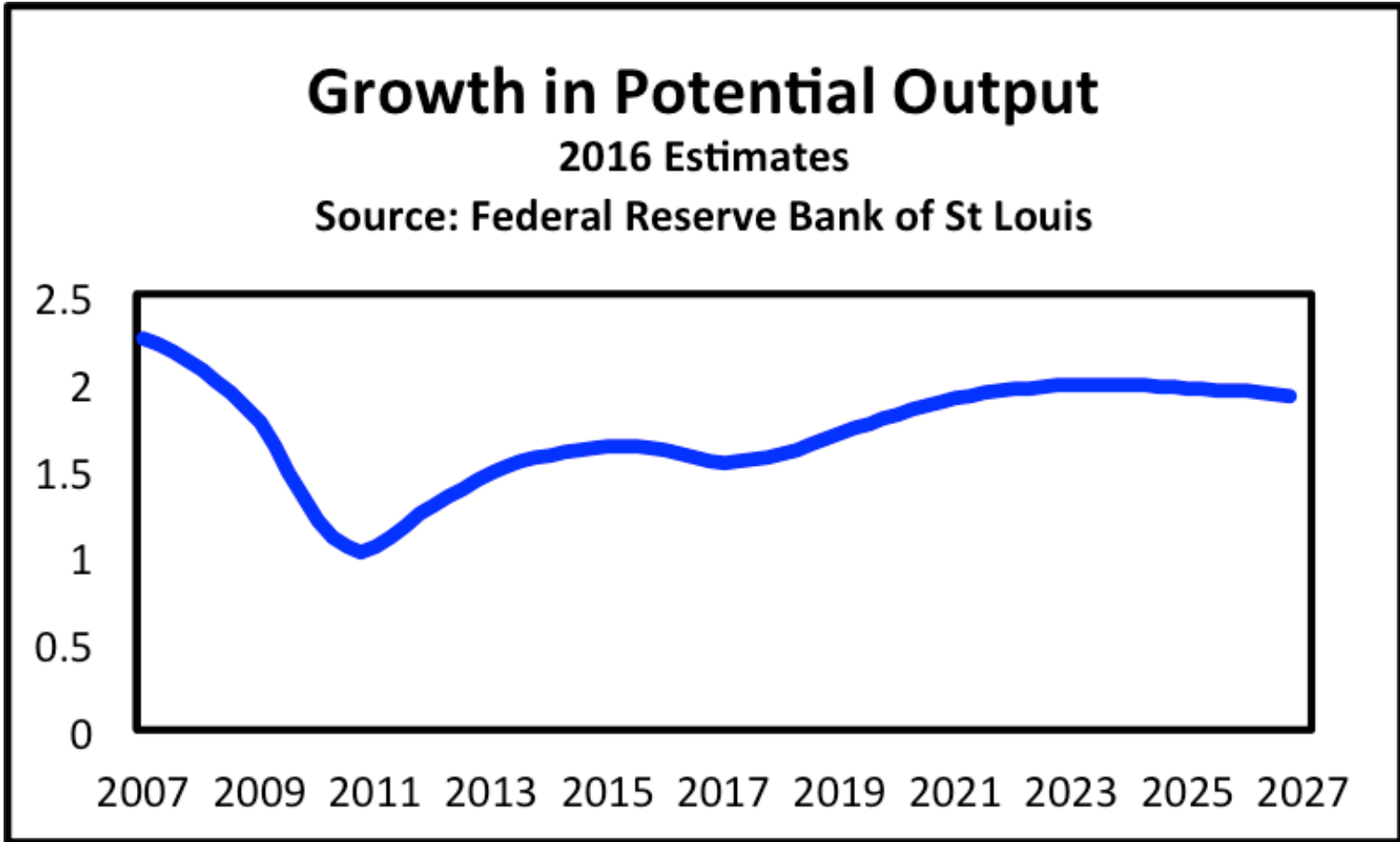
But potential output today is more than 16% lower than what was expected in 2006!



How much is trend and how much is cycle?

- CBO estimates of potential GDP growth, 2010-16:
 - 2.6% (2006)
 - 2.3% (2011)
 - 1.4% (2016) (versus longer-run trend 1.9 – 2.0%)
- The green estimates resemble SW's and reflect demographic and long-term productivity trends.
- The red number reflects slow intermediate-term productivity growth, which also shows up in the SW estimates, but in the cyclical components.

The shrinking CBO output gap reflects slower growth in potential, not faster growth in real GDP!



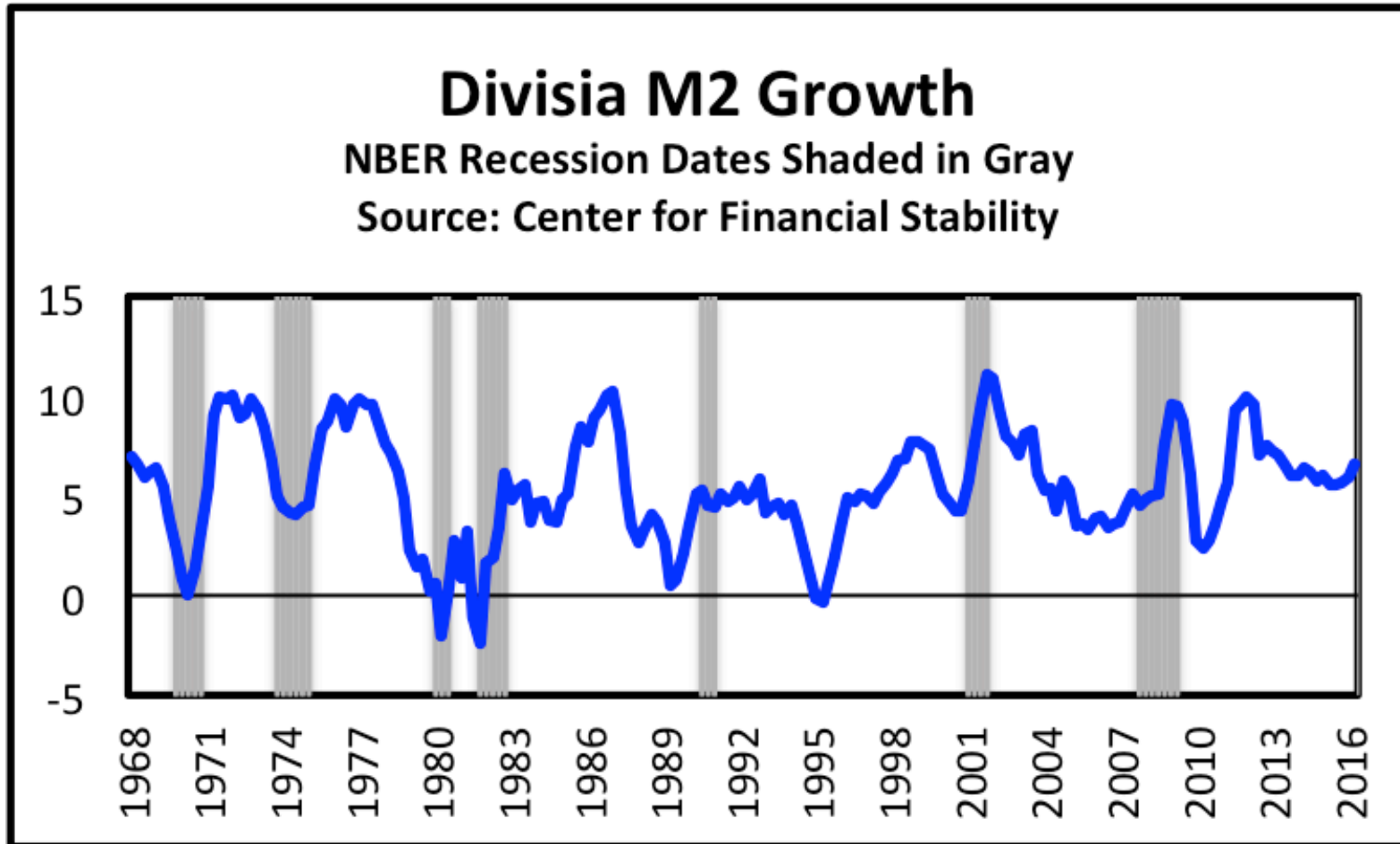
How much is trend and how much is cycle?

- What is going on with productivity? Is this entirely due to supply-side factors?
- We know from Orphanides that output gap mismeasurement can be a huge problem for monetary policymaking.
- Is there any chance we could be overestimating the impact of trends in the current environment?

The Monetary Policy Problem

- Already, the Stock-Watson estimates point to fiscal policy as being surprisingly tight and foreign demand as unusually weak.
- Could insufficiently accommodative monetary policy be partly to blame, too?

Monetary aggregates have been ignored since the mid-1990s, but are still leading indicators.



Money and output are still correlated over the cycle, but the lags have gotten longer.

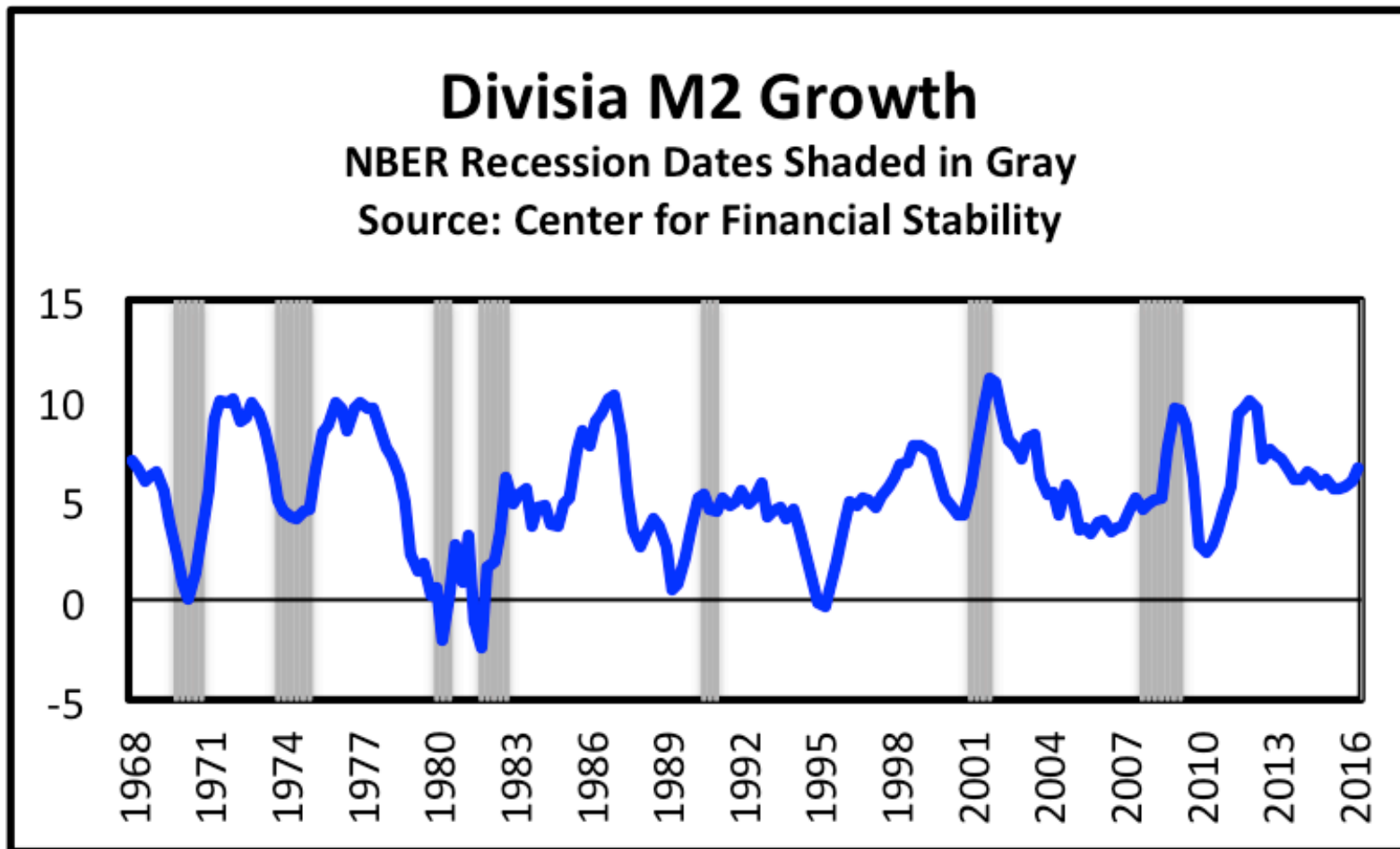
BUSINESS CYCLE CORRELATIONS:

REAL GDP AND LAGGED DIVISIA MONEY

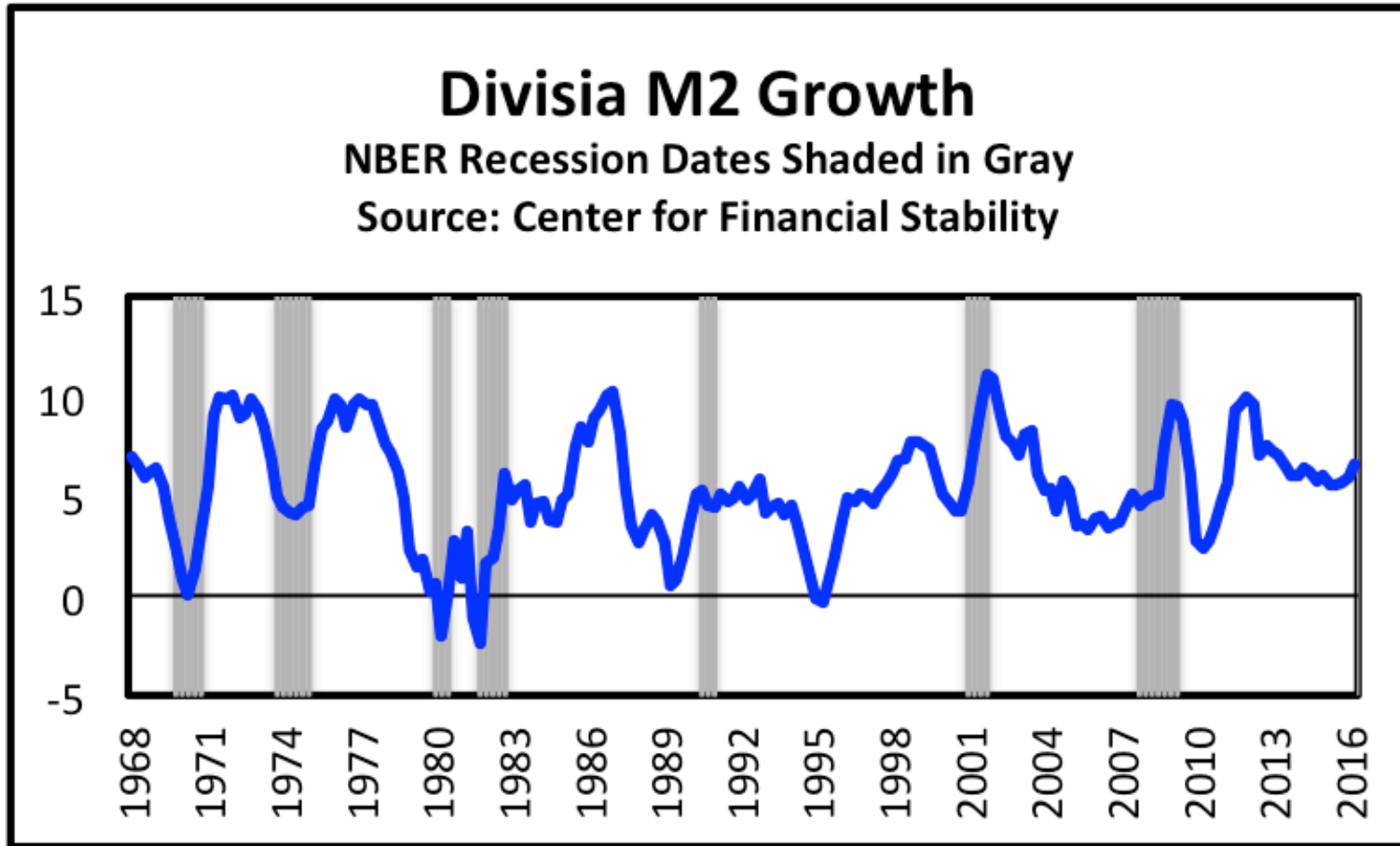
Sample Period	M1(t-k) with Y(t)		M2(t-k) with Y(t)	
1967:1 – 2016:2	0.32	k = 4	0.45	k = 4
1967:1 – 1983:4	0.80	k = 2	0.84	k = 2
1984:1 – 1999:4	0.45	k = 7	0.41	k = 8
2000:1 – 2016:2	0.73	k = 8	0.69	k = 11

See Michael Belongia and Peter Ireland. “Money and Output: Friedman and Schwartz Revisited.” *Journal of Money, Credit, and Banking*, September 2016.

The Fed appears to have pulled back too soon in 2010.



From a quantity-theoretic perspective, policy **has** tightened and now seems about right.



The Monetary Policy Problem

- A lot of uncertainty about long and, especially, intermediate-term productivity trends.
- Tight fiscal policy, weak foreign demand, and (inadvertently) tight monetary policy probably have something to do with the slow recovery.
- Against this backdrop, a cautious and gradual approach to raising rates seems fully appropriate.