

# Diverging Monetary Policies: Key Considerations for Asia\*



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\*The views expressed herein are those of the authors and do not necessarily represent those of the Federal Reserve Bank of Kansas City or the Federal Reserve System.

## Slower trend growth in the US going into liftoff

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- Trend growth has been downshifting in the US and remains significantly below trends in EM, particularly compared to Asia
- Slower trend growth in the US raises questions about the equilibrium real rate and longer-run federal funds rate, although markets are focused on liftoff
- As forward guidance ended, US monetary policy turned “data dependent” and FOMC communications are striving to communicate the policy strategy clearly and transparently

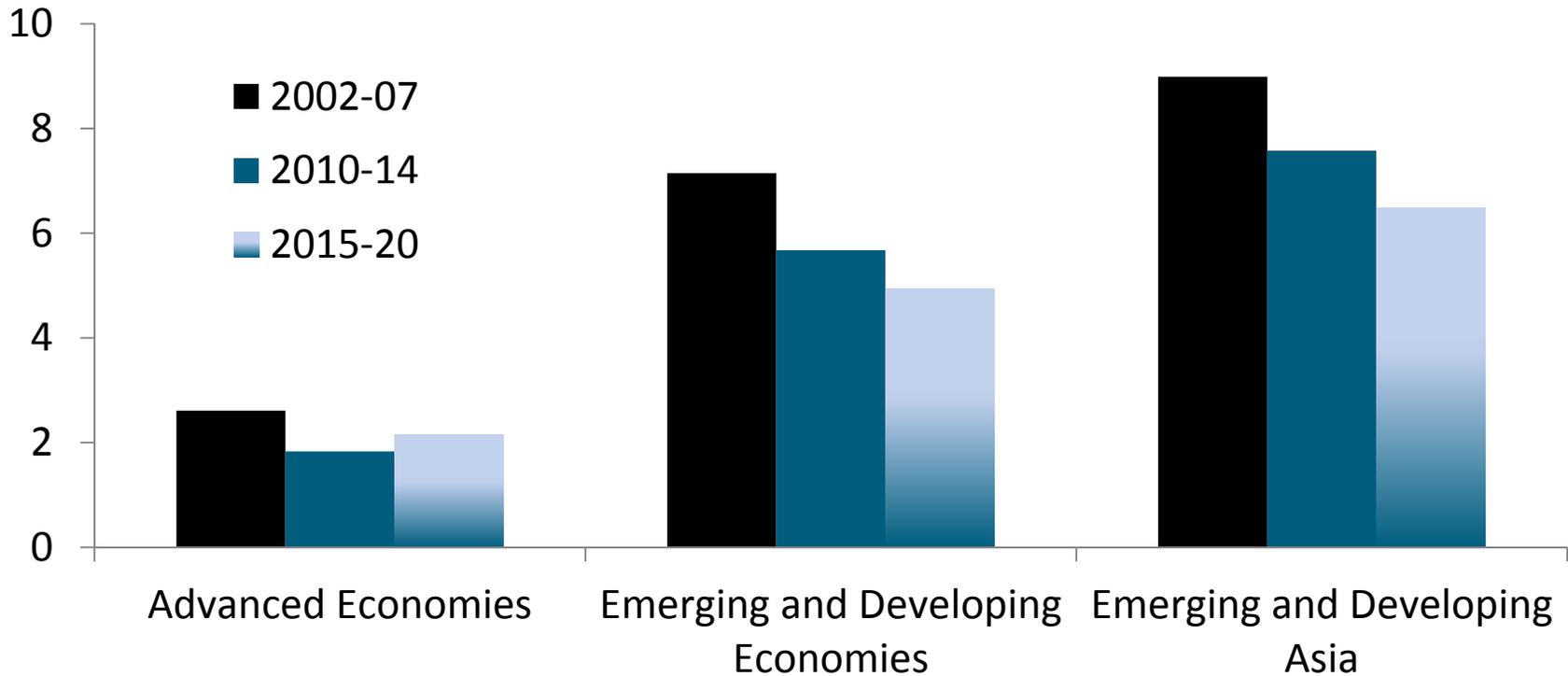
## Emerging market monetary policy considerations

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- Monetary policy in Asian EM are minding several factors:
  - Lower inflation
  - Exchange rate movements
  - Moderating potential growth
  - Commodity price fluctuations
  - Slowing export growth
  - Financial stability
  - Capital flow volatility risk

# Growth in emerging market economies is projected to remain well above advanced economies, but is also expected to slow

Real GDP, y/y % chg



Source: IMF

## Recent developments in emerging Asia

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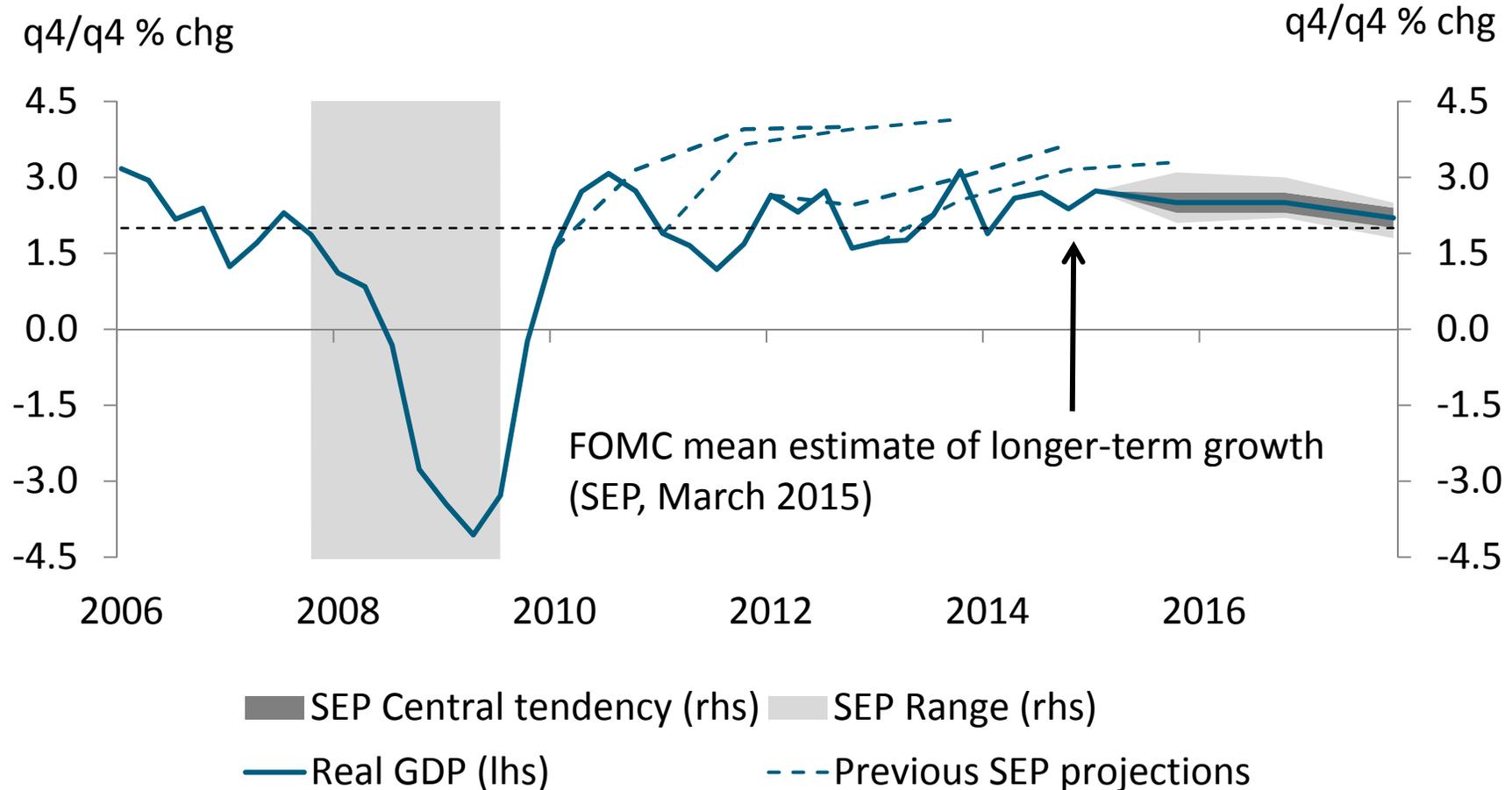
- Growth relative to expectations has disappointed in the first half of 2015 in some Asian EM countries
- Lower oil prices pulled inflation lower, though is providing a limited boost to consumer spending in many EM Asia economies
- Several EM Asian central banks have eased in response

## Policy divergence between the US and emerging Asia

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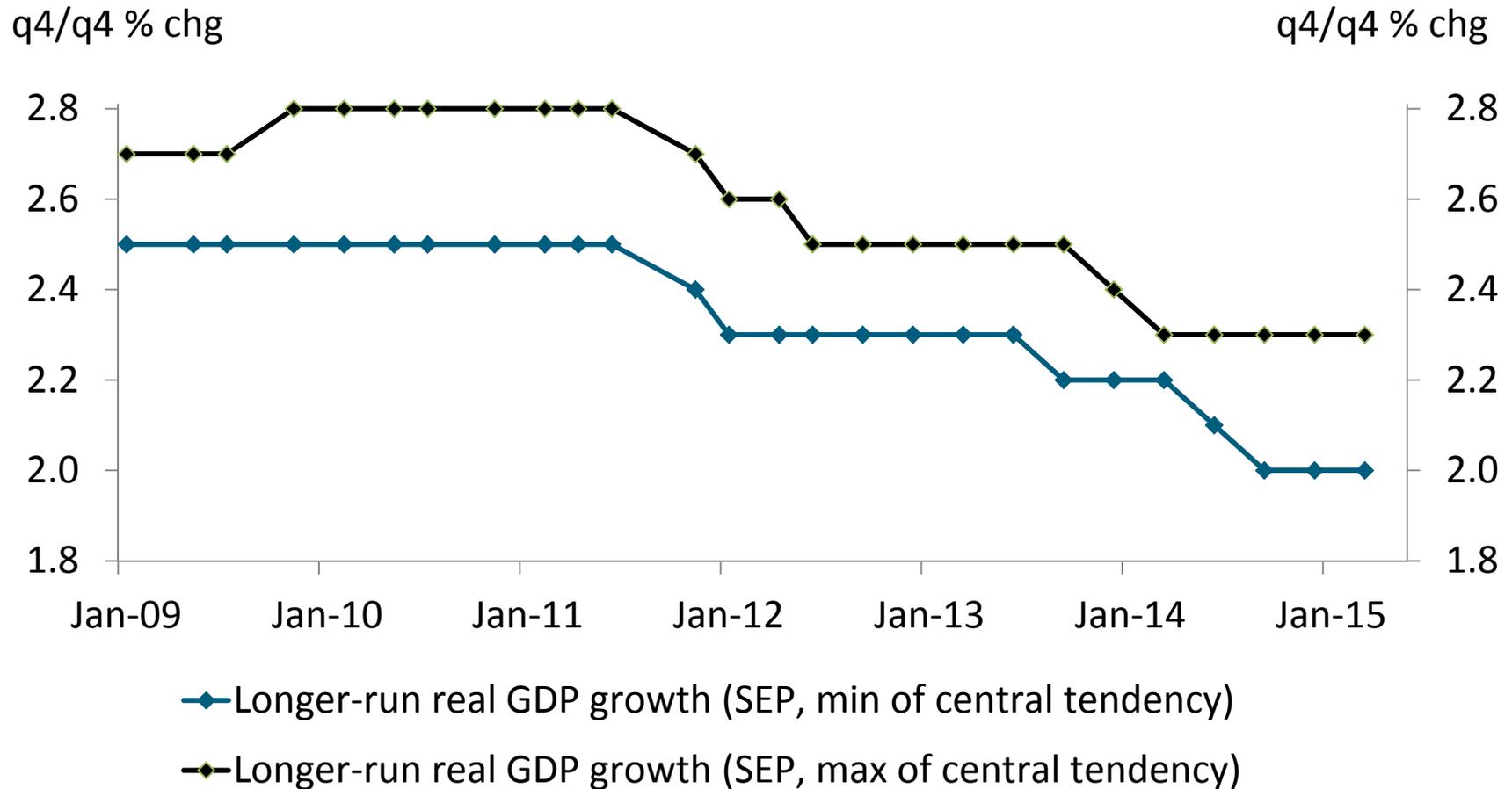
- US growth also disappointed in Q1 and inflation remains below the 2% target
- However, labor markets continue to improve and factors weighing on inflation are dissipating
- 15 of 17 FOMC participants indicated in the June Summary of Economic Projections liftoff in 2015 will likely be appropriate

## The FOMC projects above-trend real GDP growth over the forecast horizon



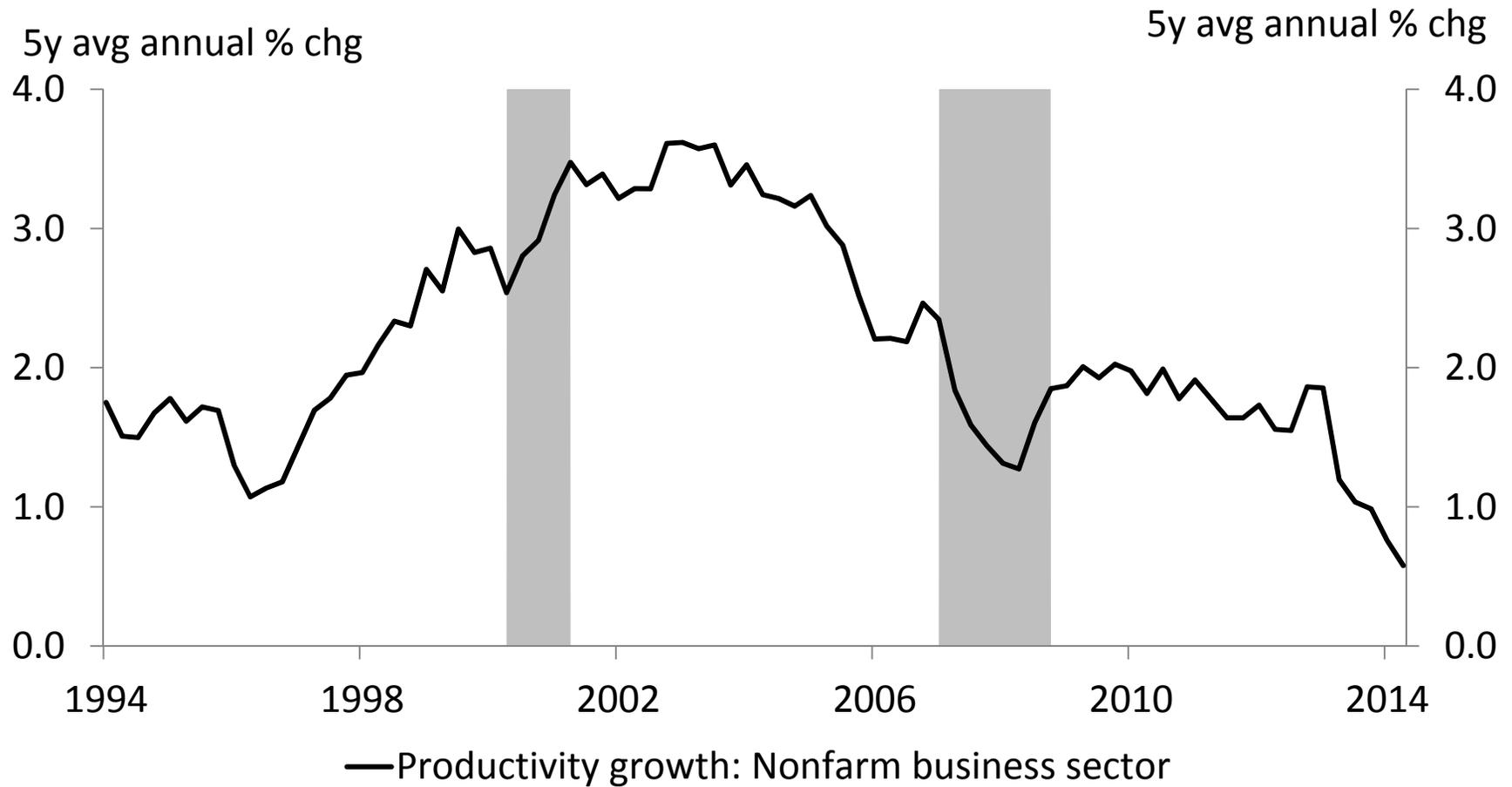
Source: Bureau of Economic Analysis, Federal Reserve, Haver Analytics

## FOMC estimates of longer-term real GDP growth have been steadily marked lower



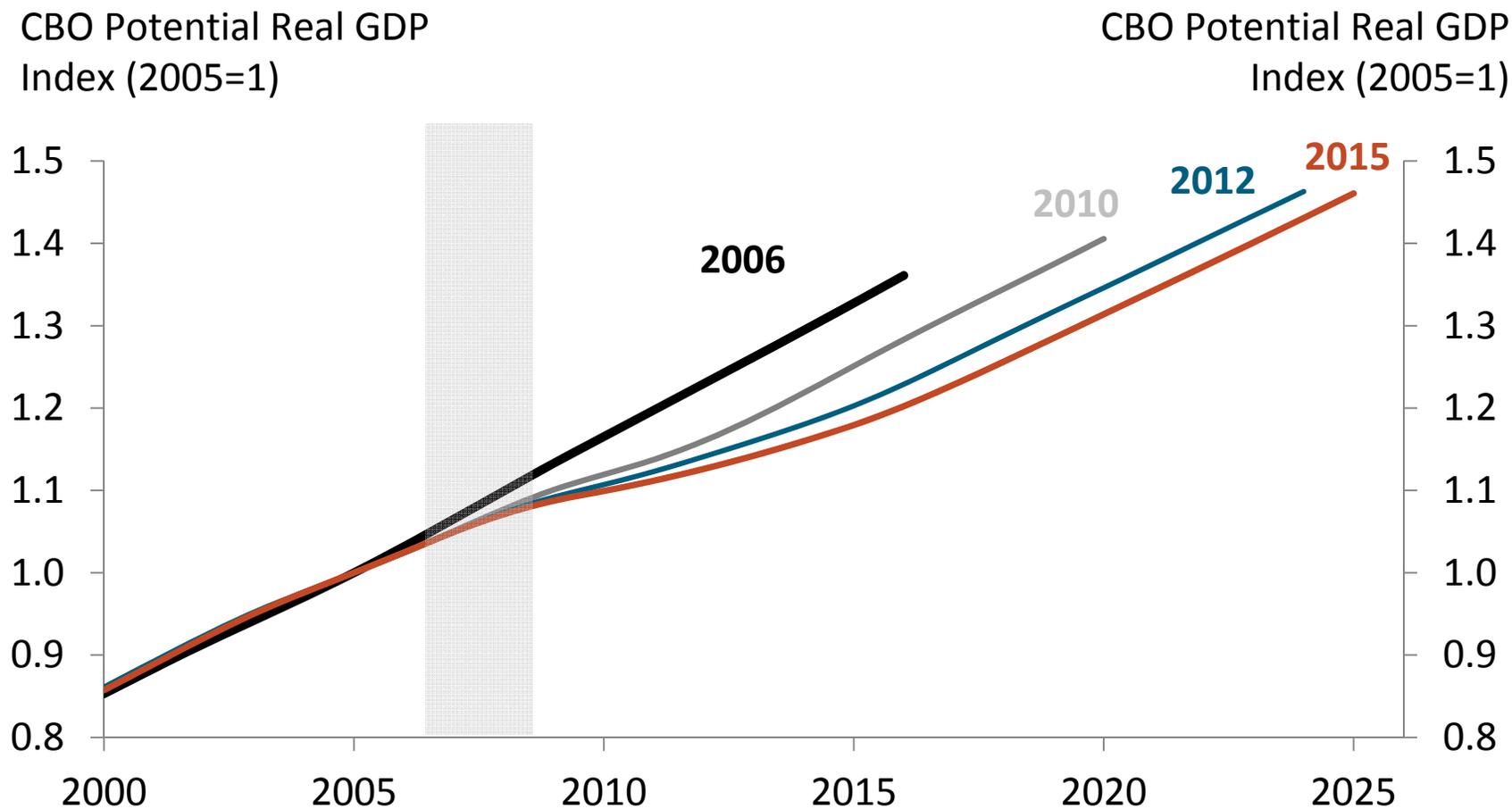
Source: Federal Reserve, Haver Analytics

# The trend in productivity growth has slowed



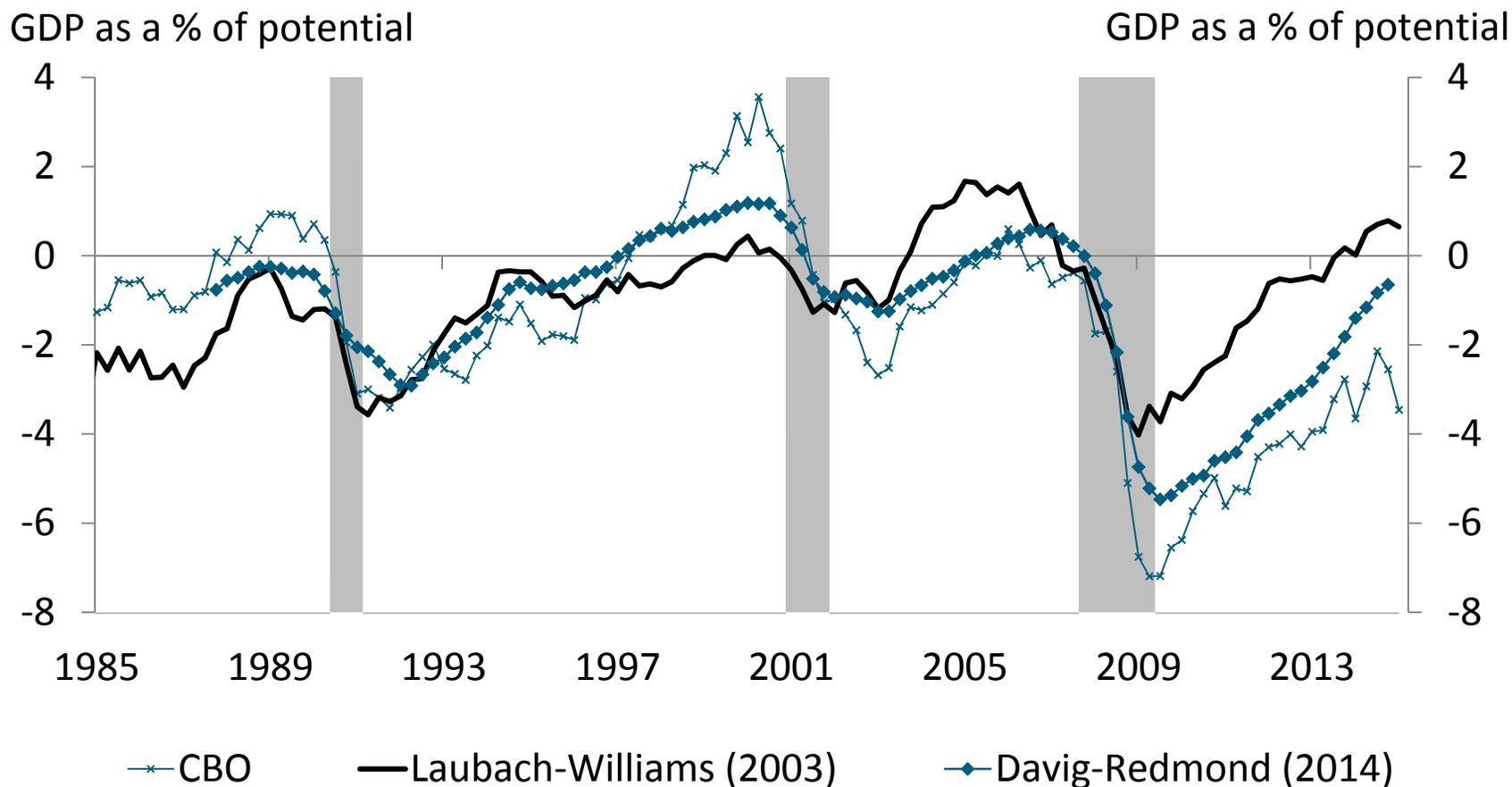
Source: Bureau of Labor Statistics, Haver Analytics

## Slower than expected growth has resulted in gradual downward revisions to potential GDP



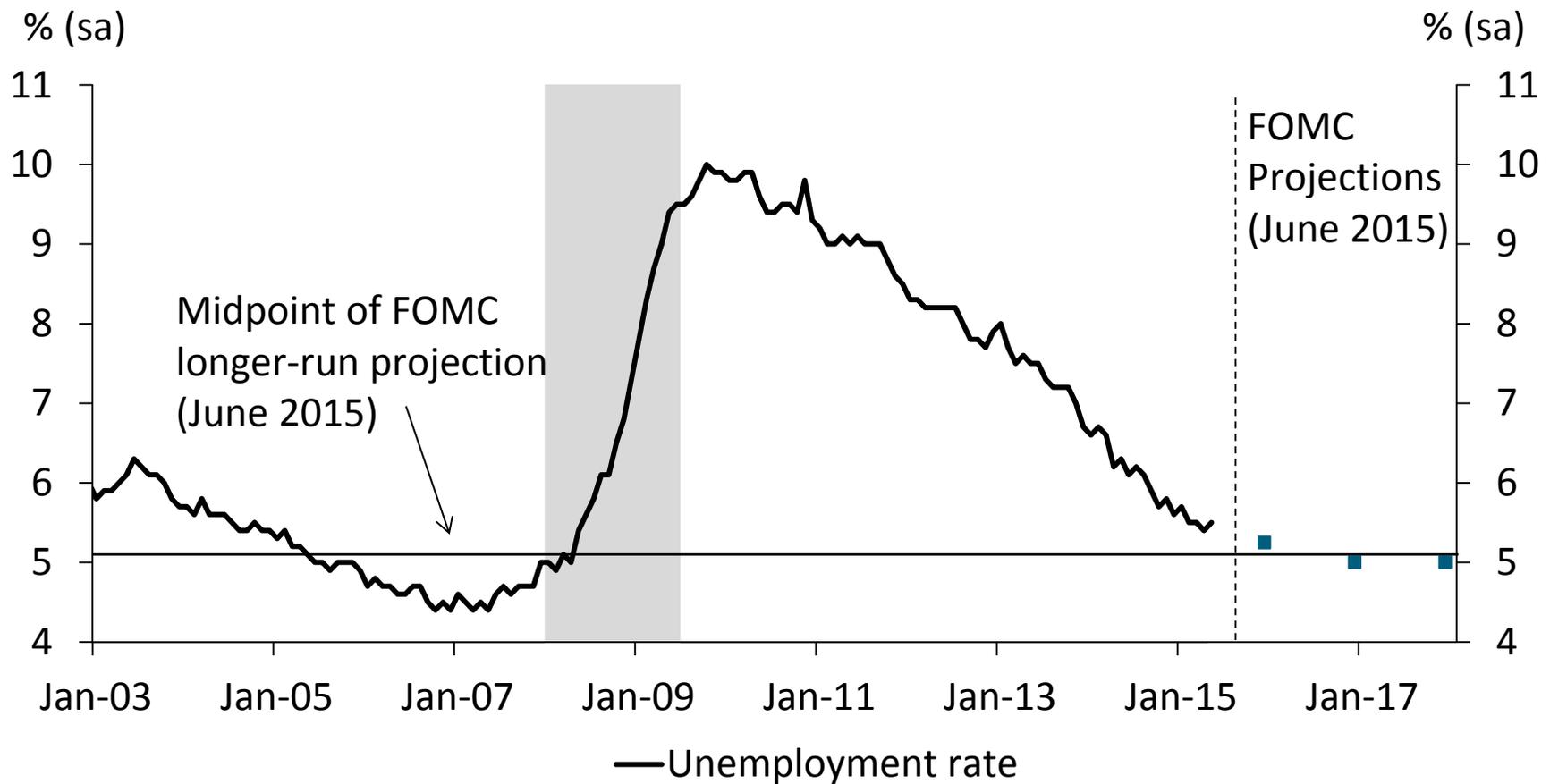
Source: Congressional Budget Office, Haver Analytics

## Measures of the output gap are sending mixed messages



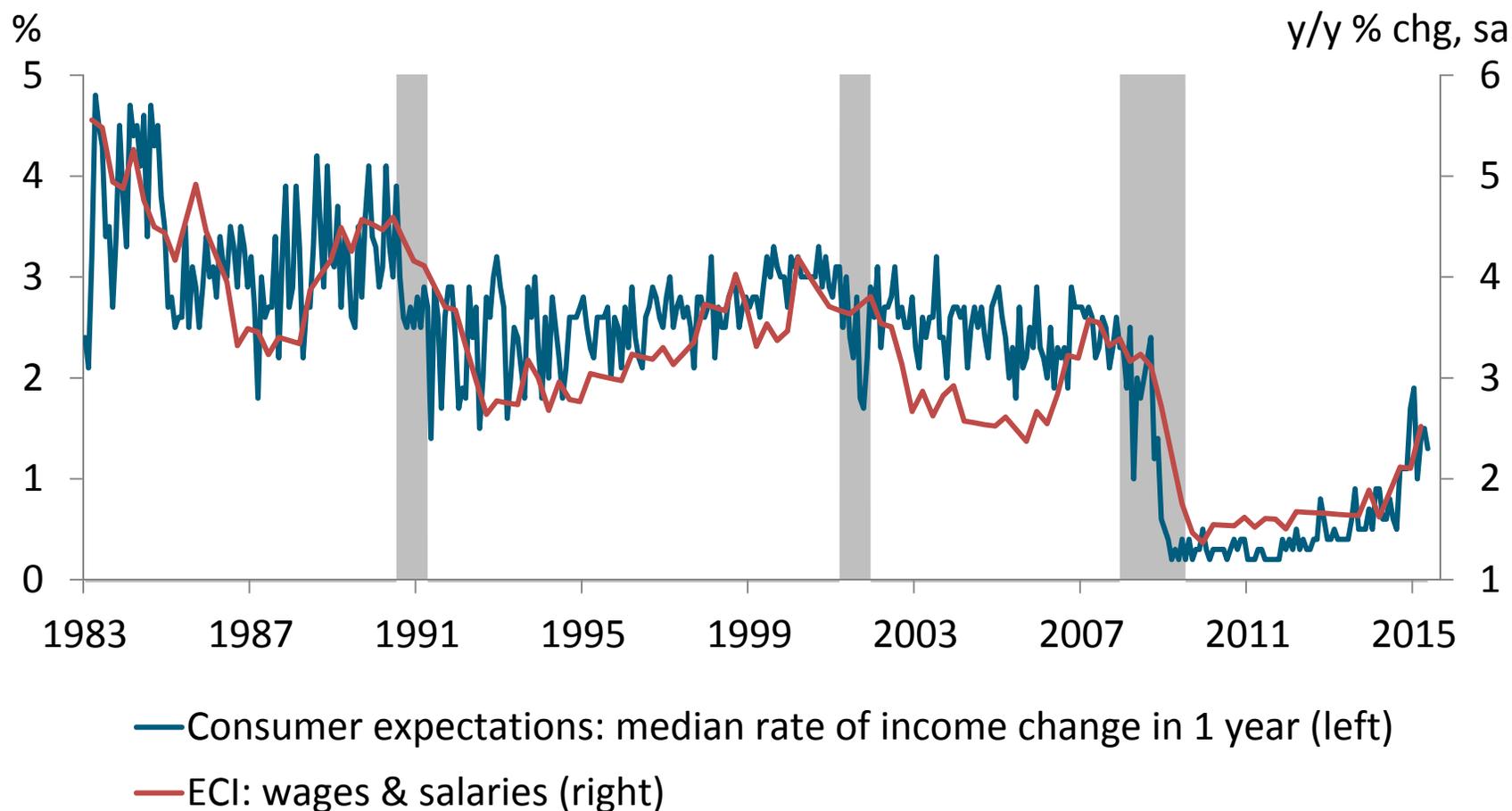
Source: FRB KC, FRB SF, Congressional Budget Office, Haver Analytics

## Job growth remains strong and the unemployment rate is approaching its longer-run normal level



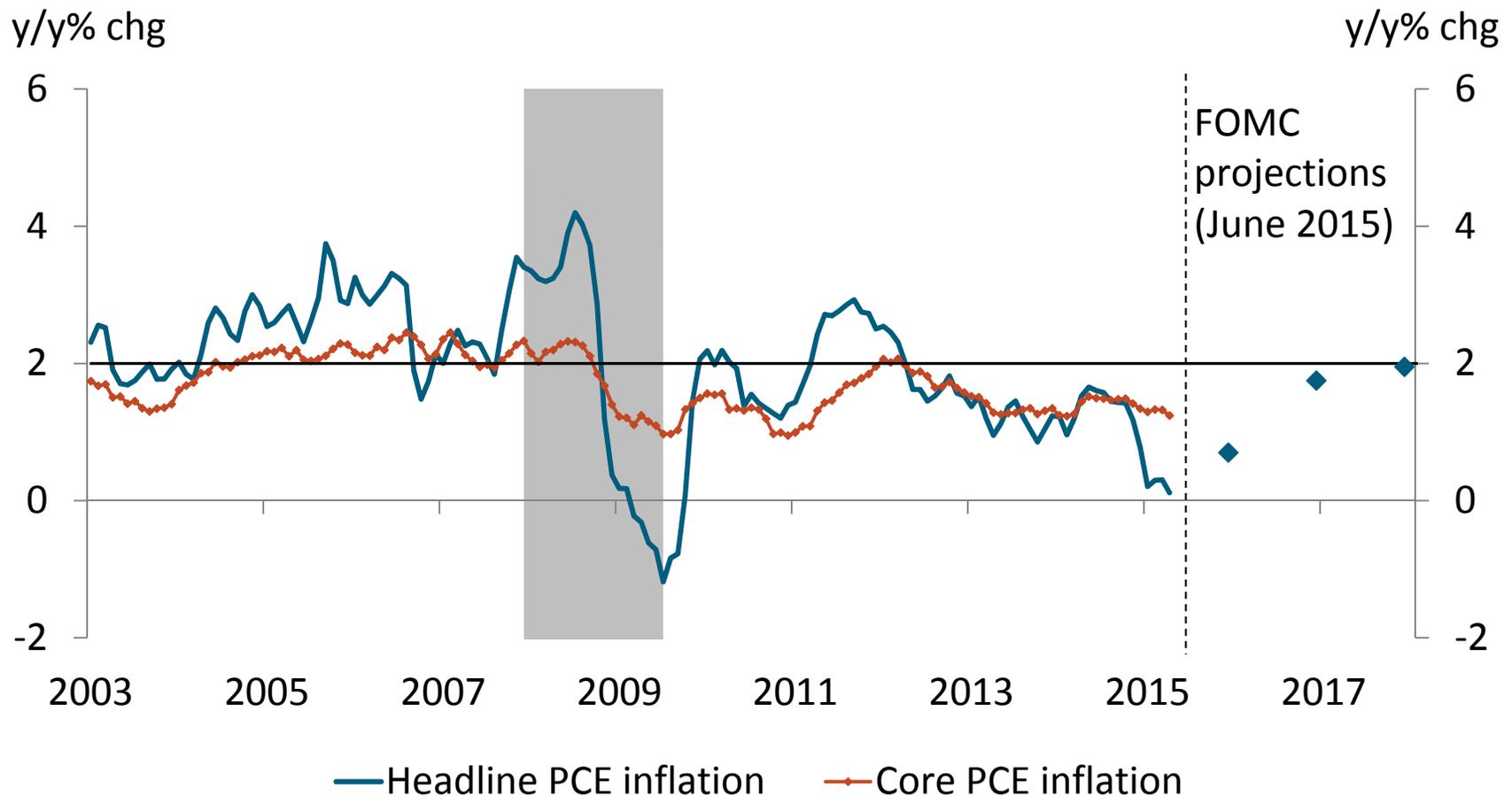
Source: Bureau of Labor Statistics, NBER, Federal Reserve Board, Haver Analytics

## Measures of wage growth and income expectations are rising



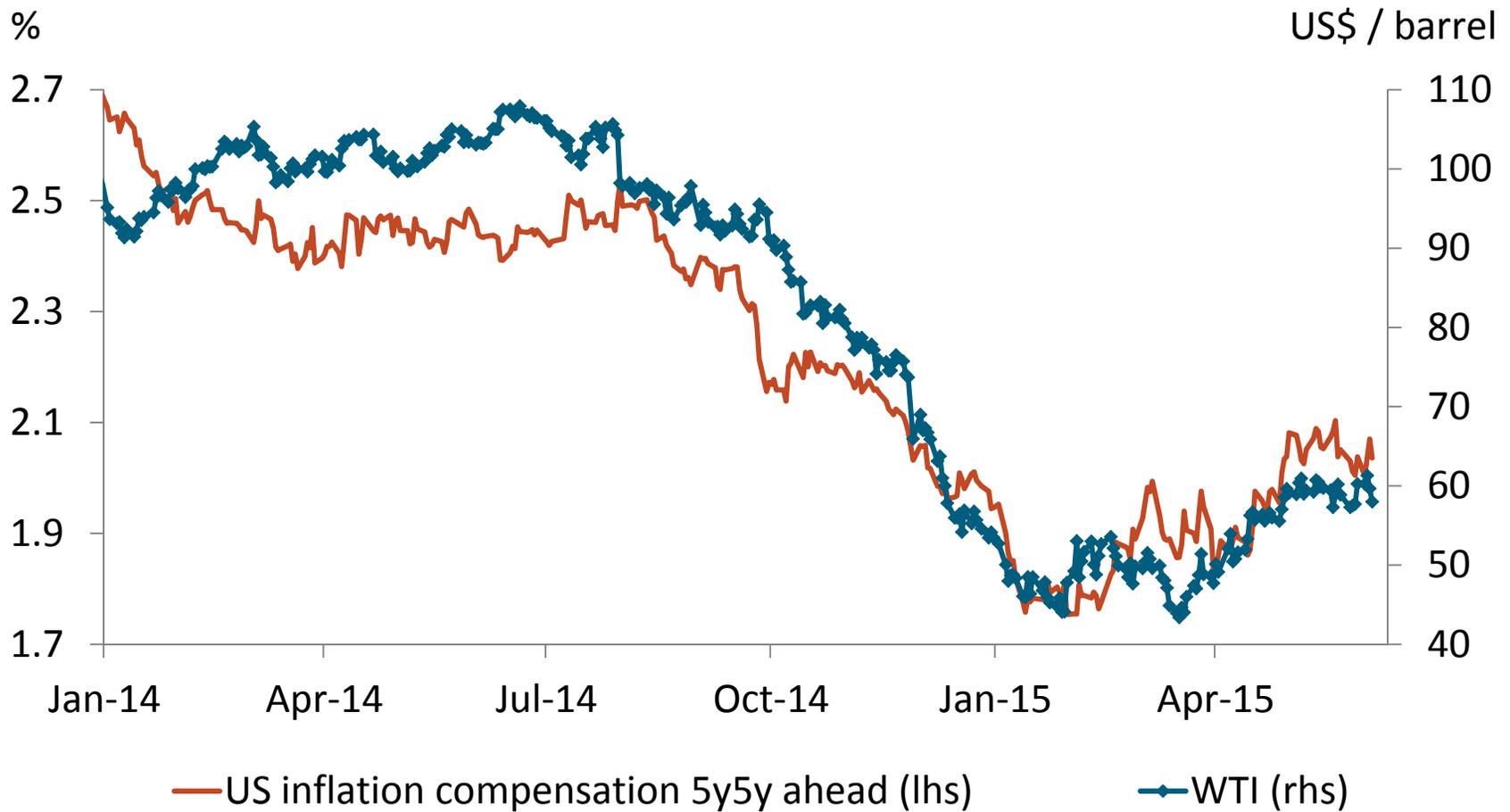
Source: Bureau of Labor Statistics, University of Michigan, NBER, Haver Analytics

## Headline inflation remains below the 2% goal, though is projected to rise



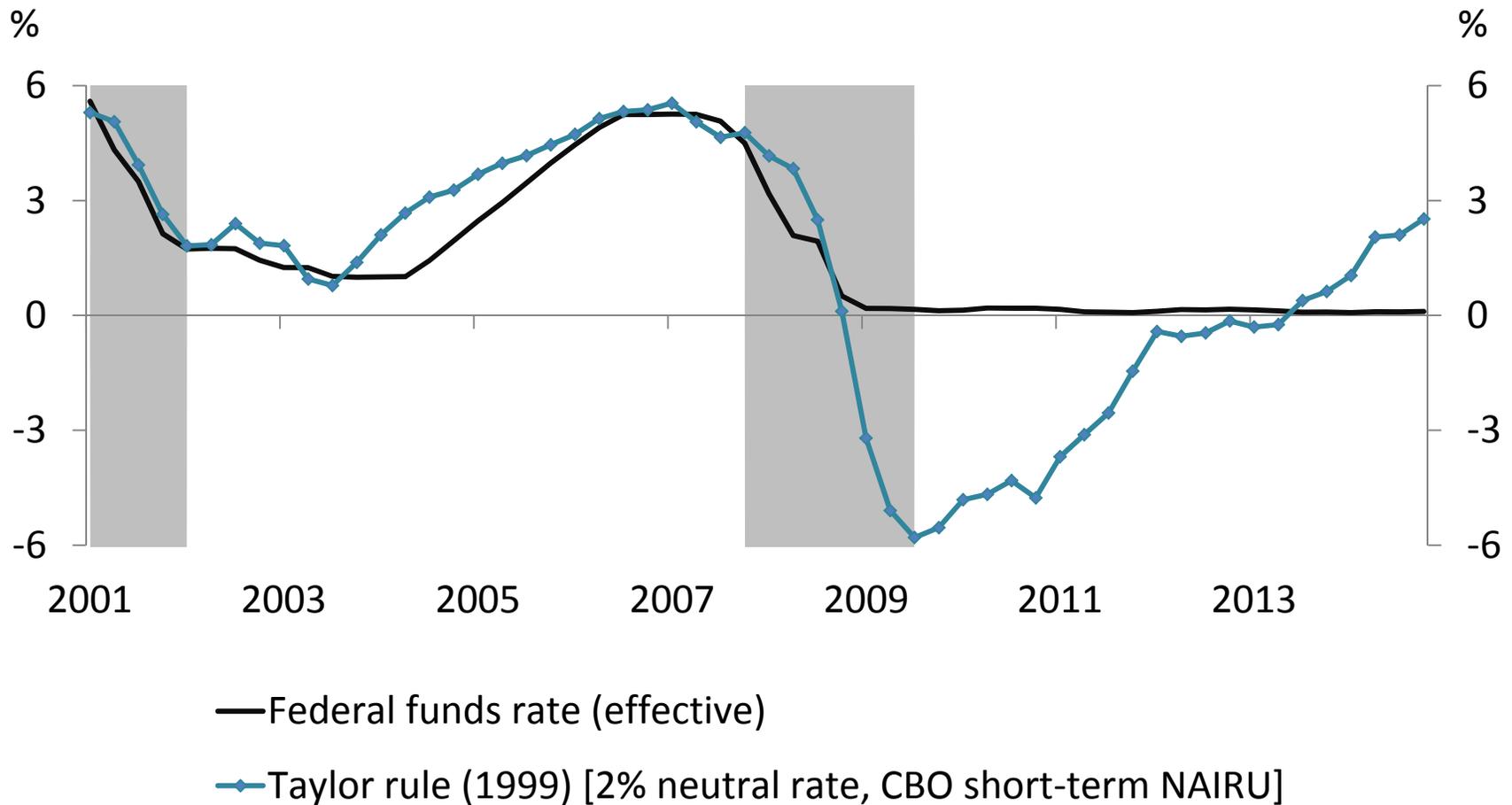
Source: Bureau of Economic Analysis, Federal Reserve, Haver Analytics

## Oil prices and longer-term inflation expectations have edged higher



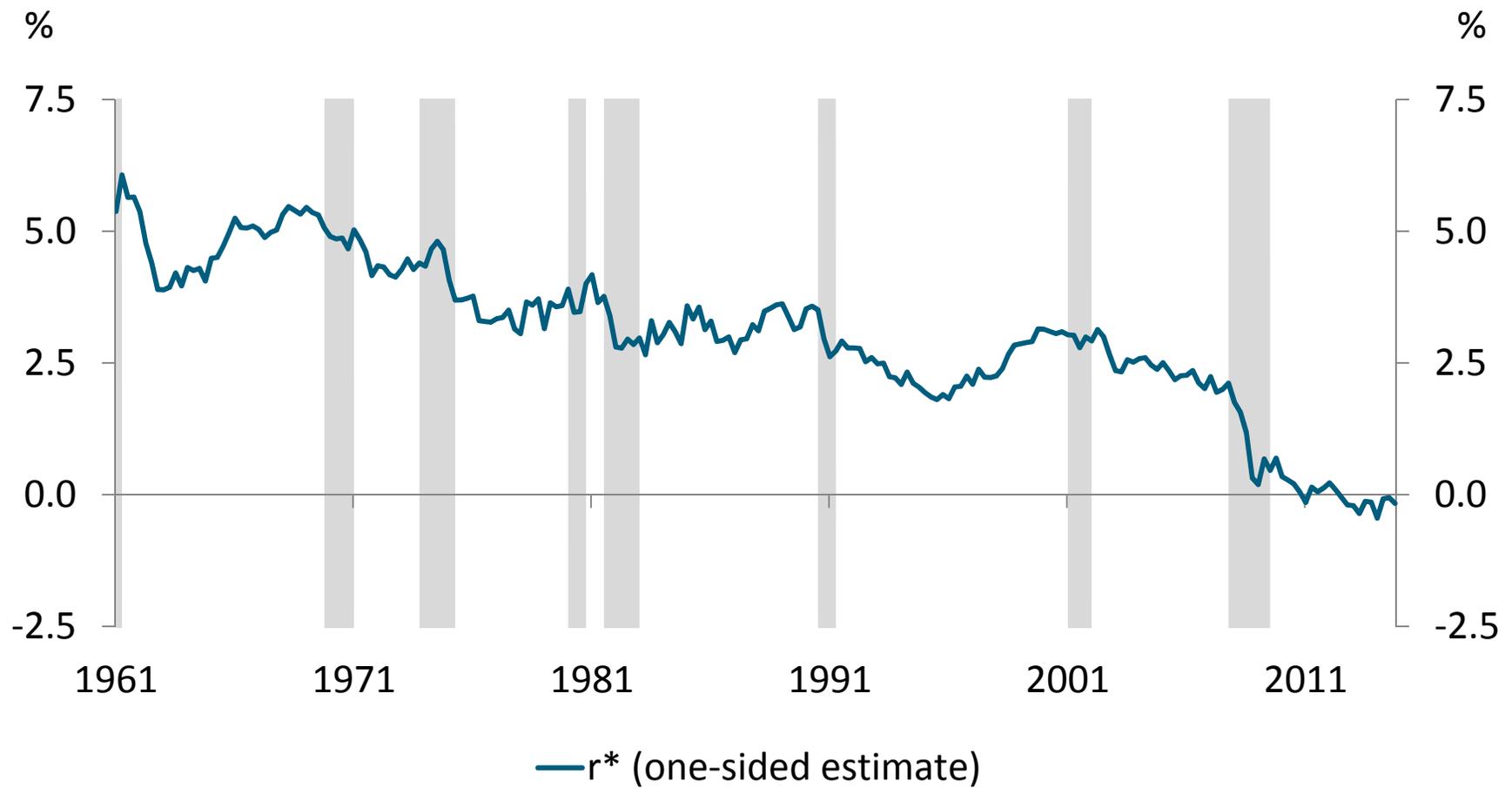
Source: Federal Reserve Board, EIA, Haver Analytics

## Some commonly-used policy benchmarks, such as the Taylor rule, suggest the federal funds rate should be higher



Source: Federal Reserve Board, CBO, FRB KC, Haver Analytics

## The equilibrium real rate in the US remains depressed



Source: FRB SF, Haver Analytics

## What is the equilibrium real rate?

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- Heuristically, the equilibrium real rate enters many common models as follows

$$\text{Real GDP Growth}_t = -\sigma(r_t - r_t^*) + \text{“other factors”}$$

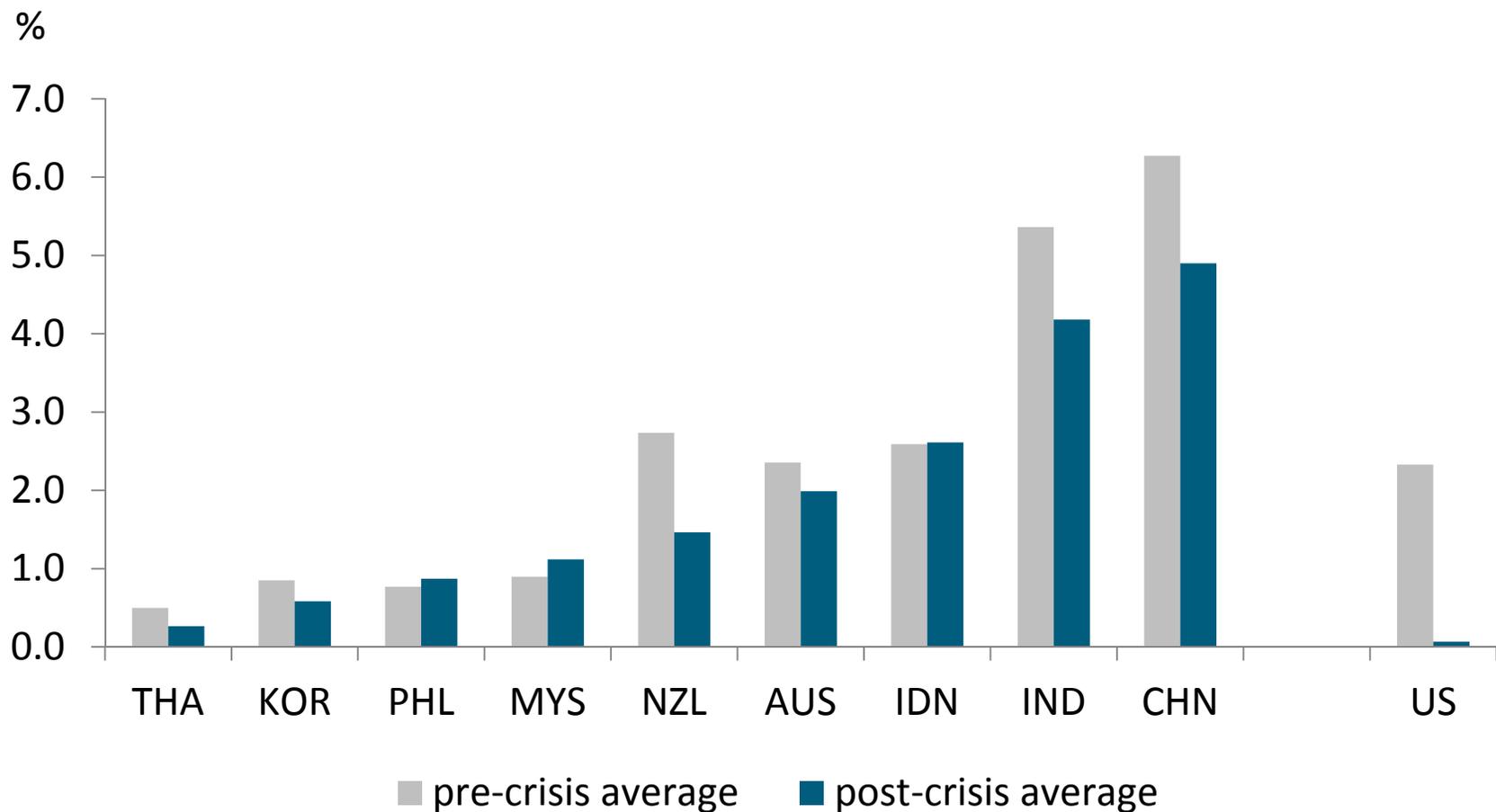
- $r_t$  is the real short-term rate controlled by the central bank
- $r_t^*$  is the equilibrium real rate set by factors such as fiscal policy and productivity growth

## What does a low equilibrium real rate in the US mean?

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- Monetary policy that holds real rates low will not be as stimulative as in the past
- The longer-term federal funds rate will likely be lower than in the past
- Capital flows will likely trend towards economies with higher equilibrium real rates, which may add to reversal risk for EM

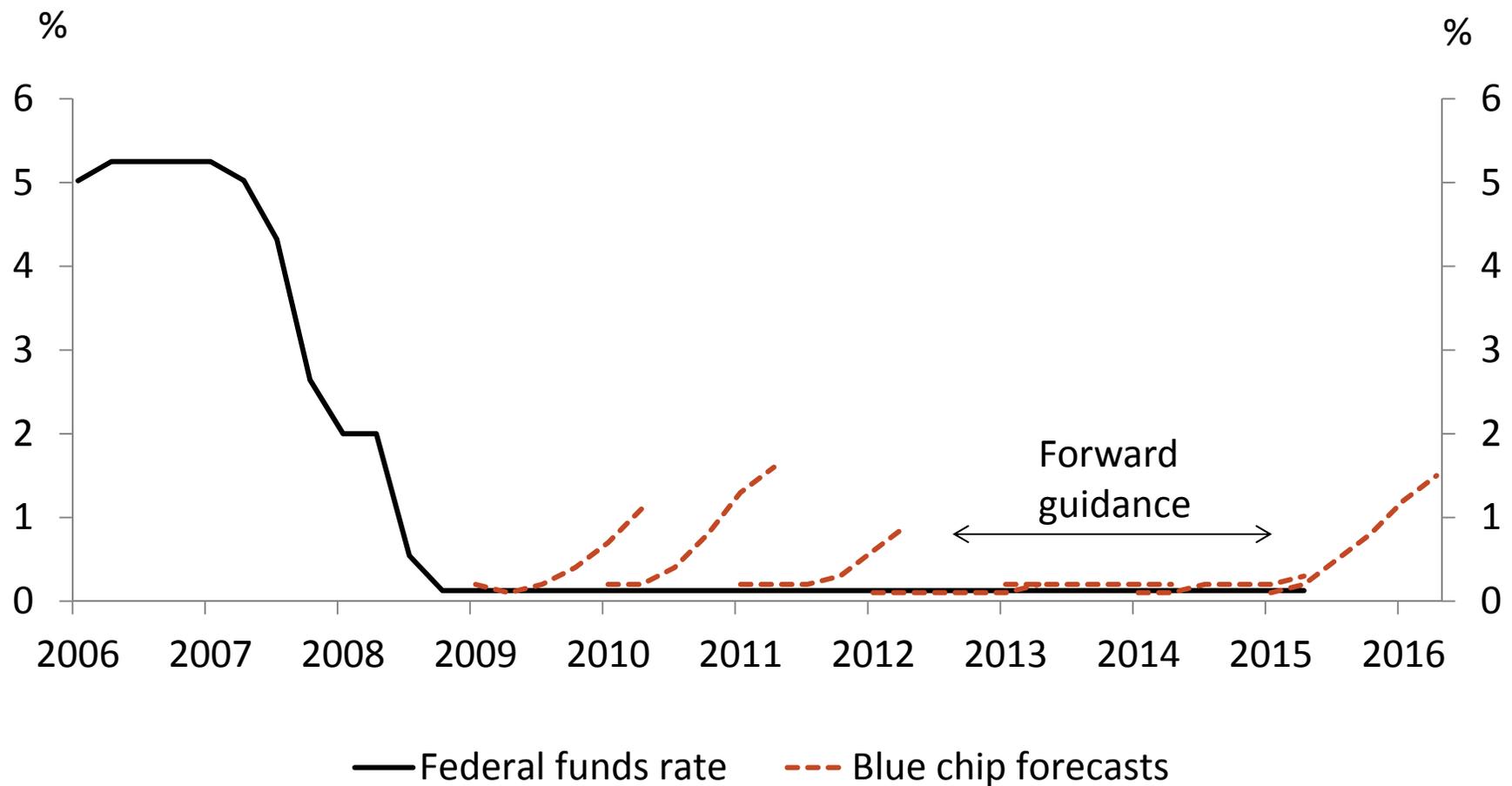
## The equilibrium real rate has fallen far more in the US compared to Asia



Source: Longmei Zhang, Kum Hwa Oh, IMF, FRB SF

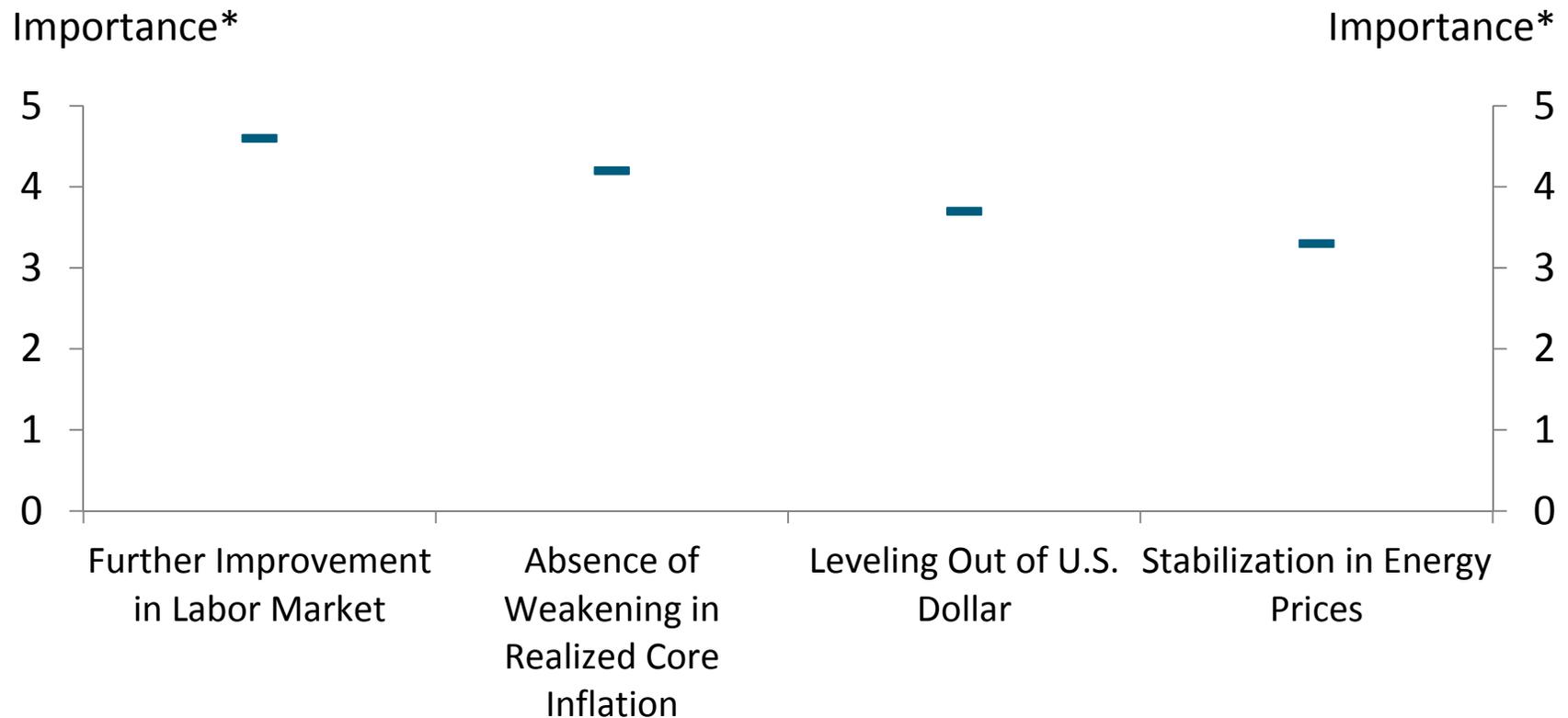
# The Fed's forward guidance had a notable impact on private sector interest rate forecasts, but policy is now data dependent

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Source: Blue Chip, Federal Reserve, Haver Analytics

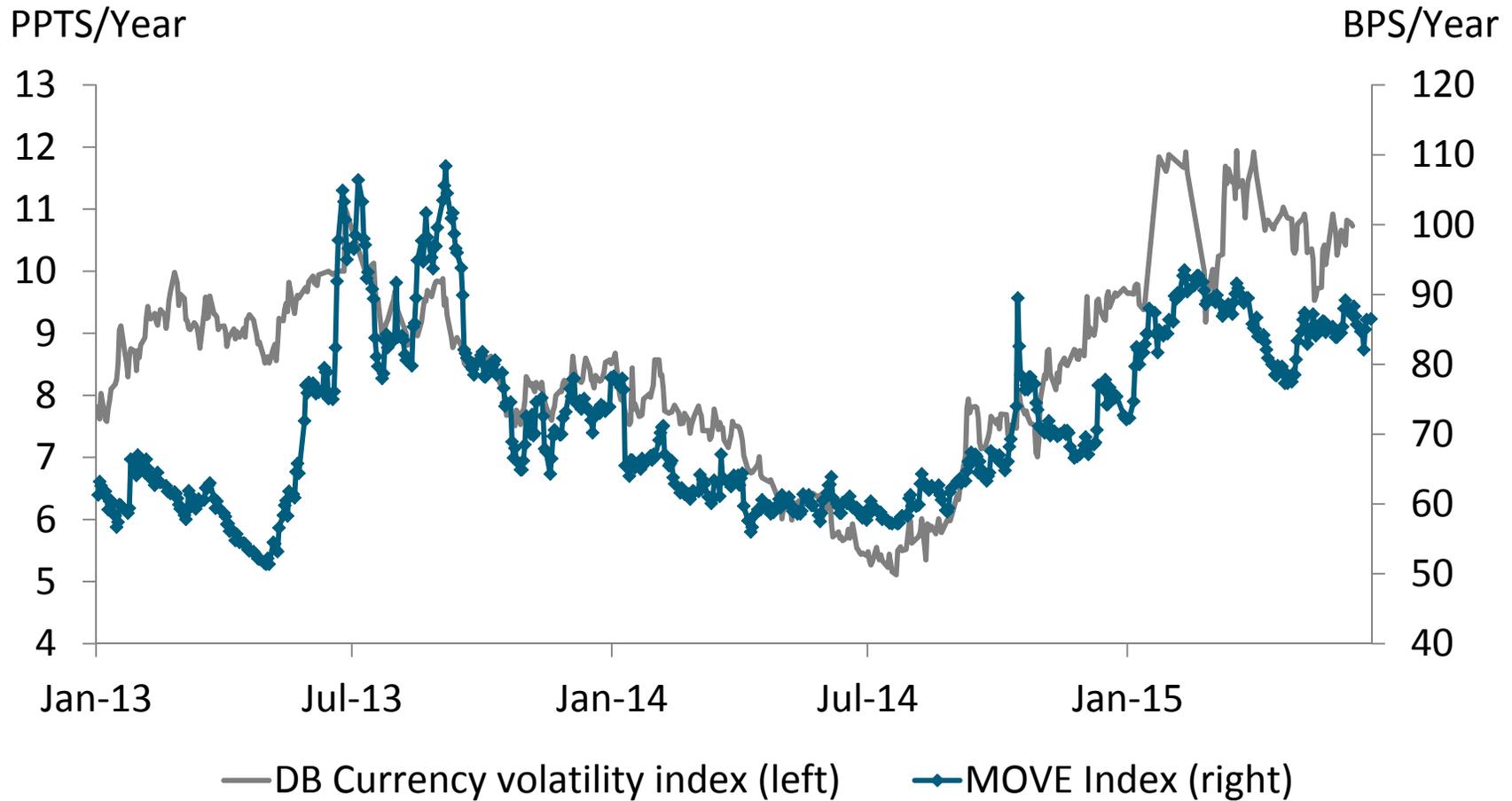
## Market participants see several factors driving the FOMC's "reasonable confidence" in the inflation outlook



\* 1 is not important, whereas 5 is very important.

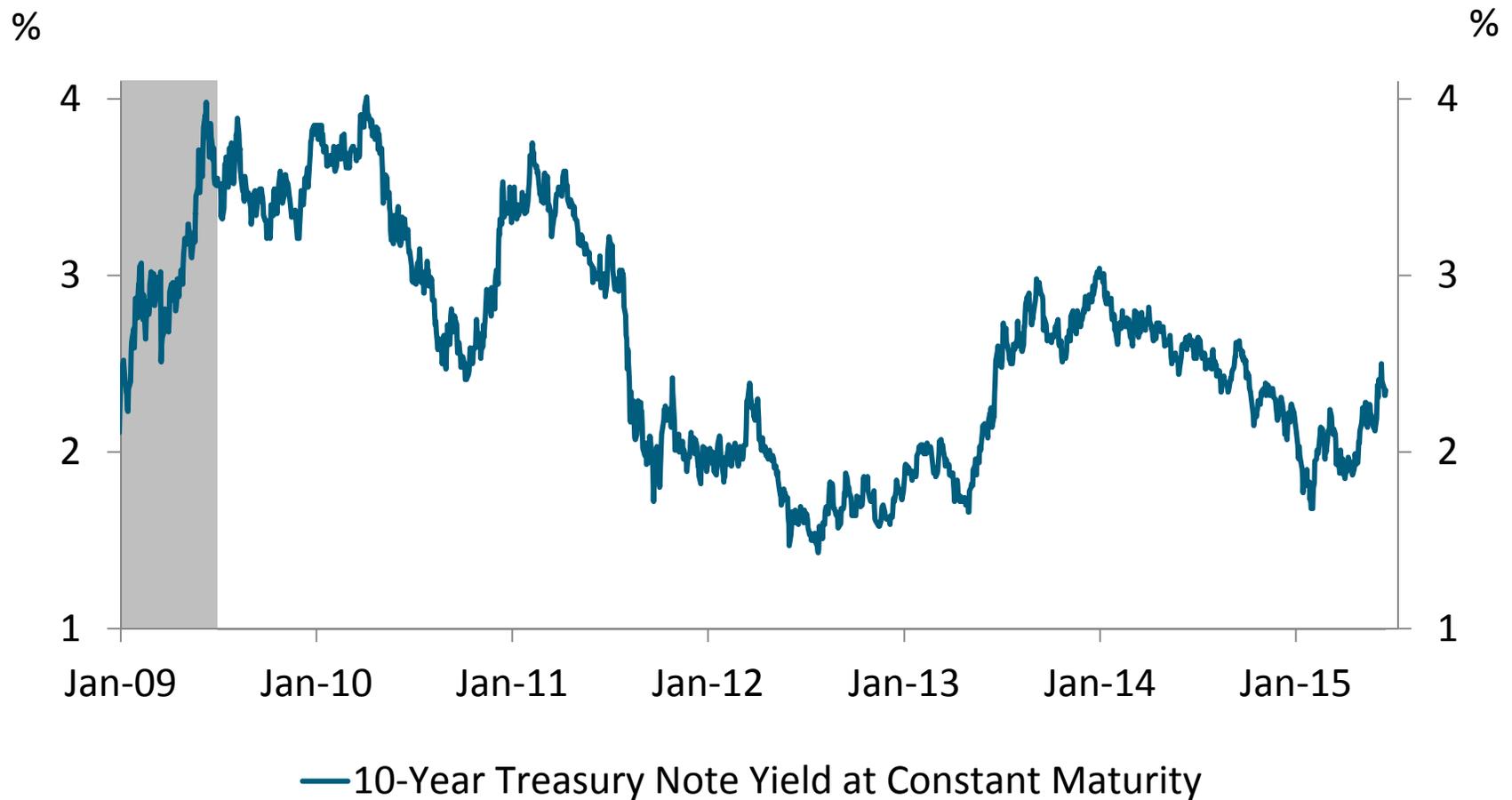
Source: Survey of Primary Dealers and Survey of Market Participants, April 2015. FRB NY

## Implied volatility of currency and US interest rates remain elevated



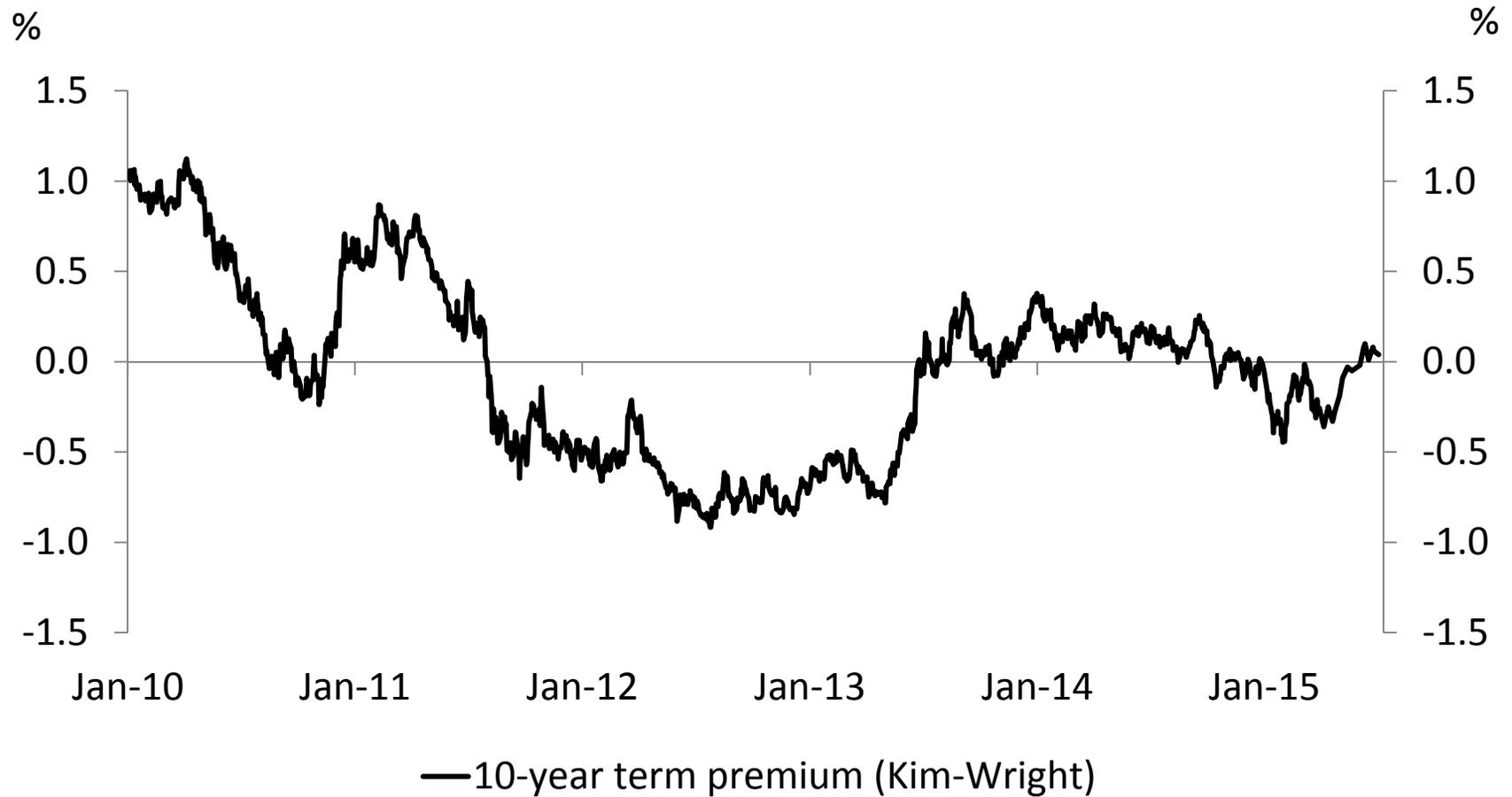
Source: BOA/Merrill Lynch, Deutsche Bank, Haver Analytics

## Longer-term rates have recently moved higher



Source: Federal Reserve Board, Haver Analytics

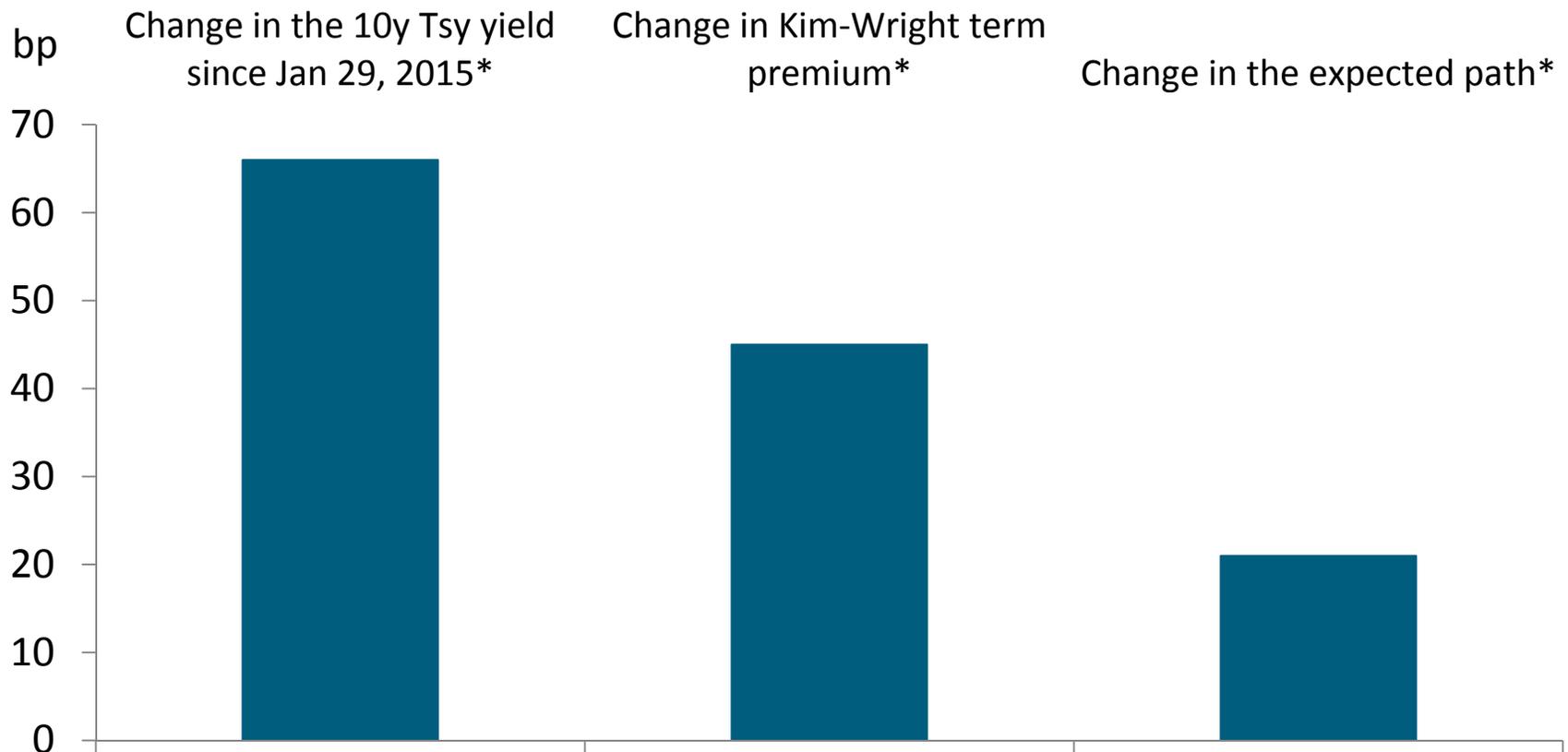
## Term premia increased sharply in 2013 and have again recently increased



Source: Federal Reserve Board, Haver Analytics

# The rise in long-term yields since January reflects both tighter expected monetary policy and a higher term premium

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\* Through July 3, 2015

Source: FRB KC, FRB NY

# The March FOMC statement elicited a sharp market reaction

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## Percentile Rank of March FOMC Price Changes Since January

Asset	Change	Percentile
2-Year Nominal	-11 bps	90th
10-Year Real	-14 bps	96th
10-Year Breakeven	+6 bps	99th
S&P 500 Index	+1.6%	95th
Euro-Dollar**	1.10%	97th

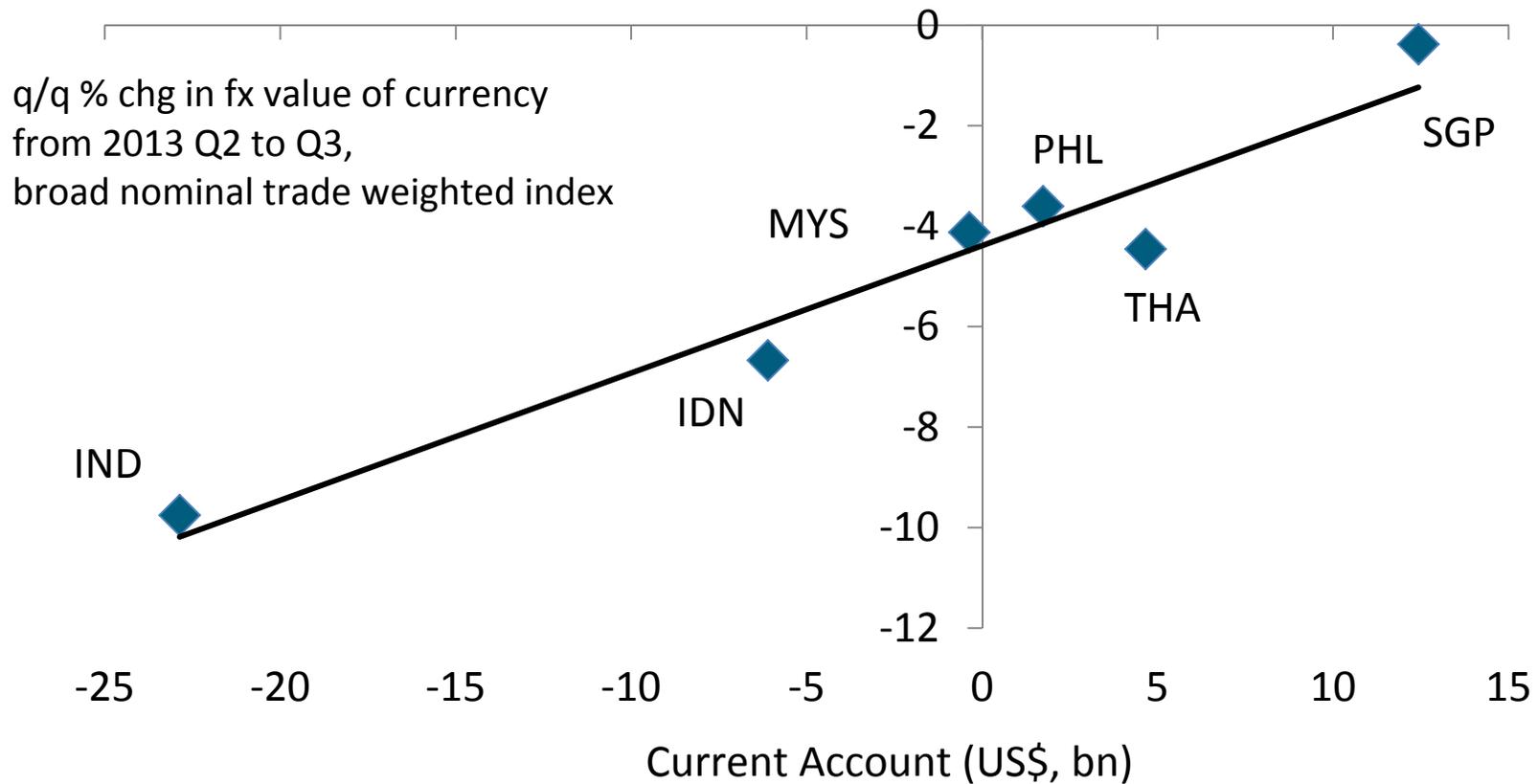
\*Percentile rank of absolute change in one-hour windows around FOMC statement releases (95 observations).

\*\*Positive value indicates dollar depreciation against the euro.

Source: Bloomberg

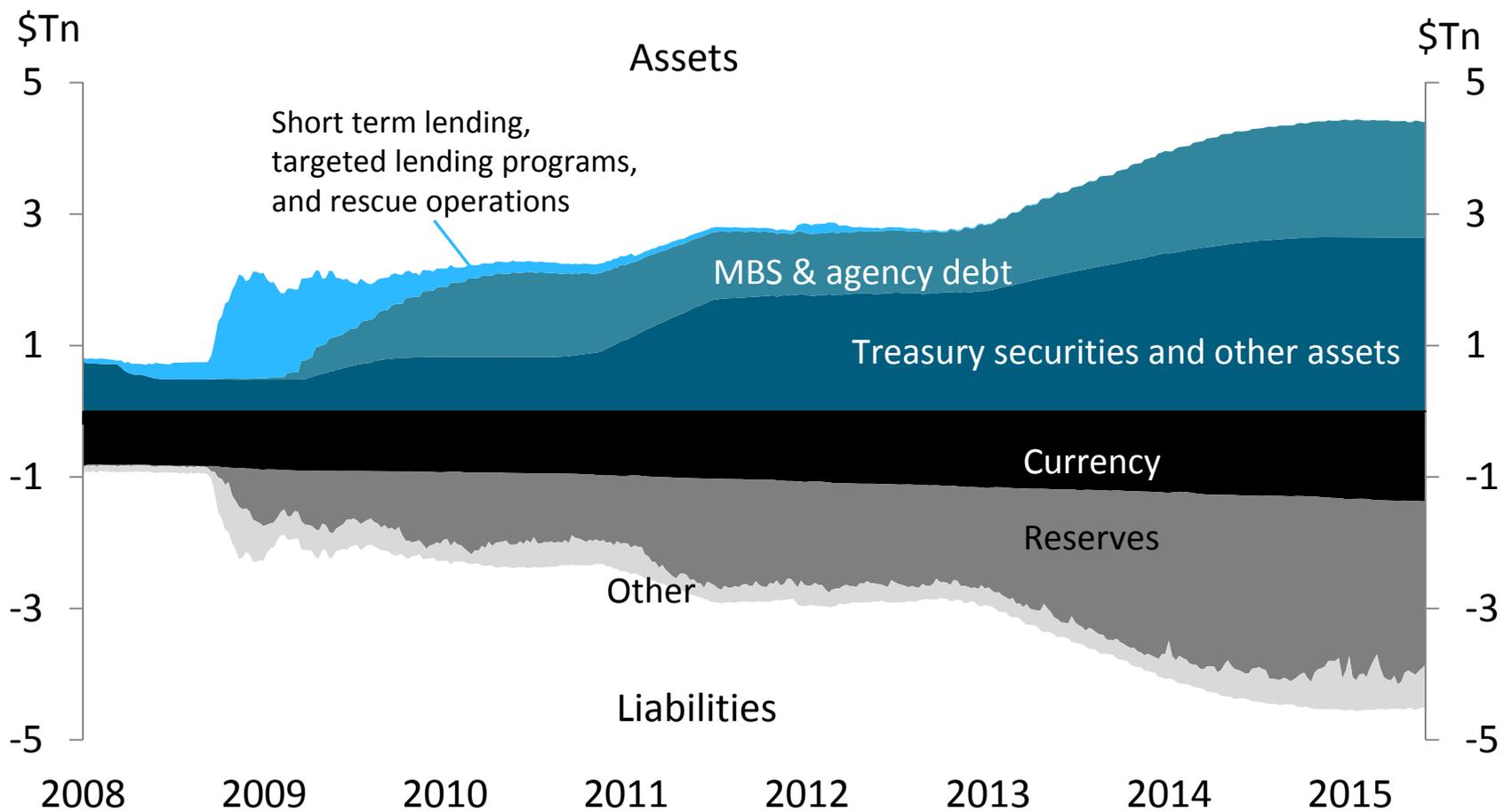
## EM Asian currency movements in mid-2013 were closely connected to external balances

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Source: FRB KC, IMF, JP Morgan, Haver Analytics

# Fed balance sheet policies will also be an important dimension of policy going forward



Source: Federal Reserve Board, Haver Analytics

## Monetary Policy Normalization Principles and Plans

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- The federal funds rate will remain the target, but new tools will be used to influence the funds rate
- Holdings of US Treasury and agency-MBS securities will be reduced in a “gradual and predictable” manner
- After liftoff the “Committee expects to cease or commence phasing out reinvestments after it begins increasing the target range for the federal funds rate”
- In the long-run, securities will only be held to the extent necessary to “efficiently and effectively” implement policy

## Risks from the US that could spark capital flow reversals for emerging markets

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- Stronger-than-expected consumer spending, reflecting wealth gains, rising wages and past benefits from lower gasoline prices
- Upward move in oil prices, possibly pushing longer-term inflation expectations higher
- A “snap back” in term premia in US Treasury securities that unexpectedly push longer-term rates higher

## Alternatively...

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- The US could be facing a prolonged episode of slow growth, reflecting secular stagnation
- Some are concerned that US longer-term inflation expectations may have declined a bit in response to soft realized inflation
- The US expansion is quite mature, so may not respond favorably to a full tightening cycle

## Main takeaways

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- Short-run divergence: The US moves towards liftoff, while Asian central banks ease
- Longer-run divergence: Equilibrium real rates have fallen far more in the US than in Asia, which suggest terminal policy rates may differ more than in the past
- The liftoff decision is only one aspect of US policy normalization, as the path of the policy rate, terminal policy rate, and balance sheet adjustments are also important considerations



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