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The Role of the Fed's Balance Sheet for the U.S. Monetary Policy Outlook in 2017

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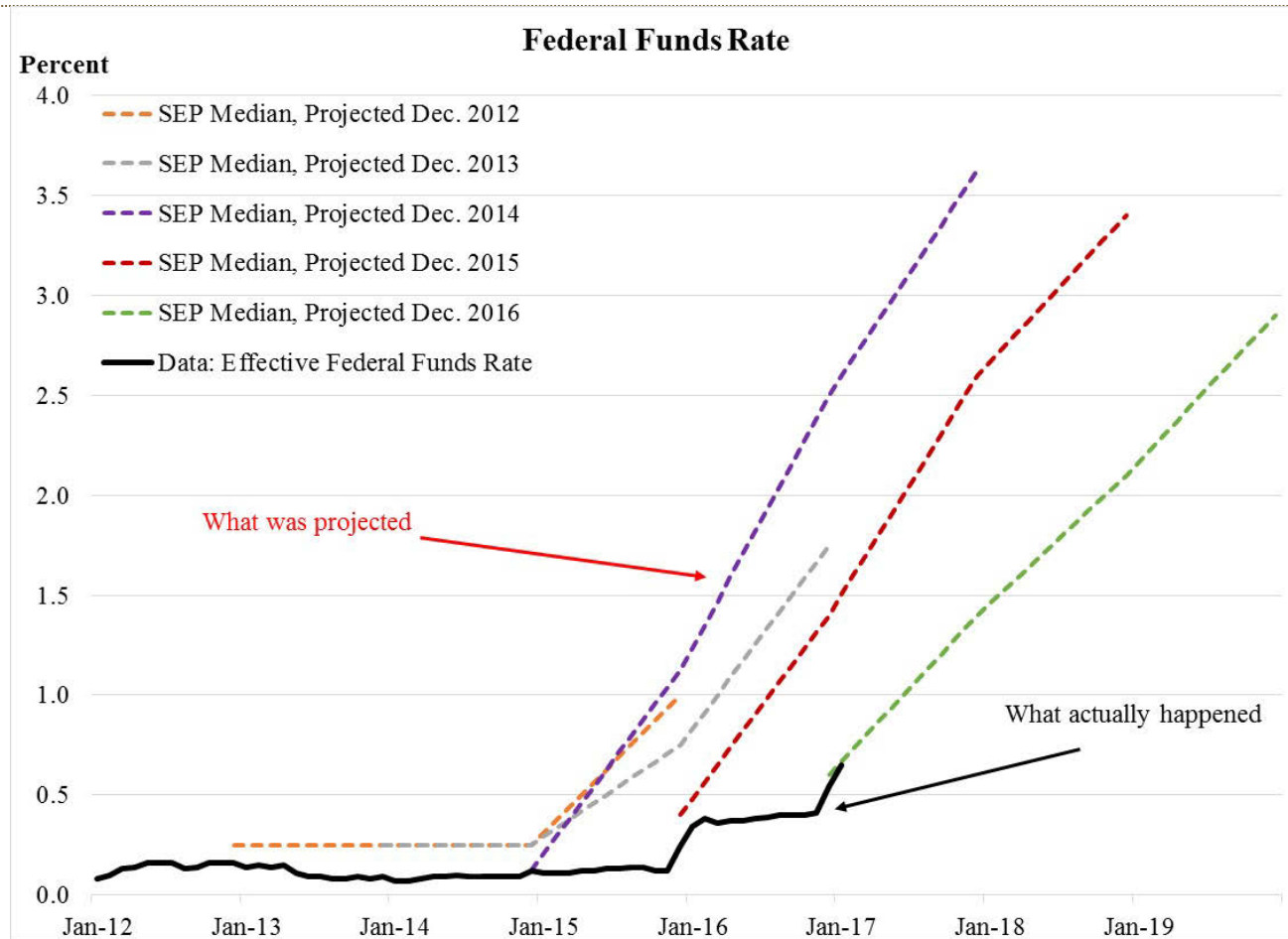
Introduction

Key themes in this talk

- The Fed has essentially achieved its objectives concerning inflation and unemployment.
- The low-safe-real-interest-rate regime that has characterized global financial markets in recent years is unlikely to change dramatically during 2017.
- Therefore, the policy rate required to keep inflation near target is quite low.
 - There is some upside risk to this outlook.
- Now may be a good time for the FOMC to begin to consider allowing the balance sheet to normalize by ending reinvestment.

A Problem with Federal Open Market Committee Projections

The FOMC policy rate projections versus reality



A questionable model

- In 2016, we at the St. Louis Fed concluded that the model behind this type of projection was questionable.
 - The June 2016 announcement and many remarks I gave in the following months covering various aspects of the St. Louis Fed's new regime-based approach to near-term projections are available on my webpage under "[Key Policy Papers](#)."

What is the core issue?

- Today's policy rate, at just 63 basis points, appears to be too low when casually compared to past historical experience.
 - In the past, when unemployment was relatively low and inflation was close to target, the policy rate was much higher.
- We at the St. Louis Fed concluded that what is different today is that the safe real interest rate is better thought of as being in a “low regime.”
- Moreover, we think the low-safe-real-rate regime is unlikely to change in the near term.
- This means the policy rate can also remain relatively low over the forecast horizon.

Will the Low-Rate Regime Go Away Naturally in 2017?

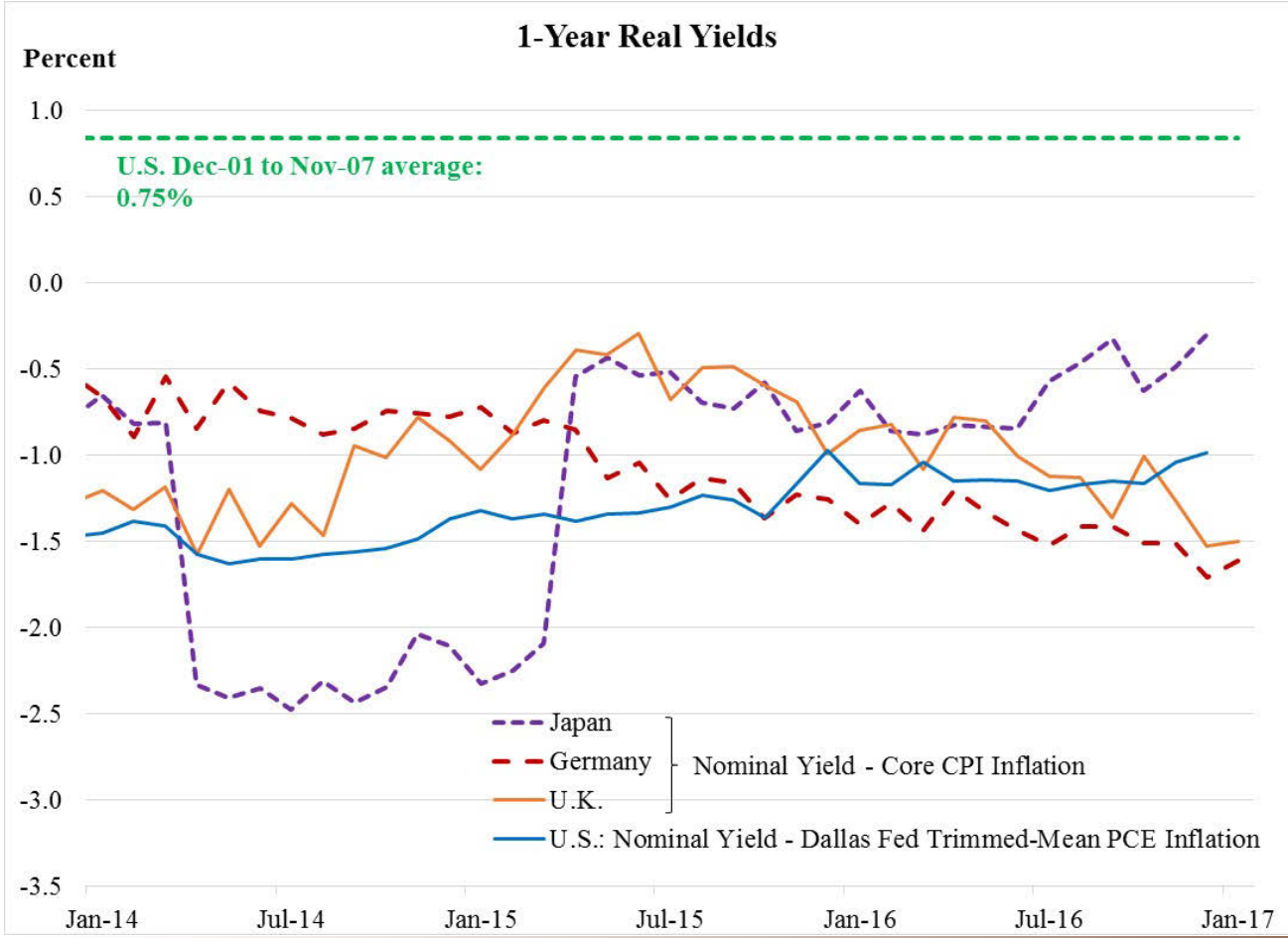
Will the low-rate regime go away naturally in 2017?

- Some considerations on this question:
 - The low-real-rate regime is a global phenomenon.
 - The low-real-rate regime has been many years in the making and is unlikely to turn around quickly.
- This suggests that the regime will not go away naturally—therefore, a relatively low policy rate will remain appropriate.

The low- and high-real-rate regimes in the U.S.

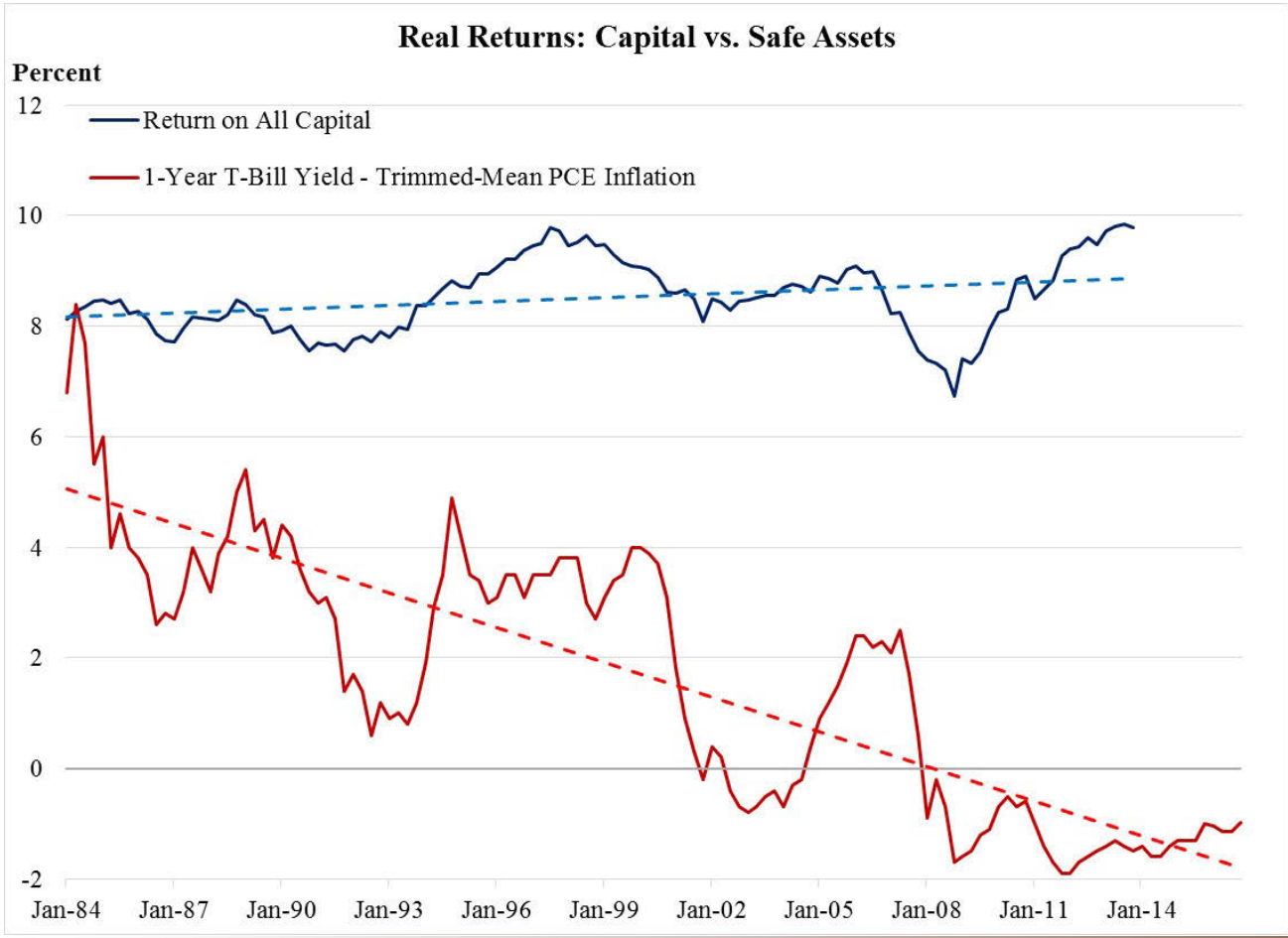


One-year ex-post real yields are low globally



Source: Haver Analytics and author's calculations. Last observation: Dec. 2016 (U.S. and Japan); Jan. 2017 (U.K. and Germany).

Low safe real rates have been developing over decades



Source: P. Gomme, B. Ravikumar and P. Rupert. "Secular Stagnation and Returns on Capital," FRB of St. Louis Economic Synopses No. 19, 2015; Federal Reserve Board, FRB of Dallas and author's calculations.

Bottom line on the low-safe-rate regime

- Real rates of return on government paper are exceptionally low in the current global macroeconomic environment.
- This has led to a lot of theorizing about a possible shortage of safe assets globally.
- Regardless of the theory, empirically it seems unwise to predict that the forces driving safe real rates to such low levels are likely to reverse anytime soon.
- This then feeds through to the policy rate, which is also likely to remain low.

Will the New Administration's Policies
Drive the Safe Real Interest Rate
Higher in 2017?

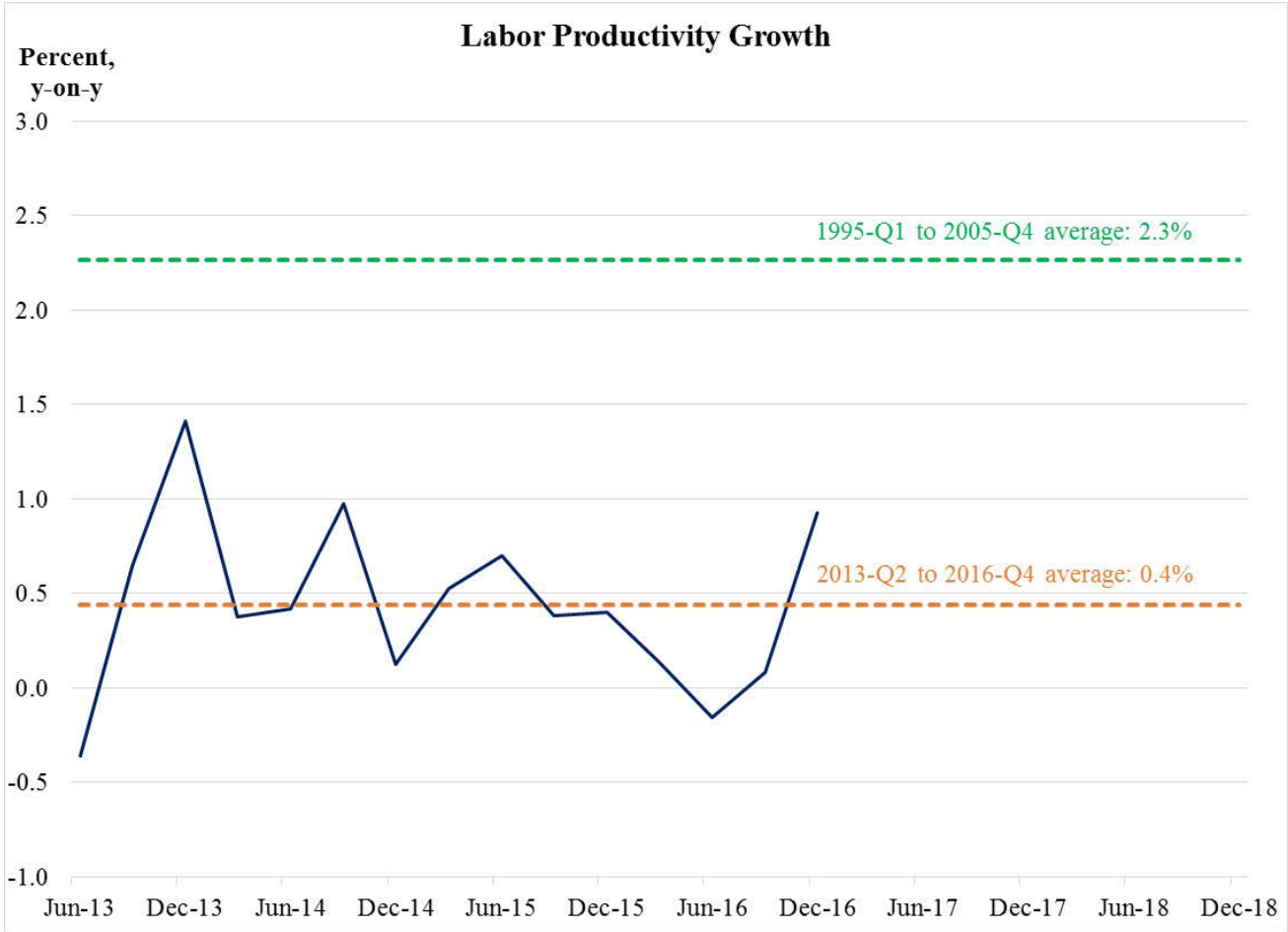
The impact of new policies on the real rate

- Will the new administration's policies move the U.S. out of the low-real-interest-rate regime?
- Here are two considerations:
 - The economy is not in recession today, so these policies should not be viewed as countercyclical measures.
 - This is a source of great confusion.
 - U.S. productivity growth is low and could be improved considerably.
 - This could increase the safe real rate.

Impact of new policies on productivity

- Whether the new administration's policies represent a “regime shift” depends on whether these policies will have a sustained impact on productivity.
- Three policy changes may have an impact in 2018 and 2019:
 - Deregulation: To the extent that some areas of regulation are excessive, this could improve productivity.
 - Infrastructure: Putting the right public capital in place could improve productivity.
 - Tax reform: Tax changes that encourage business investment in the U.S. could improve productivity.

The high- and low-productivity-growth regimes



Impact of longer-term policies

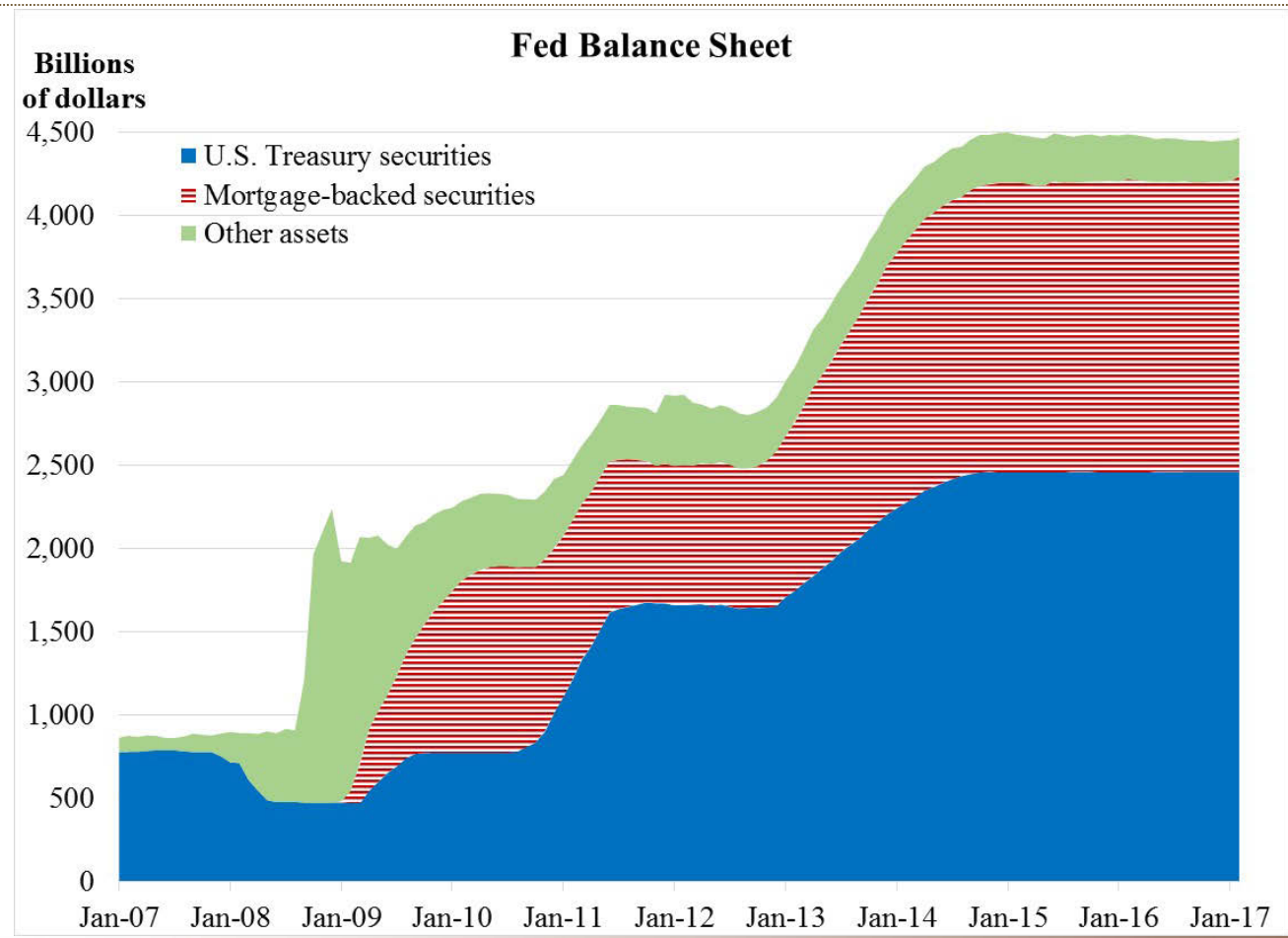
- Other macroeconomic issues include trade and immigration.
- Trade negotiations tend to be slow-moving relative to monetary policy.
- Trade arrangements can have important macroeconomic effects, but over the longer term.
- Similarly, immigration reform would likely have important effects on the macroeconomy, but over a longer horizon.

The Fed's Balance Sheet Policy

The Fed could begin to normalize its balance sheet

- The Fed's balance sheet has been an important monetary policy tool during the period of near-zero policy rates.
- The FOMC has not set a timetable for ending the current reinvestment policy.
- Now that the policy rate has been increased, the FOMC may be in a better position to allow reinvestment to end or to otherwise reduce the size of the balance sheet.
- Adjustments to balance sheet policy might be viewed as a way to normalize Fed policy without relying exclusively on a higher policy rate path.

The Fed's balance sheet today



Current policy is distorting the yield curve

- The current FOMC policy is putting some upward pressure on the short end of the yield curve through actual and projected movements in the policy rate.
- At the same time, current policy is putting downward pressure on other portions of the yield curve by maintaining a \$4.47 trillion balance sheet.
- This type of “twist operation” does not appear to have a theoretical basis.
- A more natural normalization process would allow the entire yield curve to adjust appropriately as normalization proceeds.

Bernanke commentary on the Fed balance sheet

- Recent blog commentary by former Fed Chair Bernanke does not address the unusual “twist” in current monetary policy.[†]
- Instead, Bernanke makes two arguments:
 - The effects of changing the size of the balance sheet are uncertain.
 - The FOMC has not decided on a “final size” for the balance sheet.
- I did not find the arguments put forward by the former chair to be compelling reasons for keeping the balance sheet at its current size.

A critique of Bernanke's commentary

- The effects of balance sheet policy are uncertain, but are often attributed to a signaling effect that the FOMC intended to stay “lower for longer” on the policy rate.
 - That signaling effect may be important when the balance sheet is rising and the policy rate is near zero, but would not exist when the balance sheet is shrinking and the policy rate has moved away from the zero lower bound.
- As for the final size of the balance sheet, few would argue that the current \$4.47 trillion level is appropriate.
 - Ending reinvestment would still leave the balance sheet very large for years.

Creating balance-sheet “policy space”

- Some have argued that the size of the balance sheet should not be reduced until the policy rate is high enough that it can be reduced appropriately should a recession develop.
- This is sometimes called “policy space.”
- The same “policy space” argument can be made for the size of the balance sheet.
- We should be allowing the balance sheet to normalize naturally now, during relatively good times, in case we are forced to resort to balance sheet policy in a future downturn.

Conclusion

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- Safe real rates of return are exceptionally low and are not expected to rise soon, a “low-safe-real-rate regime.”
 - This, in turn, means that the policy rate may be expected to remain exceptionally low over the forecast horizon.
- The new administration’s policies may have some impact on the low-safe-real-rate regime if they are directed toward improving medium-term U.S. productivity growth.
- Ending balance sheet reinvestment may allow:
 - for a more natural adjustment of rates across the yield curve as normalization proceeds and
 - for “policy space” in case balance sheet policy is required in a future downturn.



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