



CENTRAL  
to  
AMERICA'S  
ECONOMY™

# Current Monetary Policy, the New Fiscal Policy and the Fed's Balance Sheet

**James Bullard**

*President and CEO, FRB-St. Louis*

Economic Club of Memphis

March 24, 2017

Memphis, Tenn.

---

# Introduction

## Key themes in this talk

---

- The U.S. economy has arguably converged to a low-growth, low-safe-real-interest-rate regime, a situation that is unlikely to change dramatically during 2017.
- The Fed can take a wait-and-see posture regarding possible fiscal policy changes.
- The policy rate can remain relatively low and still keep inflation and unemployment near targets.
- Now may be a good time for the FOMC to consider allowing the balance sheet to normalize by ending reinvestment.

---

# The Low-Growth Regime

## Real GDP growth around 2 percent

- Real GDP growth measured from one year earlier has averaged just 2.1 percent over the last seven years.
  - Year-over-year comparisons help to smooth out the data.
- This length of time is far beyond ordinary business cycle dynamics.
- The last two years have shown virtually no change in year-over-year real GDP growth.
  - 2015-Q4: 1.9 percent, 2016-Q4: 1.9 percent.
- A natural conclusion is that the economy has converged upon a growth rate of 2 percent.

## Real GDP growth in 2017

---

- These considerations make it seem unwise to forecast more rapid growth in 2017.
- In addition, some indications for growth in the first quarter of 2017 are below 2 percent.
- If the tracking estimates turn out to be correct, the economy will have to grow much more rapidly during the last three quarters of 2017 to surpass 2 percent for the year as a whole.

## Tracking estimates for 2017-Q1 real GDP growth

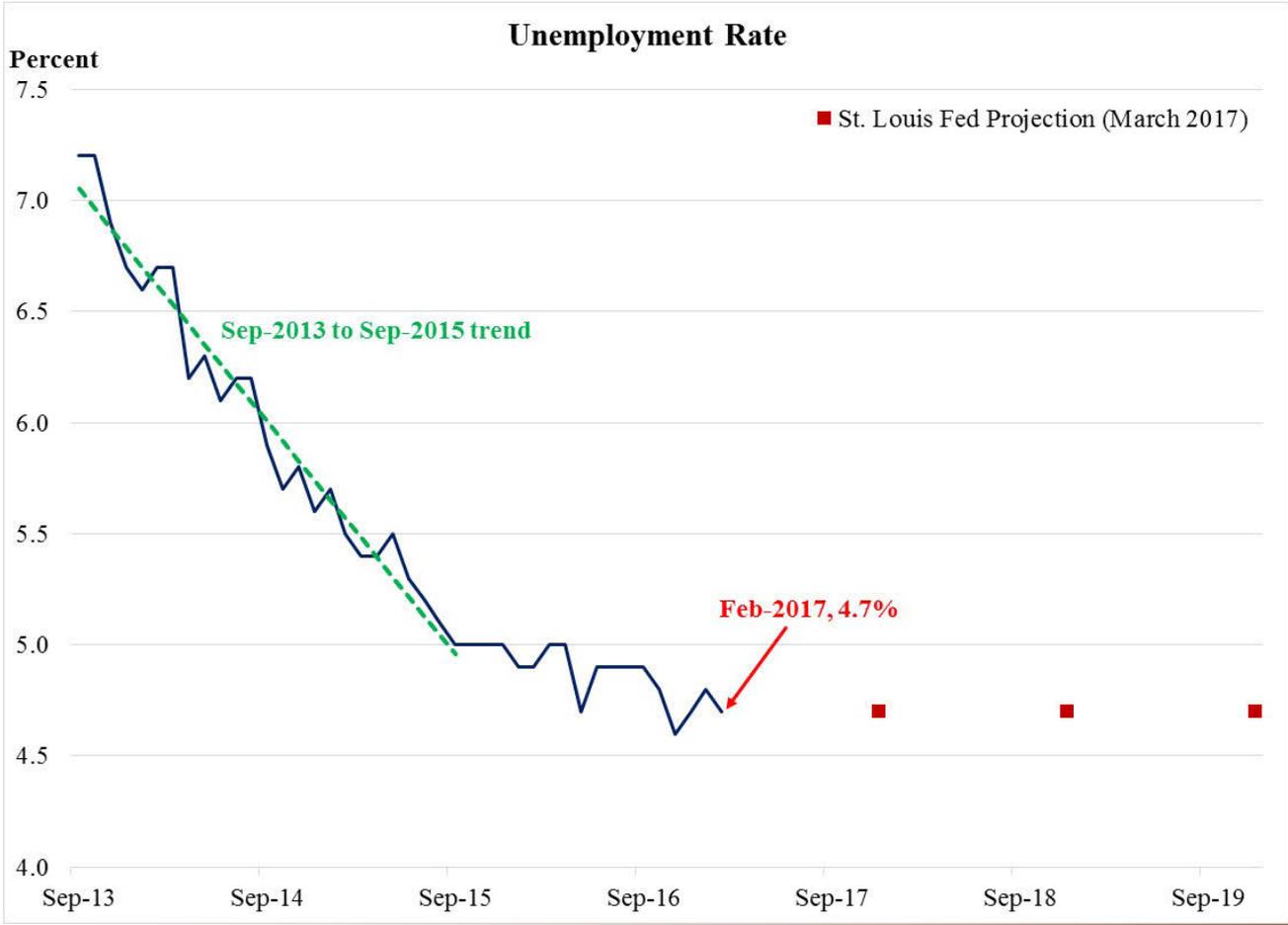
Source	Date	Estimate*
Blue Chip Consensus	March 10	1.9%
Atlanta Fed GDPNow	March 16	0.9%
Macroeconomic Advisers	March 17	1.2%
FRBNY Staff Nowcast	March 17	2.8%
St. Louis Fed Economic News Index	March 17	2.5%
CNBC Moody's Consensus (median)	March 22	1.4%

\* percent change from the previous quarter, annualized

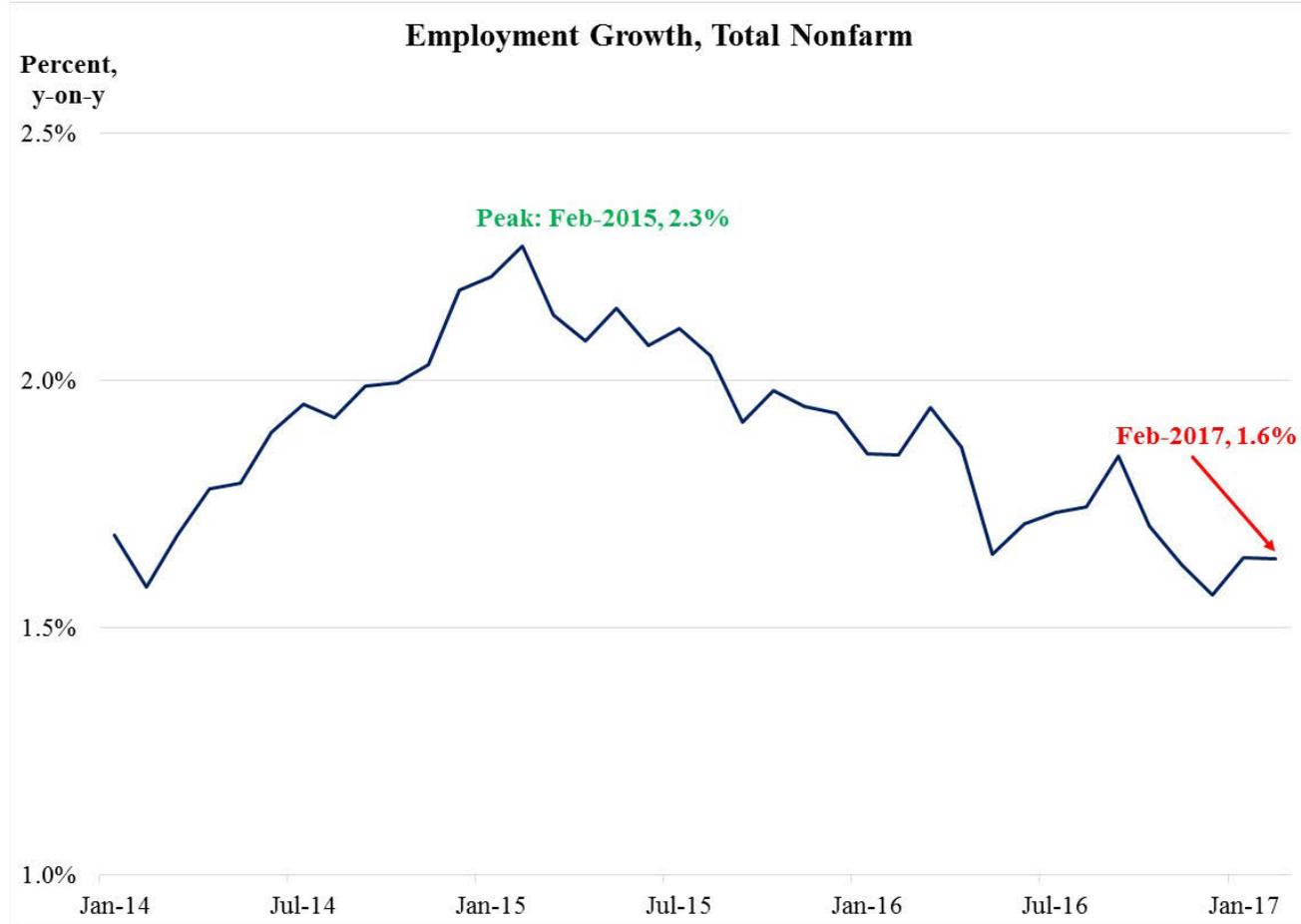
## Labor market improvement is also slowing down

- Labor market improvement has slowed over the last 18 months, despite the attention paid to recent jobs reports.
- The unemployment rate fell to 5 percent in September 2015 and has declined only a few tenths of a percent over the last 1.5 years.
- Nonfarm payroll employment growth measured from one year earlier was 2.3 percent in February 2015 and has slowed to 1.6 percent today.
- Private hours growth measured from one year earlier was 3.4 percent in February 2015 and has slowed to just 1.4 percent today.
- Bottom line: Labor market improvement has been slowing.

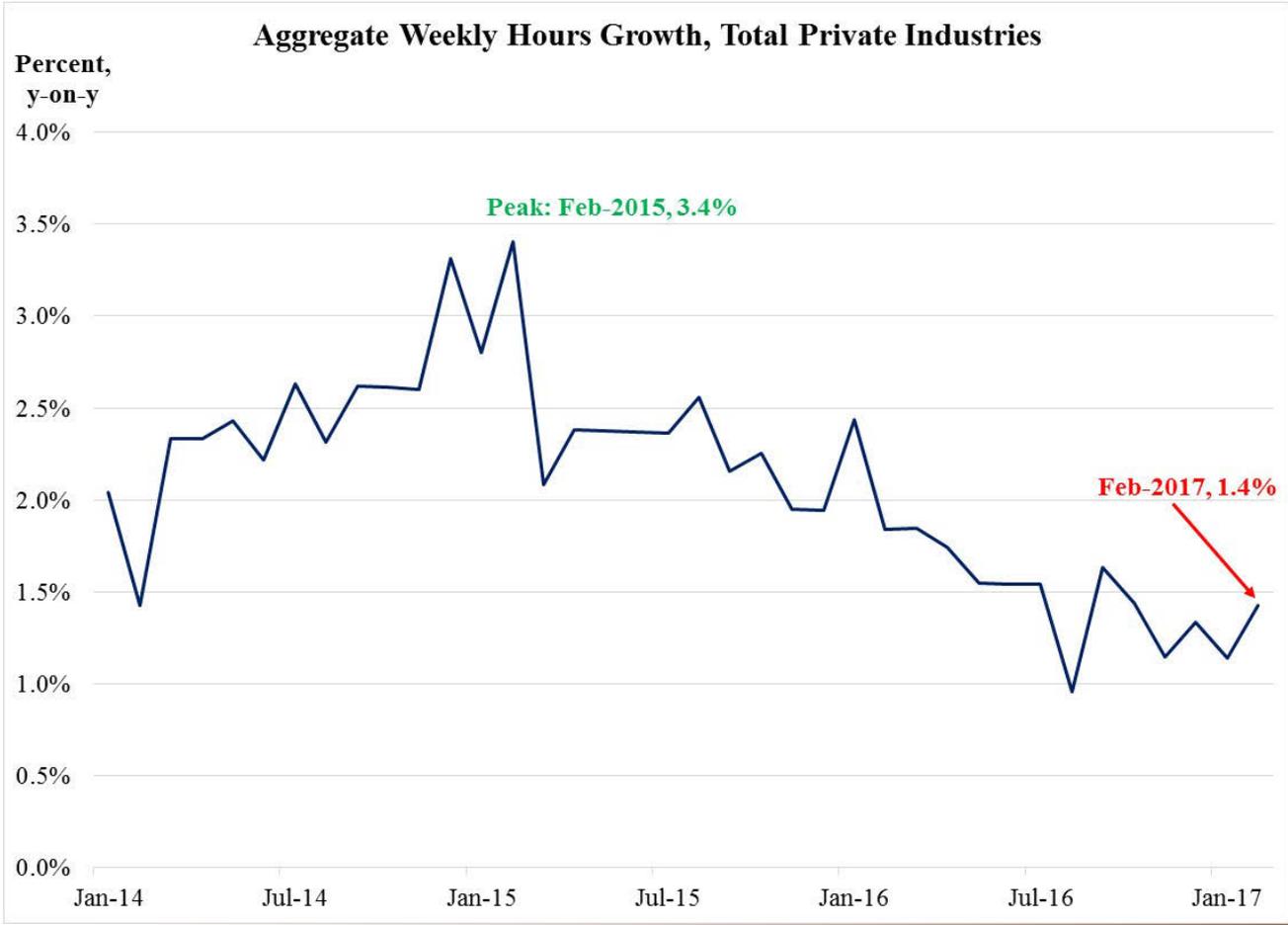
# The decline in the unemployment rate has slowed



## Employment growth has slowed



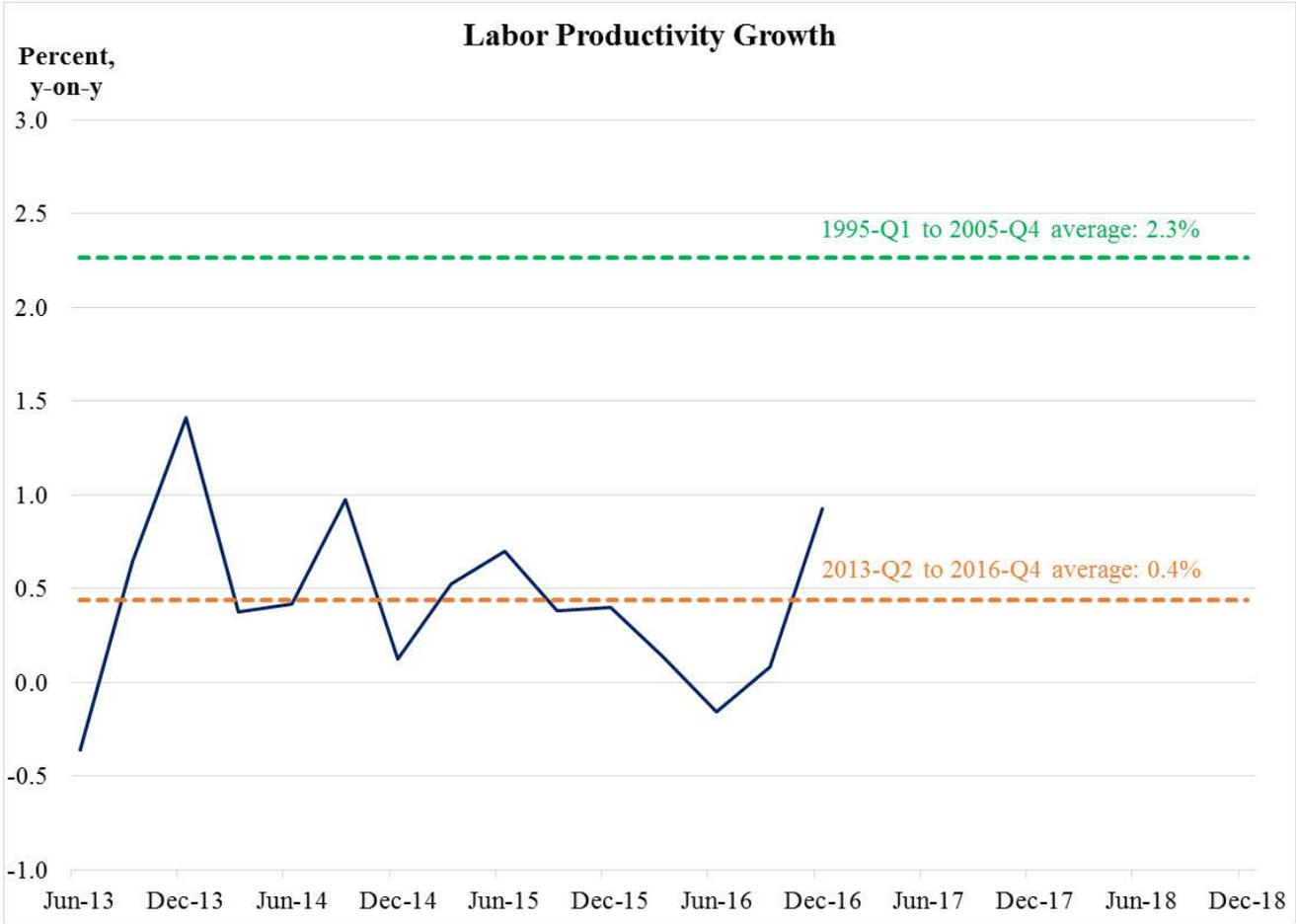
# Hours growth has slowed



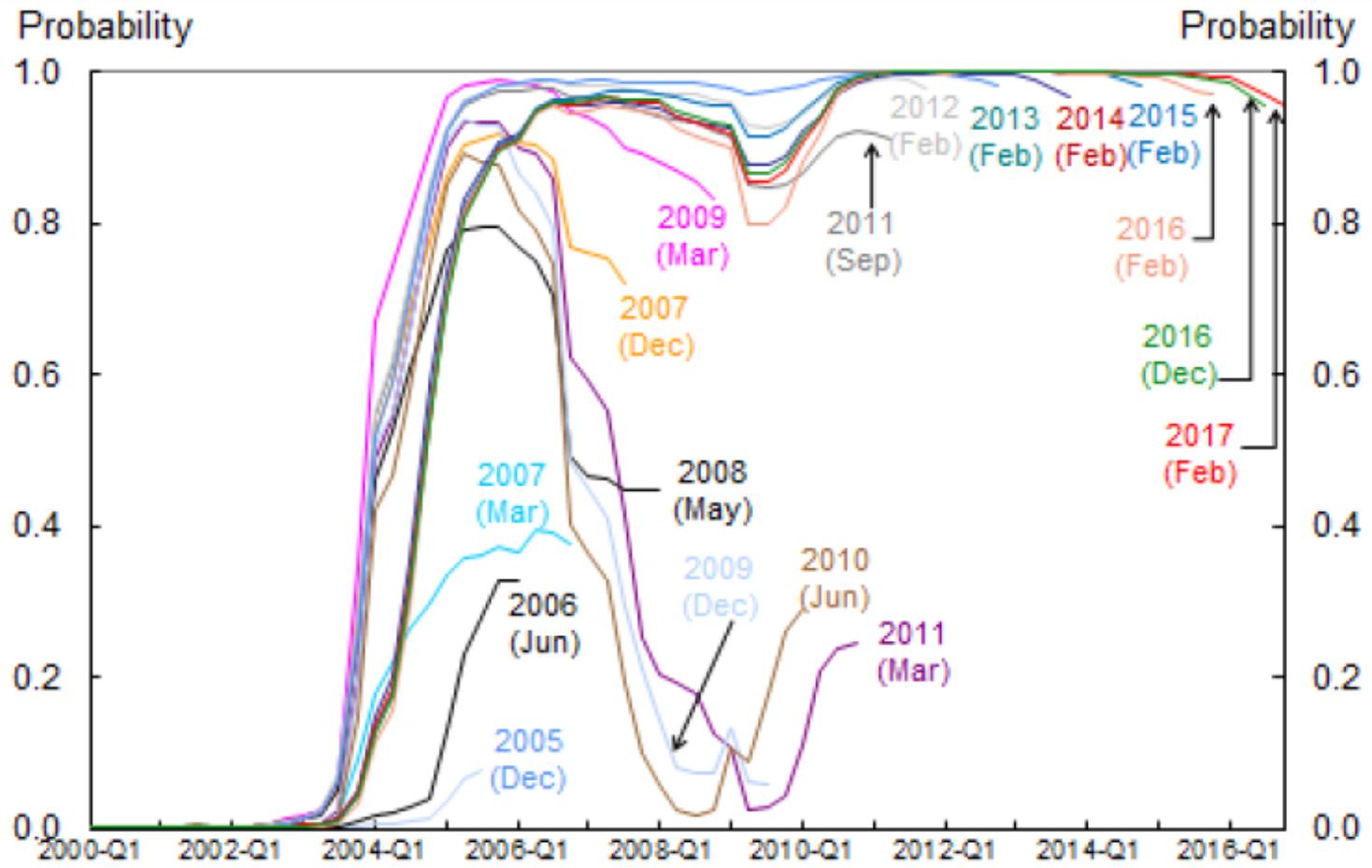
## Why has U.S. economic growth been relatively slow?

- U.S. growth over the medium and longer term is thought to be driven by labor force trends and productivity trends.
- U.S. labor productivity has been growing at an average rate of 0.4 percent since early 2013, whereas it grew at a rate of 2.3 percent per year from 1995 to 2005.
- A statistical model that estimates the probability that the U.S. economy is in a low-productivity-growth regime puts nearly all the probability on the low-growth regime.\*
- Bottom line: Faster productivity growth is the surest path to more rapid real GDP growth in the U.S.

# The high- and low-productivity-growth regimes



# Low-productivity-growth regime probability

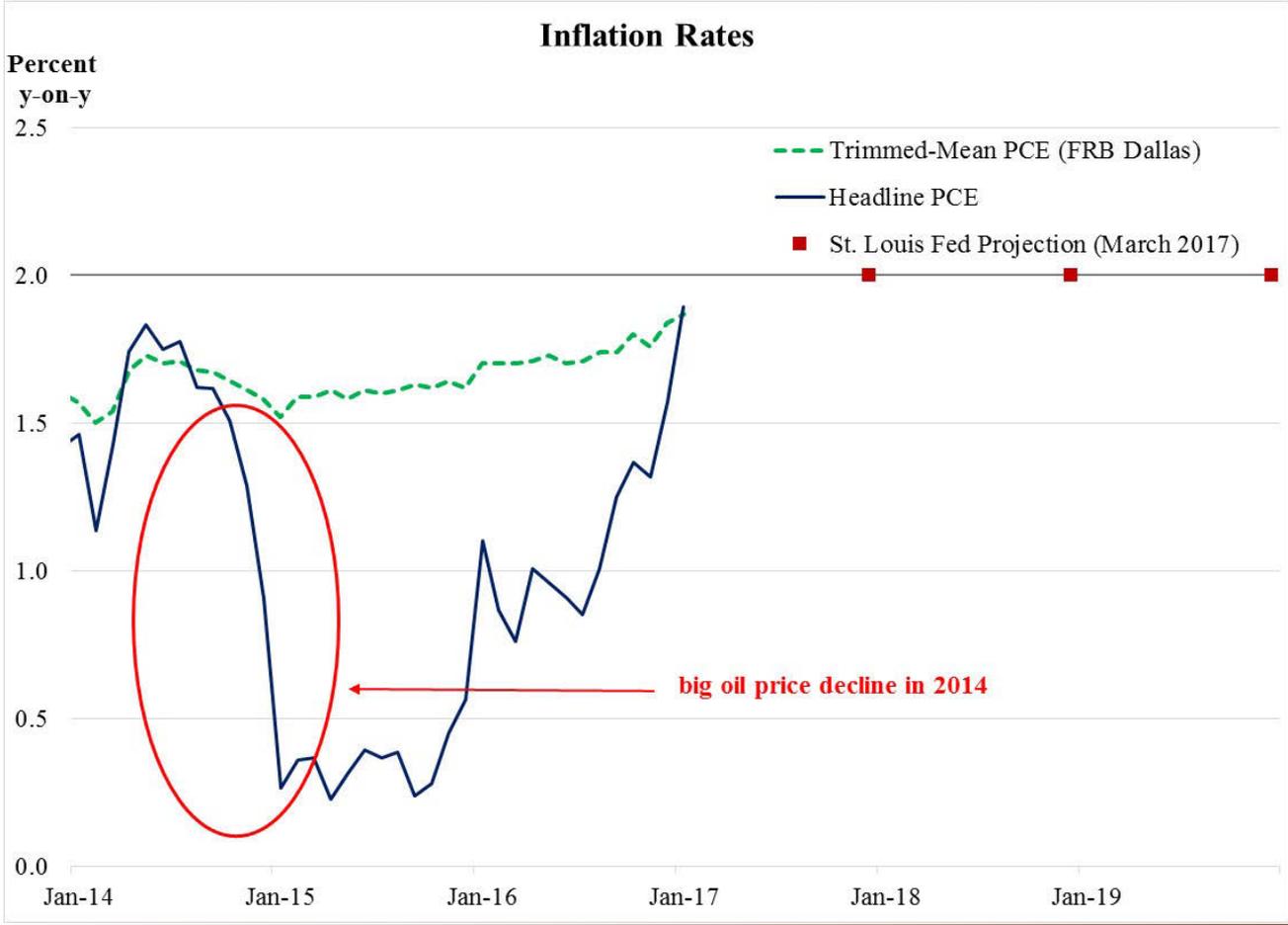


## The impact on inflation: Barely perceptible

---

- U.S. inflation as measured by the Dallas Fed trimmed-mean inflation rate measured from one year earlier has barely increased in the last several years (1.9 percent in January).
  - This measure controls for some of the effects of energy prices.
- Headline inflation measured from one year earlier has also returned to the 2 percent target (1.9 percent in January).
- Bottom line: Inflation has essentially returned to 2 percent and is expected to remain there.

# Inflation essentially at 2 percent



---

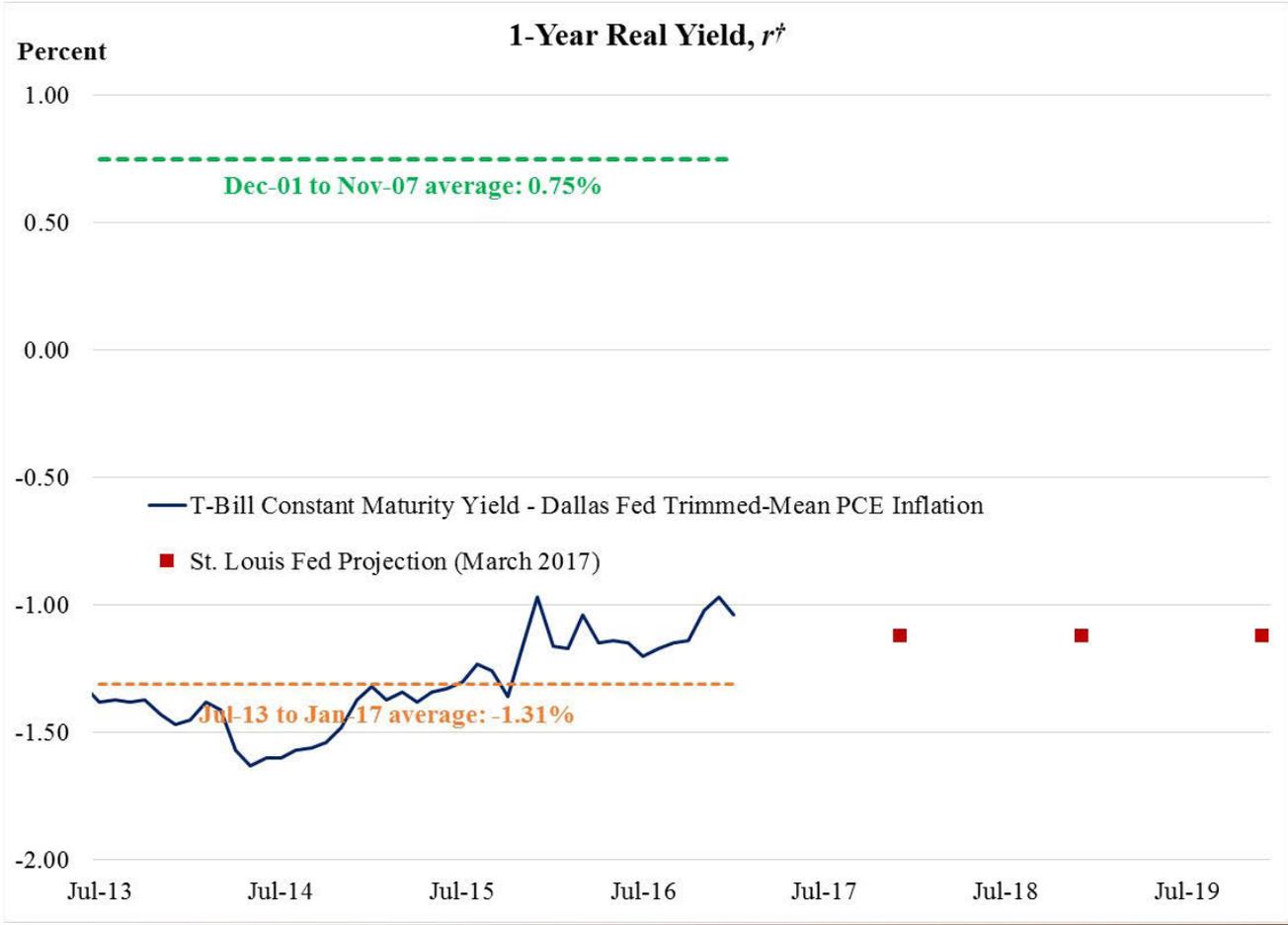
# The Low-Safe-Real-Rate Regime

## The low-safe-real-rate regime: Unlikely to change soon

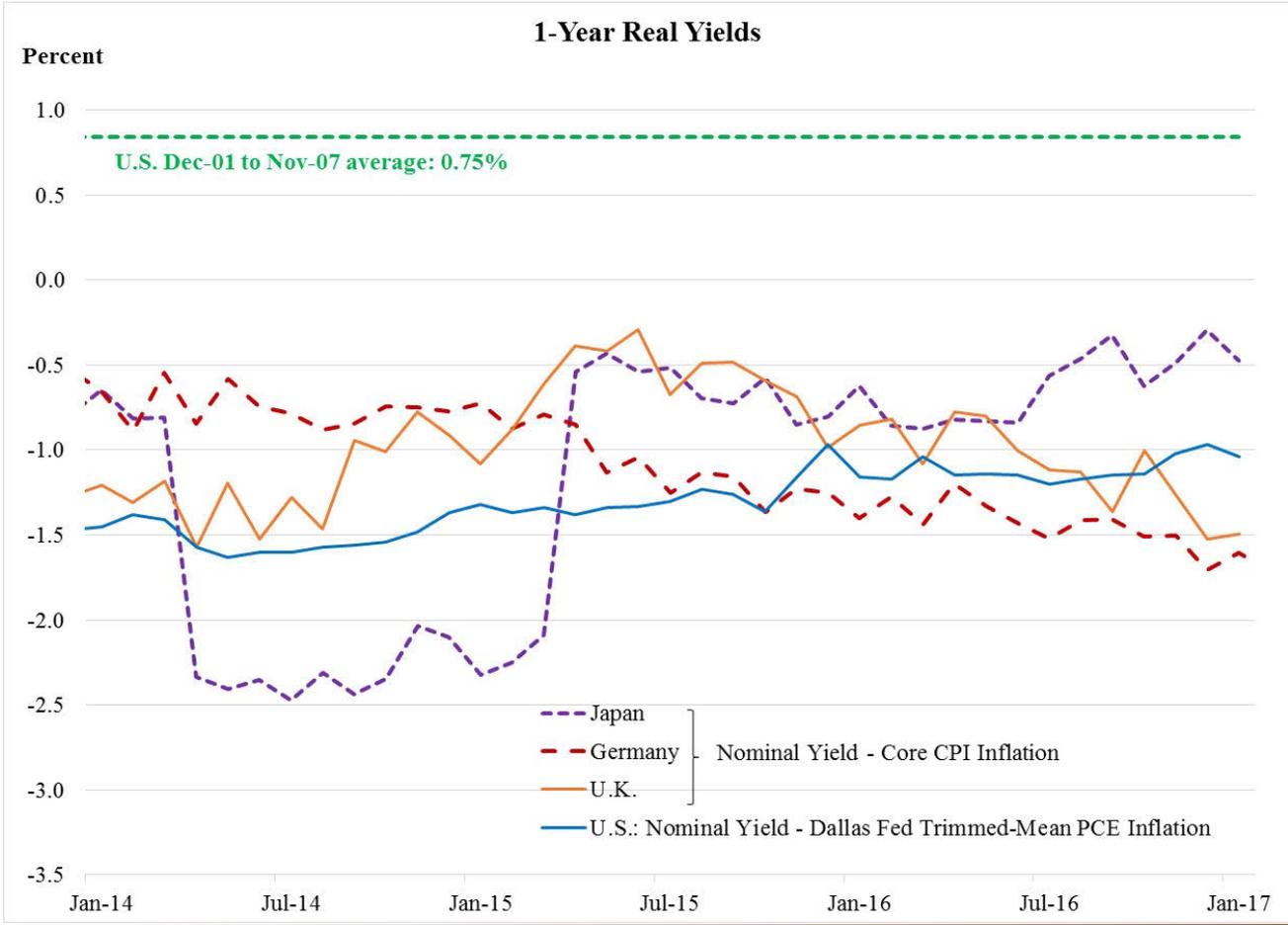
---

- The low-safe-real-rate regime is a global phenomenon.
- The low-safe-real-rate regime has been many years in the making.
- These considerations suggest that the regime will not go away quickly, and so it may be unwise to forecast that the safe rate will rise.
- The Fed's policy rate setting uses the safe rate as a benchmark.
- I conclude that a relatively low policy rate is likely to remain appropriate going forward.

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

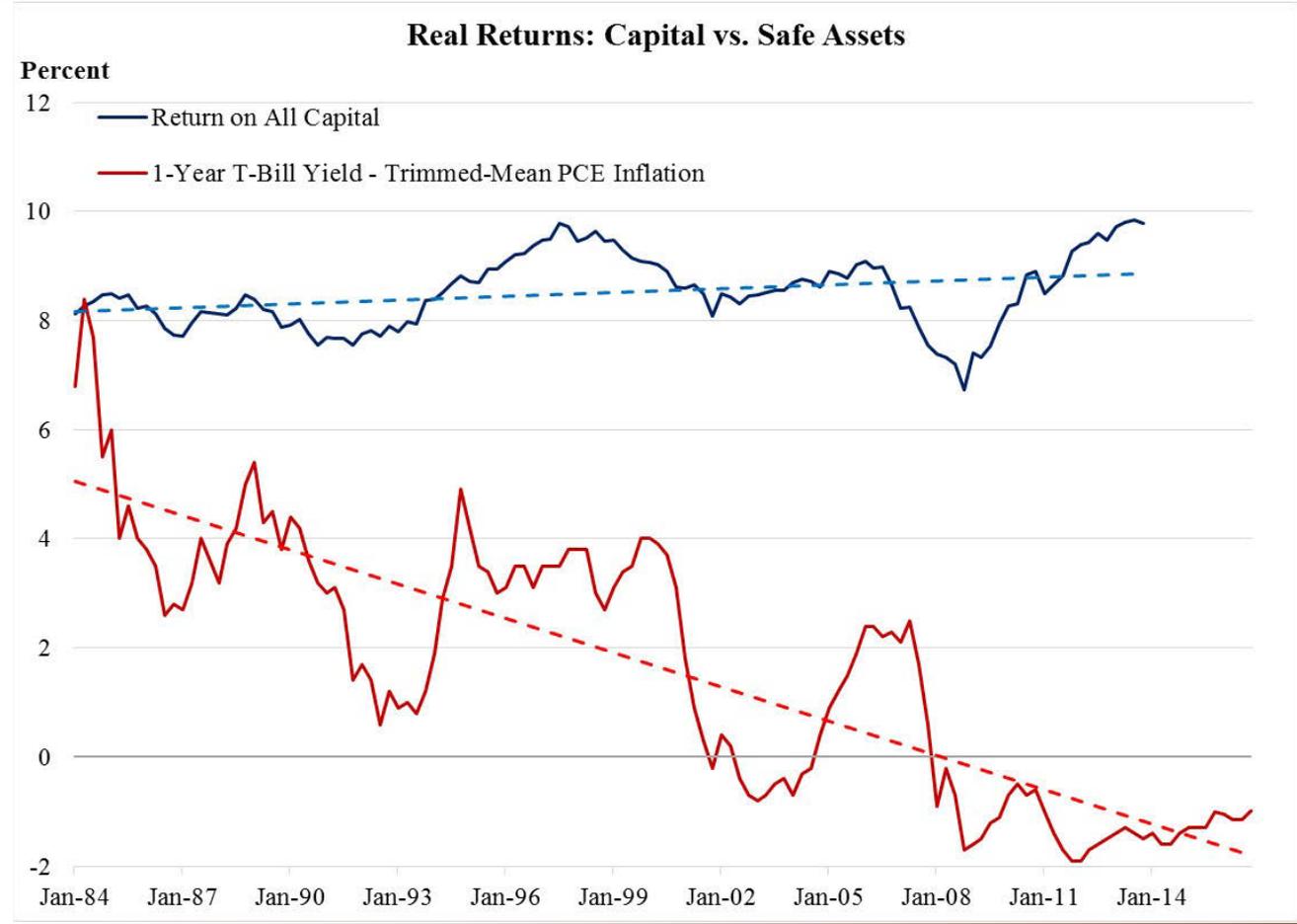


# One-year ex-post real yields are low globally



Source: Haver Analytics and author's calculations. Last observation: Jan. 2017 (U.S., U.K. and Japan); Feb. 2017 (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.
- 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.

---

# Impact of the New Fiscal Policy

## Impact of the new fiscal policy

---

- Will the new fiscal policy move the U.S. into a higher growth 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.
    - However, the Fed can wait to see how fiscal policy develops.

---

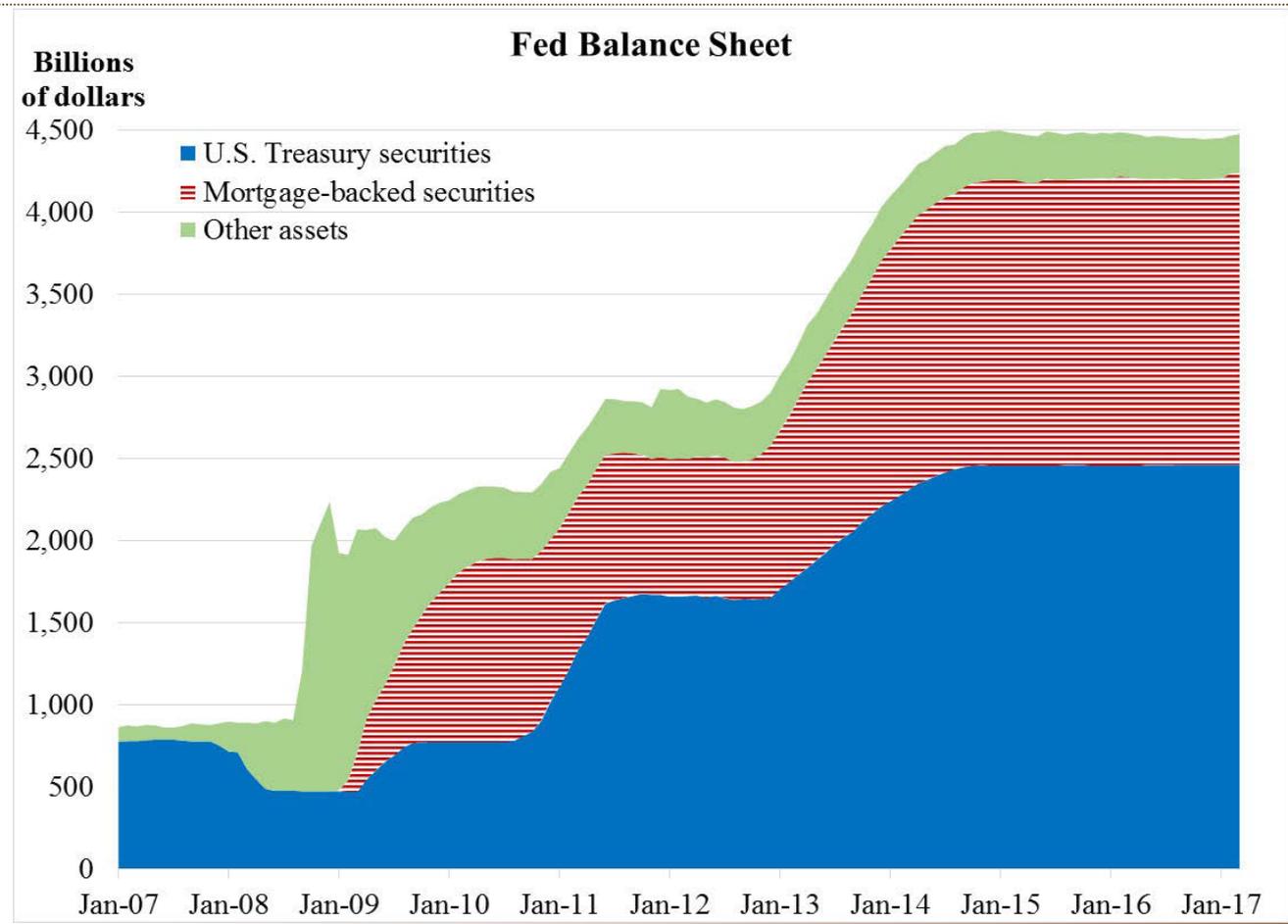
# The Fed's Balance Sheet Policy

## 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 assets



## 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 \$4.48 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.<sup>†</sup>
- 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 \$4.48 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

## Conclusion

---

- The U.S. economy has arguably converged to a low-real-GDP-growth, low-safe-real-interest-rate regime.
- Because of this, the Fed's policy rate can remain relatively low while still keeping inflation and unemployment near goal values.
- The new fiscal policy could impact productivity growth and therefore improve the pace of real GDP growth.
  - The Fed can wait to see how the new fiscal policy evolves.
- Ending balance sheet reinvestment may allow for a more natural adjustment of rates across the yield curve as normalization proceeds.



CENTRAL  
to  
AMERICA'S  
ECONOMY™

***Federal Reserve Bank of St. Louis***  
[stlouisfed.org](http://stlouisfed.org)

***Follow us on Twitter***  
[twitter.com/stlouisfed](https://twitter.com/stlouisfed)

***Federal Reserve Economic Data (FRED)***  
[fred.stlouisfed.org](http://fred.stlouisfed.org)

***James Bullard***  
[stlouisfed.org/from-the-president](http://stlouisfed.org/from-the-president)