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Now may be a good time for the Federal Open Market Committee (FOMC) to begin allowing the balance sheet to normalize by ending reinvestment, St. Louis Fed President James Bullard said at George Washington University in Washington, D.C. He noted that current FOMC policy is distorting the yield curve and that ending reinvestment may allow for a more natural adjustment of rates across the yield curve as normalization proceeds. He also suggested acting now, during relatively good times, in case the Fed must resort to using the balance sheet as a monetary policy tool in a future downturn, as it did when the fed funds rate was closer to zero.

St. Louis Fed's Bullard Discusses the Fed's Balance Sheet and the U.S. Monetary Policy Outlook

WASHINGTON, D.C. – Federal Reserve Bank of St. Louis President James Bullard discussed [“The Role of the Fed’s Balance Sheet for the U.S. Monetary Policy Outlook in 2017”](https://www.stlouisfed.org/-/media/project/frbstl/stlouisfed/files/pdfs/bullard/remarks/2017/bullard_gwu_alumni_lecture_feb_28_2017.pdf)at the George Washington University Alumni Lecture in Economics on Tuesday.

During his presentation, Bullard shared his views on the outlook for the Federal Open Market Committee’s (FOMC’s) key policy rate (i.e., the federal funds rate target) and the Fed’s balance sheet. He noted that inflation and unemployment are now in line with the Fed’s objectives, and that 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,” he said.

Bullard added that now may be a good time for the FOMC to begin allowing the balance sheet to normalize by ending reinvestment. “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," he said.

The Low-Rate Regime

A core issue today is that the policy rate, at just 0.63 percent, appears to be too low when casually compared with past historical experience, Bullard said. He noted that, 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,'" he said. 1

In discussing whether the low-safe-real-rate regime will go away naturally in 2017, Bullard said given that the low-real-rate regime is a global phenomenon and has been many years in the making, it 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," he explained.

Regarding the question of whether the new U.S. administration's policies will drive the safe real interest rate higher, Bullard said, "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."

He noted that potential policy changes in the areas of deregulation, infrastructure spending and tax reform could lead to improved productivity in 2018 and 2019. Other policy proposals, such as those related to trade and immigration, have the potential to affect the macroeconomy over the longer term, he said.

Balance Sheet Policy and the Yield Curve

Turning to the Fed's balance sheet, Bullard noted that the FOMC has not set a timetable for ending its 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," he said. "Adjustments to balance sheet policy might be

viewed as a way to normalize Fed policy without relying exclusively on a higher policy rate path."

In addition, he noted that 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," he explained. Bullard added that a more natural normalization process would allow the entire yield curve to adjust appropriately as normalization proceeds.

A contrasting view is that the balance sheet should not be reduced until the policy rate is higher. For example, Bullard cited a [recent blog commentary](https://www.brookings.edu/blog/ben-bernanke/2017/01/26/shrinking-the-feds-balance-sheet/)by Ben Bernanke in which the former Fed chair highlighted two reasons for keeping the balance sheet at its current size—the effects of changing the size of the balance sheet are uncertain and 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," Bullard said, noting that Bernanke did not address the unusual "twist" of the yield curve in his 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," Bullard said. "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."

He added, "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."

Balance-Sheet Policy Space

Permitting some adjustments to the balance sheet may also create balance-sheet "policy space," Bullard noted.

"Some have argued that the size of the balance sheet should not be reduced until the policy rate is high enough that the policy rate can be reduced appropriately should a recession develop. This is sometimes called 'policy space,'" he explained.

Furthermore, the same "policy space" argument can be made for the size of the balance sheet, he said, adding, "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."

1For more information on the St. Louis Fed's regime-based approach to near-term projections, see the ["Key Policy Papers"](https://www.stlouisfed.org/from-the-president/key-policy-topics)section of Bullard's webpage.

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The Policy Rule Debate: A Simpler Solution

There has been growing public debate over how the Federal Reserve should conduct and communicate monetary policy. Some recent proposals, for instance, would require the Fed to specify a monetary policy rule that it would follow in adjusting the key policy rate (i.e., the federal funds rate