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"Observations on Monetary Policy and the Zero Lower Bound"

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Remarks for a Panel Discussion at the 2020 Spring Meeting of the Shadow Open Market Committee: "Current Monetary Policy: The Influence of Marvin Goodfriend"

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The views expressed today are my own, not necessarily those of my colleagues on the Federal Reserve Board of Governors or the Federal Open Market Committee.

Good afternoon. I would like to thank the organizers of this conference for inviting me to participate on this panel – and more broadly for organizing a conference examining many of the challenges policymakers have faced over the past 20 years. As many of you know, these were challenges that Marvin Goodfriend anticipated, well before the Great Recession forced policymakers to confront them. Specifically, our panel topic – monetary policy and the zero lower bound – is one that Marvin devoted a good deal of thought to. And as I'll touch on today, his emphasis on this topic proved prescient.

I will focus my remarks on his paper, "Overcoming the Zero Bound on Interest Rate Policy," that appeared in the *Journal of Money, Credit, and Banking* roughly 20 years ago. The article was originally written for a Federal Reserve conference held in Woodstock, Vermont, in October 1999 – before most economists were thinking of this as a significant problem.[1]

Indeed, in October 1999, the federal funds rate was 5.2 percent and the Federal Reserve was increasing interest rates. In fact, the funds rate had not been below 2 percent since the early 1960s, despite several severe recessions. The "job-loss" expansion in the mid-2000s had not yet occurred, nor had the Financial Crisis. And despite the developments in Japan, where short-term nominal rates hit zero in 1999, most economists considered it unlikely that the U.S. policy rate would fall to zero. Moreover, the thinking was that in the highly unlikely event it did fall that far, it would be there for only a quarter or two.

For several reasons, Marvin had the foresight to take seriously the possibility of zero interest rates in the U.S. The zero interest rates prevailing in Japan at the time, together with a low-inflation environment in many developed countries, prompted Marvin to revisit and expand on an issue that had been examined previously, in the context of the Great Depression. In fact, I had numerous discussions with Marvin about Japan's "Lost Decade" of the 1990s, and what its relevance could be for future monetary policymaking.

In our conversations and in his 1999 paper, Marvin emphasized two policies that were actually implemented, later, in response to the Financial Crisis – negative interest rates, which were adopted in Europe and Japan; and open market purchases of long bonds, which were implemented in the U.S., Japan, and Europe.

On the first, Marvin highlighted that negative nominal interest rates might be helpful in a significant economic downturn when the policy rate had already reached zero. Although many dismissed this suggestion, given the higher (zero) return to holding currency, Marvin focused on the technical issues regarding the central bank's ability to charge negative nominal rates on bank reserves. Yet Marvin realized that even if policymakers could succeed in charging negative interest rates, and possibly help the overall economy recover, he correctly noted that such a policy could "create stress for lenders and people heavily dependent on interest income."

On the second policy, the open-market purchases of long-term bonds that Marvin discussed were ultimately employed during the Financial Crisis in almost every developed country. He viewed these asset purchases as an important part of the monetary policy toolbox, particularly when short-term rates approached their lower bound. However, he advocated that the U.S. Treasury Department should agree to indemnify the central bank against capital losses. Indeed, he understood the potential political pitfalls a central bank would face in such an environment. I would point out that this type of indemnification was done in the U.K., but not in the United States.

Overall, Marvin showed a great deal of intellectual dexterity at a time when the United States was far from seeing short-term rates approach the zero bound. In many respects, his paper provided a prescient preview of many of the actions ultimately taken by global central banks during the Financial Crisis.

Of course, some of the operational suggestions, such as implementing a carry-tax on currency, were unlikely to get much political traction, despite their potential ability to make his policy suggestions more effective. But the clarity in Marvin's thinking and the boldness of his suggestions highlight the creative intellect that characterized much of his work.

Now that we have the experience of the Financial Crisis and the resulting Great Recession, we should ask ourselves some important questions. What further issues should policymakers consider as we confront the current low-interest-rate environment, given the potential for adverse shocks? And, with more than 20 years of experience since Marvin wrote his paper, what additional concerns should we have?

I'll offer three observations on those questions.

First, Marvin foresaw another element of the current situation that few anticipated – that the equilibrium real rate of interest might fall to a very low level. In fact, in the time since he wrote his paper in the late 1990s, the amount of "space" for monetary policy to operate before hitting the effective lower bound has diminished significantly. Indeed, we are in a low-interest-rate environment for reasons that go beyond the low-inflation environment emphasized in Marvin's paper, and this may have implications for the effectiveness of the policy solutions at the zero lower bound.

Specifically, in June 2007 – prior to the Financial Crisis – the effective federal funds rate and the 10-year U.S. Treasury rate were above 5 percent. While the federal funds rate ultimately fell to zero in 2008, the 10-year U.S. Treasury rate did not, as Marvin anticipated. Long rates at the time remained above zero. Now, however, for a variety of reasons, the federal funds rate is at only 1.1 percent (the target range being 1 to 1.25 percent), and the 10-year U.S. Treasury rate fell below 1 percent this week. As investors are more aware of the likelihood of short-term rates hitting the zero lower bound, they have been more willing to use U.S. Treasury bonds as hedges against recession risk.

On January 21, around the time of the first U.S. coronavirus cases, the 10-year U.S. Treasury rate was 1.8 percent. With on-going concerns about the coronavirus, the 10-year rate declined by roughly 80 basis points. If the economic reaction to the coronavirus does result in the funds rate falling to its effective lower bound, this heightened sensitivity of the 10-year U.S. Treasury rate to adverse news raises the possibility that the 10-year U.S. Treasury rate could follow close behind. In fact, this "co-movement" has been the case for some time in many countries. As a result, there would be little room for the Federal Reserve to lower rates through large purchases of long-term Treasury securities – like it did to make conditions more accommodative in and after the Great Recession – if a recession occurred in this rate environment.

Such a situation would raise challenges policymakers did not face even during the Great Recession. In such a case, as Marvin highlighted in his 1999 article, we should allow the central bank to purchase a broader range of securities or assets. Such a policy, however, would require a change in the Federal Reserve Act. And I agree with Marvin's analysis that if the Federal

Reserve pursued such a policy, it should possess an explicit agreement with the U.S. Treasury Department to indemnify the Fed against losses. Alternatively, the Federal Reserve could consider a facility that could buy a broader set of assets, provided the Treasury agreed to provide indemnification.

Second, while Marvin felt that negative interest rates might be effective and could be made operational, I will say that I remain skeptical. Marvin recognized potential side effects, but I personally view the adverse side effects as likely quite large. Marvin noted negative rates would pose a significant challenge for banks, and I more than agree with him. We need banks to be healthy enough to provide credit and liquidity in challenging economic times.

Compared with banks in the United States, banks in Europe and Japan – where rates have been negative for some time – have lower price-to-book ratios, lower return on assets, and lower leverage ratios. While there are many factors influencing these comparatively lackluster metrics, I would suggest that negative interest rates have been part of the problem.[2]

In my view, negative interest rates poorly position an economy to recover from a downturn. And other actions that have helped support banks in Japan and Europe might not be politically feasible in the United States.

In addition, many developed countries have financial stability authorities that have tools to potentially limit excessive leverage for households and firms. It is important to note that the United States has no such organization with the authority and tools to restrain excessive leverage from developing in a low-interest-rate environment. And while the U.S. Congress could, for example, limit the tax deductibility of debt when it involves excessive leverage, such tax reform seems unlikely any time soon.

Third, and finally, I view the recent experience of countries with negative rates as evidence that such a policy would not be particularly successful in stimulating economic activity. In part, concerns with retirement and pension arrangements in an environment of negative rates have caused saving rates to rise, not fall, in some of these countries – meaning that consumers are less willing to spend and fuel the economic recovery. In addition, firms' behavior does not seem to respond very strongly to negative rates. Further, while the exchange rate effects from interest rate changes can be important for firms, they become virtually nonexistent if every country moves their rates into negative territory.

In a low-interest-rate environment, the obvious alternative to monetary policy in a downturn is to depend on fiscal policy shouldering a greater share of the burden for providing needed stimulus to the economy. Somewhat surprisingly, there seems to be little movement toward making automatic stabilizers more prominent, or preparing to invest significantly more in the sorts of public investment projects that yield positive returns.

In 1999, Marvin Goodfriend was able to consider what had not occurred in the recent past, and contemplate bold alternatives. Over the next few years, that type of vision and boldness will be needed by all policymakers if we have to consider how policy should react to any large, adverse shock to the economy.

Thank you.

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[1] See Goodfriend, Marvin, "Overcoming the Zero Bound on Interest Rate Policy" – at the conference *Monetary Policy in a Low-Inflation Environment* in Woodstock, VT, published in the *Journal of Money, Credit and Banking, November 2000 Part 2,* and at https://www.richmondfed.org/publications/research/working_papers/2000/wp_00-3.

[2] For additional discussion, see Nov. 11, 2019 remarks by Eric S. Rosengren: *Financial Stability and Regulatory Policy in a Low Rate Environment*.