Remarks by Dennis Lockhart, former president and CEO, Federal Reserve Bank of Atlanta, at Global Interdependence Center meeting, December 13, 2019, in Philadelphia

Key points:

- Since leaving the Fed in 2017, I have been paying more attention to the broad operating context in which the Fed and other central banks are making policy. By 'operating context' I mean the scope of what is possible in policy reaction to economic developments. This can be called the 'policy space' available for reaction to developments, particularly an adverse economic reversal or downturn.
- The operating context and associated policy space have been evolving since the financial crisis of 2007-8. When the crisis hit, the scope for policy rate cuts was substantial compared to today. When I joined the Federal Reserve in 2007, the Federal funds rate was set at 5 ¼%. By December 2008, the Federal Open Market Committee was able to cut the policy rate by 500 basis points to the effective lower bound of 0.0% to 0.25%.
- The balance sheet of the Federal Reserve system was small in 2008-9 (approx. $800-900 billion) compared to its peak in 2014 ($4.5 trillion). Bank reserves held at the Fed were limited compared to today's level of reserves.
- A "new abnormal" coalesced toward the end of 2019 characterized by…
    - a low policy rate (1.5% to 1.75%, after three cuts in 2019)
    - a much lower estimated neutral policy rate,
    - a large balance sheet—even after substantial 'normalization'
    - moderate economic growth
    - low, below-target inflation
    - negative policy rates in much of the world, exerting some gravitation pull on U.S. interest rates
- This is the context in which the FOMC will be deliberating on policy in 2020. This set of circumstances gives the FOMC **limited 'policy space'** to react to a severe downturn. These circumstances could last for a while. They may morph from new abnormal to new normal.
- There are several implications:
    - The FOMC may have to operate monetary policy at the effective lower bound more frequently. The chances of returning to a policy rate range of zero to ¼% are greater than they were historically. Resort to a policy rate below zero is unlikely, but not to be completely ruled out.
    - The FOMC has limited tools to employ either singly or in combination. At present, the Committee has 6 policy rate cuts of 25 basis points in reserve. After, or possibly somewhat before, hitting zero, alternative tools include the resumption of quantitative easing, attempts at yield curve management, and forward guidance in various forms. All these

tools have some history either in the United States or elsewhere. There are not a lot of new ideas being mentioned in current discussion.

  - Two extreme tools may be available—negative policy rates and so-called 'helicopter money'. Neither is likely to be employed in the U.S. except in the most extreme circumstances.
  - The potency of available tools is debatable. It has been argued that the U.S. economy is just not that rate-sensitive anymore. The minutes of the October FOMC meeting mentioned a view expressed by some participants that quantitative easing may not be so potent when starting at already low longer-term rates. Negative policy rates in Europe and Japan have certainly not worked miracles.
  - Operating monetary policy near the zero lower bound may require a pre-emptive bias in decision making. This is the 'ounce of prevention' approach mentioned frequently by Chairman Powell over 2019. This approach would necessarily put greater weight on identifiable risks to the economy than signals from current data. While data dependence may remain sacrosanct rhetorically, actual decisions may be made on less fulsome data evidence of what is really happening. Such a pre-emptive bias would entail the risk of false positives. For example, in some, but not all, recent years the first quarter was surprisingly weak. This development presented the Committee the dilemma of having to take the weak data seriously or "look through" first quarter weakness. Going forward, there will be some tension between adherence to data dependence--with its imperative of exercising patience to distinguish signal from noise--and acting pre-emptively to forestall downturns.
  - This set of circumstance puts ever more reliance on effective communications with both the financial community and the general public. Now that I am outside the Federal Reserve, it's my opinion that the FOMC and individual policy makers communicate effectively, for the most part, with financial market participants, but not so well with the general public. I doubt that some Fed messaging much penetrates the consciousness and behavior of the broad public. If a major aspect of future Fed communication is an effort to influence the inflation expectations of the broad public, continuing refinement of communication methods must be a priority. I applaud past experimentation with various communication channels and media.
- The theme of this talk has been the FOMC's reality of limited monetary policy space. Add to this one more constraint in responding to a severe downturn—limited fiscal space. Given the current fiscal situation and political dysfunction at the Federal level, it is hard to put high odds on an appropriate fiscal response in combination of the Fed's monetary policy.

- These remarks have been intended to be cautionary, not fatalistic. The circumstances that limit policy space may be persistent, however. I am prepared to believe they may last because I see long-slog factors such as demographics among the fundamental drivers of potential growth, inflation, estimates of the neutral policy rate, and resultant policy space in the event of a shock or severe downturn.