Why Have the Fed's Policies Failed to Stimulate the Economy?

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The Fed's sustained low policy rate, quantitative easing (QE), and forward guidance have stimulated financial markets and boosted asset prices but have failed to stimulate the economy. As planned, the Fed's efforts to lower bond yields and reduce the real cost of capital, encourage risk taking, and lift stock and real estate values have succeeded. But nominal GDP growth has actually decelerated to 2.5 percent in the last year from its subdued 3.9 percent average pace of the prior six years, and real growth has languished.

The most disappointing aspect of the slow economic expansion has been the weak rise in business investment. Consumption and residential investment have grown fairly steadily. But despite lower costs of capital and only modest increases in labor costs, investment has fallen persistently below expectations while employment gains have actually been strong. Labor productivity has risen at a painfully slow 0.5 percent pace in the last six years and has fallen in the last three quarters, a unique trend during modern economic expansions. These trends have far-reaching implications.

In response, estimates of potential growth and the natural rate of interest have been reduced sharply. The Fed has delayed normalizing rates, and bond yields hover near historic lows. Even with

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mounting evidence that monetary policy is having little stimulative impact on the economy, a constant Fed theme has been that as long as inflation is below its longer-run 2 percent target and inflationary expectations remain well anchored, sustaining monetary ease is appropriate. This theme presumes that the economy is constrained by insufficient demand that may be remedied by monetary policy. Until recently, very few Fed members have challenged that assessment.

Recent trends make it increasingly clear that economic performance has been constrained by factors that are beyond the scope of monetary policy and that the Fed's policies are contributing to mounting financial distortions with unknown consequences. Such policies are inconsistent with the Fed's macroprudential risk objectives—a point emphasized by Peter Fisher (2016).

Factors Constraining Investment and Growth

Standard explanations of weak investment are that business capital spending has been slowed by the rising share of GDP in less capital-intensive production, particularly in some labor-intensive services, rising investment overseas (that is not measured in GDP), and measurement issues. The largest U.S. companies based on market capitalization are investing less in traditional physical capital than the largest companies in prior decades. Measurement problems center on the challenge of fully capturing information technology, human capital, and intangible capital in the National Income and Product Accounts. These factors likely explain part of the weakness in measured domestic investment and GDP.

Government policies have been a key source of the weak investment and economic growth. The negative impact of the rising public debt overhang and expectations of future tax increases on potential growth has been widely discussed (Reinhart, Reinhart, and Rogoff 2012). In addition, a growing web of government regulations (at the federal, state, and local levels), mandated expenses, and higher tax burdens have weighed on the investment environment and constrained growth. Higher tax burdens have stemmed from administrative rulings as well as rate increases. Considered separately, the vast majority of these policies has had little impact on macroeconomic performance. However, they combine to increase aggregate operating costs, distort production processes and labor inputs, and lower after-tax rates of return on investment. Anecdotal evidence and business survey results reflect these negative impacts, but their cumulative effects are not captured in standard macro models, including the Fed's FRB-US model. They also influence household spending and financial decisions.

While the Fed's monetary policies have lowered real costs of capital, the governments' economic policies and expectations of higher taxes, more mandated expenses, and additional regulatory burdens in the future lower expected rates of return on investment and add a layer of uncertainty. Businesses considering a five- or seven-year investment project certainly take into account the possibility of higher taxes and regulatory burdens over the duration of the investment project. These expectations raise the "hurdle rates" on business investment decisions and offset the benefits of the lower costs of capital. Consequently, businesses take a more conservative approach to investment spending: replacing aged equipment and software, while trimming some large expansion plans. Businesses also have an incentive to expand overseas and purchase foreign firms for tax reduction purposes ("tax inversions").

In response to some government-mandated expenses and labor laws, businesses are changing labor inputs and relying more on part-time workers. With less investment spending, businesses also invest less in training employees on how to use new capital. This reduction in capital and on-the-job training contributes to weaker labor productivity.

Businesses are taking advantage of the Fed-induced low yields to issue bonds but are using the proceeds to buy back shares to meet the demands of yield-hungry investors. The rising corporate leverage and higher cash distributions to stockholders are efficient from a corporate perspective but result in less investment and lower potential growth.

Household behavior is also affected. Dimmed expectations of future disposable incomes have led to more precautionary saving, and real consumption has not kept pace with real disposable incomes. Households are allocating more out-of-pocket spending to medical care and health insurance, in part due to the Affordable Care Act, so they have less to spend on other goods and services. Tight mortgage credit standards and more onerous administrative costs have constrained mortgage originations.

The negative economic impacts of government policies are structural and beyond the scope of the Fed to remedy through monetary policy. Potential growth has been constrained. Prior to 2008–09, potential growth was estimated to be approximately 2.6 percent but is now closer to 2 percent—the Fed's latest estimate is 1.8 percent. This is a dramatic shift, with a huge cumulative economic impact.

Throughout most of this expansion, the Fed has argued that the weak economic growth and labor market underperformance have been due to insufficient demand. This position has supported the view that aggressive monetary ease is needed to stimulate the economy. The Fed has frequently argued that had it not pursued aggressive monetary ease, economic performance would have been much worse. That argument may be appropriate in describing the success of the Fed's alternative liquidity facilities and the first round of QE, but it grossly overstates the efficacy of monetary policy in recent years.

In the nearly six years since the Fed initiated QE2 (followed by "calendar-based" forward guidance, Operation Twist, QE3, and the use of various moving targets to signal its wish to sustain the negative real Fed funds rate), the deceleration of GDP growth and subdued business investment highlight the nonmonetary nature of the disappointing economic performance that is beyond the Fed's ability to influence. The Fed's assertion that its monetary policy has generated several million new jobs during this period is implausible.

Noteworthy, former Fed Chair Ben Bernanke stated in a recent blog that there may be supply constraints that are inhibiting economic growth, and if so, the Fed cannot do anything about it (Bernanke 2016). This is an important acknowledgment by the influential former Fed Chair. Leading economic media may also be acknowledging the Fed's limitations; witness a recent *Wall Street Journal* front page headline: "Central Bank Tools Losing Their Edge" (Ip 2016).

Recently, the Fed's view has evolved toward a growing perception that its monetary policy is having a diminishing economic impact. At the same time, some Fed members are expressing concerns about mounting financial distortions. The three official dissents at the September 2016 FOMC meeting and votes of 8 of 12 Federal Reserve District Banks recommending an increase in the discount rate in July reflect the increasing unease at the Fed about its current policy. (The Board of Governors voted to keep the discount rate unchanged.)

A Lower Natural Rate of Interest

The natural rate of interest has fallen as expected rates of return have declined and potential growth has been reduced by weak investment and productivity. These trends have heightened pessimism and lowered expectations about the future. In describing the fundamental linkages between economic performance, the time preferences of households, and the natural rate, Marvin Goodfriend (2016) emphasizes the important role of taxes, regulations, markups, and other distortions underlying the pessimism about future incomes that have driven down the natural rate. Although persistently poor performance and diminished expectations about future incomes have lowered the natural rate of interest, nobody knows with any precision what the natural rate really is. The Fed's projections imply a natural rate of 0.9 percent (the median FOMC member projects a 2.9 percent longer-run Fed funds rate and the Fed's inflation target is 2 percent). Presumably, the Fed's estimate of potential growth of 1.8 percent is consistent with a positive real rate of return on capital and a positive natural rate of interest.

This implies that the Fed's monetary policy is very accommodative, with its current real policy rate of minus 1 percent and its extremely large balance sheet. Such policy is inconsistent with the Fed achieving its dual mandate.

What Should the Fed Do?

The Fed should commence raising rates toward a neutral rate consistent with its estimates of potential growth and its 2 percent inflation target and shift the focus of its communications to emphasize how monetary policy is limited in its ability to achieve the Fed's dual mandate while deemphasizing short-run economic and market concerns. The Fed must cease altering policy in response to global and financial turmoil that does not materially influence the U.S. economy and make clear that volatility is a normal characteristic of financial markets. The Fed's effort to be transparent must involve articulating how economic performance is influenced by other policies and real factors that are beyond the Fed's scope.

Gradually raising rates would leave the Fed's easy monetary policy intact, maintain a negative real Fed funds rate and plentiful excess bank reserves, and would not harm economic performance. History shows clearly that during economic expansions when the

Fed raises rates from an accommodative stance of monetary policy, growth is sustained. A clear Fed explanation of why it is normalizing rates—and why it is no longer delaying raising rates—would boost confidence. The Fed projects that real GDP will grow at a 2 percent pace through 2018, slightly above its estimate of potential growth, even as it raises rates along the Fed's estimated appropriate path (the so-called dots in the Fed's official September projections). The Fed must align its monetary policy with its forecasts.

In addition, the Fed should stop using its bloated balance sheet as a forward guidance signaling device and cease reinvesting the proceeds of maturing assets. Allowing for a very gradual unwinding of excess reserves without any outright sales would have no impact on credit supply. The low bond yields that have resulted from the Fed's forward guidance have not stimulated capital spending or the economy, and the excess reserves that exceed $2.5 trillion only add to financial distortions. Any modest increase in bond yields from current very low levels would have negligible economic impact.

A clearer explanation by the Fed of the nonmonetary policies and factors that have contributed to lower potential growth, weak capital spending and productivity, and structural unemployment would help steer the policy debate toward the issues that really matter for economic performance. The Fed needs to correct the misperceptions that monetary policy is capable of managing every aspect of economic performance and that activist monetary policy is necessary because the government's economic and fiscal policy processes are dysfunctional. Monetary ease cannot offset or cover up for misguided tax, spending, and regulatory policies. The Fed should also spell out clearly how its easy monetary policies influence federal budget and fiscal policies.

Such clarity may not sit well with Congress, which has come to rely excessively on the Fed, but it would reset monetary policy and enhance the Fed's credibility.

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