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Monetary Policy, Bond Returns and Debt Dynamics[☆]Antje Berndt^a, Şevin Yeltekin^b^a*Poole College of Management, NC State University, 2801 Founders Drive, Raleigh, NC 27695 and RSFAS, Australian National University*^b*Tepper School of Business, Carnegie Mellon University, 5000 Forbes Avenue, Pittsburgh, PA 15213***Abstract**

Using the government's intertemporal budget constraint, we quantify the contribution of returns paid on the U.S. government's debt portfolio to the evolution of the debt-to-GDP ratio. We show that announcements of unconventional monetary policy measures by the Federal Reserve between 2008.IV and 2012, as a part of macroeconomic stabilization, were associated with a sizable increase in returns and debt-to-GDP ratios and contributed to fiscal imbalances. We use the Federal Reserve's portfolio composition as a proxy for unconventional monetary policy measures and show that it is significantly related to future bond returns and fiscal balances. (*JEL* C5, E4, E6, G1, H6)

Keywords: monetary policy, debt dynamics, bond returns, predictability

1. Introduction

The 2007-08 financial crisis and subsequent recession have led to unprecedented efforts by the Federal Reserve to stabilize the financial sector and real economy. After driving short-term interest rates to record lows in 2008, the Federal Reserve employed unconventional monetary policy measures such as Quantitative Easing (QE) and Operation Twist (OT) to aid in financial and economic recovery. Just like any other major policy choices, these unconventional measures were associated with important trade-offs: the benefit of financial and economic stabilization versus the potential exposure of the Federal Reserve to income and balance-sheet risks, amongst others.

A growing literature has been investigating certain aspects of these trade-offs. While some papers concentrate on the benefit side and assess whether unconventional monetary policy succeeded in reducing borrowing costs for households and firms, others explore the income and balance-sheet risks facing the Federal Reserve, after its unprecedented large-scale asset purchases.¹ Our contribution is to evaluate the impact of unconventional monetary policy on fiscal balances, an issue that has not been addressed in the literature. Such an analysis is particularly relevant as the recent unconventional monetary policy actions have been coincident with large government deficits, rapid increases in debt and concerns over fiscal limits.

Fiscal limits are not only relevant for future government spending and tax policies, but also impose constraints on the Federal Reserve's ability to control inflation and effectively conduct monetary policy. Such arguments are presented by Leeper (2009), Cochrane (2011), and Davig et al. (2011). They are reminiscent of the "unpleasant monetarist arithmetic" of Sargent and Wallace (1981), in which growing fiscal imbalances near fiscal limits put unremitting pressure on inflation to reduce the real liabilities of the federal government, even when monetary policy is tight. Our focus is on understanding how monetary policy itself, especially unconventional monetary policy, may contribute to fiscal imbalances, which in turn could limit the effectiveness of monetary policy in the future via the unpleasant monetarist arithmetic.

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¹ See Section 2 for a discussion of this literature and specific references.

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