St. Louis Fed's Bullard Addresses Issues Facing Near-Term Monetary Policy; Warns Against Over-Emphasis on Output Gap to Gauge Inflation Risks

10/11/2009

ST. LOUIS—During a speech Sunday at the 51st annual meeting of the National Association for Business Economics, St. Louis Fed President James Bullard reaffirmed the need for a Taylor-type policy rule for the Federal Reserve's asset purchase program. Such a rule would help communicate how asset purchases may be adjusted as economic conditions change, while remaining consistent with the Fed's goals of ensuring price stability and sustainable economic growth, he said.

Bullard also expressed concern that inflation risks in the medium term may be higher than widely believed. He said that too much emphasis is being given to the idea that the recession implies that the output gap is currently quite large, minimizing the risk of inflation.

He also proposed a different framework for how U.S. monetary policy could be implemented in the future using interest on reserves held at the Fed. A similar structure is already in place at several other central banks.

Bullard's presentation, "Three Issues for Near-Term Monetary Policy," is available online.

MONETARY POLICY

On current monetary policy, "the key issue is how to think about the asset purchase program," Bullard said. "Liquidity programs are shrinking, but the asset purchase program is only partially complete."

He added that while the asset purchase program is considered a successful tool for quantitative easing, it has also caused a large and persistent increase in the monetary base. "This may lead to inflation in the medium-term, depending on markets' expectations of monetary policy going forward," Bullard said.

Prior to December 2008, the Fed communicated its monetary policy via adjustments in interest rates. However, with nominal interest rates currently near zero, the likely path of the Fed's monetary policy is now unclear to financial markets.

"Good policy means that the Fed needs to communicate to the private sector how it intends to react to shocks in the future," Bullard said. "There has been little indication of how or whether these [asset purchase] amounts might be adjusted given incoming information on economic performance. This lack of clarity has created uncertainty in financial markets."

Bullard called for the development of a quantitative rule for monetary policy in the current environment. "We have spent 20 years refining ideas about interest rate rules and optimal monetary policy," Bullard said. "We should now consider quantitative rules because we are at the zero bound, and may remain there for some time depending on how the economy performs."

FUTURE IMPLEMENTATION OF MONETARY POLICY

Going forward, Bullard said the Fed's ability to pay interest on reserves—an authority granted to the central bank in the fall of 2008—could serve as a new tool in the implementation of monetary policy in the U.S. He pointed out that many other central banks around the world operate with three rates:

- an interest rate paid on deposits at the central bank,
- a lending rate for loans from the central bank and
- a policy rate that lies between the two.

"The Fed could implement monetary policy differently," he said. "It could implement the lending and deposit rates via standing facilities. The stance of policy would then depend on all three rates, although they might often be adjusted together."

THE OUTPUT GAP

Bullard also cautioned that policymakers should not place too much emphasis on output gap estimates when trying to assess inflation risks in the medium-term.

"I am concerned about a popular narrative in use today—the narrative being that the output gap must be large since the recession is so severe," he said. "And so, any medium-term inflation threat is negligible, even in the face of extraordinarily accommodative monetary policy. I think this narrative overplays the output gap story."

He added that measuring the gap is very difficult, both theoretically and practically. He cited research that shows much of the inflationary run-up in the 1970s can be attributed to a misreading of the output gap at the time.

"Even if economists were to accept a particular measure, the empirical relationship with inflation is not robust," he said. In addition, traditional output gap measures do not account for the concept of bubbles.

"It has been popular to describe recent events as a collapse of a bubble in housing. A look at the housing data makes a convincing case," Bullard said. "But when it comes to calculating traditional output gaps, there is no notion of a bubble. If part or most of the fall in output was a collapsed bubble, then today's output gap would be smaller than it appears." This would mean that inflation risks in the medium term are higher than otherwise thought.

###