St. Louis Fed's Bullard Discusses "The First Phase of the U.S. Recovery"

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ST. LOUIS — In a speech Wednesday to area business leaders at the 2009 Commerce Bank Economic Breakfast, St. Louis Fed President James Bullard described the forces driving this nascent economic recovery and posed the question: How sustainable is this growth going forward?

The first phase of the recovery has been driven by several factors, he said, including global growth: "Stronger-than-expected global growth, especially in Asia, has been a main force."

View Bullard's presentation, "The First Phase of the U.S. Recovery."

Other forces are driving the fledgling recovery in the U.S.: Personal consumption and the housing sector have stabilized. The stress in financial markets is abating.

Bond spreads have narrowed and credit default swap prices have declined. However, "some stress still remains in these markets," he said.

Labor markets are still a trouble spot, but there are signs of improvement. "While civilian unemployment remains high," Bullard said, "the pace of job losses has slowed."

Inflation is still low, although global commodity prices are quite volatile and "inflation uncertainty remains elevated compared with last fall," Bullard said.

Monetary Policy

Looking ahead, Bullard discussed the three components of current monetary policy: the Fed's liquidity programs, the near-zero interest rate policy and the asset purchase program.

Since the liquidity programs are naturally tapering off as the crisis recedes, they are not an inflationary concern.

"Policy rates are near zero in the U.S. and the rest of G-7 countries, something not seen in postwar economic history," Bullard said, adding that interest rates may stay low for some time. "The FOMC did not begin policy rate increases until 2 ½ - 3 years after the end of each of the past two recessions."

Assuming that the most recent recession ended this past summer, and assuming that the FOMC would behave in the same way that it's behaved in the past, this could mean the FOMC would not start increasing rates until early 2012. To be sure, Bullard said the

FOMC will be heavily weighing concerns that stem from criticisms that the Fed kept interest rates too low for too long, contributing to the housing market bubble.

“The market’s focus on interest rates is disappointing, given quantitative easing,” he said. Markets are still thinking of monetary policy strictly as changes in interest rates—even though the Fed has been conducting successful policy this past year through quantitative easing. Markets should be focusing on quantitative monetary policy rather than interest rate policy.

The FOMC has committed to buy up to $1.725 trillion in assets by the first quarter of 2010, which means that the Fed’s balance sheet will peak at close to $2.4 to $2.5 trillion. This amount is about three times the traditional size of the Fed’s balance sheet and corresponds to more than double the normal size of the monetary base. While the asset purchase program is considered to have been successful in mitigating the crisis, it has caused a large and persistent increase in the monetary base, which creates a risk of inflation in the medium term, he said.

“The main challenge for monetary policy going forward will be how to adjust the asset purchase program without generating inflation and still providing support to the economy while interest rates are near zero,” Bullard said. Medium-term inflation hinges on what the Fed will do with this program. Bullard said that he would like the FOMC to adopt a state-contingent policy rule that would allow for the adjustment of asset purchases as new information on the economy becomes available.

Regulatory Reform and the Role of the Fed

“‘Too Big to Fail’ is an intolerable situation that must be addressed,” Bullard said. “A resolution regime for large financial firms is imperative.” He added that any regulatory reform efforts need to take this into account.

Bullard emphasized that the firms at the epicenter of the crisis were large and complex global institutions and that many of them were not banks. “Quite a few of the large firms in trouble were not banks and did not come under banking regulation,” Bullard said. “The main issue here is not about banking reform, but about the shadow banking system and addressing regulation for that financial segment,” he said.

As for the Fed’s role in future regulation and policy, Bullard said that as a lender of last resort, the Fed needs to have a role in regulating any institutions to which it might lend.

Also, in order for monetary policy to be effective, “the Fed needs to know the condition of the financial system through hands-on regulatory involvement,” he added. “Fed independence is vital in maintaining credible monetary policy.”

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