St. Louis Fed's Bullard Discusses the First Phase of the U.S. Recovery and Beyond

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SHANGHAI — In remarks Monday at a conference in Shanghai, St. Louis Fed President James Bullard discussed the economic recovery under way in the U.S. and around the world, several key U.S. monetary policy issues, and the growing need for better analysis and understanding of asset price bubbles.

Bullard presented his remarks, "The First Phase of the U.S. Recovery and Beyond," as part of the Global Interdependence Center's conference on *Financial Interdependence in the World's Post-Crisis Capital Markets*.

The Global Recovery

"Growth is improving around the world, and Asia has been a leader in terms of global recovery," Bullard said.

He noted that according to IMF estimates, while world GDP is estimated to have declined 1.1 percent in 2009 on a year-over-year basis, it is expected to increase 3.1 percent in 2010.

"The IMF estimates that for 2010, GDP growth will be positive for the G-7 and BRIC (Brazil, Russia, India and China) economies, although these economies are not expected to grow at pre-crisis rates," he said.

"Manufacturing is also improving globally, with purchasing manager surveys in the U.S., Euro Area, France and China recently reaching index levels above 50," he added. Index readings above 50 percent suggest the manufacturing economy for these areas is expanding.

He noted that housing price declines have slowed in several countries, including the U.S. and Spain, and prices have started to rise in countries like China and the U.K.

"In addition, world equity prices have also improved, with the average G-7 equity price increase around 60 percent from its trough, and with an even stronger recovery in the BRIC countries," he said.

The U.S. Recovery

Bullard said forces driving the U.S. economic recovery include stronger-than-expected global growth, especially in Asia. Other forces include recovering consumption expenditures, less stress in financial markets and stabilization in the housing sector.

“U.S. consumption seems to be stabilizing,” Bullard said. In financial markets, he noted that U.S. credit spreads have narrowed and U.S. credit default swap and equity prices have continued to improve, although they have not reached pre-crisis levels.

“The U.S. housing sector is also stabilizing,” he said, though he noted that while the most recent statistics on private housing indicate that housing starts are picking up, they are at the lowest level in 40 years.

He said that real GDP in the U.S. grew 2.2 percent in the third quarter of 2009 from the previous quarter, and that forecasters expect real GDP growth to remain in a positive range of 2.8 percent to 4.7 percent in the near-term horizon. On the employment front, “Civilian unemployment remains high, but the pace of job loss has slowed,” he said.

In regard to inflation, Bullard said, “While U.S. inflation remains low, inflation uncertainty continues to be elevated.”

U.S. Monetary Policy

Looking ahead, Bullard said there are three components to the Fed’s current U.S. monetary policy: the liquidity programs, the near-zero interest rate policy and the asset purchase program.

He explained that since the liquidity programs are naturally tapering off as the financial crisis recedes, they are not an inflationary concern.

Regarding the zero interest rate policy, “Policy rates are near zero in the U.S. and the rest of the G-7 countries, something not seen in postwar economic history,” Bullard said. “Interest rates may remain low for quite some time.”

“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.”

He added, “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.

Bullard said 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.”

Asset Price Bubbles

In addition to the asset purchase program in relation to monetary policy, Bullard also addressed the issue of asset price bubbles.

“Asset price bubbles are a very serious issue for monetary policy,” he said, adding that this issue has been debated extensively over the past 15 years, and this debate will intensify. “This may mean that monetary policy should put more weight on asset prices going forward. We need better analysis of policy issues with respect to bubbles.”

He said the question of “whether ‘easy’ money fuels speculative investment—causing large and sharp increases and decreases in asset prices, and ultimately, large costs on an economy—raises two questions for monetary policy.”

“Can the Fed identify incipient bubbles in real time? When are policy judgments better than market judgments?” he asked. “If yes, what should the Fed do?”

He noted that monetary policy necessarily affects asset prices and interest rates.

“Historically this did not appear to create prolonged run-ups in asset prices, but changes in the recovery of employment in the past two recessions led the Fed to keep interest rates low for a long time,” he said. “Both periods featured prolonged increases in certain asset prices: for technology in the 1990s and housing in the 2000s. During this time, unemployment hit lows of 3.8 percent in 2000 and 4.4 percent in 2007, and inflation was low and stable.”

If the fed funds rate target was kept too low for too long in the 1990s and 2000s, “Why didn’t we see more inflation?” he asked. “Yet, without an increase in inflation, asset price misalignments seem to have caused significant problems for the macroeconomy.”

Bullard discussed what an appropriate policy response might be once a bubble has been identified. “Given the Fed mandates of maximum sustainable employment and stable prices, plus ensuring financial stability, monetary policy would be a blunt instrument when responding to bubbles because monetary policy actions impact the macroeconomy and cannot be targeted exclusively at a particular sector.”

He added, “If the asset prices contain reliable information about future inflation and output, then the Fed might respond to the bubble using monetary policy, but the focus would not be on responding to the bubble per se. Another alternative would be to use regulatory, supervisory and lender of last resort powers for financial stability, but financial institutions would need to be capable of withstanding large shocks to asset prices, as well as other shocks.”

Regarding questions whether U.S. monetary policy is fueling global asset bubbles, Bullard stressed that the Fed’s priority is the economic recovery of the U.S.

“U.S. policymakers are unlikely to react to departures of prices from fundamental values in other countries,” he said. “It is the authorities in other countries who must decide how to respond to their individual country’s departure from fundamentals.”

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