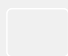

St. Louis Fed's Bullard Discusses "Policy Challenges for Central Banks in the Aftermath of the Crisis"

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STOCKHOLM, Sweden — In remarks today at the Swedbank Economic Outlook Conference, "Economic Policy in the Aftermath of the Financial Crisis," St. Louis Fed President James Bullard discussed the state of the global economic recovery amid the European sovereign debt crisis. He noted that a new, more volatile macroeconomic era may be emerging in the aftermath of unprecedented government actions taken to ameliorate the financial crisis worldwide. On U.S. regulatory reform, Bullard said important problems will remain unresolved by the proposed legislation.

The Global Recovery

"In the U.S. and globally, the recovery remains on track," Bullard said in his presentation, "Policy Challenges for Central Banks in the Aftermath of the Crisis." In the U.S., he noted, real GDP is expected to reach its second quarter 2008 peak before year-end.

Globally, growth is projected to return in 2010 and continue in 2011, Bullard said. While the current sovereign debt crisis in Europe has raised concerns of financial market contagion, "There are several reasons why this new threat to global recovery will probably fall short of becoming a worldwide recessionary shock," Bullard explained.

He noted, "Governments have made it very clear over the course of the last two years that they will not allow major financial institutions to fail outright at this juncture. Because these too-big-to-fail guarantees are in place, the contagion effects are much less likely to occur."

A More Volatile Macroeconomic Era

"A large part of successful macroeconomic policy is clear delineation of how the government will act in various states of the world," Bullard explained. "During the financial panic of 2008 and 2009, and again today, governments have been forced to take unprecedented actions. While these policy moves were necessary, they have eroded the credibility for stable rules-based policy built up over the last 25 years."

Bullard added, "We know that credibility is often established only over a long period of time. One key problem going forward will be how to re-establish credibility for macroeconomic policy. Credible policies are more effective, but may not be possible in the near term. Medium-term policy choices will have to take this into account."

The limitations of current regulatory reform measures now being concluded in the U.S. could also contribute to the volatile economic environment going forward, Bullard said.

“There are clear limits to what U.S. regulatory reform is likely to accomplish,” he explained. “Important problems will remain unresolved by the legislation.” As an example, he cited how the reform package does not fully address the non-bank financial firms, also known as the shadow banking sector, which played a huge role in the crisis.

He added, “It is a hallmark of the crisis in the U.S. that these firms turned out to be susceptible to run-like phenomena. We know what to do about bank runs—institute deposit insurance plus prudential regulation. There is no palatable analog for runs on non-bank financial firms. Additional capital requirements do not solve this problem. Since this problem is central to the financial crisis, and since we do not have a good solution at hand, I expect the problem of runs on non-bank financial firms to remain part of the macroeconomic landscape for the foreseeable future.”

“New regulations need to take a view of the entire financial landscape – otherwise, many activities are forced into less regulated entities,” he said. “Pending legislation does not appear to be sufficiently broad in concept to address this concern.”

Monetary Policy Challenges

Bullard concluded with a look at the current challenges facing policymakers with rates remaining near zero in the U.S. and other G-7 countries. “The policy to keep rates near zero for an extended period can influence real activity at the zero lower bound, according to modern monetary theories,” Bullard explained. “The effects depend on the credibility of the promise.”

He said this policy does carry the risk that “markets may confuse the policy with the ‘interest rate peg’ policy, in which rates do not adjust in response to shocks. In particular, multiple equilibria or ‘bubbles’ are possible.”

Bullard noted that the Fed’s near-zero interest rate policy had been supplemented with an aggressive quantitative easing policy that has generally been regarded as effective. He noted, however, that removing this policy without creating an inflationary impact will depend on perceptions on how and when it will be removed. “In theory, any credible commitment to remove the policy in finite time will work well. In practice, markets may well lose faith sooner than that.”