St. Louis Fed's Bullard: The U.S. Economic Situation and Recent Monetary Policy Developments

12/2/2010

WASHINGTON, D.C. - In remarks Thursday at a meeting of the National Economists Club, St. Louis Fed President James Bullard discussed his perspective on the recent Federal Open Market Committee policy decision to pursue additional quantitative easing.

In his presentation, "The U.S. Economic Situation and Recent Monetary Policy Developments," Bullard also addressed some of the risks and criticisms of the FOMC policy decision. Bullard said that while this policy carries both risks and rewards, he believes the benefits outweigh the risks.

On November 3, the FOMC announced it would purchase Treasury securities at a pace of about $75 billion per month through the first half of 2011. The Committee will review the pace of its securities purchases and the overall size of the asset-purchase program on a regular basis, in light of incoming information, adjusting the program as needed to best foster maximum employment and price stability.

Bullard stressed the importance of the program's regular review clause. "When the FOMC targets interest rates, a typical move is 25 basis points, and forward guidance is limited," he said. "This allows the Committee to adjust the policy rate in response to a changing outlook for the economy. The regular review clause allows the QE program to be adjusted in response to incoming data in the same way."

Bullard described his view of the FOMC decision in five parts:

1. Disinflationary Trend

Bullard said that while inflation was close to the implicit FOMC target during the first part of the year, "during 2010, a clear disinflation trend developed."

2. Lessons from Japan

"Japanese experience indicates that a near-zero nominal interest rate, mildly deflationary equilibrium exists and is difficult to escape," Bullard said. "The Japanese experience has generally been regarded as disappointing. U.S. policy should strive to avoid this possibility."

In his paper published earlier this year, Bullard argued it may not be prudent to rely on a near-zero policy rate alone to keep the U.S. out of the deflationary outcome; he recommended that current interest rate policy be supplemented with additional quantitative easing.

3. Monetary Policy Should Be Directed at Avoiding a Japanese-style Deflationary Outcome

Bullard outlined a policy strategy given the slower recovery and disinflationary trend currently faced by the U.S.

- First, he said the FOMC must avoid further disinflation. "Further disinflation with short-term nominal interest rates at zero would mean rising real interest rates in the face of a slowing pace of recovery," Bullard said.
- Second, the unintended steady state must be pre-empted. "It would be difficult to escape the low nominal interest rate, mildly deflationary equilibrium that Japan has experienced," Bullard said.
- Third, Bullard said the FOMC must defend its implicit inflation target from the low side, which helps maintain longer-run inflation expectations.

4. Asset Purchases Can Substitute for Ordinary Monetary Policy

"While asset purchases are sometimes viewed as unconventional," Bullard said, "the financial market effects have been entirely conventional: real interest rates declined, inflation expectations rose, the dollar depreciated, and equity prices rose."

Bullard said that asset purchases of Treasury securities at longer maturities can substitute for ordinary monetary policy by putting downward pressure on nominal interest rates further out the yield curve and upward pressure on expected inflation, thus, putting downward pressure on real interest rates.

5. Maximum Effects on the Real Economy Should Also Be Conventional

An easing of monetary policy produces its maximum impact on real economic variables, including output, consumption, and investment, six to 12 months after implementation. As with interest-rate targeting policy, disentangling the real effects of quantitative easing from other influences will be difficult, as economic performance will be influenced by other developments during this period. "Most likely," Bullard said, "the real effects will be just as conventional as the financial market effects."

Bullard also addressed some of the risks and criticisms raised about QE2:

- On criticisms that the program may not be effective, Bullard said that the financial market effects of the program have been about what one would expect from an easing of monetary policy.
- On concerns that QE2 depreciates the dollar, Bullard noted that dollar depreciation is a normal by-product of an easier monetary policy, provided all else is held constant in the rest of the world, and that the U.S. has long maintained an independent monetary policy, a flexible exchange rate, and open capital markets. He stated that other countries need to have systems in place that can adjust to modest changes in U.S. monetary policy.
- Regarding the rise in nominal interest rates, Bullard said that QE2 puts downward pressure on nominal rates through securities purchases but that the effects of successful policy would put upward pressure on nominal rates. Therefore, Bullard argued, looking at the level of nominal rates alone is insufficient to judge the success of QE2.
- On inflationary concerns, Bullard said that while too much inflation is a legitimate concern, the 2010 disinflationary trend is worrisome right now. He emphasized that keeping inflation near the implicit inflation target is very important for maintaining the FOMC's credibility.
- Regarding arguments for using a commodity money standard, Bullard stated that although this approach was widely discussed in previous decades when inflation was high and variable, the volatility of commodity prices in recent years has made this approach problematic. He argued that inflation targeting can be seen as the

intellectual descendant of commodity money standards. “Inflation targeting forces accountability for inflation outcomes onto the central bank,” he said.
- On fears that the Fed is monetizing the debt, Bullard said the FOMC has often stated its intention to return the Fed balance sheet to pre-crisis levels over time. Once the FOMC returns the Fed balance sheet to its normal size, Bullard noted, the Treasury will be left with just as much debt held by the public as before the Fed took any of these actions.
- On claims that QE mitigates fiscal problems, Bullard argued that QE has no impact on the longer-run U.S. fiscal outlook and that this outlook remains very poor no matter what the Fed does.

Bullard also highlighted the imperative need for the Congress and the President to attack the long-run budget problems the nation faces. He said that Europe has given the U.S. an important wake-up call on how devastating it can be to leave long-run structural deficit problems unaddressed.