St. Louis Fed's Bullard Discusses Quantitative Easing, Global Inflation, and Commodity Standards

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BOWLING GREEN, Ky. - In remarks Thursday at the Bowling Green Area Chamber of Commerce Coffee Hour, St. Louis Fed President James Bullard discussed what he views are three of the most widely talked-about topics regarding monetary policy today.

In his presentation, "Quantitative Easing, Global Inflation, and Commodity Standards," Bullard first explained how the Fed's second round of quantitative easing was a substitute for ordinary monetary policy easing, concluding that quantitative easing "is an effective tool when the policy rate is near zero." He then examined whether U.S. monetary policy analysis should focus on a global output gap rather than the U.S. output gap. Finally, Bullard briefly discussed the merits of commodity standards and inflation targeting, stating that "inflation targeting is a better choice in the current environment."

Quantitative Easing as Classic Monetary Policy

Last November, the Federal Open Market Committee (FOMC) announced that the Fed would purchase Treasury securities at a pace of about $75 billion per month through the first half of 2011—the program commonly known as "QE2." The Committee also stated that it would regularly review the program in light of incoming information and adjust the program as needed. Bullard noted that changes to monetary policy at the December and January meetings were minimal.

"Even before this action, monetary policy was ultra-easy," Bullard said. In particular, he noted that prior to the November decision, the policy rate had been near zero for an "extended period" and the Fed's balance sheet was much larger than it was before the crisis. Regarding the motivation for QE2, Bullard highlighted the disinflationary trend in 2010 and added that the "Japanese experience with mild deflation and a near-zero nominal interest rate has been poor." Given the near-zero policy rate environment, Bullard said that "asset purchases can substitute for ordinary (interest-rate targeting) monetary policy."

Bullard stated that ahead of the November FOMC meeting, the policy change had been largely priced into markets, and the financial market effects were conventional. In particular, he said, "real interest rates declined, inflation expectations rose, the dollar depreciated, and equity prices rose." Bullard added, "These are the 'classic' financial market effects one might observe when the Fed eases monetary policy in ordinary times." Bullard concluded that "quantitative easing has been an effective tool, even while the policy rate is near zero."

Since QE2 was announced, the economic outlook has improved, Bullard noted. "The natural debate now," he said, "is whether to complete the program, or to taper off to a somewhat lower level of asset purchases."

Global Inflation: Should the U.S. Consider Global Output Gaps?

Bullard noted that some critics suggest the Fed is encouraging global inflation, which may imply that the Fed is not appropriately weighing global conditions. He noted that "the Fed is charged with controlling U.S. inflation, but perhaps global inflation will drive U.S. prices higher or cause other problems."

Bullard highlighted the different recovery speeds and inflation trends of advanced and emerging economies. During the global recovery, advanced economies have experienced moderate growth and a deflationary trend, while emerging economies have experienced strong growth and an inflationary trend. "Inflation is a threat especially for countries with quasi-fixed exchange rates with the dollar," he said, noting that "those countries are choosing to import U.S. monetary policy to some extent."

Much monetary policy analysis focuses on the U.S. output gap, Bullard noted. He then posed the question of whether the U.S. should focus on a "global output gap." He raised the possibility that a global output gap might give a better indication of global conditions and cited studies that suggest it might give a better indication of future U.S. inflation.

"U.S. policymakers often say the U.S. output gap is large; this is interpreted as putting downward pressure on U.S. inflation," Bullard said. In contrast, "the global output gap is probably much narrower or even positive; this would then be interpreted as putting upward pressure on inflation."

Bullard said that his past criticisms of gap-based analyses of inflation dynamics still apply. For example, he noted that "empirical relationships between gaps and inflation are shaky." "Still," he concluded, "the idea of 'global output gaps' is one way to frame the recent criticism of the Fed and promote fruitful debate."

Commodity Standards and Inflation Targeting

Although commodity standards were last discussed when U.S. inflation was high and variable, Bullard noted that today, inflation is quite low. He added, "Tying the currency to commodities when commodity prices are highly variable is questionable."

While a commodity standard forces accountability on the central bank, "it did not always work because governments sometimes changed the rate between the commodity and the currency," Bullard said. "Inflation targeting is another way to force more accountability to the central bank and anchor longer-term expectations. Make the central bank say what it intends to do," he said, "and hold the central bank accountable for achieving the goal."

"Inflation targeting," Bullard concluded, "is the appropriate modern alternative to historical commodity standards."