St. Louis Fed's Bullard Discusses U.S. Monetary Policy and the Path to Normalization

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LONDON, U.K. – Federal Reserve Bank of St. Louis President James Bullard addressed members of various financial institutions on Wednesday at the UBS Macro Dinner in London. He delivered remarks titled "U.S. Monetary Policy and the Path to Normalization."

During his presentation, Bullard explained how the Fed's second round of quantitative easing was "a classic easing of monetary policy" and "an effective tool, even while the policy rate is near zero."

Bullard also discussed the situation in early 2011, stating that "U.S. growth prospects remain reasonably good for 2011." He added that recent global and domestic events "present considerable uncertainty," but he concluded that "the most likely scenario is that these uncertainties are unwound in relatively benign ways." He discussed such a de-escalation scenario for each situation.

Finally, Bullard talked about the normalization of monetary policy and compared it to previous tightening cycles. "Discussion of the normalization of U.S. policy will likely return as the key issue in 2011," he concluded.

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 would adjust the program as needed.

Bullard noted that even before the November decision, monetary policy was extremely accommodative. Regarding the motivation for QE2, Bullard noted last summer's "disinflation and declining inflation expectations," adding 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, "asset purchases can substitute for ordinary (interest-rate targeting) monetary policy."

Bullard stated that the policy change had been largely priced into markets ahead of the November FOMC meeting and that the financial market effects were conventional. "In particular, real interest rates declined, inflation expectations rose, the dollar depreciated, and equity prices rose," he said. "These are the 'classic' financial market effects one might observe when the Fed eases monetary policy in ordinary times."

“This experience shows that monetary policy can be eased aggressively even when the policy rate is near zero,” Bullard said.

He noted that the effects of monetary policy on the real economy lag from six to 12 months. “Real effects are difficult to disentangle because other shocks hit the economy in the meantime,” which, he added, is a standard problem in evaluating monetary policy.

The Situation in 2011

Bullard stated that, relative to last summer, U.S. growth prospects improved by early 2011. “Private sector forecasters and the FOMC all marked up their forecasts,” he said. “Anecdotal reports were more bullish,” showing “profitable businesses with considerable cash and an improving outlook.” He added, “An improving economy 18 months post-recession is generally a strong positive.”

Noting the improved economic outlook since QE2 was implemented, “the natural debate is how and when the exit should begin,” Bullard said. “However, additional uncertainty has clouded this picture.”

Bullard said, “In recent weeks, macroeconomic uncertainty has been on the rise from four key sources.” He noted that “all four situations contain potential for escalation.” If escalation occurs, he added, how and when to begin normalizing monetary policy would become less clear. “Still, the most likely prospect is that all four are resolved without becoming global macroeconomic shocks,” he said.

Bullard discussed a de-escalation scenario for each of the four situations:

- If further increases in world oil prices remain limited, the uncertainty premium in oil prices associated with turmoil in the Middle East and North Africa will decline. Bullard said that oil “prices would have to continue to increase substantially to derail U.S. growth prospects significantly.”
- If Japan contains the fallout at the Fukushima Daiichi nuclear plant, uncertainty regarding the natural disaster and the damaged nuclear reactors there will be reduced.
- If the U.S. Congress funds the government through 2011 and makes some progress on deficit reduction, uncertainty about the U.S. fiscal situation and the possibility of a government shutdown will be lessened.
- If European governments approve a plan to address continuing sovereign debt concerns, the continued uncertainty regarding resolution of the European sovereign debt crisis will be reduced.

Normalization of U.S. Monetary Policy

Bullard said that U.S. monetary policy cannot remain extremely accommodative indefinitely. “Exit strategy was widely discussed in 2010, and that debate will likely revive during 2011,” Bullard said.

“The process of normalizing policy, even once it begins, will still leave unprecedented policy accommodation on the table,” he stated. “The FOMC may not be willing or able to wait until all global uncertainties are resolved to begin normalizing policy.”

Bullard noted that normal monetary policy has two parts: “QE accommodation is removed by returning the balance sheet to an ordinary size over time,” and “the policy rate begins to approach levels associated with moderate expansion.” Bullard said that normalization will take time and added that it is the most difficult part of the business cycle for a central bank.

Bullard compared this normalization to previous tightening cycles. “Reversing QE through balance sheet normalization will put upward pressure on interest rates,” which,

Bullard noted, is a complication that was not present previously. "The Committee can sell assets as needed to begin tightening, without raising the policy rate."

Bullard noted that the Fed pays interest on excess reserves (IOER), which also was not present in previous tightening cycles. "With IOER, the policy rate could be increased without changing the size of the balance sheet." As an alternative to paying interest on all those reserves, he said, "reserves can also be drained via term deposits and reverse repos."

Bullard then compared state-contingency in the previous two tightening cycles. "In 1994, the Fed tightened policy unexpectedly and in uneven amounts," and the financial market effects were considered disorderly, he noted. Policy was then normalized, he said, and the economy boomed for the rest of the decade. "In 2004, the Fed tightened policy in perfectly even amounts," and he noted that although the financial markets effects were considered orderly, the financial crisis is sometimes blamed in part on this excessively smooth approach.

Bullard said that the lessons of 1994 and 2004 will be instructive in developing the right exit strategy.