St. Louis Fed's Bullard Discusses Economic Outlook and Recent Monetary Policy Developments

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LOUISVILLE, Ky. – Federal Reserve Bank of St. Louis President James Bullard delivered remarks titled "The U.S. Economic Situation and Recent Monetary Policy Developments" on Monday at the state of Kentucky's "A Day with the Commissioner" event.

During his presentation, Bullard discussed the U.S. economic outlook, stating that "U.S. growth prospects remain reasonably good for 2011." He then explained how the Fed's second round of quantitative easing "has been successful as classic policy easing" and "has shown that the Fed can conduct an effective monetary policy even when policy rates are near zero." He also discussed headline and core inflation, stating that "headline inflation, not core, is the key policy goal with respect to prices." Finally, Bullard briefly discussed the merits of commodity standards and inflation targeting, concluding that "inflation targeting is a better choice in the current environment."

The U.S. Economic Outlook

While first-quarter real GDP growth may be weaker than many expected a few months ago, Bullard said that "the outlook for the remainder of 2011 remains reasonably strong." He noted that labor market conditions have improved, manufacturing activity remains robust, and U.S. financial stress levels are near normal. He also said that key global uncertainties are likely to dissipate.

"In recent weeks, macroeconomic uncertainty has been on the rise from four key sources," Bullard said. The sources he discussed were:

1. Turmoil in the Middle East and North Africa and the associated uncertainty premium in oil prices;
2. The natural disaster and the damaged nuclear reactors in Japan;
3. The U.S. fiscal situation and the possibility of a political stalemate; and
4. Continued uncertainty regarding resolution of the European sovereign debt crisis.

Bullard pointed out that all four situations have the potential to escalate. If escalation occurs, 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.

Regarding employment, Bullard noted that over the past 12 months, about 138,000 private sector jobs have been added to nonfarm payrolls per month on average. "I expect this will accelerate during 2011," he said. "U.S. firms have cash and are looking for opportunities to invest."

Recent Developments in U.S. 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 FOMC also stated that it would regularly review the program in light of incoming information and would adjust the program as needed.

"The financial market effects of QE2 looked the same as if the FOMC had reduced the policy rate substantially," Bullard said. "In particular, real interest rates declined, inflation expectations rose, the dollar depreciated, and equity prices rose. These are the 'classic' financial market effects one might observe when the Fed eases monetary policy in ordinary times."

He added, "This experience shows that monetary policy can be eased aggressively even when the policy rate is near zero."

In light of higher inflation and inflation expectations recently, Bullard discussed headline and core inflation measures (which refer to overall price index measures and measures without the food and energy components). He said core inflation is often smoother than headline inflation, but "the 'core' concept has little theoretical backing" and is "very arbitrary."

"Headline inflation is the ultimate objective of monetary policy with respect to prices," Bullard said, noting that these are the prices households actually pay. "Core inflation is not an objective in itself," he added. "The only reason to look at core is as an indicator for headline."

However, Bullard said that core inflation was consistently below headline inflation from 2003-2006. Thus, "core was not a good indicator of headline during this period." He noted that core inflation averaged about 2 percent while headline inflation averaged about 2.9 percent for the Consumer Price Index (CPI) and about 2.6 percent for the Personal Consumption Expenditures (PCE) price index. This difference between headline and core is "substantial over a period of four years," he said. He attributed the difference during those years to rising energy prices and the expanding economy.

Commodity Standards and Inflation Targeting

Although commodity standards were last discussed in the 1970s 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 forced 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."

"In this sense, inflation targeting is the modern successor to a commodity standard," Bullard said.