St. Louis Fed's Bullard Discusses Effectiveness of QE2

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ST. LOUIS – Federal Reserve Bank of St. Louis President James Bullard delivered remarks titled "QE2: An Assessment" at the St. Louis Fed's Quantitative Easing (QE) Conference on Thursday.

During his presentation, Bullard discussed the use of balance sheet policy (or quantitative easing) to conduct stabilization policy once short-term nominal interest rates are near zero. "The purchase and sale of liquid assets, such as Treasury securities, is very similar to ordinary monetary policy, except that a particular nominal interest rate target is not set," he said.

Bullard focused mostly on the Fed's second round of quantitative easing (which is commonly referred to as "QE2"), analyzing the motivation for and effectiveness of this policy action. Overall, Bullard said that QE2 was classic monetary policy easing. "This experience shows that monetary policy can be eased aggressively even when the policy rate is near zero," he said.

Balance Sheet Policy

When short-term nominal interest rates are near zero, Bullard said, "asset purchases at longer maturities can substitute for ordinary monetary policy." These purchases put downward pressure on nominal interest rates further out the yield curve and upward pressure on expected inflation. Thus, expanding the balance sheet puts downward pressure on real interest rates.

With the policy rate near zero since December 2008, the FOMC has voted to pursue a balance sheet policy twice. The first quantitative easing program—announced in late November 2008 and expanded in March 2009—consisted of more than $1.7 trillion in purchases of agency debt, agency mortgage-backed securities, and long-term Treasury debt. The second quantitative easing program—announced in November 2010—included $600 billion in purchases of longer-term Treasury debt.

"Balance sheet policy, like all monetary policy, should be conducted in a state-contingent way," Bullard added. (In other words, policy should be adjusted based on the state of the economy.)

QE2: Motivation

Regarding the motivation for QE2, Bullard highlighted the disinflation trend that developed during 2010 and the slower pace of recovery during the summer of 2010. "These developments left the U.S. at risk of a Japanese-style outcome," he said. The

"Japanese experience with mild deflation and a near-zero nominal interest rate has been poor."

In 2010, U.S. monetary policy included a near-zero policy rate, a large balance sheet, and "extended period" language for the near-zero policy rate. Lengthening the "extended period" in response to the economic developments could potentially be counter-productive and send the U.S. to a Japanese-style outcome. In order to avoid that, the FOMC voted to pursue QE2.

Bullard said that macroeconomists and policymakers are generally very fragmented on the issues raised by Benhabib, Schmitt-Grohe, and Uribe.[1]

QE2: Was It Effective?

Markets began pricing in additional FOMC action after Chairman Ben Bernanke's Jackson Hole speech in late August 2010. Although the FOMC made the decision to purchase additional assets in November 2010, "most effects were already priced into financial markets at that point," Bullard said.

"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."

Although the financial market effects were priced in ahead of the November decision, Bullard said that the effects of QE2 on the real economy would be expected to lag by six to 12 months. "Real effects are difficult to disentangle because other shocks hit the economy in the meantime," he said, adding this seems to have happened during the first half of 2011. Disentangling the real effects is a standard problem in evaluating monetary policy, he noted.

"QE2 has shown that the Fed can conduct an effective monetary stabilization policy even when policy rates are near zero," Bullard concluded.

[1] *Editor's Note: For more discussion, see Bullard's paper published last year, "Seven Faces of 'The Peril.'"*