St. Louis Fed's Bullard Discusses U.S Monetary Policy at a Crossroads

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SAN DIEGO, Calif. – On Friday, Federal Reserve Bank of St. Louis President James Bullard delivered remarks titled "U.S. Monetary Policy at Another Crossroads" at the 2011 "Dealmakers of the Year" Business Breakfast, hosted by Point Loma Nazarene University's Fermanian Business & Economic Institute.

Bullard talked about the weaker-than-expected recovery, noting that U.S. economic growth is sluggish and that the Federal Open Market Committee (FOMC) has warned about "substantial downside risks." He said that monetary policy will respond should economic performance deteriorate, adding that "the Fed has potent tools at its disposal and is not now, or ever, 'out of ammunition'."

Bullard offered three guidelines for conducting an effective, systematic, countercyclical monetary policy during this period of near-zero nominal interest rates. First, he said, "Going forward, policy should strive to be more rules-based and less discretionary than it has been in the last three years." Second, he said that monetary policy can affect the economy through inflation and expected inflation, which would affect real interest rates. The FOMC could influence expected inflation via outright asset purchases, he explained, adding that a "meeting-by-meeting approach would allow the Committee to carefully monitor and adjust any program." Third, he said the FOMC should remain aware of the Japanese example, whereby relying solely on promises of low policy rates for longer and longer periods of time may be a path to a Japanese-style outcome, and thus, may be counterproductive. In addition, he said that tying a promise of low policy rates to unemployment outcomes, for example, could pull monetary policy off course for decades.

Sluggish Economic Growth

Bullard noted that while the pace of economic recovery has been disappointing, most components of real GDP, such as real consumption expenditures, have recovered to or beyond their levels in the fourth quarter of 2007. Investment, however, remains about 16 percent below its 2007 Q4 level, in large part because of weakness in residential investment and investment in nonresidential structures. "This looks like a collapsed real estate bubble," Bullard said. He added that if the investment component of GDP had recovered to the extent that consumption has recovered, GDP would be an estimated 4.2 percent higher. However, he said that "it is not reasonable to think that these particular areas of investment should robustly expand in the aftermath of a collapsed real estate bubble."

Bullard said that he still expects modest and improving economic growth over the next year, although the current sluggish growth does leave the U.S. economy vulnerable to further negative shocks. He stated that monetary policy would need to respond appropriately should further weakness in the economy develop. He stressed that although the FOMC cannot currently operate through its preferred channel—that is, short-term nominal interest rates—the Committee still has tools that it can use should further monetary policy action be warranted. He then discussed some guidelines concerning monetary policy going forward in this period of near-zero interest rates.

Embrace Rule-Like Behavior

Bullard said that most of the monetary policy actions pursued during the period of near-zero nominal interest rates have not been consistent with notions of optimal policy developed over the past several decades. Instead, he noted, recent actions have been characterized by one-time policy announcements with fixed end dates. To be sure, most of the economic literature from the past 30 years has emphasized that "a policy is not a one-time action but a rule mapping economic circumstances into changes in the policy instrument both today and in the future," he said.

"The Committee in the past did not contemplate announcing several hundred basis point interest rate moves with a fixed end date. Yet that is how the Committee behaves today," Bullard said. He further explained that instead, the Committee adjusted the policy rate meeting-by-meeting in reaction to economic events and also announced a continuation value, or bias, concerning future policy announcements—an approach that he said served the FOMC well for decades.

In today's environment, Bullard said that "the Committee can still control inflation through an appropriate balance sheet policy," and the principle of adjusting policy meeting-by-meeting applies here as well. "A meeting-by-meeting balance sheet policy constitutes a rules-based policy because the Committee would make adjustments in response to economic events, just as in the interest rate targeting world," Bullard said. In contrast, the policy approach in recent years—announcing large dollar amounts, fixed end dates and rapidly changing tactics—seems fairly discretionary, he stated. "Returning to a more rules-based approach may provide needed stability to the U.S. macroeconomy."

Monetary Policy Transmission

With nominal interest rates so close to zero, Bullard said that monetary policy can be transmitted through inflation and expected inflation. When the policy rate is near zero, higher expected inflation leads to lower real interest rates. He noted that a monetary authority's outright purchases of government debt are considered inflationary, and this is supported by international evidence throughout history. "This channel can be used to help keep inflation near target during the current unusual circumstance, and to help provide some support to the nation's economic recovery," he said.

Bullard stressed that "outright asset purchases are a potent tool and must be employed carefully" and cited the increase in inflation and inflation expectations during the past year, despite many measures of economic performance indicating a relatively weak economy. (For evidence of the effectiveness of the FOMC's second large-scale asset purchases program, see Bullard's recent commentary.) Thus, for this policy, he said that "the Committee still has to judge tradeoffs between inflation and support for the recovery."

Some Alternative Approaches

Bullard said the FOMC could use the promised date of the first interest rate increase, which is the so-called communications tool, as the primary policy tool during the upcoming period of near-zero policy rates. According to some models, he said, the Committee could influence financial market conditions and provide monetary accommodation by shifting the promised date. He noted that while the communications tool may work inside models, it has some important caveats for the application of policy. For example, he said it is not clear how credible the announcements would be. “If the economy is actually performing quite well at the point in the future where the promise begins to bite, then the Committee may simply abandon the promise and return to normal policy,” he said. “But this behavior, if understood by markets, would cancel out the initial effects of the promise, and so nothing would be accomplished by making the initial promise.”

Bullard talked about another drawback to the communications tool, which he also discussed in his paper, “Seven Faces of ‘The Peril’,” published in 2010. “Simply promising to keep the policy rate near-zero for longer and longer periods of time may encourage a Japanese-style outcome in which the policy rate simply remains near zero and markets come to expect a mild rate of deflation,” he said. Despite clear support for this possibility in both the theoretical literature and the Japanese data, Bullard stated that it continues to be ignored too often in policy discussions.

Another option to the communications tool would be for the FOMC to tie a promise of near-zero policy rates to actual economic outcomes, such as the unemployment rate, Bullard said. However, he noted that some advanced economies have experienced the situation where unemployment rose and stayed high; this has occurred in Europe during the past 30 years, for example. “If such an outcome happened in the U.S., and monetary policy was explicitly tied to unemployment outcomes, monetary policy could be pulled off course for a generation,” he stated.