St. Louis Fed's Bullard Discusses U.S. Economy and Monetary Policy

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ST. LOUIS – Federal Reserve Bank of St. Louis President James Bullard delivered remarks titled "The U.S. Macroeconomic Situation and Monetary Policy" on Tuesday at an event sponsored by the CFA Society of St. Louis.

Regarding the macroeconomic outlook, Bullard said the U.S. economy has avoided the "recession scare" of August. "Despite drops in confidence, hard data on the U.S. economy continues to show moderate growth," he said. Bullard noted that the Federal Open Market Committee (FOMC) in recent months has warned about "substantial downside risks," mostly coming from Europe. If the European situation worsens, he said, the Fed can re-open some of the liquidity facilities used during 2008-2009.

During his discussion on monetary policy, Bullard said that "outright asset purchases are a potent tool and must be employed carefully." He also talked about the Fed's communications tool and the idea of tying a promise of near-zero policy rates to a numerical unemployment outcome. "Tying monetary policy directly to the level of unemployment is unwise," he concluded.

The Recession Scare

Bullard noted that in August 2011, forecasters marked up the probability of a U.S. recession occurring in the second half of the year. He attributed most of this to the July 29 gross domestic product (GDP) report, which included downward revisions to recent GDP data.

While the debt ceiling debate and the European sovereign debt crisis have lowered consumer and business confidence, Bullard said that household and business behavior did not change enough to validate the recession predictions. He explained that Europe is generally viewed as too distant to force a major change in households' behavior, and large businesses tend to have growth strategies in Asia rather than Europe.

The European Situation

In regard to the European situation, Bullard said that "events in Europe pit a slow-moving political process against a fast-moving financial crisis." While "results are unpredictable at this point," he said, "European leaders tend to be very supportive of keeping the 'European Project' of ever-greater European integration moving forward."

Recent Monetary Policy

While outright asset purchases are a potent monetary policy tool, Bullard said they must be used carefully because "increases in the size of the balance sheet entail additional inflationary risks if accommodation is not removed at an appropriate pace." He noted that inflation and inflation expectations rose during the past year, despite many measures of economic performance indicating a relatively weak economy. "With the policy rate at zero, this means real short-term rates have declined," he said. (For evidence of the effectiveness of the FOMC's second large-scale asset purchases program, see Bullard's recent commentary.)

Bullard said that "a meeting-by-meeting balance sheet policy constitutes a rules-based approach because the Committee would make adjustments in response to economic events, just as in the interest rate targeting world." In contrast, he said, "the policy approach of the last several years, with announcements of large dollar amounts, fixed end dates, and rapidly changing tactics, seems fairly discretionary."

Alternative Approaches

Should further monetary accommodation be necessary, 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. He noted that while shifting the promised date in order to influence financial market conditions may work inside some models, this tool has some important caveats for the application of policy.

For example, Bullard said it is not clear how credible the announcements would be. Non-credible announcements would simply "fall flat," he added. "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 also discussed two possible alternatives to inflation targeting—targeting the price level and targeting the level of nominal income. He said that according to some literature, price-level targeting would provide better outcomes than inflation targeting. Targeting the level of nominal income is an older idea, he stated. Fed Chairman Ben Bernanke has said the FOMC would continue using its flexible inflation targeting framework, Bullard noted.

Another policy option would be for the FOMC to tie a promise of near-zero policy rates to actual economic outcomes, such as a numerical unemployment outcome, Bullard said. However, he noted that most proposals for using this tool tie monetary policy to an *actual* unemployment rate but an *anticipated* inflation rate. "This asymmetry is hard to justify," Bullard explained.

Furthermore, "unemployment rates have a checkered history in advanced economies over the last several decades," Bullard said. He cited the example of Europe, where unemployment rose and has simply remained high during the past 30 years. "If such an outcome happened in the U.S. and monetary policy was tied to a numerical unemployment outcome, monetary policy could be pulled off course for a generation," he said.

Bullard noted that labor market policies (e.g., unemployment insurance, worker retraining) have direct effects on the unemployed. In contrast, he said, "monetary policy is a blunt instrument which affects the decision-making of everyone in the economy." In particular, low interest rates hurt savers, he stated. "It may be better to focus on labor market policies to address unemployment instead of monetary policy."