St. Louis Fed's Bullard Discusses Inflation Targeting, U.S. Economy, Housing and Monetary Policy

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VANCOUVER, British Columbia – Federal Reserve Bank of St. Louis President James Bullard discussed "The U.S. Economy in the Aftermath of the Financial Crisis" Friday during the Simon Fraser University / BMO Bank of Montreal Lecture in Economics.

Bullard discussed the importance of the Federal Open Market Committee's (FOMC's) decision at the January 2012 meeting to name an explicit, numerical inflation target of 2 percent, as measured by the annual change in the personal consumption expenditures (PCE) price index. "Inflation targeting emphasizes control over inflation as the key long-term goal of monetary policy," he said, adding that with this move, the Fed joins many other central banks around the world in adopting an inflation target.

Regarding the U.S. economic situation, Bullard said the economy has brighter prospects in 2012, although housing markets have ongoing problems in the aftermath of the collapsed real estate bubble. However, he said, "It is neither feasible nor desirable to attempt to re-inflate the U.S. housing bubble of the mid-2000s."

Concerning the Fed's new monetary policy tools, Bullard said that "increases in the size of the balance sheet entail additional inflationary risks if accommodation is not removed at an appropriate pace." He also discussed the Fed's communications tool and the idea of tying a promise of near-zero policy rates to a numerical unemployment outcome. The communications tool may have credibility problems, he said, and "a non-credible announcement would simply be unhelpful."

Inflation Targeting in the U.S.

In a targeting context, inflation refers to headline (rather than core) inflation, Bullard said. The headline PCE price index is targeted, he explained, because "it does not make sense to ignore some inconveniently volatile prices, like those for gasoline and food" (as is the case with core inflation). He noted that while headline PCE inflation measured from one year ago is somewhat above the 2 percent target, it has been declining recently.

While control over inflation is the key long-term monetary policy goal, "the actions of the FOMC can also temporarily influence the direction of the economy in the short run," Bullard said. The latter can help smooth macroeconomic fluctuations and is called monetary stabilization policy, he explained.

The FOMC has adopted a *flexible inflation targeting* policy, which combines an inflation target with a sensible stabilization policy, Bullard stated. "Flexible inflation targeting enables a central bank to conduct stabilization policy without compromising the longer-run goal of keeping inflation low and stable," he added. The lesson learned from the 1970s experience, when double-digit inflation was accompanied by poor macroeconomic performance, was that "allowing high inflation just causes problems and does nothing to address fundamental macroeconomic issues," he said. [1]

Brighter Prospects for the U.S. in 2012

Bullard noted that last August, forecasters marked up the probability of a U.S. recession occurring in the second half of 2011. He attributed most of this to the July 29 gross domestic product (GDP) report, which included downward revisions to GDP data. While the debt ceiling debate and the European sovereign debt crisis lowered consumer and business confidence, household and business behavior did not change enough to validate the recession predictions, he said.

Bullard explained that while U.S. households remain nervous about the European situation, Europe is generally viewed as too distant to force a major change in households' behavior. "So, despite drops in confidence last summer, hard data on the U.S. economy continued to show moderate growth," he said, adding that household confidence has increased since then.

Regarding Europe, Bullard noted that the European Central Bank offered three-year refinancing at low rates on broadened collateral in December and recently offered a second tranche, worth about $713 billion. "At least for now, this has calmed European markets relative to last fall," he stated.

U.S. Housing Markets

In discussing the collapsed housing bubble, Bullard noted that most components of U.S. GDP – except for the components of investment related to real estate – have recovered to their levels in the fourth quarter of 2007. "It is therefore not reasonable to claim that the 'output gap' is exceptionally large," he said.

Bullard also stated that it is not feasible or desirable to attempt to re-inflate the bubble. For instance, he said, "the crisis has likely scared off a cohort of potential homeowners, who now see homeownership as a much riskier proposition than renting." The crisis has also left U.S. households with more debt than they had intended, he said, adding that "this is the first U.S. recession in which deleveraging has played a key role."

On the topic of too much debt, he noted that U.S. homeowners have about $9.9 trillion in mortgage debt outstanding against $712 billion of equity. According to Bullard, households would have to pay down this debt by about $3.7 trillion to return to a normal loan-to-value ratio of 58.4 percent, assuming a normal ratio based on the average LTV ratio from 1970-2005. The amount is roughly equal to one-quarter of one year's GDP. "This will take a long time," he said. "It is not a matter of business cycle frequency adjustment."

Monetary Policy Tools

Regarding asset purchases, Bullard said that increases in the size of the Fed's 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 and a half, despite many measures of economic performance indicating a relatively weak U.S. economy.

While the FOMC could use the promised date of the first interest rate increase – the communications tool – as the primary policy tool during the upcoming period of near-zero policy rates should further monetary accommodation be necessary, Bullard said this tool has some important caveats. For example, he said it is not clear how credible the actual announcements would be. "If the economy is performing 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."

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 and an *anticipated* inflation rate. "This asymmetry is hard to justify," he stated.

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 added.

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."

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[1]For more discussion, see Bullard's Feb. 6, 2012, speech "Inflation Targeting in the USA."

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