St. Louis Fed's Bullard Discusses Global Output Gaps

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BEIJING, China – Federal Reserve Bank of St. Louis President James Bullard presented remarks titled "Global Output Gaps: Wave of the Future?" on March 28 at the "Monetary Policy in a Global Setting: China and the United States" conference, which was organized by the St. Louis Fed and Beijing's Tsinghua University.

In his presentation, Bullard addressed some critics' concerns that the Fed is encouraging global inflation perhaps by not weighing global conditions appropriately. He discussed whether U.S. monetary policy analysis, which often examines the U.S. as a closed economy (thus disregarding for simplicity international trade and finance), should focus on a "global output gap" rather than the U.S. output gap. "The intuition is that 'dollar bloc' countries should appropriately be viewed as closely tied together," he said. Based on some existing research that analyzes open economies, Bullard said there are good reasons to think the global output gap is a relevant indicator for domestic inflation. "This might help explain why current U.S. inflation is higher than would be predicted based on a closed economy analysis," he concluded.

Should the U.S. Consider Global Output Gaps?

Bullard noted that some critics of Federal Open Market Committee policy suggest the Fed is encouraging global inflation, despite the fact that U.S. inflation is relatively low. The spirit of this criticism is that the Fed may not be appropriately weighing global conditions. "The Fed is charged with controlling U.S. inflation," he noted, adding, "but possibly global inflation will drive U.S. prices higher or cause other problems."

Much monetary policy analysis focuses on the U.S. output gap, Bullard noted. He then posed the question of whether the U.S. should focus on a global output gap in light of the criticism. According to some recent research, he said, "the global perspective on the output gap might give a better indication of global conditions, and possibly a better indication of U.S. inflation prospects."

Bullard said that his past criticisms of gap-based analyses of inflation dynamics still apply. For instance, "empirical relationships between gaps and inflation are shaky," he said. "Still, the idea of 'global output gaps' is one way to frame the recent criticism of the Fed and promote fruitful debate."

Global Output Gaps

U.S. inflation has increased during the past 18 months even though most measures of the U.S. output gap have remained very wide, Bullard noted. "Typical estimates suggest inflation should have remained low or even moved lower during 2011," he said.

Regarding this inflation puzzle, he noted that “one explanation could be that the output gap is not nearly as wide as commonly supposed.”[1]

On the other hand, “an alternative explanation is that the U.S. output gap is not the relevant output gap for U.S. inflation,” Bullard said, suggesting that perhaps the global output gap is what really matters. “The global output gap is probably much narrower or even positive; this would then be interpreted as putting upward pressure on U.S. inflation,” he added.

Regarding the dollar bloc, Bullard noted that inflation has been a threat especially for countries that have quasi-fixed exchange rates with the dollar. “Those countries are choosing to import U.S. monetary policy to some extent,” he stated.

Bullard presented some possible measures of a global output gap, with the idea being that the weighted average of the output gaps for advanced economies and emerging markets may be positive. “This may suggest upward, not downward, pressure on U.S. inflation from this source,” he said.

Some Economic Theory and Empirical Evidence

Bullard discussed some models currently available in economic research that analyze the relationship between global output gaps and domestic inflation. In these models, he said, the monetary authorities in one country can ignore the output gap in other countries only if inflation is defined as “domestic (producer) price inflation” and exchange rates are perfectly flexible. However, “these conditions are often not met in reality,” he said.

Bullard added that output gaps have measurement issues. For instance, he said that global output gaps are even more difficult to measure than domestic output gaps. “However, the idea of generally robust emerging markets suggests that one might be less worried that the global output gap is very large,” he said.

While foreign output gaps will matter for domestic inflation dynamics in the models, Bullard examined whether the theory can explain actual outcomes. He found mixed evidence regarding the impact of global output gaps on domestic inflation. He cited one study, however, that suggests globalization might be more important going forward than it was in the past. “Thus, the global output gap idea may be the ‘wave of the future’ rather than an explanation for past economic outcomes,” he said.

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[1] See Bullard’s March 23, 2012, speech *“Monetary Policy and the U.S. Economy in 2012” for additional comments on the output gap.*