St. Louis Fed's Bullard Discusses U.S. Monetary Policy, Housing Bubble

6/5/2012

ST. LOUIS – Federal Reserve Bank of St. Louis President James Bullard discussed "The Aftermath of the Housing Bubble" on Tuesday during an event jointly hosted by the Bipartisan Policy Center's Housing Commission and the Jack Kemp Foundation.

During his presentation, Bullard discussed current monetary policy in the U.S. and the economic outlook. He also discussed the collapse of the U.S. housing bubble and its implications for the economy. "Recovery from this event is ongoing and will ultimately take many years," he said, noting that households are saddled with far too much mortgage debt compared with historical norms. "Monetary policy has been ultra-easy during this period, but cannot reasonably encourage additional borrowing by households with too much debt," he added.

Current U.S. Monetary Policy

Many analysts of the U.S. economy are pointing to a "global slowdown," Bullard said. For example, the Euro-area unemployment rate has increased over the past year, and Chinese economic data has indicated slower growth than anticipated so far this year. While the U.S. data has been mixed in recent weeks, Bullard noted that "the outlook for 2012 has not changed significantly so far," with many expecting a stronger second quarter than first quarter in terms of real GDP growth and a stronger second half of 2012 than first half.

Regarding labor market conditions, Bullard said, "The recent nonfarm payrolls report was disappointing, but not enough to substantially alter the contours of the U.S. outlook." He added that seasonal adjustment factors may be disturbing the normal interpretation of the data; when looking at non-seasonally adjusted data, employment growth from one year earlier is better in 2012 than in either 2010 or 2011.

Bullard noted that the situation in Europe has driven U.S. interest rates lower. "Both nominal and real interest rates have fallen substantially over the last year in the U.S.," he said.

"One possible FOMC strategy is to simply pocket the lower yields and continue to wait-and-see on the U.S. economic outlook," he said, adding that "current policy is already very easy, as the policy rate remains near zero and the balance sheet remains large." Furthermore, while the global problems are being driven by the continued turmoil in Europe, "a change in U.S. monetary policy at this juncture will not alter the situation in Europe," Bullard stated.

U.S. Housing Markets

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

The “large output gap” view of the recent U.S. economy faces several difficulties, Bullard said. For instance, it suggests that GDP growth should be very rapid, that inflation should be much lower, and that the housing bubble did no lasting damage to the economy.

On the other hand, the “lower trend growth” view provides a more natural explanation of events, Bullard said. Based on this view, GDP growth is expected to be relatively slow, inflation can remain near the Fed’s inflation target of 2 percent, and the housing bubble did lasting damage to the economy. “In short, this view suggests that most of the business-cycle adjustment has already taken place, and that what remains is a slow rate of trend growth due to longer-term adjustment processes still taking place in real estate,” he concluded.

Bullard then spoke about the aftermath of the bubble. “It is neither feasible nor desirable to attempt to re-inflate the housing bubble. The bubble did a lot of damage and should not be repeated,” Bullard said. “Policy should be directed to encouraging market-based adjustment as quickly as possible,” he added, noting that “allocating losses to one group or another is not helpful in a macroeconomic sense.” He also said that the housing bubble collapse may have shifted preferences for home ownership, with the rent-versus-own decision shifting decidedly in favor of renting.

The crisis has also left U.S. households with more debt than they had intended, Bullard said, adding that “this is the first U.S. recession in which deleveraging has played a key role.” It will take a long time for homeowners with mortgage debt to return to the normal loan-to-value ratio of roughly 60 percent, he said, noting that “it is not a matter of business-cycle frequency adjustment.”

Bullard also discussed some geographic aspects of the housing bubble, noting that in March 2006, mortgage conditions (as measured by the percentage of mortgages 30-plus days past due or in foreclosure) were pristine. While mortgage distress peaked in 2010, mortgage conditions remained distressed in March 2012 throughout much of the U.S.

“We should expect and plan for slow adjustment in housing markets,” Bullard said.