St. Louis Fed's Bullard: Current U.S. Monetary Policy Still Appropriately Calibrated

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LITTLE ROCK, Ark. – Federal Reserve Bank of St. Louis President James Bullard discussed "U.S. Monetary Policy: Still Appropriate" on Friday as part of a Dialogue with the Fed event sponsored by the Bank's Little Rock Branch.

During his presentation, Bullard discussed some aspects of the current macroeconomic situation. "The current stance of monetary policy is ultra-easy, and remains appropriately calibrated given the macroeconomic situation in the U.S.," he said.

Bullard also discussed recent, and possibly additional, improvements to Federal Open Market Committee (FOMC) communications. "FOMC communications could be improved further by producing a quarterly monetary policy report (QMPR) similar to those produced by other central banks," he said. "This could potentially provide a more fulsome discussion of the outlook for the U.S. economy and for policy than is currently provided."

The Current Macroeconomic Situation

Bullard described some of the actions the Fed has taken since 2008 to ease monetary policy aggressively. "These Fed actions remain impactful today," he said. In particular, he noted that the policy rate remains near-zero, the large Fed balance sheet remains in place, "Operation Twist" is still ongoing and will alter the balance sheet composition through the end of this year, and the calendar-date guidance regarding the first increase in the policy rate remains in effect.

"In short, current monetary policy remains ultra-easy and is likely appropriately calibrated to the current situation," Bullard said.

He noted that "most analysis suggests Fed actions have helped produce very low nominal and real interest rates across the yield curve." Based on his own calculations, Bullard estimated that yields would normally be considerably higher given current macroeconomic conditions. Part of the explanation for the low rates, he stated, is that continued turmoil in Europe has caused U.S. interest rates to fall due to a "flight-to-safety" effect.

In further discussion regarding the European sovereign debt crisis, Bullard said that it does not have easy solutions and noted that the crisis is fundamentally about countries that have borrowed too heavily on international debt markets. "This is not a problem that monetary policy can remedy," he emphasized, adding that "attempts to use

monetary policy to fix fiscal problems have historically ended with substantial inflation." Therefore, he stated, "Debt problems take a long time to work out, so we should expect a drawn-out adjustment process in Europe."

In discussing the effects of European turmoil on the U.S., Bullard said that recent spillover has come mostly in the form of lower U.S. interest rates and that, so far, financial stress in the U.S. has increased only modestly. While U.S. financial firms have higher levels of capital now than they did in 2008, he said, "In the event of a severe financial shock, the Fed could re-open liquidity facilities pioneered during 2008-2009."

Regarding U.S. labor markets, Bullard noted that they have improved over the last year, despite relatively slow economic growth. In particular, the unemployment rate has fallen by 0.8 percentage points (from 9 percent in May 2011 to 8.2 percent in May 2012). "This is relatively fast compared to U.S. macroeconomic history over the last 25 years," he stated.

On U.S. inflation, Bullard noted that it is close to the FOMC's 2 percent target by many measures and that expected inflation is near target as well. Despite some claiming that "price level targeting" would make a difference, Bullard pointed out that "the U.S. price level appears to be quite close to an appropriate price level path." Furthermore, the U.S. price level has not strayed from an appropriate path as it did in Japan during the 1990s and in the U.S. during the 1930s, he said.

Risks to Current Fed Policy

Bullard then discussed some of the possible risks to the FOMC's current policy. "The ultra-easy monetary policy has been appropriate so far, but could reignite a 1970s-type experience globally if pursued too aggressively," he said, noting that the 1970s era included four recessions in 13 years, double-digit inflation and double-digit unemployment. "The lesson was clear," Bullard said. "Do not let the inflation genie out of the bottle."

Regarding other potential risks, including concerns that the FOMC has done too little, Bullard said, "If anything, the Committee may be trying to do too much with monetary policy, risking monetary instability for the U.S. and the global economy." He added that should the U.S. economy encounter further negative shocks, "the Committee can respond as appropriate to a significant deterioration relative to the current forecast."

Bullard then explained the risks inherent in considering changes in monetary policy to improve the U.S. employment outlook, noting that it is important to remember that "monetary policy is a blunt instrument which affects the decision making of everyone in the economy." Given that labor market policies (e.g., unemployment insurance, worker retraining) have direct effects on the unemployed, "It may be better to focus on labor market policies to directly address unemployment instead of taking further risks with monetary policy," he said.

Another potential risk is distortions in the economy, Bullard said, noting that the near-zero rate policy has been in place for more than three years now, and it is projected to remain in place for several more. "The near-zero rates cause other distortions in the economy, including punishing savers," he said.

Fed Communications

"The FOMC has increased the degree of transparency surrounding monetary policy in a variety of ways since the 1990s," Bullard said. For example, in January 2012, the FOMC began releasing participants' forecasts of the future path for the policy rate.

Although the economy is described by many variables, Bullard noted that the Fed's current communication strategy operates with only a few variables. "The FOMC could

instead publish a quarterly document akin to the Bank of England's 'Inflation Report,'" he said.

"A report of this type could potentially lay down a benchmark 'Fed view' on the key issues facing the U.S. economy," Bullard said, adding that "FOMC participants could point out where their views differ from the benchmark." Furthermore, he said, the release of the report could be coordinated with Chairman Bernanke's quarterly press briefings. Such a report could provide "a broader discussion of the U.S. outlook," Bullard said.

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