St. Louis Fed's Bullard Discusses Shadow Interest Rates and the Stance of U.S. Monetary Policy

11/8/2012

ST. LOUIS – Federal Reserve Bank of St. Louis President James Bullard gave remarks Thursday night on "Shadow Interest Rates and the Stance of U.S. Monetary Policy," as part of the Ninth Annual Corporate Finance Conference held at the Olin Business School at Washington University in St. Louis.

Pinning down the stance of monetary policy in a zero lower bound environment is very challenging. During his presentation, Bullard posed the question of whether current U.S. monetary policy is "too easy." He cited recent research by Leo Krippner, a financial market economist at the Reserve Bank of New Zealand, which suggests that current U.S. monetary policy may be considerably easier than commonly understood. "In particular, the current U.S. policy stance may be substantially easier than the policy stance recommended by commonly-used monetary policy feedback rules," Bullard said.

A Shadow Policy Rate

The level of nominal short-term interest rates is conventionally taken to indicate the stance of policy, Bullard said, noting that lower values are described as "easier" policy. However, given that the Federal Open Market Committee's (FOMC's) policy rate has been near zero since December 2008, how should the monetary policy stance be described? Bullard said that when the policy rate is near zero, a "shadow short-term rate" can be understood as a metric for the stance of monetary policy.

Krippner calculates such a shadow rate, which is currently about -5 percent. It averaged -5.12 percent from August 2010, when Chairman Ben Bernanke indicated that additional asset purchases may be needed, to the end of October 2012. Krippner's calculation is a modified version of the approach by the late Fischer Black, who was a leader in mathematical finance.

Implications for U.S. Monetary Policy

Bullard noted that in recent years, it has become popular to describe the desired level of the policy rate by using versions of Taylor-type policy rules. One such rule is often called the Taylor (1999) rule. These rules relate the current value of the policy rate to macroeconomic variables (e.g., inflation and the output gap or unemployment gap). "Most policy rules in this class currently recommend a negative policy rate," he said. Since the recommended short-term rate cannot be negative, he explained, one interpretation is that unconventional policies have been needed to try to achieve the recommended policy rate.

Using the Krippner calculation of a shadow short-term nominal interest rate as a measure of actual policy, Bullard compared this shadow rate with the recommended policy rate from a standard policy rule. "According to these estimates, the shadow policy rate is currently more than 300 basis points lower than the rate recommended by the Taylor (1999) rule," he said. "This suggests that actual U.S. monetary policy may currently be easier than the recommendations from that particular rule."

Another implication, he said, is that policy may have been too tight relative to this recommended policy rate in 2009, at which point the FOMC had not yet taken many of its unconventional policy actions, such as forward guidance and QE2. "The actual policy stance as measured by the shadow rate has recently been more volatile than during the pre-2008 era," Bullard added. "This may be because monetary policy has been harder to interpret during the period of the zero lower bound."

The Value of Unconventional Policy

According to Bullard, the Krippner study provides one way to evaluate the FOMC's recent unconventional policy actions. "Significant unconventional policy actions at times seem to conform well with movements in the shadow policy rate," Bullard said, noting that times of less conformity may indicate an ineffective policy action.

He added, "The accumulation of policy actions since 2008 has generally been associated with a continuing decline in the level of the shadow rate—that is, an easier and easier policy stance." He also noted that Krippner's results are consistent with other estimates (e.g., those of San Francisco Fed President John Williams in a 2011 *Economic Letter*).

"Current policy may be easier than often perceived," Bullard said. "These findings are interesting and I encourage further and more detailed analysis in this area."