St. Louis Fed's Bullard Discusses Debate on Tapering the Fed's Asset Purchases

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BOSTON – Federal Reserve Bank of St. Louis President James Bullard gave remarks Friday on "The Tapering Debate" at the 2013 Municipal Finance Conference, hosted by the Brandeis International Business School.

During his presentation, Bullard discussed recent developments in monetary policy. In particular, he noted that at its June meeting, the Federal Open Market Committee (FOMC) authorized Fed Chairman Ben Bernanke to discuss possible plans for reducing the pace of asset purchases, which is often referred to as "tapering" asset purchases. "The financial market reaction was substantial, even though the Committee did not actually change any policy settings at that point or at its recently-concluded July meeting," Bullard said.

Given that altering the pace of asset purchases will depend on economic conditions, Bullard shared his views on how four areas of macroeconomic performance—labor markets, GDP growth, the Fed's large balance sheet and inflation—might affect tapering. "The Committee needs to see more data on macroeconomic performance for the second half of 2013 before making a judgment on this matter," Bullard concluded.

Recent Developments in Monetary Policy

Current U.S. monetary policy has three components: the policy rate, forward guidance and asset purchases, he said. The policy rate has been near zero since December 2008, while forward guidance is a promise to keep that rate near zero at least until unemployment falls below 6.5 percent or inflation rises above 2.5 percent. Asset purchases of Treasury securities and mortgage-backed securities are continuing at $85 billion per month until there is substantial improvement in the labor market, as stated by the FOMC.

As the Chairman has emphasized, any decision on the asset purchase program is conceptually separate from any decision concerning the policy rate. "In particular, a decision to reduce the pace of asset purchases does not change the nature of the Committee's commitment to keep the policy rate near zero," Bullard explained. He then discussed some possible arguments that might be made for or against tapering.

Labor Market Performance

Bullard noted that by some key measures (e.g., the unemployment rate and payroll employment growth), labor markets have improved since the FOMC adopted its current asset purchase program last September. However, other measures (e.g., the labor

force participation rate and the employment-population ratio) have not seen such improvement.

Therefore, a key labor market issue for the tapering debate is whether the FOMC should focus attention primarily on nonfarm payroll employment and unemployment or consider a wider range of labor market indicators. "If the former, then labor markets have clearly improved since September 2012. If the latter, then labor markets may be judged to remain weak, but the criterion for labor market improvement would be considerably muddied," Bullard said.

Growth in Real GDP

Recent real GDP growth has been weak, averaging about 1 percent over the past three quarters. Bullard noted that while the FOMC would not normally remove accommodation if real GDP growth was viewed as weak, the FOMC may still wish to remove accommodation if future growth is expected to be strong.

Bullard then addressed the case for an optimistic view of the U.S. economy, explaining that many, but not all, of the factors slowing down the U.S. economy are waning. "Real estate markets are improving, equity markets have rallied, the European sovereign debt crisis remains subdued for now, U.S. fiscal brinksmanship has been less of a problem and household deleveraging is further along," he said.

Although he expressed caution against relying too much on optimistic forecasts alone, Bullard noted that a key growth issue for the tapering debate is whether the FOMC should focus attention primarily on recent growth performance or on future projected growth. "If the former, then growth has clearly been weak in recent quarters. If the latter, then growth may be judged to be improving, but forecasting performance for this variable has been poor over the last several years," he said.

The Size of the Fed's Balance Sheet

The Fed's large balance sheet has been viewed as posing risks to the FOMC's exit from unconventional monetary policy, Bullard noted. While the balance sheet is large by the standards of the past several decades, he pointed out that the Fed's balance sheet relative to GDP is not particularly large compared to other major central banks or to historical data.

Thus, regarding the balance sheet, a key issue for the tapering debate is whether the FOMC should be more concerned about its exit strategy when the size of the Fed's balance sheet relative to GDP is 30 percent than when it is 20 percent. "If yes, then balance sheet size may be judged a constraint at some point in the future. If no, then exit is equally difficult if the balance sheet is 30 percent or 20 percent of GDP, and the Committee need not view balance sheet size as a constraint going forward," he said.

Inflation

Turning to recent inflation developments, Bullard noted that current inflation is low and that, on balance, inflation expectations have declined since March. "The Committee would not normally remove policy accommodation in an environment where inflation is below target and is projected to remain there," he said.

A key inflation issue for the tapering debate is, therefore, whether the current low levels of inflation, as measured by the year-over-year percentage change in the personal consumption expenditures price index, will naturally move up toward 2 percent in the coming months and quarters. If the answer is yes, Bullard said, the FOMC could reduce the pace of asset purchases without worrying about pushing inflation even further below target. "If no, then inflation may be pushed even lower by a decision to taper and hence the risk of deflation may increase," he added.

Regarding these four issues for the tapering debate, Bullard suggested that most of them can be better addressed once the FOMC sees additional macroeconomic data from the second half of this year. “In particular, it is important to wait to see if better macroeconomic outcomes materialize in the months and quarters ahead,” Bullard concluded.

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