St. Louis Fed's Bullard Discusses Zero Interest Rate Policy

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PHILADELPHIA – Federal Reserve Bank of St. Louis President James Bullard discussed "Permazero as a Possible Medium-term Outcome for the U.S. and the G-7," at the Philadelphia Fed Policy Forum on Friday.

During his presentation, Bullard said that he continues to be an advocate for the Federal Open Market Committee (FOMC) to begin monetary policy normalization. "My argument has been that the FOMC's goals have been met, while the FOMC's policy settings remain extreme," he said. Regarding the goals, he noted that labor markets are close to normal and that inflation net of the oil price shock is reasonably close to the Fed's 2 percent target. In contrast, the policy rate remains 3.25 percentage points below the FOMC's long-run level, and the Fed's balance sheet remains more than $3.5 trillion larger than its pre-crisis level.

"Prudent policy suggests edging the policy rate and the balance sheet toward more normal levels," Bullard said.

However, given the theme of the conference, "The New Normal for the U.S. Economy," Bullard discussed some issues that may be important for the U.S. and the G-7 over the medium term. In particular, he examined the possibility of remaining at zero or near-zero policy rates over the medium term.

Permazero

Implicit in his argument to begin normalization, Bullard noted, is a desire to return to the 1984-2007 macroeconomic equilibrium. This period was characterized by relatively long economic expansions, relatively shallow recessions and relatively good monetary policy that was well understood by policymakers and financial markets.

"That equilibrium was associated with a higher nominal interest rate structure than we have today," Bullard added. "However, what if we cannot return to such a situation?"

He proceeded to examine the implications of this question, particularly given the near-zero policy rate that has been in place in the U.S. for the past several years and the medium-term outlook for low short-term nominal interest rates in the G-7 countries even as the U.S. contemplates liftoff. Furthermore, Bullard noted that negative shocks to the economy are always possible, which have the potential to push short-term nominal interest rates back to the zero lower bound.

"Zero interest rate policy (ZIRP) has usually been viewed as temporary and as part of a policy reaction to a very large macroeconomic shock. But ZIRP has been in place for seven years, far beyond ordinary business cycle time," he said, adding, "Arguably, this is

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James Bullard is president and chief executive officer of the Federal Reserve Bank of St. Louis. In these roles, he participates in the Federal Open Market Committee (FOMC) and directs the activities of the Federal Reserve's Eighth District.

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an interest rate peg—a constant value of the policy rate independent of changes in macroeconomic conditions."

Bullard pointed out that many economists believe an interest rate peg is poor monetary policy, since trying to keep the short-term nominal interest rate unnaturally low could lead to instability in the form of very high inflation. "Yet today we have had ZIRP for seven years, and inflation remains below target," he noted.

To this end, he then explored the implications of neo-Fisherian ideas that include the core idea that an interest rate peg, in some circumstances, can be stable. In this context, "ZIRP, far from being a harbinger of runaway inflation, would instead dictate medium- and long-term inflation outcomes," he said. (For additional discussion, see Bullard's speech on Nov. 12, 2015, "Permazero.")

Bullard noted that the policy implications of the neo-Fisherian ideas are profound. "The continuing G-7 ZIRP, far from putting dangerous upward pressure on inflation, may be leading us to an outcome with low nominal interest rates and low inflation that can last for a very long time," he said. "This contrasts sharply with conventional wisdom and central bank rhetoric, including my own, which emphasizes that the ZIRP is putting upward pressure on inflation and offers the best hope for returning inflation to target."

In conclusion, consistent with the theme of the conference, Bullard focused on issues that may be important for the medium- and long-term monetary policy outlook. "Neo-Fisherian ideas may have an important impact on our thinking about monetary policy in the future," he said.

Nonetheless, Bullard reiterated, "My current policy position remains in favor of beginning policy normalization in the U.S."