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U.S. Monetary Policy: Still Appropriate

James Bullard

President and CEO, FRB-St. Louis

Dialogue with the Fed

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This talk

- Some aspects of the current macroeconomic situation.
- Fed communications: Time for a Quarterly Monetary Policy Report?

The Current Macroeconomic Situation

The Fed has been easing aggressively since 2008

- The policy rate was lowered in early 2008, hit near-zero in late 2008, and remains there today.
- The FOMC purchased agency MBS in 2009.
- The FOMC began QE2 in 2010 as deflation loomed.
- In 2011, the FOMC began a version of “Operation Twist” which continues today.
- Also in 2011, the Committee began to give calendar-date guidance regarding the first increase in the policy rate, currently set at “late 2014.”

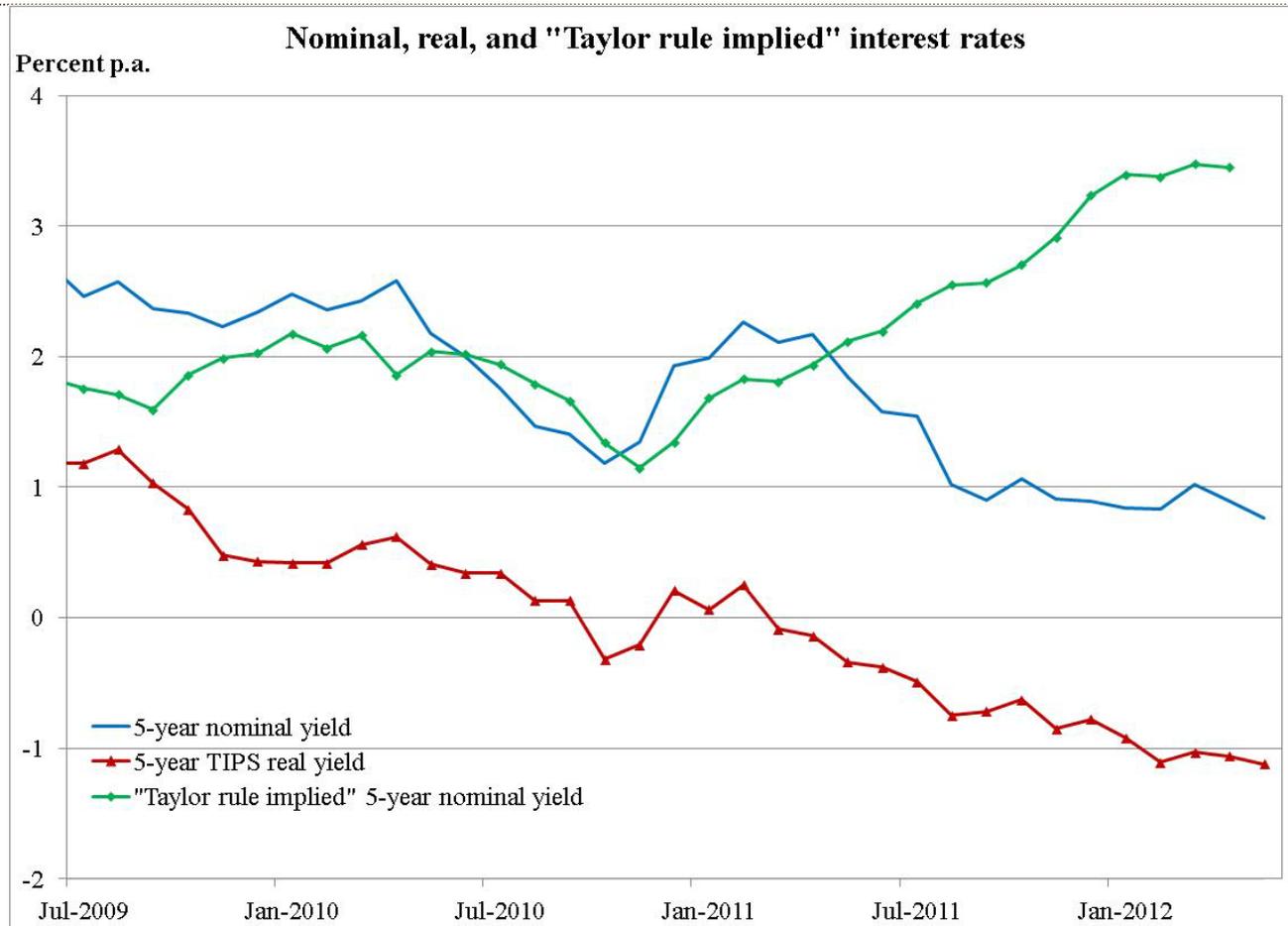
Easy policy remains in effect

- These Fed actions remain impactful today:
 - 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.
 - The calendar date language is still in effect.

Both real and nominal interest rates are very low

- In short, *current monetary policy remains ultra-easy and is likely appropriately calibrated to the current situation.*
- Most analysis suggests Fed actions have helped produce very low nominal and real interest rates across the yield curve.
 - A regression of the 5-year Treasury yield on an unemployment gap and a core inflation gap suggests yields would normally be considerably higher given current macroeconomic conditions.
- Part of the explanation is that continued European turmoil has caused U.S. rates to fall due to a “flight-to-safety” effect.

Real and nominal interest rates: Lower than normal

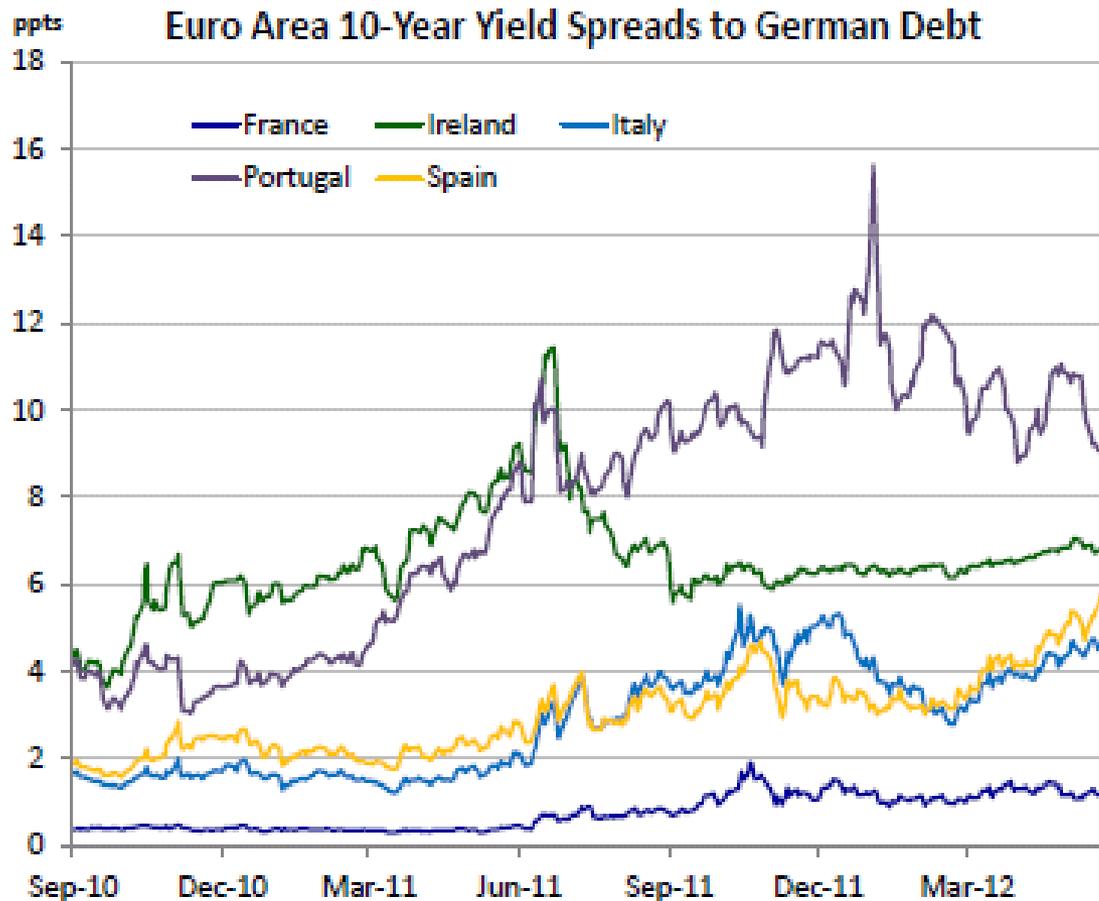


Source: Federal Reserve Board and author's calculations. Last observations: May 2012 (nominal and TIPS yields), April 2012 (Taylor rule implied yield).

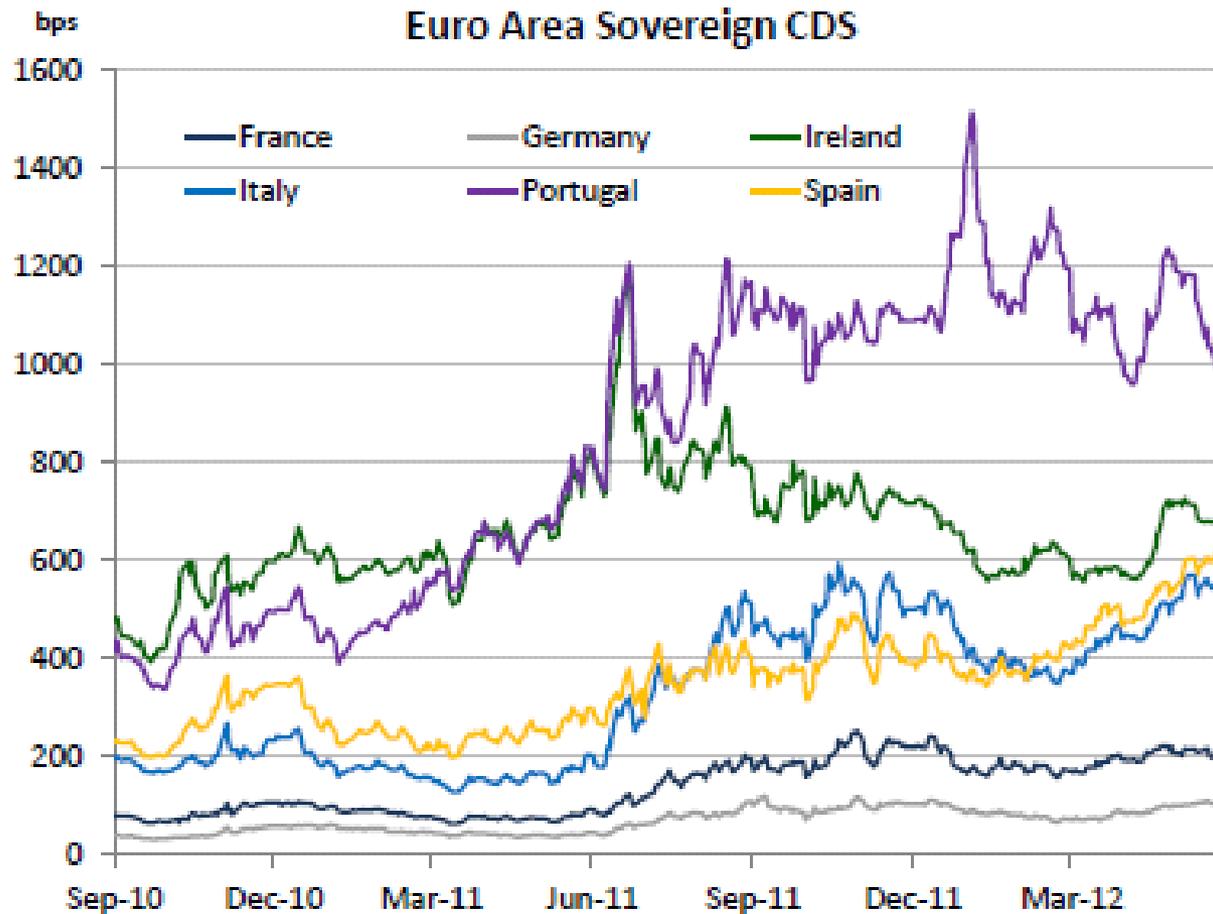
Turmoil in Europe

- The sovereign debt crisis in Europe does not have easy solutions.
- 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.
 - Attempts to use monetary policy to fix fiscal problems have historically ended with substantial inflation.
- Debt problems take a long time to work out, so we should expect a drawn-out adjustment process in Europe.

Yield Spreads on European debt



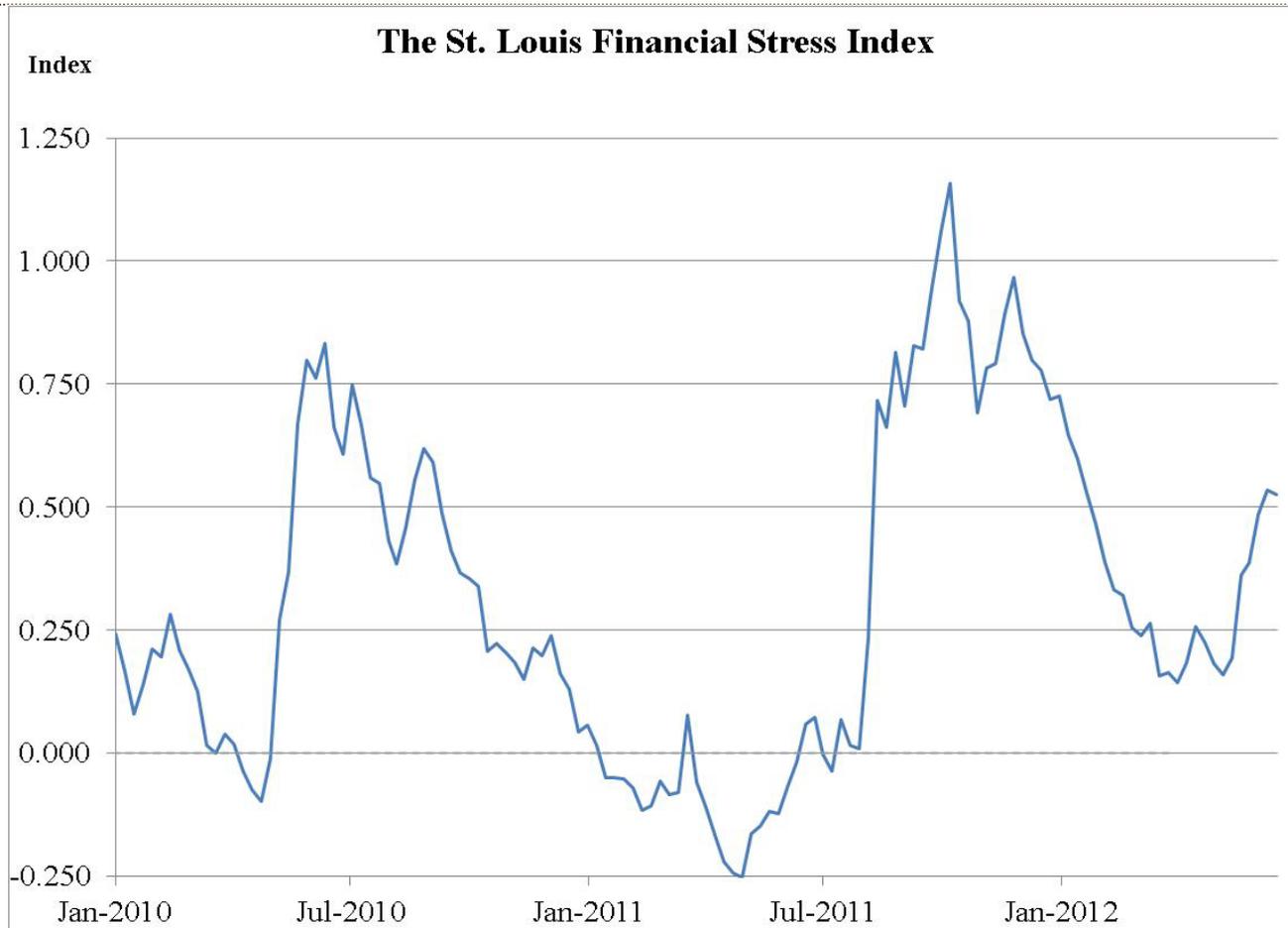
CDS on European debt



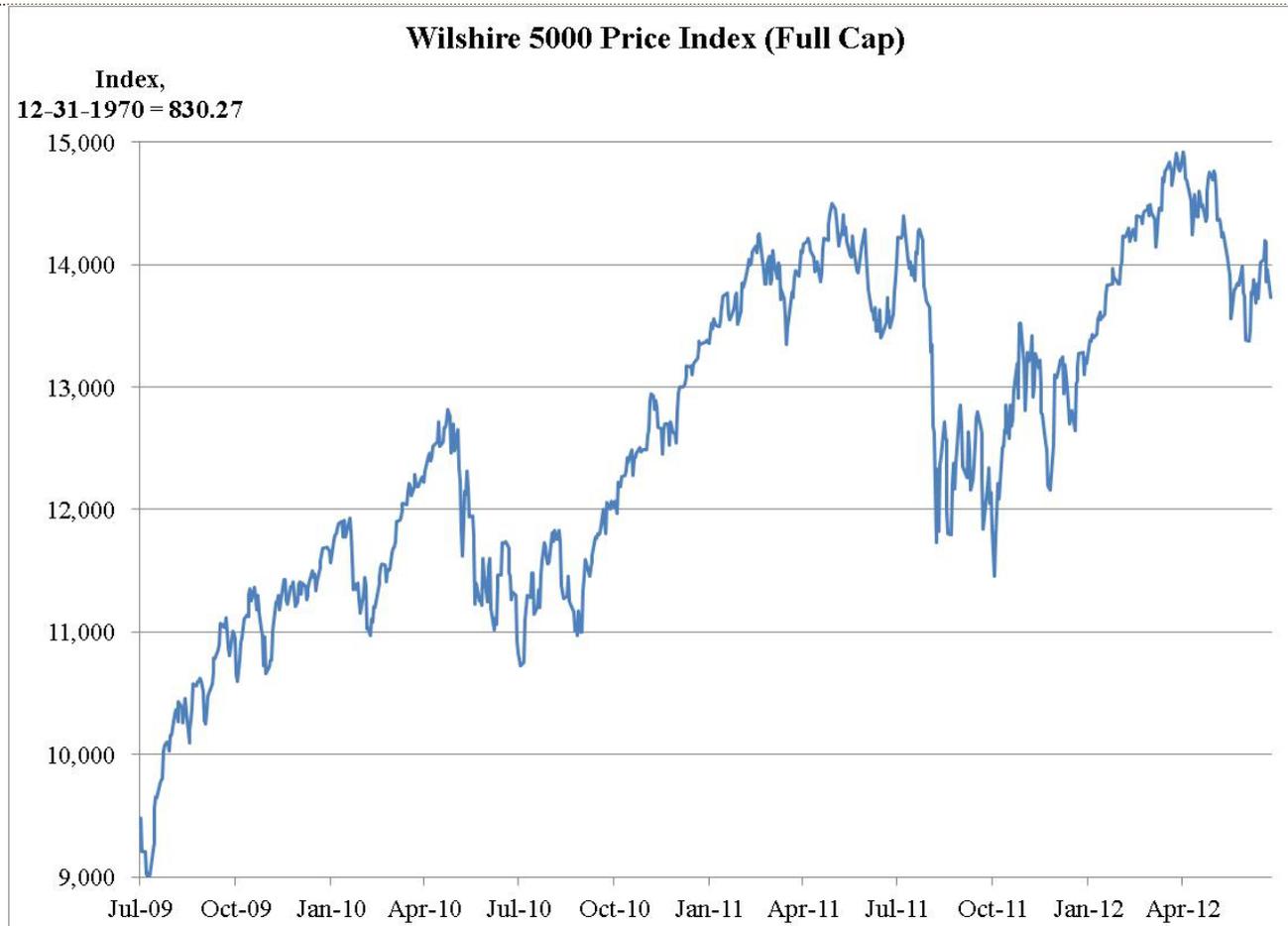
Spillover to the U.S.?

- So far, recent spillover to the U.S. has come mostly in the form of lower U.S. interest rates.
 - Equity prices are down recently, but remain up for 2012.
- U.S. financial firms have higher levels of capital than they did in 2008.
 - In the event of a severe financial shock, the Fed could re-open liquidity facilities pioneered during 2008-2009.
- Financial stress in the U.S. has increased only modestly so far.

Financial stress measures up modestly



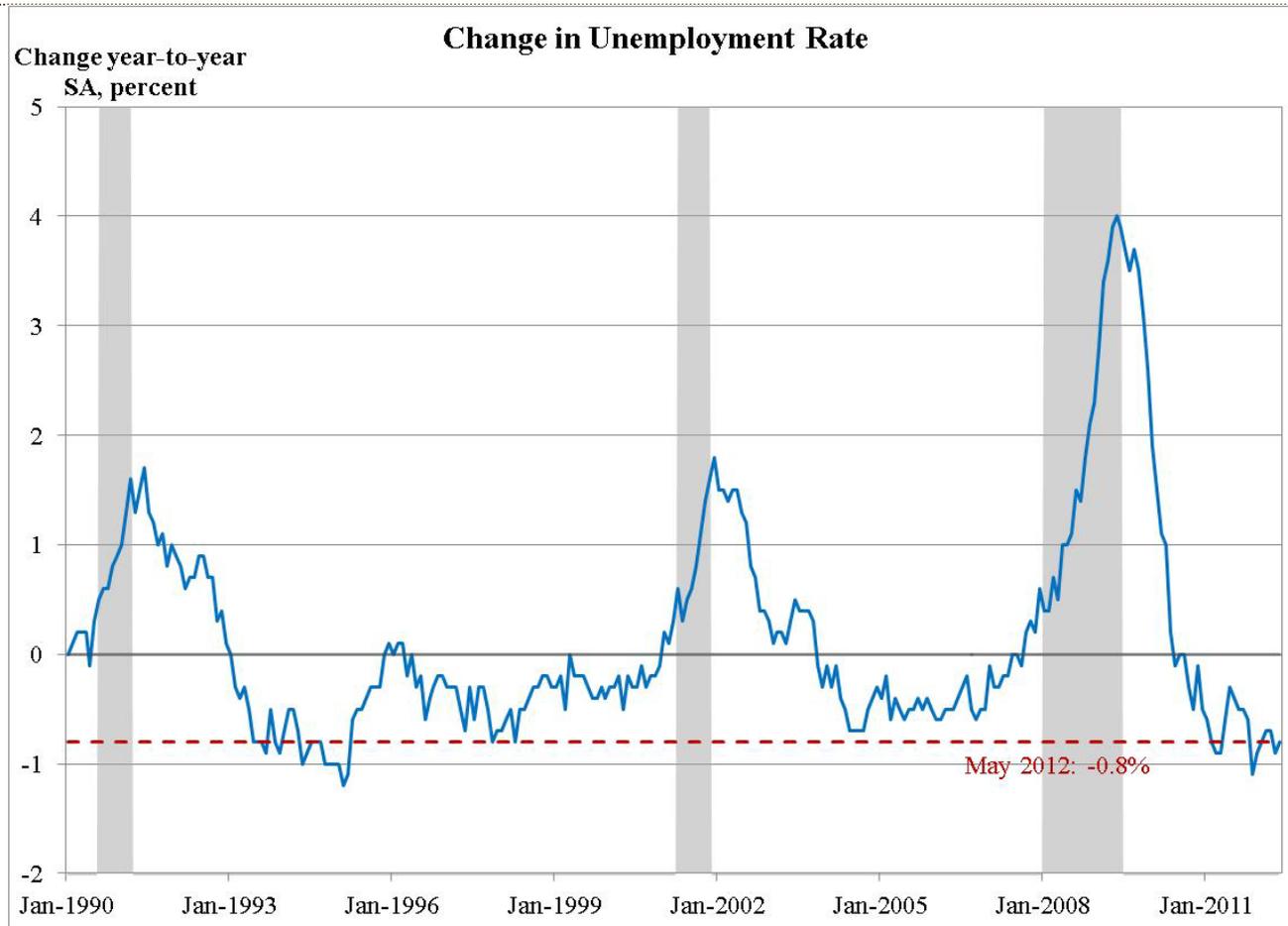
Equity markets remain higher in 2012



Labor markets have improved over the last year

- Unemployment has fallen by 0.8 percent in the last year.
- This is relatively fast compared to U.S. macroeconomic history over the last 25 years.
- That this occurred during a period of relatively slow growth has led to a robust debate.

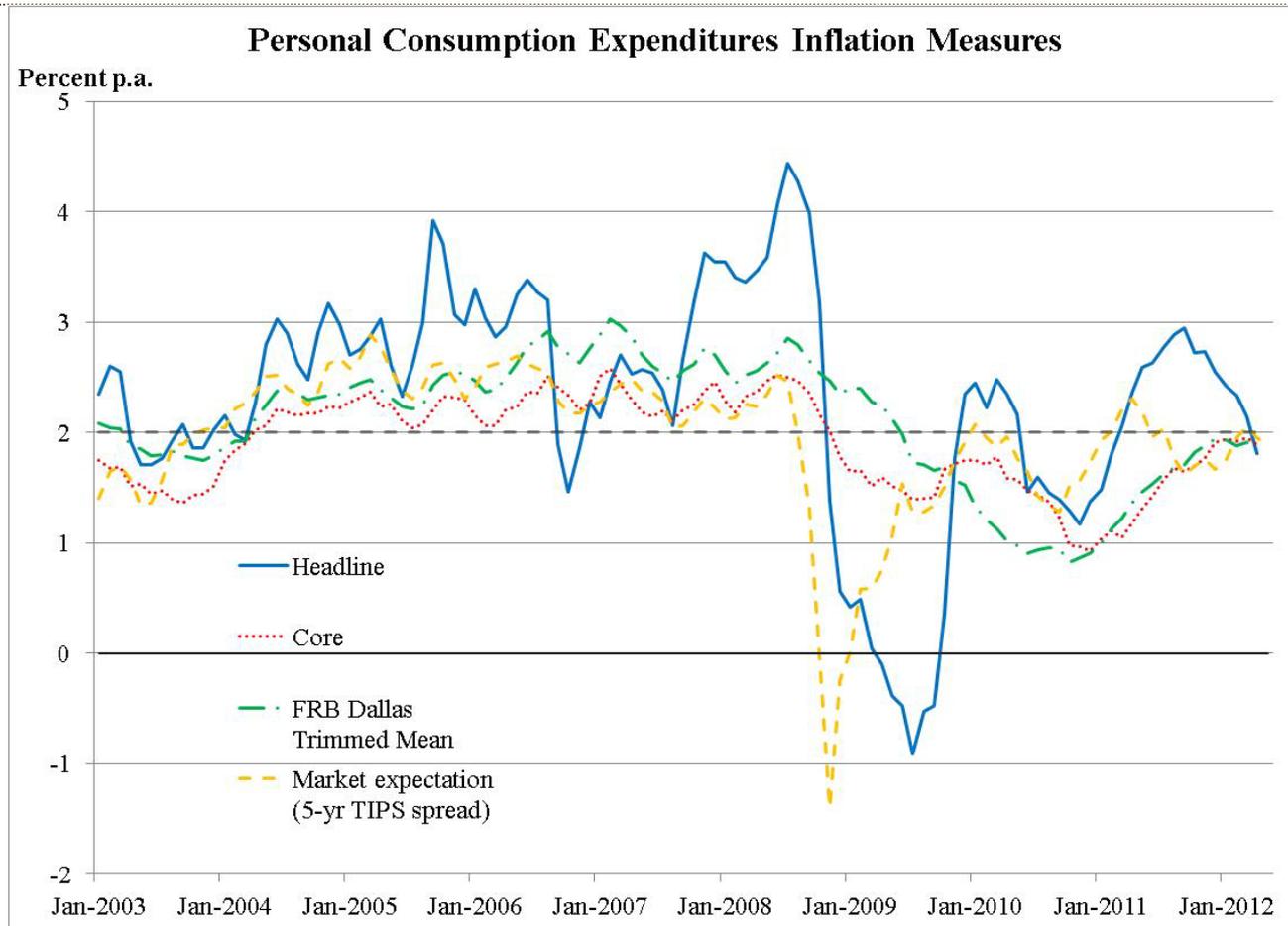
Unemployment changes, 1990-present



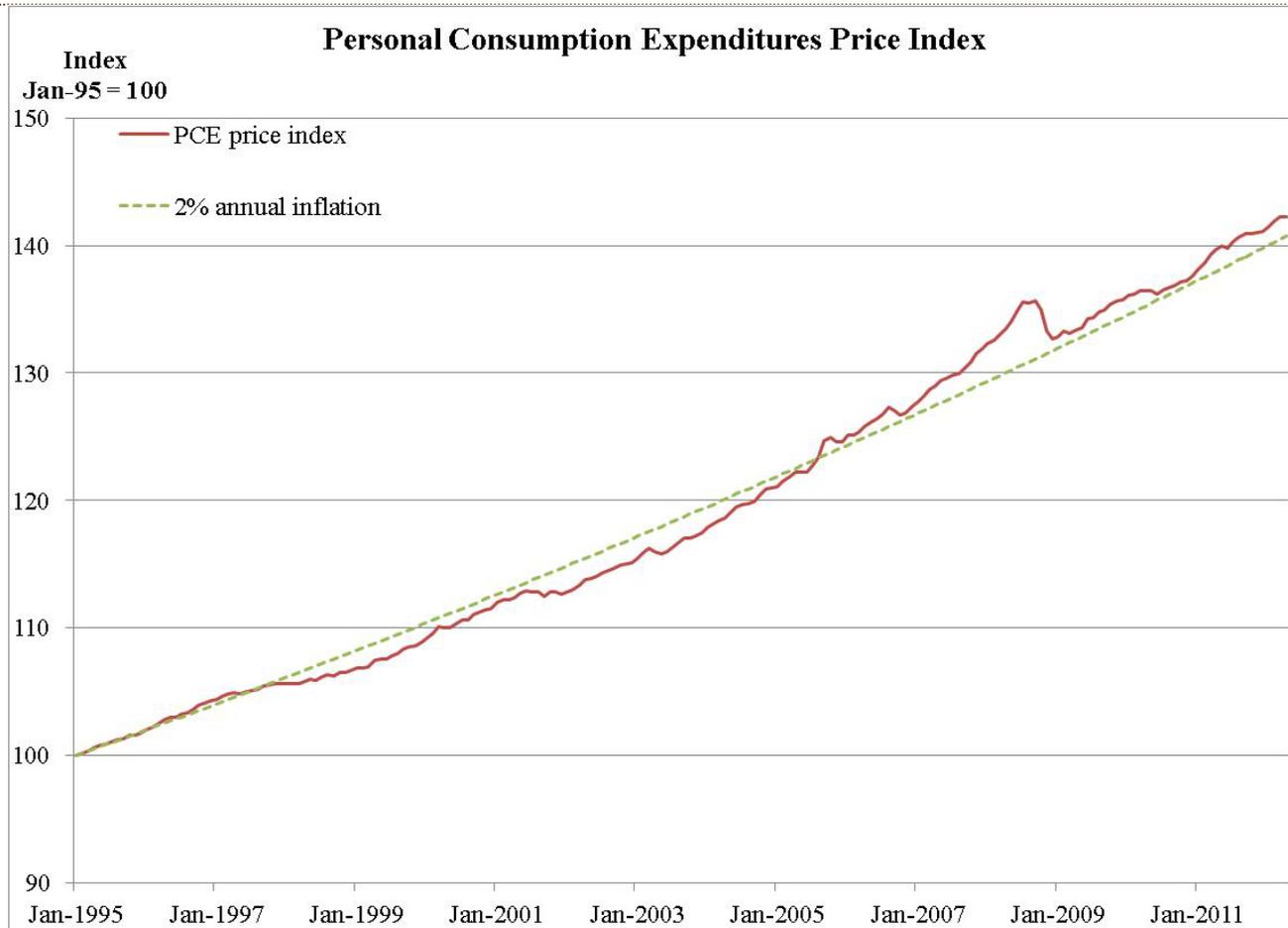
U.S. inflation: About at target

- Inflation is close to target by many measures.
- Expected inflation is also near target.
- Some claim that “price level targeting” would make a difference.
 - However, the U.S. price level appears to be quite close to an appropriate price level path.
 - The U.S. price level has not strayed from an appropriate path as it did in Japan during the 1990s and the U.S. during the 1930s.

U.S. inflation: About at target



The price level path seems appropriate



The Risks

The main risk

- The ultra-easy monetary policy has been appropriate so far, but could reignite a 1970s-type experience globally if pursued too aggressively.
- The 1970s era included 4 recessions in 13 years, double-digit inflation, and double-digit unemployment.
- The lesson was clear: “Do not let the inflation genie out of the bottle.”

Other risks

- The Committee has done too little?
 - This seems unlikely given the litany of major policy actions listed in earlier slides.
 - 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.
- The U.S. economy may encounter further negative shocks?
 - It is possible, but the Committee can respond as appropriate to a significant deterioration relative to the current forecast.
- The FOMC has allowed the price level to fall off the appropriate path? The earlier chart suggests not.

Labor market policies

- The U.S. has about 12.7m unemployed people, against 142m employed and 88m out of the labor force.*
- Labor market policies such as unemployment insurance and worker retraining have direct effects on the unemployed.
- Monetary policy is a blunt instrument which affects the decision making of everyone in the economy.
- It may be better to focus on labor market policies to directly address unemployment instead of taking further risks with monetary policy.

Additional distortions

- The near-zero rate policy has been in place for more than three years, and is projected for several more.
- This length of time is far beyond the typical recession/recovery discussion in the academic literature.
- The near-zero rates cause other distortions in the economy, including punishing savers.

Fed Communications

The Fed has become more transparent

- The FOMC has increased the degree of transparency surrounding monetary policy in a variety of ways since the 1990s.
- In January 2012, the Committee began releasing forecasts of the FOMC participants.
- The forecasts include a future path for the policy rate.
- The reception for this aspect of increased transparency has been mixed.

Possible improvements to communications

- The current communication strategy operates with only a few variables, while the economy is described by many variables.
- The FOMC could instead publish a quarterly document akin to the Bank of England's "Inflation Report."
- This could potentially provide a more fulsome discussion of the outlook for the U.S. economy and for policy than is currently provided.

A broader discussion of the U.S. outlook

- A report of this type could potentially lay down a benchmark “Fed view” on the key issues facing the U.S. economy.
- Release of the report could be coordinated with the quarterly press briefings conducted by Chairman Bernanke.
- FOMC participants could point out where their views differ from the benchmark.
- Many other central banks proceed in this manner.

Conclusions

Summary

- The current stance of monetary policy is ultra-easy, and remains appropriately calibrated given the macroeconomic situation in the U.S.
- FOMC communications could be improved further by producing a quarterly monetary policy report (QMPR) similar to those produced by other central banks.



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