Monetary Policy Tools in an Environment of Low Interest Rates

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The Economy Today

- A sharp recession.
  - Declining output during 2008 Q4.
  - Further declines likely in 2009 first half.
  - Substantial job losses.
Nonfarm Payroll Employment Around Business Cycle Peaks

Index Peak = 100

-18 -16 -14 -12 -10 -8 -6 -4 -2 0 2 4 6 8 10 12 14 16 18 20 22 24

Months from Peak

1981-82
1990-91
2001
2007 Q4
MA Forecast (Jan-6)
The Economy Today

- Important aspects.
  - Worldwide downturn.
  - Ongoing problems in financial markets.
  - Zero nominal interest rates.
World Policy Rates
(Daily data as of Feb. 5, 2009)

Rate (%)

Monetary Policy Today

- Zero nominal interest rate policy.
  - Takes nominal interest rate movements off the table for now.
  - Interest rates moving lower worldwide.
  - Fiscal policy is active.

- Alternative policies for the Fed.
  - Liquidity programs.
  - Announcements to keep rates low for some time.
  - Open market operations in agency MBS.
  - Extraordinary expansion of the monetary base.
Federal Reserve Credit

Source: Federal Reserve.
Main topics for today

- Conventional versus unconventional monetary policies.
- Ongoing financial market turmoil.
- Disinflation as a problem.
- Balance sheet expansion as a problem.
Conventional monetary policy

- Usually defined in terms of nominal interest rates.
- Private sector completely accustomed to thinking in these terms.
- This needs to change.
  - Normal times: Nominal interest rate targeting works well.
  - Exceptional times like today: Ability to signal to the private sector via nominal interest rate movements is lost.
  - Medium-run expectations for inflation can begin to drift.
  - No natural Fed move to make to head off inflation which is “too low.”
Conventional policy, part two

- Times of crisis and lender of last resort.
  - Central Banks often flood the banking system with reserves in times of crisis.
  - Once the crisis passes, the action is reversed.
  - The inflationary consequences of this type of action are minimal.
  - 9/11 was a great example.
Reserves of Depository Institutions around September 11, 2001 (Weekly data)

Source: Federal Reserve Board.
Innovative, unconventional policies

- The current financial crisis began in earnest in August 2007.
- The Fed continued to target nominal interest rates as usual during the first year of the crisis.
- The Fed also introduced new lending programs, such as the TAF, intended to reduce stigma and encourage bank borrowing from the Fed.
- Many other programs followed.
Term Auction Facility Credit

Source: Federal Reserve Board.
Beginning in September 2008, financial market turmoil intensified. Part of the Fed’s response was to flood the banking system with reserves. This part is not so unconventional, as it is the normal central bank response to severe distress. The scale dwarfs events like 9/11. The time scale of the crisis is also much longer than normal.

Meanwhile, with short-term rates at zero, the FOMC turned to alternative assets for open market operations. In particular, agency MBS for $500 billion. The agency part also not so unconventional.
Mortgage Rates
(Daily data)

The Risk of Inflation

The monetary base has increased dramatically in the U.S. since September 2008.

- Deficit spending is increasing dramatically.
- These would normally be considered inflationary developments – medium term.
- How to stop this?
St. Louis Source Base
(Weekly data as of 1/28/2009)

Billions of Dollars

Source: Federal Reserve Bank of St. Louis, FRED
The Risk of Inflation: How to stop this?

- **Reversibility.**
  - Many of the newly introduced programs are temporary.
  - It seems the reserve build up could be reversed quickly and easily.

- **Questions:**
  - “Crisis” as a short event?
  - Criteria? What does normal look like, given that some segments of financial markets will not return?
  - Scale of the programs is large. A problem?

- **Another idea:** Set an inflation target.
The Risk of Deflation

- An inflation target might also help prevent deflation.
- The Japanese experience has been unpleasant.
  - Clear problems in their banking sector in the 1990s, not unlike the U.S. today.
  - Deflation in year-over-year core numbers for much of the time since the mid-1990s.
- Why worry about deflation?
  - Nominal contracts, especially in housing.
  - Unexpected deflation would worsen the situation.
The Japanese Experience:
Consumer Price Index Less Food and Energy

Source: Organization for Economic Cooperation and Development
Ongoing financial market turmoil

Financial market turmoil looks set to continue into 2009.
Sustained growth probably cannot return until financial markets stabilize.
Time may not be a healer.
- The information problems permeating markets do not naturally go away.
Sharp recession has contributed to a new round of losses.
Information problems need to be addressed directly.
Weekly Stock Prices of 10 Large US Banks

- Citigroup Inc. New York
- Bank of America Corp. Charlotte
- JPMorgan Chase & Co. New York
- Wachovia Corp. Charlotte
- Washington Mutual Inc. Seattle
- U.S. Bancorp Minneapolis
- Bank of New York Mellon Corp.
- SunTrust Banks Inc. Atlanta
- State Street Corp. Boston
Financial market oversight

- Regulatory reform in the wake of this crisis is a global issue.
  - It will take time to design a reform that has a chance of working.
  - Large financial firms will have incentives to avoid rules by locating elsewhere.
- Parts of the regulatory system work well today.
  - The depression-era smaller bank panic has not occurred.
  - The combination of deposit insurance and prudential regulation has worked well in this sense.
Financial market oversight, continued

- Non-bank financials turned out to be susceptible to “bank runs.”
  - Short-term, collateralized creditors ran on large investment banks.
  - This problem is not easy to fix: “deposit insurance plus regulation” does not make sense.
- Access to the discount window should be tied to Fed regulation.
  - Information flow is critical for responsible Fed lending.
  - Information flow is also critical for informed monetary policy.
Conclusions

- A time of very fluid, volatile expectations.
  - We know expectations are a major factor in macroeconomic performance.
- The Fed is pursuing a set of less conventional policies.
  - The quantitative effects are more uncertain than normal.
  - The zero nominal interest rate takes away the Fed’s ability to signal.
  - But the less conventional policies are every bit as powerful.
- Optimal financial market oversight is a difficult problem.
  - It will not be easy to design a reform that works.
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