Monetary Policy and the U.S. Economy

James Bullard
President and CEO

19 August 2010
Rogers, Arkansas

Any opinions expressed here are my own and do not necessarily reflect those of the Federal Open Market Committee members.
This talk

- The U.S. macroeconomic outlook has been downgraded, but remains positive going forward.
- The European sovereign debt crisis has abated somewhat but remains a factor in the global economic mix.
- Core inflation has fallen to low but still manageable levels.
- Any additional quantitative easing undertaken by the FOMC should be a disciplined reaction to further disinflation risks.
Outlook: Downgraded but still positive
NIPA revision: The recession was deeper than initially estimated

Real GDP Growth: Current and Previous Estimates
Percent change, annual rate

Source: Bureau of Economic Analysis. Last observation: Q2-2010.
Not all signals from GDP suggest slowing

- The second-quarter figure was influenced by imports.
- Economists sometimes consider domestic purchases as an indicator of household appetite for spending.
- Real final sales to domestic purchasers includes imports.
Growth of final domestic demand for Q2-2010 was strong

Source: Bureau of Economic Analysis. Last observation: Q2-2010.
Manufacturing continues to expand

- Industrial production rose 1 percent in July.
- ISM surveys remain within the range defined as expansionary.
Manufacturing continues to expand, but at a slower pace

Non-manufacturing activity also continues to expand

Labor markets remain weak

- Unemployment remains high.
- Private-sector jobs growth has been below expectations in the past three months.
- Hours worked has increased at a slow rate.
- But … U.S. productivity has improved dramatically compared with other G-7 economies.
Aggregate hours are growing slowly

Productivity in the U.S. has increased since the crisis.
Housing markets remain weak

- Home sales remain at a low level.
- Single family home construction also remains at a low level.
- Dramatic improvement seems unlikely in the near term.
- House prices remain below a 2001 nominal GDP benchmark.
House prices remain low

The European sovereign debt crisis abates
Developments in Europe

- The European sovereign debt crisis has abated somewhat, but remains an important factor in the global economic mix.
- Future developments depend on the ability of sovereign governments to deliver on fiscal retrenchment programs.
- Sensible fiscal retrenchment can improve the medium-term growth prospects for these countries.
The cost of credit insurance is high.
European bond spreads remain elevated

The effect on the U.S. has abated

- Measures of U.S. financial stress have fallen from peak levels.
- The eurodollar exchange rate has retraced much of the euro weakness from this spring.
- Key longer-term interest rates in the U.S. are below pre-crisis levels.
Financial stress rose sharply after April 23

Capital market rates are below pre-crisis levels

Inflation developments
Disinflation during 2010

- Disinflationary trends have reasserted themselves during 2010.
- Some key measures of core inflation have fallen to about one percent.
- Inflation that is “too low” can be problematic, as the Japanese experience has shown.
Core inflation measures are low

Source: BLS, BEA, and FRB Cleveland. Last observation: June 2010 for PCE measures and July 2010 for CPI Measures.
Inflation and nominal interest rates

- Taylor-type policy rules in combination with a Fisher relation creates two possible long-run outcomes for the macroeconomy.
- Japan has been in one of these, the U.S. in the other.
- The Japanese experience has generally been regarded as disappointing.
- U.S. policy should strive to avoid this possibility.
- For more commentary, see my paper “Seven Faces of the Peril,” posted on my web site.

http://research.stlouisfed.org/econ/bullard/index.html
Interest rates and inflation in Japan and the U.S.

Source: OECD data and author’s calculations. Last observation: May 2010.
Expected inflation

- Expected inflation at the targeted steady state is relatively high.
- Expected inflation at the unintended steady state is low or negative.
- Fortunately, expected inflation in the U.S. today, as measured from TIPS data, remains relatively high.
- However, these expectations have moved lower partly in response to the crisis in Europe.
Expected inflation has declined

Another look at expected inflation

TIPS Breakeven Inflation Rates
March 1, 2010 - August 16, 2010

The near-zero rate policy

- Keeping the policy rate near-zero may push the economy toward the targeted steady state.
- However, the policy is also consistent with the unintended steady state, where there is mild deflation.
- It may not be prudent to rely on low policy rates alone to keep the U.S. out of the deflationary outcome.
- Instead, supplement current policy with additional QE, should inflation move lower.
- The U.K. QE program can be viewed as more successful than the U.S. program for this reason.
U.S. and U.K. core inflation: opposite directions

Source: OECD. Last observation: June 2010.
What should QE look like?
Large, sudden purchases rarely are optimal

- “Shock and awe” is almost never a good way to proceed.
- Instead, policy actions should be commensurate with the risks that the economy faces.
- A series of smaller policy actions can add up to a large action, but only if incoming data suggest that as the appropriate course.
- Example: 25-basis-point interest rate moves are relatively small by themselves, but can have large effects as part of a policy path for interest rates.
A disciplined program

- Today, with core inflation at low but manageable levels and the economy expected to continue to expand, no action is necessary.
- Should economic developments suggest increased disinflation risk, purchases of Treasury securities in excess of those required to keep the size of the balance sheet constant may be warranted.
- Purchase size should be in proportion to the size of any deterioration in the outlook.
- One key goal of the program is to keep core inflation in the U.S. from falling close to levels observed in Japan.
Conclusions

- The U.S. outlook has been downgraded, but still remains positive—continued expansion is the most likely course going forward.
- The European sovereign debt crisis has abated somewhat, but remains a factor in the global economic mix.
- Core inflation has fallen to low, but still manageable, levels. If the risk of further disinflation builds, Fed action may be warranted.
- Any QE actions should be disciplined and focused.