Faith in Financial Reform Fragile: St. Louis Fed President

By Editor Test *Tue, Jun 1, 2010*

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A new, more volatile macroeconomic era may be emerging in the wake of government solutions taken to solve the financial crisis worldwide, according to St. Louis Federal Reserve President James Bullard.

On U.S. regulatory reform, Bullard said important problems will remain unresolved by the proposed legislation. He spoke recently at the Swedbank Economic Outlook Conference, "Economic Policy in the Aftermath of the Financial Crisis."

"In the U.S. and globally, the recovery remains on track," Bullard said in his presentation, "Policy Challenges for Central Banks in the Aftermath of the Crisis." In the U.S., real GDP is expected to match its second quarter 2008 peak before year-end, he said.

While the current sovereign debt crisis in Europe has raised concerns of financial market contagion, "There are several reasons why this new threat to global recovery will probably fall short of becoming a worldwide recessionary shock," Bullard explained. He expects global growth to return in 2010 and continue in 2011.

"Governments have made it very clear over the course of the last two years that they will not allow major financial institutions to fail outright at this juncture. Because these too-big-to-fail guarantees are in place, the contagion effects are much less likely to occur," he added.

But these policy moves have eroded the credibility for stable rules-based policy built up over the last 25 years, he said.

"One key problem going forward will be how to re-establish credibility for macroeconomic policy. Credible policies are more effective, but may not be possible in the near term," he said. "There are clear limits to what U.S. regulatory reform is likely to accomplish. Important problems will remain unresolved."

For example, the reform package does not fully address the non-bank financial firms, also known as the shadow-banking sector, which played a huge role in the crisis. "It is a hallmark of the crisis in the U.S. that these firms turned out to be susceptible to run-like phenomena. Additional capital requirements do not solve this problem. I expect the problem of runs on non-bank financial firms to remain part of the macroeconomic landscape for the foreseeable future."

"New regulations need to take a view of the entire financial landscape. Otherwise, many activities are forced into less regulated entities," he said. "Pending legislation does not appear to be sufficiently broad in concept to address this concern."

On interest rate policy, he said, "The policy to keep rates near zero for an extended period can influence real activity at the zero lower bound, according to modern monetary theories. The effects depend on the credibility of the promise… Markets may confuse the policy with the ‘interest rate peg’ policy, in which rates do not adjust in response to shocks. In particular, multiple equilibria or ‘bubbles’ are possible.”

The Fed’s near-zero interest rate policy had been supplemented with an effective quantitative easing policy. Removing this policy without triggering inflation will depend on perceptions about how and when it will be removed. “In theory, any credible commitment to remove the policy in finite time will work well,” he said. “In practice, markets may well lose faith sooner than that.”