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## St. Louis Fed president questions U.S. monetary policy

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By Kerry Pechter    Tue, Apr 10, 2012

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*"Monetary policy is a blunt instrument which affects the decision-making of everyone in the economy," said James Bullard, pointing out that low interest rates hurt savers. Better to address unemployment directly than through monetary policy, he added.*

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Federal Reserve Bank of St. Louis President James Bullard discussed "The U.S. Monetary Policy Outlook" last week during the 13th Annual InvestMidwest Venture Capital Forum.

Bullard said that brighter prospects for the U.S. economy provide the Federal Open Market Committee (FOMC) with the opportunity to pause in its aggressive easing campaign. "An appropriate approach at this juncture may be to continue to pause to assess developments in the economy," he stated. Concerning the FOMC's communications tool, the "late 2014" language describing the length of the near-zero rate policy may be counterproductive, he said. "The Committee's practice of including distant dates in the statement sends an unwarranted pessimistic signal concerning the future of the U.S. economy."

Regarding the output gap and housing markets, "the U.S. output gap may be smaller than typical estimates suggest," Bullard said, adding that typical estimates count the "housing bubble" as part of the normal level of output. However, he said, "It is neither feasible nor desirable to attempt to re-inflate the U.S. housing bubble of the mid-2000s."

### **Monetary Policy on Pause**

At the March 2012 meeting, the FOMC updated its assessment of the economy, but otherwise left the policy statement largely unchanged, Bullard noted. Given that incoming data have generally indicated somewhat better-than-expected macroeconomic performance so far in 2012, "past behavior of the Committee suggests a 'wait-and-see' strategy at this juncture," he said.

Bullard discussed some of the policy actions that the FOMC has taken in recent years to ease financial conditions. "The ultra-easy policy has been appropriate until now, but it will not always be appropriate," he said. Many of the further policy actions the FOMC might consider at this juncture would have effects that extend out for several years, Bullard stated. "As the U.S. economy continues to rebound and repair, additional policy actions may create an over-commitment to ultra-easy monetary policy."

Bullard noted that labor market policies (e.g., unemployment insurance, worker retraining) have direct effects on the unemployed. In contrast, he said, "monetary policy is a blunt instrument which affects the decision-making of everyone in the economy." In particular, low interest rates hurt savers, he stated. "It may be better to focus on labor market policies to directly address unemployment instead of taking further risks with monetary policy."

### **Brighter Prospects for the U.S.**

Bullard noted that last August, forecasters marked up the probability of a U.S. recession occurring in the

second half of 2011. He attributed much of this to the July 29 gross domestic product (GDP) report, which included downward revisions to GDP data. In addition, he noted that the European sovereign debt crisis worsened then. However, he said, "Since last fall, the outlook has improved."

Regarding Europe, Bullard noted that the European Central Bank (ECB) offered three-year refinancing at low rates on broadened collateral in December and offered a second tranche in February. "At least for now, this has calmed European markets relative to last fall," he stated, adding that the ECB policy does not address longer-term problems.

### **Output Gaps and U.S. Housing Markets**

In discussing the collapsed housing bubble, Bullard noted that most components of U.S. GDP - except for the components of investment related to real estate - have recovered to their levels in the fourth quarter of 2007. "It may not be reasonable to claim that the 'output gap' is exceptionally large," he said.

Bullard also stated that it is not feasible or desirable to attempt to re-inflate the bubble. "The crisis has likely scared off a cohort of potential homeowners, who now see home ownership as a much riskier proposition than renting," he said. The crisis has also left U.S. households with more debt than they had intended, he said, adding that "this is the first U.S. recession in which deleveraging has played a key role."

On the topic of too much debt, he noted that U.S. homeowners have about \$9.9 trillion in mortgage debt outstanding against \$712 billion of equity. According to Bullard, households would have to pay down this debt by about \$3.7 trillion to return to a normal loan-to-value ratio of 58.4 percent, assuming a normal ratio based on the average LTV ratio from 1970-2005. The amount is roughly equal to one-quarter of one year's GDP. "This will take a long time," he said. "It is not a matter of business cycle frequency adjustment."

### **Recent Monetary Policy**

While the FOMC could use the promised date of the first interest rate increase - the communications tool - as a policy tool should further monetary accommodation be necessary, Bullard said this tool has an important downside. Although the 2014 language in effect names a date far in the future at which macroeconomic conditions are still expected to be exceptionally poor, "neither the Fed nor any other forecaster has a clear idea of what macroeconomic conditions will be like at that time," he said. "This is an unwarranted pessimistic signal for the FOMC to send," he added.

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