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Perspectives on the Current Stance of Monetary Policy

February 21, 2013

St. Louis Fed President James Bullard discussed how monetary policy is easier in 2013 than in 2012 and some considerations for the Fed's latest QE program at New York University's Stern Center for Global Economy and Business, New York, N.Y.

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• [Four factors could spell the end of QE](http://www.bizjournals.com/memphis/news/2013/02/21/four-factors-could-spell-the-end-of-qe.html), by Cole Epley, Memphis Business Journal.
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• [Bullard sees 6.5 percent unemployment by mid-2014](http://www.stltoday.com/business/columns/david-nicklaus/bullard-sees-percent-unemployment-by-mid/article_a7ccc548-510c-5e54-82b1-67fe1034d33c.html), by David Nicklaus, St. Louis Post-Dispatch.

St. Louis Fed's Bullard Discusses the Current Stance of U.S. Monetary Policy

NEW YORK – Federal Reserve Bank of St. Louis President James Bullard gave remarks Thursday on [“Perspectives on the Current Stance of Monetary Policy”](https://www.stlouisfed.org/-/media/project/frbstl/stlouisfed/files/pdfs/bullard/remarks/bullardnyustern21feb2013final.pdf)to the Center for Global Economy and Business at New York University’s Stern School of Business.

During his presentation, Bullard discussed why he views the stance of U.S. monetary policy as considerably easier in 2013 than in 2012. On the Fed’s nominal interest rate policy, he noted that the policy rate has been near zero since December 2008 and that the Federal Open Market Committee [(FOMC)](https://www.stlouisfed.org/fomcspeak/)has promised to maintain the near-zero rate into the future, so-called “forward guidance.” In December 2012, the FOMC replaced the fixed-date forward guidance with a “threshold” approach. “The threshold approach has disposed of the ‘pessimistic signal’ that was a side effect of the date-based forward guidance. This should make the forward guidance more effective,” he said.

Regarding the Fed’s balance sheet policy, outright asset purchases have replaced the “Operation Twist” program, which Bullard noted may not have been as effective as hoped. “Open-ended outright purchases are a more potent tool,” he said. Furthermore, he noted that the FOMC has promised to maintain an aggressive asset purchase program, and he discussed some considerations for the future of this program.

A Shadow Interest Rate

The level of nominal short-term interest rates is conventionally taken to indicate the stance of policy, Bullard said, noting that lower values are described as “easier” policy. However, when the policy rate is near zero, as it has been in the U.S. since December 2008, he said that a “shadow short-term rate” can be understood as a metric for the stance of monetary policy.

Leo Krippner of the Reserve Bank of New Zealand calculates such a shadow rate, which averaged -4.57 percent from August 2010 to January 2013. Bullard said this is considerably more negative than values recommended by common monetary policy rules. One such rule is often called the Taylor (1999) rule, which relates the current value of the policy rate to inflation and the output gap. Bullard noted that Fed officials have sometimes used this rule to describe monetary policy.

“The shadow policy rate is currently about 250 basis points lower than the rate recommended by the Taylor (1999) rule,” Bullard said. “This suggests that actual U.S. monetary policy may currently be easier than the recommendations from that particular rule.”

The bottom line is that “the current policy stance looks very easy according to this analysis,” he said.

Thresholds and the Policy Rate

Before December, the FOMC stated that the policy rate would likely remain near zero until mid-2015. “This created a ‘pessimism problem’ for the Committee,” Bullard said. He explained that “the date could be interpreted as a statement that the U.S. economy is likely to perform poorly until that time,” which he has called an “unwarranted pessimistic signal.” However, he said, “The Committee did not intend to send such a signal.”

Rather than using a given date, Bullard noted that the FOMC has now changed its forward guidance to a description of economic conditions at the time of the first rate increase. Such a dependency on economic conditions is known as “state-contingent” policy.

“In December the Committee instead adopted ‘thresholds,’ values for inflation (2.5 percent) and unemployment (6.5 percent) that give an indication that the time for a policy rate increase may have arrived," he explained. "Now, as data arrive on U.S. economic performance, private sector expectations concerning the timing of the first rate increase can automatically adjust," Bullard said. "The Committee is no longer sending the pessimistic signal, because the threshold conditions can be met at any time."

He stated that "the current St. Louis Fed forecast for the unemployment rate implies that the 6.5 percent threshold will be crossed in June 2014." However, he noted, the policy rate implied jointly by the Taylor (1999) rule and the St. Louis Fed forecasts should increase in August 2013. Thus, "The Committee's thresholds imply a 'Woodford period' since the policy rate would be held at zero past the point where ordinary FOMC behavior would indicate an increase," Bullard said. The period from August 2013 to June 2014 would be the "Woodford period," which refers to Michael Woodford of Columbia University. "According to received theory, this is a more stimulative monetary policy and possibly even an optimal monetary policy when the zero lower bound is constraining," Bullard added.

Bullard stated that while the thresholds fixed the pessimism problem, they still have some challenging aspects. "The use of thresholds is not a panacea," Bullard cautioned. He discussed several issues that the FOMC is likely to face going forward with this strategy. For instance, he said, "The FOMC cannot pretend to target medium- or long-term unemployment." In addition, "The Committee needs to reiterate that it considers many more variables in attempting to gauge the state of the U.S. economy." Finally, he said that "the thresholds will likely be viewed as triggers for action."

How Long Can QE Continue?

Turning to the Fed's latest QE program, Bullard discussed four considerations going forward. First, while substantial labor market improvement is a condition for ending the program, Bullard said that "the Committee could consider many different aspects of labor market performance when evaluating whether there has been 'substantial improvement.'" These include unemployment, employment, hours worked, and Job Openings and Labor Turnover Survey (JOLTS) data. "The Committee will have to make a judgment about the degree of labor market improvement," he said.

Second, "Without an end date, the Committee may have to alter the pace of purchases as news arrives concerning U.S. macroeconomic performance," Bullard said, noting that "substantial labor market improvement" does not arrive suddenly. "This suggests that as labor markets improve somewhat, the pace of asset purchases could be reduced somewhat, but not ended altogether," he explained. "This type of policy would send important signals to the private sector concerning the Committee's judgment on the amount of progress made to that point."

A third consideration for the QE program is inflation and inflation expectations, Bullard said. Current readings on inflation are rather low, which he said may give the FOMC some leeway to continue asset purchases for longer than otherwise. Although worries about rising inflation have so far been unfounded, "the lesson from QE2 is that inflation and inflation expectations did trend higher," he said, adding that it is too early to know if that will happen with the current QE program.

Finally, he said, "The size of the balance sheet could inhibit the Committee's ability to exit appropriately from the current very aggressive monetary policy." He explained that when interest rates rise, asset values will fall, which could possibly complicate monetary policy decisions.

Taking into consideration all of the recent changes to monetary policy, "the stance of U.S. monetary policy is considerably easier today than it was during 2012," Bullard said. "2012 policy was characterized by a relatively weak 'Operation Twist' program combined with somewhat counterproductive date-based forward guidance," he said. In contrast, "2013 is characterized by a relatively potent open-ended outright asset purchase program combined with more effective threshold-based forward guidance."

Contact Us
• Laura Girresch 314-444-6166
• Anthony Kiekow 314-949-9739