

example. “If such an outcome happened in the U.S., and monetary policy was explicitly tied to unemployment outcomes, monetary policy could be pulled off course for a generation,” he stated.

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- **September 26, 2011.** Presentation. ["America's Investment Problem and Monetary Policy," \(bullard_mga_september26_2011_final.pdf\)](#) *Policy Making After the Crisis*, New York City, NY.
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St. Louis Fed's Bullard Discusses America's Investment Problem and Monetary Policy

NEW YORK CITY - On Monday, Federal Reserve Bank of St. Louis President James Bullard delivered remarks titled [“America’s Investment Problem and Monetary Policy”](https://www.stlouisfed.org/-/media/project/frbstl/stlouisfed/files/pdfs/bullard/remarks/bullard_mga_september26_2011_final.pdf) as part of a panel discussion on “Policy Making After the Crisis.” as part of a panel discussion on “Policy Making After the Crisis.”

Bullard talked about the recovery in U.S. GDP and noted that its components, except for investment, have largely recovered to their 2007 peak. “This looks like the collapse of a real estate bubble,” he stated. However, most analysis does not take the idea of a collapsed bubble sufficiently into account when discussing the nature of the U.S. recovery, he said. “Taking the bubble view more seriously has implications for the expected pace of the U.S. recovery and for the likely fundamental potential growth rate of the U.S. economy.” This, in turn, has important implications for U.S. monetary policy, Bullard noted. “The behavior of inflation over the last year supports the idea that the fundamental output gap has been smaller than recognized, and that asset purchases are a potent tool for influencing inflation and inflation expectations,” he concluded.

Regarding the Federal Open Market Committee's (FOMC's) options for conducting countercyclical monetary policy in a near-zero policy rate environment, Bullard said that "the Fed's balance sheet policy—outright purchases and sales—is the most natural and effective tool for this purpose." He stated that the FOMC should decide on any future asset purchases on a meeting-by-meeting basis and should also indicate the likelihood that it will continue on its current path at the following meeting. The FOMC's communications tool—which is the main alternative to asset purchases—"has some potential drawbacks," he said.

The Recovery in GDP

Bullard noted that most of the main components of real GDP are at a higher level today than they were in the fourth quarter of 2007, which marked the previous business cycle peak. While consumption, government expenditures, imports and exports have all recovered, investment remains about 16 percent below its level in the fourth quarter of 2007.

Bullard added that real investment in nonresidential structures and real private residential investment are especially low compared to the business cycle peak. While GDP would be an estimated 4.2 percent higher if the investment component had recovered to the extent that consumption has, he said that "it is not reasonable to think that these particular areas of investment should robustly expand in the aftermath of a collapsed real estate bubble."

Thus, Bullard said that the previous business cycle peak is not a good benchmark for GDP growth. "It is not reasonable to expect the economy to climb rapidly back to the 2007 Q4 peak since part of that peak was due to artificial growth driven by bubble behavior," he said. "A more reasonable interpretation is that fundamental potential growth in the U.S. has been somewhat lower than previously thought." He added that the behavior of inflation during the past year provides some evidence for this.

Monetary Policy

“The FOMC’s asset purchase program clearly drove both inflation and inflation expectations higher and closer to the Committee’s implicit target over the last year,” Bullard said. Given that actual real economic performance was weaker than the FOMC anticipated last fall, according to the July 29 GDP report, “this should have meant less inflation, not more,” he stated.

“This suggests that the output gap may have been considerably smaller than previously thought, and perhaps also that the output gap has considerably less influence on inflation than commonly thought,” Bullard said. “The larger influence on actual inflation comes from inflation expectations,” which have tended to be higher over the past year, according to TIPS measures, he noted.

Bullard also shared his views on the FOMC’s policy tools going forward. “The Committee needs to be able to conduct a systematic countercyclical monetary policy during the period of near-zero policy rates,” he said. He noted that “asset purchases are a potent tool and must be employed carefully” and cited the increase in inflation and inflation expectations during the past year, despite many measures of economic performance indicating a relatively weak economy. “The meeting-by-meeting approach would allow the Committee to carefully monitor and adjust any program,” he stated.

Bullard said the FOMC could use the promised date of the first interest rate increase, which is the so-called communications tool, as the primary policy tool during the upcoming period of near-zero policy rates. According to some models, he said, the Committee could influence financial market conditions and provide monetary accommodation by shifting the promised date. He noted that while the communications tool may work inside models, it has some important caveats for the application of policy. For example, he said it is not clear how credible the announcements would be. “If the economy is actually performing quite well at the point in the future where the promise begins to bite, then the Committee may simply abandon the promise and return to normal policy,” he said. “But this behavior, if understood by markets, would cancel out the initial effects of the promise, and so nothing would be accomplished by making the initial promise.”

Bullard talked about another drawback to the communications tool, which he also discussed in his paper, “ [Seven Faces of ‘The Peril,’](<https://research.stlouisfed.org/publications/review/10/09/Bullard.pdf>) ” published in 2010. “Simply promising to keep the policy rate near-zero for longer and longer periods of time may encourage a Japanese-style outcome in which the policy rate simply remains near zero and markets come to expect a mild rate of deflation,” he said. “This possibility has clear support in the theoretical literature but is too often ignored in policy discussions.”” published in 2010. “Simply promising to keep the policy rate near-zero for longer and longer periods of time may encourage a Japanese-style outcome in which the policy rate simply remains near zero and markets come to expect a mild rate of deflation,” he said. “This possibility has clear support in the theoretical literature but is too often ignored in policy discussions.”

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- **September 12, 2011.** [Opening Remarks.](#) ([opening_remarks_dialogue_with_the_fed_12sep2011_finalpdf](#)) Given at the *"Dialogue with the Fed: Beyond Today's Financial Headlines"* discussion, St. Louis.
[Related news articles.](#)

New Evening Discussion Series Kicks Off Sept. 12 at the St. Louis Fed

ST. LOUIS - It's been almost three years since the bankruptcy of Lehman Brothers, the subsequent bailout of AIG and the government takeover of Fannie Mae and Freddie Mac. Today, financial markets still have not fully regained the ground they lost from 2008 – 2009. U.S. unemployment remains high and the housing market is stagnant. Europe continues to manage its sovereign debt crisis and global markets are volatile. Data and news reports can be confusing and even overwhelming.