address this concern."

Monetary Policy Challenges

Bullard concluded with a look at the current challenges facing policymakers with rates remaining near zero in the U.S. and other G-7 countries. "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," Bullard explained. "The effects depend on the credibility of the promise."

He said this policy does carry the risk that "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."

Bullard noted that the Fed's near-zero interest rate policy had been supplemented with an aggressive quantitative easing policy that has generally been regarded as effective. He noted, however, that removing this policy without creating an inflationary impact will depend on perceptions on how and when it will be removed. "In theory, any credible commitment to remove the policy in finite time will work well. In practice, markets may well lose faith sooner than that."

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- **May 25, 2010**. Speech. "The Road to Economic Recovery Following the Financial Crisis," delivered at the *Distinguished Speakers Seminar*, European Economics and Financial Centre, London.
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The Road to Economic Recovery Following the Financial Crisis

May 25, 2010

Distinguished Speakers Seminar, European Economics and Financial Centre, London

I appreciate assistance and comments provided by my colleagues at the Federal Reserve Bank of St. Louis. Marcela M. Williams, Special Research Assistant to the President, provided assistance. I take full responsibility for errors. The views expressed are mine and do not necessarily reflect official positions of the Federal Reserve System.

It is a great pleasure to be here today to speak to you on the state of the global economy and the policy challenges faced by the Federal Open Market Committee and other central banks worldwide. I think we can all agree that these are difficult times for macroeconomic policymakers. I intend to outline some of my main thoughts on the present situation as well as what may be some of the key topics in the policy discussion going forward. Hopefully my comments will set up a vigorous question and answer session.

As usual, the remarks I make here today represent my own views and do not necessarily reflect the views of other FOMC members.

My comments are divided into two parts. In the first, I discuss the status of the global macroeconomic recovery from the very severe shock suffered during the second half of 2008. That recovery generally remains on track, but has recently been called into question because of events in Europe. I will give several reasons why one might hope that the volatility in Europe does not constitute a macroeconomic shock severe enough to derail the global recovery.

In the second part of the talk, I turn to the possibility that a new, more volatile macroeconomic era is upon us. I will suggest that just such an era may be unfolding, for two reasons. One is that governments have now taken numerous unprecedented actions, and so it will take time to transition back toward the types of credible, rules-based policies we know will deliver higher quality macroeconomic outcomes in the long run. The other is that there are clear limits to what can be accomplished through regulatory reform. These two factors combine to suggest that macroeconomic volatility may be higher in the next few years, as compared with the "Great

Moderation" years from about 1984 to 2007.

Let's get started by turning to the state of the economic recovery in the U.S. and globally.

Global Recovery

In the U.S., the recession likely ended in the summer of 2009, although the actual end may not be announced by the NBER dating committee for some time. Growth in real GDP is expected to continue through the current quarter, making for a full year of growth in national income. If current consensus private sector forecasts are realized, inflation-adjusted national income will surpass its 2008 peak later this year.

Global growth has returned as well. According to the April 2010 IMF World Outlook, 2009 was a year in which global real GDP actually contracted. That is something that did not occur in the 1970s, the 1980s, the 1990s, or any year in the current decade before 2009. I had major concerns about the whole global economy being in recession at the same time. Yet, today, global growth is projected to return in 2010, at 4.2%, and continue in 2011, at 4.3%.

In all, the economic situation in the US and globally is not very different from median forecasts made at the depth of the recession in late 2008 and early 2009. Since that time there have been several moments when it may have appeared that the global economic recovery would be derailed, but, as it turned out, the recovery has remained on track so far.

But now a new threat to global recovery is looming in the form of a sovereign debt crisis in Europe. In part as a response to the global recession, countries have now moved to larger levels of deficit spending and have accumulated higher levels of debt. The ability and willingness of some countries to repay has been called into question.

There are several reasons why this new threat to global recovery will probably fall short of becoming a worldwide recessionary shock.

To begin with, this is a question of sovereign debt, and sovereign debt crises have been with us for many, many years. There is nothing intrinsic about such crises that they need to become important shocks to the broader, global macroeconomy. Countries do default or restructure their debt from time to time, and the world goes on. To be sure, such an outcome is stressful both for the borrowing country and for the holders of the sovereign debt and can lead to substantial volatility in global financial markets. One example would be the Russian default in 1998. Still, in most cases there is little reason to think that such events by themselves have the power to trigger global recessions. Of course, it is always possible that "this time will be different" and maybe it will be, but that would be unusual given the historical evidence.

Many have noted that the European sovereign debt crisis is occurring against the backdrop of a weakened financial system in Europe and the US, and that to the extent the holders of troubled debt are these very same weakened firms, there may be some prospect for contagion to reignite the type of financial shock last seen in the fall of 2008. While this is certainly possible, I do not think this is a likely scenario. If we consider CDS prices for major US and European banks, we see that they have moved sharply higher in recent weeks, but not to the extreme levels seen during parts of late 2008 and the first half of 2009.

Why should this be the case? I think government guarantees are playing a major role here. 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. "Too big to fail" is a controversial policy, but it does have its upside in the current situation.

Let me also stress that the current agreement in Europe does buy substantial time for European governments to enact fiscal retrenchment programs. It will take time for those programs to be enacted and to gain credibility with financial markets. This is a process that will probably play out over years, not weeks. Certainly, governments have to act now to gain credibility with markets in the near term, but continuing vigilance is then also needed to keep the consolidation moving. If fiscal consolidation does not work, then debt restructuring may become the only alternative, but, if

necessary, that can be accomplished in an orderly way over time and with minimal damage to global markets. Even in an extreme case, I do not see any necessary impediments to the successful operation of a common currency.

The U.S. may actually be an unwitting beneficiary of the crisis in Europe, much as it was during the Asian currency crisis of the late 1990s. This is because of the flight to safety effect that pushes yields lower in the U.S. Of course the U.S. also has its own fiscal problems that must be directly addressed in a timely manner if the nation is to maintain credibility in international financial markets.

Let me now leave the details of the current crisis to talk more broadly about macroeconomic volatility.

The Return of Volatility

A large part of successful macroeconomic policy is clear delineation of how the government will act in various states of the world. This means that the government implements a stable, rules-based policy that is well understood by the private sector. Policies that have this character are known, in both theory and reality, to produce the highest quality macroeconomic outcomes.

In the last two years, governments and central banks in the US and in Europe have, of necessity, taken actions that would previously have been considered extremely unlikely. Markets and private-sector actors have been surprised, even if they have also agreed that some or most of the actions were necessary. In my view, this nontraditional policy has eroded some of the credibility for stable, rules-based policy that had been built up over the last 25 years. Clearly, this erosion was unintended, because actions were taken in response to crisis; still the effect has been to make the private sector keenly aware of the possibility that governments may make very aggressive and unusual policy moves. Exactly how governments will behave going forward is a question loaded with uncertainty in the aftermath of this crisis.

So, re-establishing credibility for the type of successful rules-based policy we were previously accustomed to will be a key challenge over the next

several years. We know that it can take a long time to establish credibility. We also know that credible policies are more effective. While the crisis remains fresh, it may not be possible to attain first-best, full-commitment outcomes for the macroeconomy. Instead, policies may for a time be less effective than otherwise and private-sector actors may remain overly sensitive to the prospect of unusual, aggressive policy actions. This means that macroeconomic volatility may be higher than normal for a period of time.

The now-concluding regulatory reform debate in the US also suggests that the economic environment may remain more volatile. The debate has shown that while some issues can be addressed legislatively, many problems cannot be addressed effectively either because of political constraints or, more likely, because it is simply not that clear which changes in current law might support the best economic outcomes. This suggests that some of the problems we have faced over the last three years will simply remain with us, and so will the volatility that was associated with those problems.

One example is the issue of runs on non-bank financial firms. Non-bank financial firms accounted for about 2/3 of the top 80 percent of the assets in the S&P Financials for the U.S. in late 2007. These were names such as Lehman Brothers, Merrill Lynch, Fannie Mae, Freddie Mac, Hartford Insurance, American International Group, as well as thrifts like Washington Mutual and Countrywide. This list provides a simple who's-who of the financial crisis in the U.S. It was all part of the shadow banking sector, a less regulated set of financial firms.

It is a hallmark of the crisis in the US that these firms turned out to be susceptible to run-like phenomena. We know what to do about bank runs—institute deposit insurance plus prudential regulation. There is no palatable analog for runs on non-bank financial firms. Additional capital requirements do not solve this problem. Since this problem is central to the financial crisis, and since we do not have a good solution at hand, I expect the problem of runs on non-bank financial firms to remain part of the macroeconomic landscape for the foreseeable future.

In summary, then, there are two reasons to think that the next few years may

be more volatile than they would otherwise be. One is that it is harder to run a fully credible policy in the current environment, where governments have just taken many unprecedented actions in response to crisis conditions. And another is that there are clear limits to available legislative remedies, so that we will be left to fend with some of the problems of the crisis going forward.

Conclusion

I hope these remarks today are enough to generate some interesting discussion. I really appreciate the opportunity to be here and to interact with this exceptional group. While these are challenging times for macroeconomists, I think we are also learning a great deal about how the global macroeconomy works and about policies that may be helpful going forward. Thank you very much.

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  Press Release | Related news articles.

St. Louis Fed's Bullard Discusses "The U.S. Economic Situation and Regulatory Reform" at Tennessee's "A Day with the Commissioner"

NASHVILLE, Tenn. — In remarks today at the Tennessee Department of Financial Institutions' "A Day with the Commissioner," St. Louis Fed President James Bullard discussed the U.S. economic situation and provided an overview of the Tennessee economy. He also repeated his call for regulatory reform that enhances the Fed's regulatory authority and maintains its ability to remain at arm's length from politics.

The State of the U.S. Economy

"We are seeing continued signs of recovery for the U.S.," Bullard said in his