• Anthony Kiekow 314-949-9739
• Shera Dalin 314-444-3911
• Tim Lloyd 314-444-6829

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  St. Louis Fed's Bullard Discusses Monetary Policy and U.S. Economy

  JACKSON HOLE, Wyo. – On Friday, Federal Reserve Bank of St. Louis President James Bullard delivered remarks titled [“Views on the U.S. Economy: A Four-Part Story”](https://www.stlouisfed.org/-/media/project/frbstl/stlouisfed/files/pdfs/bullard/remarks/bullard3rdrockymountaineconomicsummit29july2011final.pdf) as part of the keynote monetary policy discussion at the 3rd Annual Rocky Mountain Economic Summit in Jackson Hole.as part of the keynote monetary policy discussion at the 3rd Annual Rocky Mountain Economic Summit in Jackson Hole.

  Bullard said that “monetary policy is on hold in an ultra-easy mode,” which is “an appropriate setting for monetary policy today.” Regarding the economic outlook, Bullard discussed why U.S. economic performance will likely improve in the second half of this year. He stated that three of the four key uncertainties that have plagued the U.S. economy since February have been largely or partially resolved, while one of them—the U.S. fiscal situation—is still on the table. “Once this last uncertainty is resolved, the path to faster growth may be open,” he said.

  Bullard also shared his views on the implications of a housing bubble for the economy. “If the U.S. economy was distorted by a housing bubble in the last decade, as many believe, then the appropriate comparison of today’s output level is to the non-bubble, fundamental level of output that would have been produced,” he said.

  Monetary Policy on Hold at “Ultra-Easy”

“The Fed has taken extraordinary steps in recent years to try to run an effective counter-cyclical monetary policy,” Bullard said. These steps include a policy rate near zero, extended period language for the near-zero policy rate, and expansion of the size of the balance sheet. He noted that with the end of asset purchases associated with the Fed’s second round of quantitative easing, “the size of the balance sheet remains at a high level.”

“The large balance sheet could generate significant inflation if accommodation is not removed at an appropriate pace,” Bullard said. “The inflationary threat has driven inflation expectations higher over the last year, and actual inflation has followed.” He added that given the near-zero policy rate, this means real short-term rates have declined. “That is, the policy stance has become even easier over the last year.”

Bullard noted that the Federal Open Market Committee (FOMC) has not taken action to reduce the size of the balance sheet and remove this inflationary threat. “I conclude that monetary policy remains ‘ultra-easy’ for now. This is an appropriate setting for monetary policy today,” he said.

“However, I expect that the economy will improve during the second half of the year and into 2012,” Bullard said. “As it does, the FOMC will have to monitor the situation closely in order to remove accommodation at an appropriate pace.”

The Second Half of 2011

Bullard said that as four key uncertainties unwind, U.S. economic performance is likely to improve. He outlined the state of the uncertainties, each of which in principle could be large enough to derail global economic growth.

1. The situation in Japan has stabilized and supply disruptions stemming from that source are expected to be minimal during the second half of 2011.
2. Energy and commodity prices, especially oil prices, have declined from their highs earlier this year, and turmoil in the Middle East and North Africa has moderated. Consumers did not react to $4/gallon gasoline as negatively as they did in 2008.
3. European authorities have made some progress on Greece with the

announcement of a new agreement in recent days. Financial stress indicators have not reacted as negatively to ongoing negotiations in Europe as they did in the April-May 2010 period.
4. The U.S. fiscal situation remains unresolved.

The U.S. Fiscal Situation

“It is essential that the Congress and the President come to an agreement on the U.S. budget and the projected level of U.S. debt going forward,” Bullard stated. “There is a substantial opportunity to put the U.S. fiscal situation on firmer footing, and remove a cloud of uncertainty hanging over U.S. macroeconomic prospects.”

Regarding the Fed’s role, Bullard said that “the Fed by law cannot buy debt directly from the Treasury.” Rather, the Fed can conduct open market operations only after the Treasury floats the debt in the primary market, he noted. “Hitting the debt ceiling means the Treasury cannot float debt in the primary market,” he said. “Therefore, the notion sometimes floated in financial markets that the Fed can simply step in if necessary is incorrect.”

Bullard said, “The Fed has no options should the debt ceiling not be raised. This is as it should be, because otherwise the central bank would be thwarting the will of the Congress.” He noted that this is a point Fed Chairman Ben Bernanke has emphasized.

“Should a general crisis ensue, the Fed can of course provide liquidity to markets as it did in 2008 and 2009. But that is not a substitute for the Treasury raising funds by issuing paper,” Bullard said. “The Fed cannot remedy a failure to raise the debt ceiling.”

How to Think About a Bubble

“The U.S. economy has been struggling to recover from a very large shock suffered during late 2008 and early 2009,” Bullard said. Many analysts believe that a housing “bubble” collapsed, where “a bubble means that there was overinvestment in housing—driven by self-fulfilling beliefs alone concerning future housing prices being ever higher,” he said. “The data on

housing prices certainly seems to support this hypothesis."concerning future housing prices being ever higher," he said. "The data on housing prices certainly seems to support this hypothesis."

Bullard said a bubble implies that too many resources were dedicated to the housing sector—both directly to the sector and to related businesses that support the sector—during the 2001-2007 period. In this scenario, such resource misallocation "temporarily contributed to more rapid GDP growth than would have occurred otherwise, but was ultimately unsustainable as the bubble collapsed and caused a large recession," he said.

U.S. real GDP grew about 2.4 percent per year on average from 2001-2007, Bullard noted. As a simple example illustrating the implications of a bubble, he talked about two economies. The fundamental economy—that is, the one without a bubble—grows steadily at 1.75 percent. The bubble economy, on the other hand, temporarily grows at a faster rate, but ultimately crashes and returns to the fundamental growth rate.

Bullard noted that most analysis he has seen compares the current level of output to the peak level of output that was produced during the previous decade. However, he said, "If the bubble explanation is correct, we should be comparing today's output level to the level suggested by the underlying, non-bubble, fundamental economy that would have existed over the last decade."

Although this example is only meant to be suggestive, Bullard said, "This gives a very different perspective on where the economy is today."

Contact Us
• Laura Girresch 314-444-6166
• Anthony Kiekow 314-949-9739
• Shera Dalin 314-444-3911
• Tim Lloyd 314-444-6829

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