western Kentucky, western Tennessee and northern Mississippi. The St. Louis Fed is one of 12 regional Reserve banks that, along with the Board of Governors in Washington, D.C., comprise the Federal Reserve System. As the nation's central bank, the Federal Reserve System formulates U.S. monetary policy, regulates state-chartered member banks and bank holding companies, provides payment services to financial institutions and the U.S. government, and promotes community development and financial education.

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

- **October 11, 2009**. Speech. "Three Issues for Near-Term Monetary Policy," (bullardnabefinaloct112009pdf) delivered at the 51st annual NABE meeting: The New Global Financial and Economic Architecture Gateway to Recovery (or just more of the Blues?).
  Press Release | Related news articles | Related media interview: Excerpt of Interview with Kathleen Hays, *Bloomberg*, October 12, 2009.

  St. Louis Fed's Bullard Addresses Issues Facing Near-Term Monetary Policy; Warns Against Over-Emphasis on Output Gap to Gauge Inflation Risks

  ST. LOUIS—During a speech Sunday at the 51st annual meeting of the National Association for Business Economics, St. Louis Fed President James Bullard reaffirmed the need for a Taylor-type policy rule for the Federal Reserve’s asset purchase program. Such a rule would help communicate how asset purchases may be adjusted as economic conditions change, while remaining consistent with the Fed’s goals of ensuring price stability and sustainable economic growth, he said.

  Bullard also expressed concern that inflation risks in the medium term may be higher than widely believed. He said that too much emphasis is being given to the idea that the recession implies that the output gap is currently quite large, minimizing the risk of inflation.

He also proposed a different framework for how U.S. monetary policy could be implemented in the future using interest on reserves held at the Fed. A similar structure is already in place at several other central banks.

Bullard's presentation, "Three Issues for Near-Term Monetary Policy," is available [online](https://www.stlouisfed.org/-/media/project/frbstl/stlouisfed/files/pdfs/bullard/remarks/bullardnabefinaloct112009.pdf) ..

MONETARY POLICY

On current monetary policy, "the key issue is how to think about the asset purchase program," Bullard said. "Liquidity programs are shrinking, but the asset purchase program is only partially complete."

He added that while the asset purchase program is considered a successful tool for quantitative easing, it has also caused a large and persistent increase in the monetary base. "This may lead to inflation in the medium-term, depending on markets' expectations of monetary policy going forward," Bullard said.

Prior to December 2008, the Fed communicated its monetary policy via adjustments in interest rates. However, with nominal interest rates currently near zero, the likely path of the Fed's monetary policy is now unclear to financial markets.

"Good policy means that the Fed needs to communicate to the private sector how it intends to react to shocks in the future," Bullard said. "There has been little indication of how or whether these [asset purchase] amounts might be adjusted given incoming information on economic performance. This lack of clarity has created uncertainty in financial markets."

Bullard called for the development of a quantitative rule for monetary policy in the current environment. "We have spent 20 years refining ideas about interest rate rules and optimal monetary policy," Bullard said. "We should now consider quantitative rules because we are at the zero bound, and may remain there for some time depending on how the economy performs."

FUTURE IMPLEMENTATION OF MONETARY POLICY

Going forward, Bullard said the Fed's ability to pay interest on reserves—an authority granted to the central bank in the fall of 2008—could serve as a new tool in the implementation of monetary policy in the U.S. He pointed out that many other central banks around the world operate with three rates:

- an interest rate paid on deposits at the central bank,
- a lending rate for loans from the central bank and
- a policy rate that lies between the two.

"The Fed could implement monetary policy differently," he said. "It could implement the lending and deposit rates via standing facilities. The stance of policy would then depend on all three rates, although they might often be adjusted together."

THE OUTPUT GAP

Bullard also cautioned that policymakers should not place too much emphasis on output gap estimates when trying to assess inflation risks in the medium-term.

"I am concerned about a popular narrative in use today—the narrative being that the output gap must be large since the recession is so severe," he said. "And so, any medium-term inflation threat is negligible, even in the face of extraordinarily accommodative monetary policy. I think this narrative overplays the output gap story."

He added that measuring the gap is very difficult, both theoretically and practically. He cited research that shows much of the inflationary run-up in the 1970s can be attributed to a misreading of the output gap at the time.

"Even if economists were to accept a particular measure, the empirical relationship with inflation is not robust," he said. In addition, traditional output gap measures do not account for the concept of bubbles.

"It has been popular to describe recent events as a collapse of a bubble in housing. A look at the housing data makes a convincing case," Bullard said.

“But when it comes to calculating traditional output gaps, there is no notion of a bubble. If part or most of the fall in output was a collapsed bubble, then today’s output gap would be smaller than it appears.” This would mean that inflation risks in the medium term are higher than otherwise thought.

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With branches in Little Rock, Louisville and Memphis, the Federal Reserve Bank of St. Louis serves the Eighth Federal Reserve District, which includes all of Arkansas, eastern Missouri, southern Indiana, southern Illinois, western Kentucky, western Tennessee and northern Mississippi. The St. Louis Fed is one of 12 regional Reserve banks that, along with the Board of Governors in Washington, D.C., comprise the Federal Reserve System. As the nation's central bank, the Federal Reserve System formulates U.S. monetary policy, regulates state-chartered member banks and bank holding companies, provides payment services to financial institutions and the U.S. government, and promotes community development and financial education.

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

- **October 1, 2009**. Article. "Is the Rate of Homeownership Nearing a Bottom?" Federal Reserve Bank of St. Louis *The Regional Economist*, October 2009.

  President's Message: Is the Rate of Homeownership Nearing a Bottom?

  The housing crisis has been central to our current recession. An economist at the Federal Reserve Bank of St. Louis, Carlos Garriga, has devoted much of his research to understanding the intricacies of mortgage markets and loan choices.

  What insight might his research bring to the current environment? To begin, he has examined the evolution of homeownership rates and their connection with mortgage market innovations. For about a quarter of a century, the homeownership rate hovered around 64 percent. In 1966, it was at 63.5 percent. Twenty-seven years later, in 1993, it had barely budged to 63.8 percent. However, over the past 15 years, a significant change occurred, largely the result of government policy and innovations in mortgage markets.

Politicians pushed to increase the home-ownership rate on the premise that home-owners are more likely to maintain their property than a renter would. And, of course, almost every version of the American dream includes a house with a white picket fence.

In the early 1990s, the Federal Housing Administration (FHA) started to offer mortgage products with low down payments. Prior to this, most mortgage lenders required a 20 percent down payment on all new loans. The rationale for the down payment was to ensure that the home had enough equity to ward off foreclosure if home prices were to fall substantially. To qualify for a low down payment, homeowners had to buy lenders mortgage insurance or private mortgage insurance.

In the late 1990s, conventional lending became more sophisticated. To avoid mortgage insurance, lenders offered a second loan (at a higher interest rate) for a portion of the remaining loan amount. The advantage of the combo, or piggyback, loan was that borrowers could increase their leverage at a lower cost since mortgage interest payments could be deducted on their income tax, whereas mortgage insurance premiums were not deductible until 2007. The homeownership rate increased from 63.8 percent in early 1994 to 68 percent in 2002.

Over the following three years, the rate increased to 69.2 percent, in the heart of the housing boom. Over this period, subprime lending took off and additional mortgage products were introduced and became popular. These included zero down-payment loans, interest-only adjustable-rate mortgages (ARMs) and payment-option ARMs.

The last loan type allowed borrowers flexible monthly repayment strategies, including full amortization of principal with either zero or even negative amortization.

The bottom soon fell out. Since the end of 2006, nationwide home prices have fallen by as much as 30 percent. The homeownership rate has been steadily declining, too, since then. Through the second quarter of 2009, it was down 1.5 percentage points, to 67.4 percent. This decline reflects a rebalancing: Just as we saw the homeownership rate increase by a little over one percentage point as new mortgage products were introduced, we now see those buyers exiting the market as that equity disappears.

Assuming they could just "refinance later," they found themselves unable to make payments as prices tanked. Additionally, as Carlos recently discussed in the St. Louis Fed's   National Economic Trends publication, refinancing denials started to increase well before the peak of the housing boom, suggesting that lenders were uncomfortable with the values being assessed to homes.publication, refinancing denials started to increase well before the peak of the housing boom, suggesting that lenders were uncomfortable with the values being assessed to homes.
[[1]](https://www.stlouisfed.org#endnotes)

These borrowers obtained financing through risky tools. If all borrowers who could obtain financing through standard financing options (i.e., not zero down-payment loans, interest-only loans, etc.) had already entered the homeownership arena, they would have already been captured within the 2002 rate of 68 percent.

The homeownership rate is now down below the 2002 level; it has remained at roughly 67.5 percent for three quarters (Q4 2008 through Q2 2009). Although further data are needed, this suggests the decline might now have bottomed out, provided the economic environment doesn't pull down otherwise well-positioned homeowners.

A natural question is to wonder whether the severity of the price decline will force additional homeowners out. During the 27 years that the homeownership rate hovered around 64 percent, there were many price fluctuations and yet no change in the ownership rate. The difference is that virtually no homebuyer was highly leveraged; almost all buyers had already paid at least 20 percent of the purchase price of their home. Hence, even as prices fell, homeowners were able to "ride out" the storm. Examining homeownership rates is one small but interesting piece of the puzzle. Government policy helped buoy the home-ownership rate to historic highs, and risky lending practices pushed it even higher. Time will tell where the new equilibrium rate will settle, but signs point to a near end in the decline.

Endnotes
1. Garriga, Carlos. "Lending Standards in Mortgage Markets." National Economic Trends , May 2009, p. 1. See, May 2009, p. 1. See [http://research.stlouisfed.org/publications/net/20090501](http://research.stlouisfed.org/publications/net/20090501/cover.pdf) . [. [

/cover.pdf/cover.pdf [back to text](https://www.stlouisfed.org#1##1)]]

The Regional Economist offers insights on regional, national and international issues. Views expressed are not necessarily those of the St. Louis Fed or Federal Reserve System.

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- **September 25, 2009**. Presentation. "Monetary Policy Feedback Rules at the Zero Lower Bound," (jamesbullardsnbzurichsept25finalpdf) *Financial Markets, Liquidity and Monetary Policy* Swiss National Bank Research Conference Zurich, Switzerland.
  Press Release | Related news articles.

St. Louis Fed's Bullard Calls for the Development of Quantitative Rules for U.S. Monetary Policy That Could Be Implemented in the Current Environment

ZURICH, Switzerland —

Bullard addressed the “Financial Markets, Liquidity, and Monetary Policy” research conference that was organized by the Swiss National Bank.