ST. LOUIS POST-DISPATCH

Bullard the hawk tries on dove feathers

James Saft

November 12, 2015

In a bull market in stocks the time to sell is often when self-identified bears at last change sides.

So it may prove now in monetary policy with St. Louis Fed President James Bullard in the role of hawk now speculatively contemplating an era of "Permazero" interest rates.

The issue isn't that of at last raising interest rates: Bullard has long argued for this and in December it appears he and we are going to get it. And Bullard continues to make his accustomed arguments about the risks of inflation.

What is remarkable is that a policymaker with Bullard's views is now also talking about the possibility that up is down, black is white and inflation follows is "dictated" by monetary policy, something that could allow rates to be pegged and yet the apparatus remain stable.

"Post-crisis U.S. monetary policy could be interpreted as exactly that — an interest rate peg — and an extreme one at that, since the policy rate has remained near zero for nearly seven years," Bullard said in a talk entitled "Permazero" given Thursday at the Cato Institute.
"I will summarize some recent academic work on the idea of a stable interest rate peg and what its implications may be for current monetary policy choices. I will argue that a stable interest rate peg is a realistic theoretical possibility."

While it would be quite something if that were true, and Bullard obviously has reservations, what definitely does matter is that people like him are kicking ideas like that around. We are not in Kansas anymore.

"Should we find ourselves in a persistent state of low nominal interest rates and low inflation, some of our fundamental assumptions about how U.S. monetary policy works may have to be altered," Bullard said, later arguing that it was a "realistic possibility" that G7 rates stay close to the zero lower bound in coming years.

Given the experience of Japan, where it has been more than 20 years since policy rates were higher than 50 basis points, this isn't entirely outlandish.

While his base case remains that zero rates raise risks of future inflation, Bullard outlines the possibility that, rather than inflation expectations rising if rates stay low for long, the low rates themselves "dictate" medium- and longer-term inflation.

EVIDENCE, ADHERENTS AND RISK

If Bullard's musings are correct, the implications for monetary policy and the economy are vast. He suggests that policymakers might wish to lower their target for inflation, currently 2 percent, to the level policy produces. Asset price volatility would likely also be a result and, due to the lack of other easy-to-implement tools, quantitative easing would become a long-term feature in the financial and policy landscape.

To be sure, Bullard isn't acting as if any of this is actually true, only suggesting it may be, and that there is some supporting evidence.

Investors, on the other hand, are in some respects behaving as if inflation risks are not rising much as a consequence of seven long years of zero interest rates and a Federal Reserve balance sheet of $3.5 trillion.

So-called 10-year breakeven rates — the difference between yields on 10-year Treasury notes and 10-year inflation-linked bonds and a marker for longer-term expectations — are not showing much fear of future inflation. Ten-year breakevens are now about 1.56 percent, not only below the Fed's target, but well below the rates of more than 2 percent that pertained in 2014. That may reflect many things — the fall in the price of energy for one — but it does not argue there has been an "un-anchoring" of inflation expectations. As such it is consistent with the Permazero thesis.

It is under just this kind of pressure that the last hawks or last bears change teams. That, in some respects, is the more interesting risk, though not the central scenario.

Albert Edwards, global strategist at Societe Generale and a long-time bear, argues that weakness in higher-paid industry jobs has artificially suppressed wage pressure measures, giving the Fed a false sense of security. He also points out that if energy prices stay where they are, by June 2016 headline inflation may be at 2 percent or more. This raises the risk, in the event of continued strong labor markets, of rapid acceleration in wages and inflation fears.

"I believe things will blow up way before that; certainly by then the Fed is likely to be seen as having gotten itself way behind the tightening curve," Edwards wrote in a note to clients.

If so, Bullard may discard his dovish thoughts but do so amid serious asset price volatility anyway.