FEDERAL RESERVE BANK of ST. LOUIS

# A Sea Change in U.S. Monetary Policy


**James Bullard**
President and CEO


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*Any opinions expressed here are my own and do not necessarily reflect those of the Federal Open Market Committee.*

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# Introduction

# Key themes

- Starting in January 2019, the Federal Open Market Committee (FOMC) made significant adjustments to the path of U.S. monetary policy.
- These changes were made in anticipation of slower growth in the U.S. economy during 2019 and also in anticipation of continued uncertainty regarding global trading arrangements.
- While additional policy action may be desirable, the long and variable lags in the effects of monetary policy suggest that the effects of previous actions are only now beginning to impact macroeconomic outcomes.
- Meanwhile, inflation pressures remain muted, and a more meaningful inversion of the yield curve continues to threaten.

# A Sea Change in U.S. Monetary Policy

# The situation in late 2018

- The story begins late last year, when the interest rate outlook was considerably different than it is today.
- As of Nov. 8, the two-year Treasury, often taken as a harbinger of future FOMC policy, was trading to yield 2.98%.
- The corresponding 10-year Treasury was trading to yield 3.24%, and so the spread was 26 basis points.
- The FOMC raised the policy rate at the December meeting and projected further policy rate increases during 2019.

# The sea change in 2019

- Starting with Chair Powell's comments at the AEA meetings in Atlanta on Jan. 4, the FOMC began to change direction.
- During the first half of 2019, the FOMC began to project fewer increases in the policy rate and also laid out a plan to cease the runoff of the Fed's balance sheet.
- On June 19, the FOMC did not change the policy rate but strongly suggested that a future downward adjustment could be warranted.
- On July 31, the FOMC followed through and reduced the policy rate.

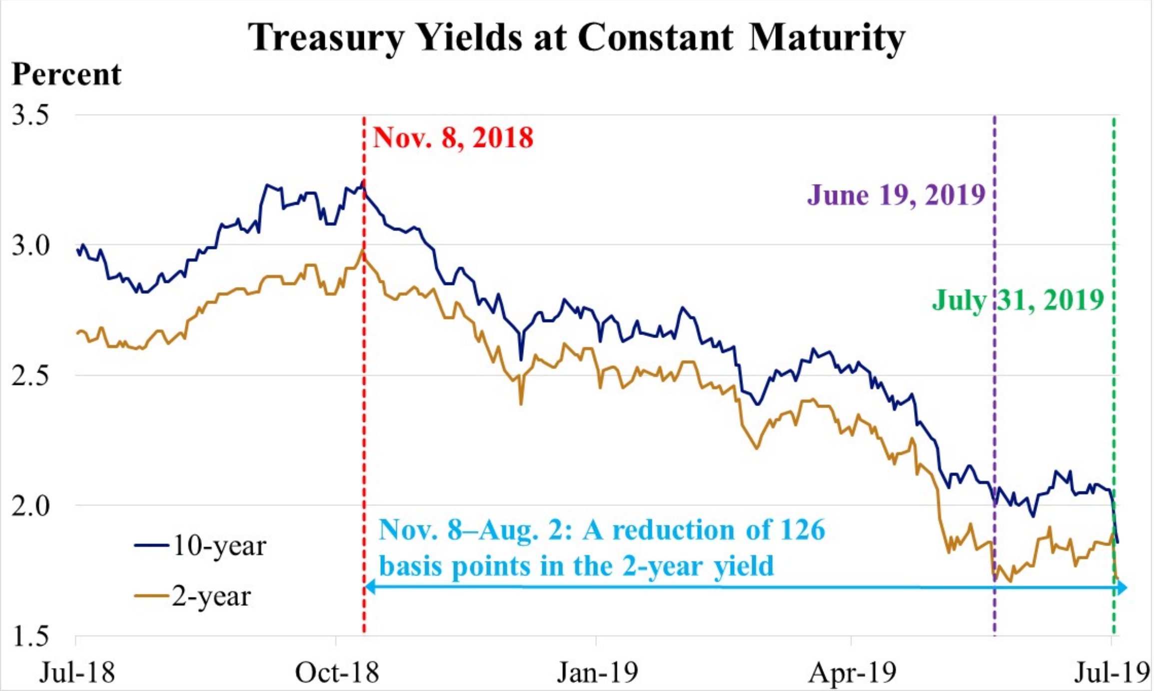
# Interest rates are dramatically lower

- What was the effect of this sea change?
- On June 19, the two-year Treasury was trading to yield 1.74%, a decline of 124 basis points from the level on Nov. 8, 2018.
- Also on June 19, the 10-year Treasury was trading to yield 2.03%, a decline of 121 basis points from the level on Nov. 8.
- As of last Friday, Aug. 2, the two-year Treasury was trading to yield 1.72%, and the 10-year Treasury was trading to yield 1.86%.

# Interpretation

- One straightforward reading of these events is that the outlook for shorter-term interest rates influenced by the FOMC, as embodied in the two-year yield, dropped because of FOMC actions by about 126 basis points during the last nine months.
- This is a very large change over this time frame.
- Furthermore, these policy actions fed through to longer-term yields, which are more important for investment decisions.
- The bottom line is that U.S. monetary policy is considerably more accommodative today than it was as of late last year.

# Effects of the sea change in monetary policy



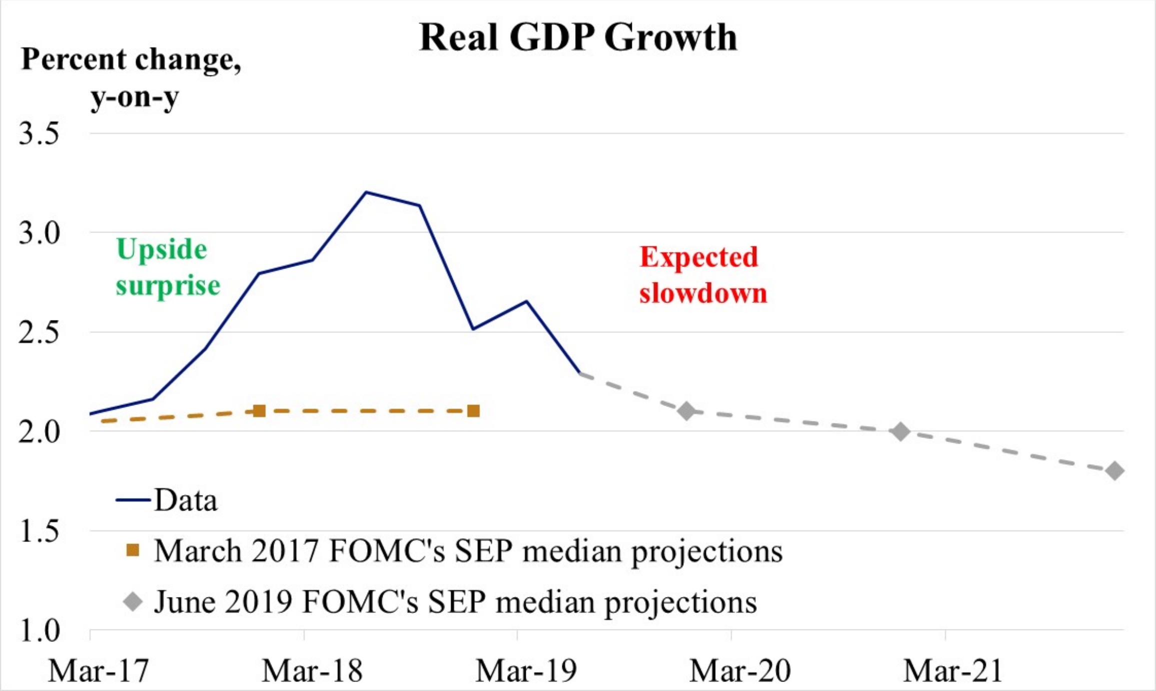

*Source: Federal Reserve Board. Last observation: Aug. 2, 2019.*

# Anticipated Slower Growth and Ongoing Trade Uncertainty

# Slower growth

- According to recently revised figures on U.S. real GDP, the economy grew at a 2.5% pace during 2018.
- Growth for 2019 as a whole has long been expected to be slower as the economy returns to its potential growth rate.
- A key risk has been that global trade uncertainties may cause this slowing to be sharper than anticipated.

# U.S. real economic growth




*Sources: Bureau of Economic Analysis and Federal Reserve Board. Last observation: 2019-Q2.*

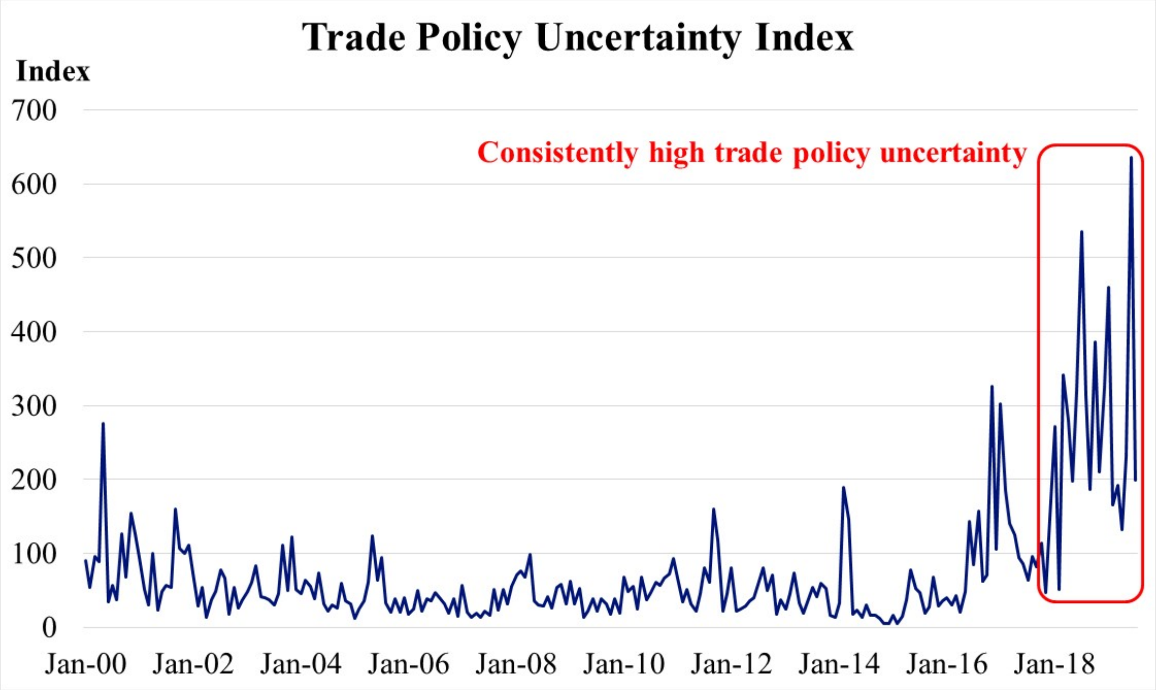
# Ongoing trade disputes

- Recent developments in global trade negotiations suggest that it will be difficult to reach a stable global trade regime over the forecast horizon.
- This is likely chilling global investment and feeding into slower global growth.
- The direct effects of trade restrictions on the U.S. economy are relatively small, but the effects through global financial markets may be larger.

# U.S. monetary policy and trade

- U.S. monetary policy cannot reasonably react to the day-to-day give-and-take of trade negotiations.
- I think of trade regime uncertainty as simply being high in the current environment and as something that is already being judgmentally factored into my monetary policy calculus.
- Particular threats or counterthreats are only manifestations of already high trade regime uncertainty.
- I do not expect this uncertainty to dissipate in the quarters and years ahead.

# High trade policy uncertainty



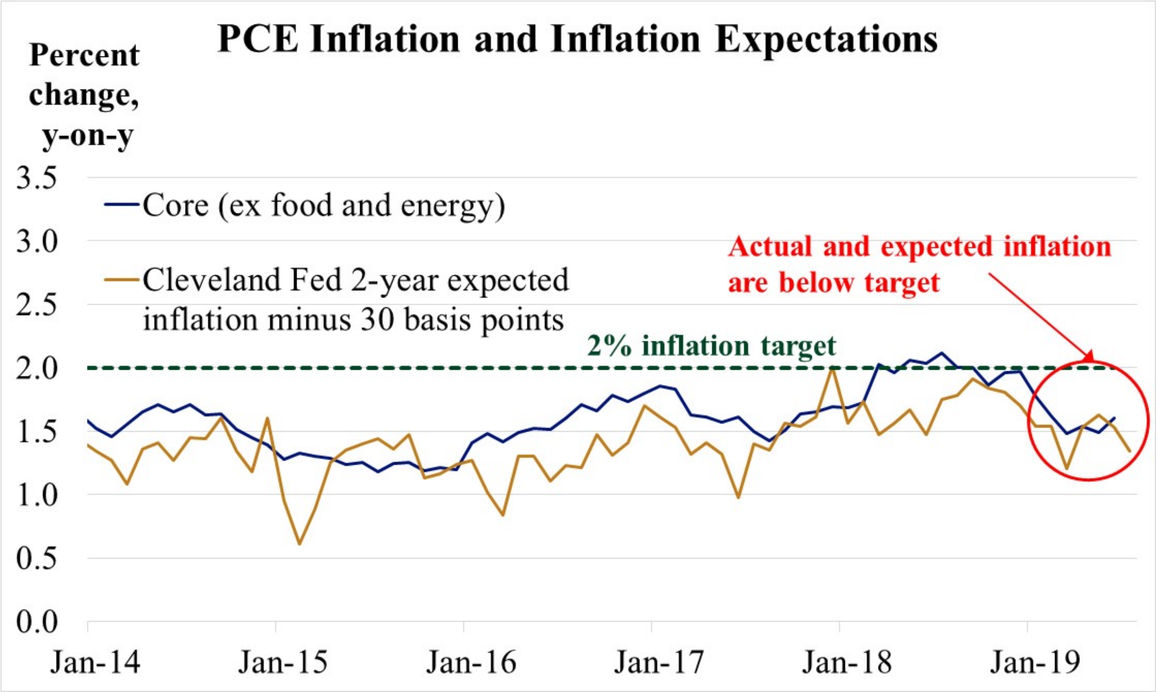

*Source: www.policyuncertainty.com. For details, see S.R. Baker, N. Bloom and S.J. Davis, "Measuring Economic Policy Uncertainty,"* Quarterly Journal of Economics, *November 2016, 131(4), pp. 1593-1636. Last observation: July 2019.*

# Muted Inflation

# Inflation expectations remain below target

- The FOMC has a stated inflation target of 2%.
  - The inflation target is in terms of the annual change in the price index for personal consumption expenditures (PCE).
  - The FOMC often uses the core PCE inflation rate to gauge inflation performance.
- Both inflation and inflation expectations are below target.
- This is occurring despite more than two years of upside surprise in the U.S. real economy.
- This is clearly concerning for the credibility of the inflation target.

# Inflation and inflation expectations low



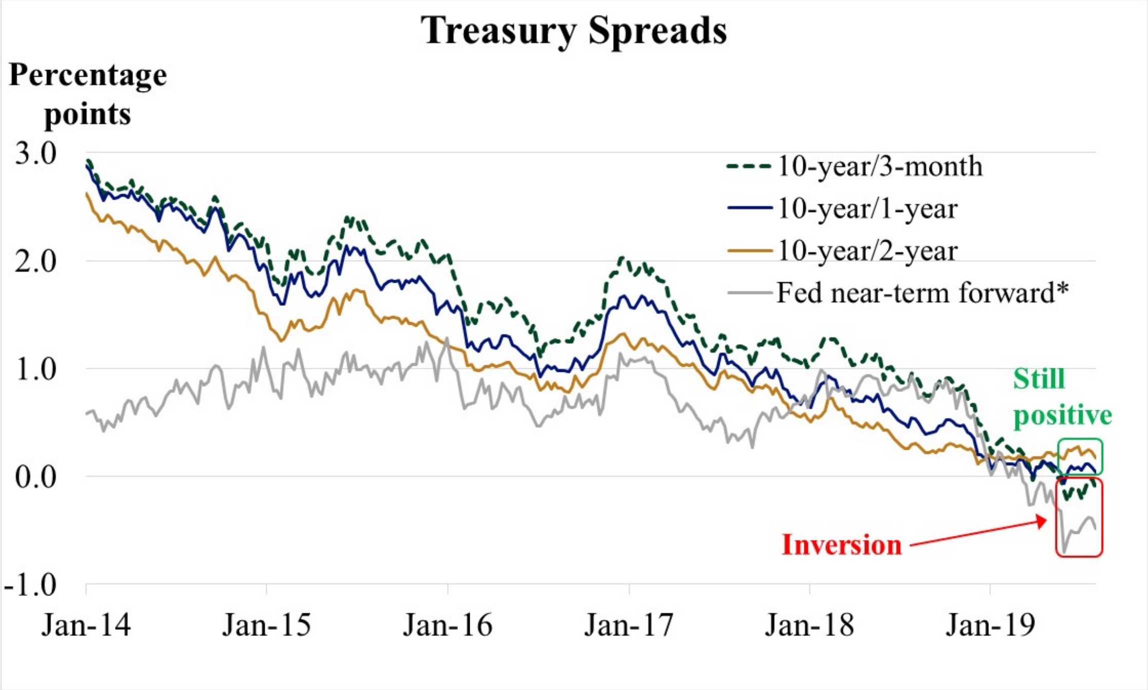

*Sources: Bureau of Economic Analysis, Federal Reserve Bank of Cleveland and author's calculations. I subtract 30 basis points from expected CPI inflation to roughly translate to a PCE inflation basis. Last observations: June 2019 and July 2019.*

# Yield Curve Issues

# Yield curve inversion

- The slope of the yield curve contains important information for monetary policymakers.
- An inversion of the yield curve has tended to predict the onset of recession in the U.S. during the postwar era.
- Some portions of the Treasury yield curve are inverted today.
  - In particular, the 10-year yield is below the effective federal funds rate.
  - However, the 10-year yield remains above the two-year yield, likely because markets are anticipating future policy moves by the FOMC, and so we are not seeing an intensification of the yield curve inversion so far.

# Yield curve partial inversion




*Sources: Federal Reserve Board, Bloomberg and author's calculations. Last observation: Week of July 31, 2019.*
** For details, see E. Engstrom and S. Sharpe, "[The Near-Term Forward Yield Spread as a Leading Indicator: A Less Distorted Mirror](), " Federal Reserve Board FEDS Working Paper No. 2018-055, July 2018.*

# Conclusion

# Monetary policy today

- The FOMC continues to face a slowing economy with some downside risk due to ongoing global trade regime uncertainty.
- Inflation and inflation expectations continue to fall short of the FOMC's 2% target.
- However, FOMC actions have also changed the outlook for shorter-term interest rates considerably over the last nine months, ultimately providing more accommodation to the economy.
- While additional policy action may be desirable, the long and variable lags in the effects of monetary policy suggest that the effects of previous actions are only now beginning to impact macroeconomic outcomes.

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