Disinflationary Policy and Financial Stability in the U.S.

James Bullard
President and CEO

Forum on “Monetary Policy and Financial Institutions Reform”
Academia Sinica, Taipei, Taiwan

July 8, 2022 (Taipei time) / July 7, 2022 (CDT)

CENTRAL TO
AMERICA’S ECONOMY®

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

Introduction

Key themes

- U.S. inflation is comparable to levels seen in the 1970s.
- The Fed has reacted by taking important first steps to return inflation to the 2% target.
- Market interest rates have increased substantially, partially in response to promised Fed action.
- U.S. labor markets remain robust, and output is expected to continue to expand through 2022.
- The U.S. banking system faces moderate stability risks, according to recent stress test results.

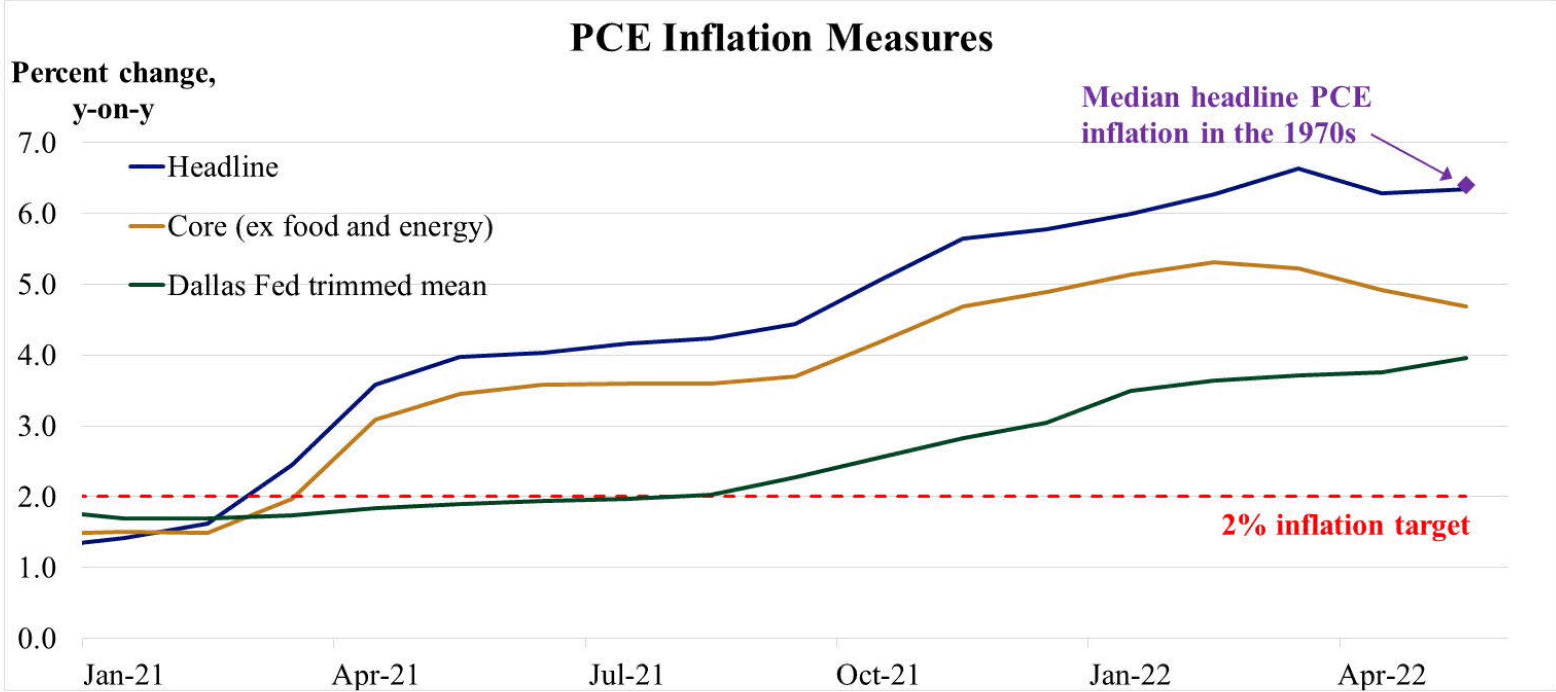
Inflation Is Comparable to 1970s Levels

U.S. inflation is far above target

- The Fed has a statutory mandate to provide stable prices for the U.S. economy.
- The FOMC has an associated inflation target of 2%, stated in terms of headline personal consumption expenditures (PCE) inflation.
- The current inflation rate on this measure is 6.3%.[†]
- Because food and energy prices can be particularly volatile, analysts sometimes refer to core PCE inflation, which is currently 4.7%.[†]
- The Dallas Fed trimmed mean inflation rate measures only the middle portion of the price change distribution, and by this measure inflation is 4.0%.[†]

[†] *Inflation figures are year-over-year percentage changes for the month of May 2022.*

Inflation is comparable to 1970s levels



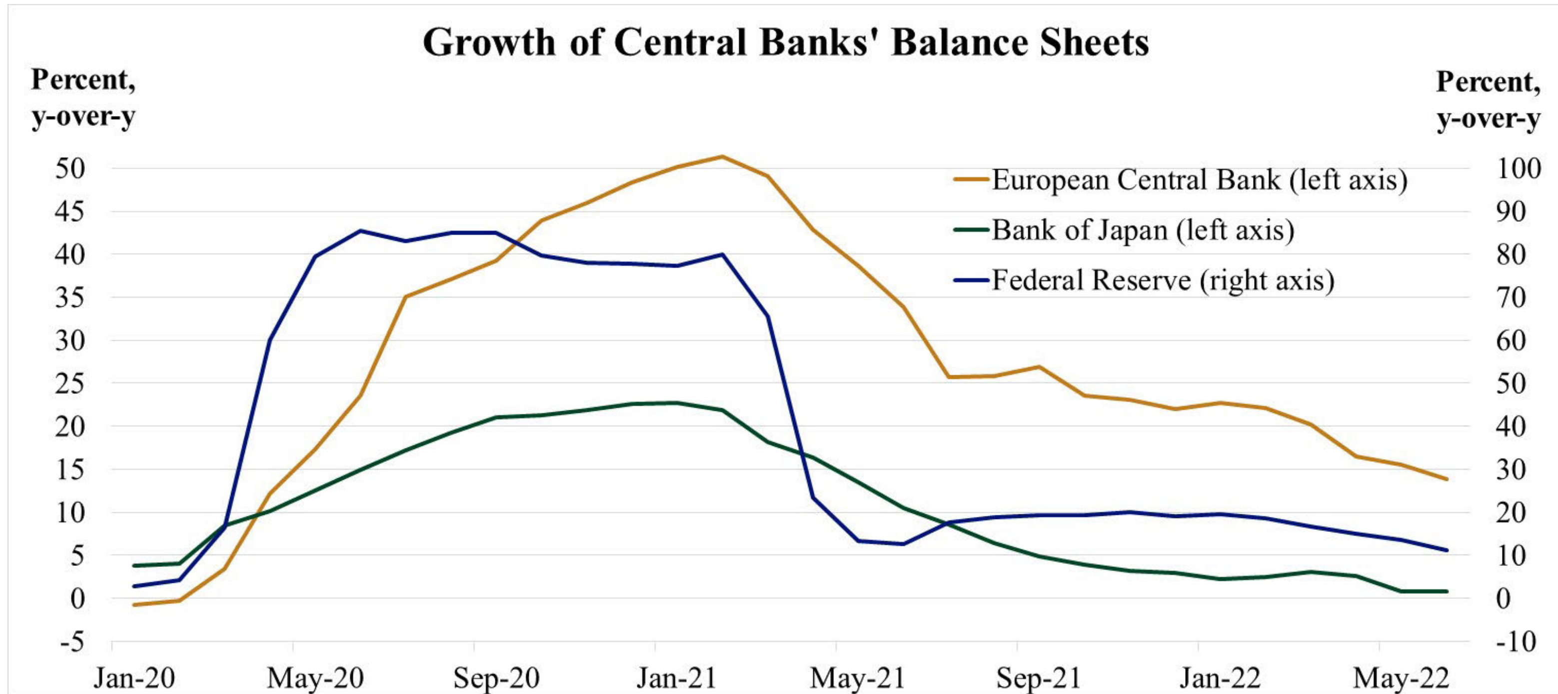
Sources: Bureau of Economic Analysis and Federal Reserve Bank of Dallas. Last observation: May 2022.

What the Fed Has Done So Far

The FOMC's moves so far

- Beginning in the second half of 2021, the Fed began to move in a more hawkish direction to take better control of inflation risks.
- With respect to the policy rate: The FOMC has increased the rate's level at the last three meetings and is poised to make further increases at coming meetings.
- With respect to the balance sheet: The FOMC has ceased asset purchases and has begun to allow passive runoff, known in markets as quantitative tightening, or QT.
- Foreign central banks are simultaneously increasing their policy rates and allowing their balance sheets to shrink.

Approaching global quantitative tightening



Sources: Board of Governors of the Federal Reserve System, European Central Bank, Bank of Japan and author's calculations. Last observation: June 2022.

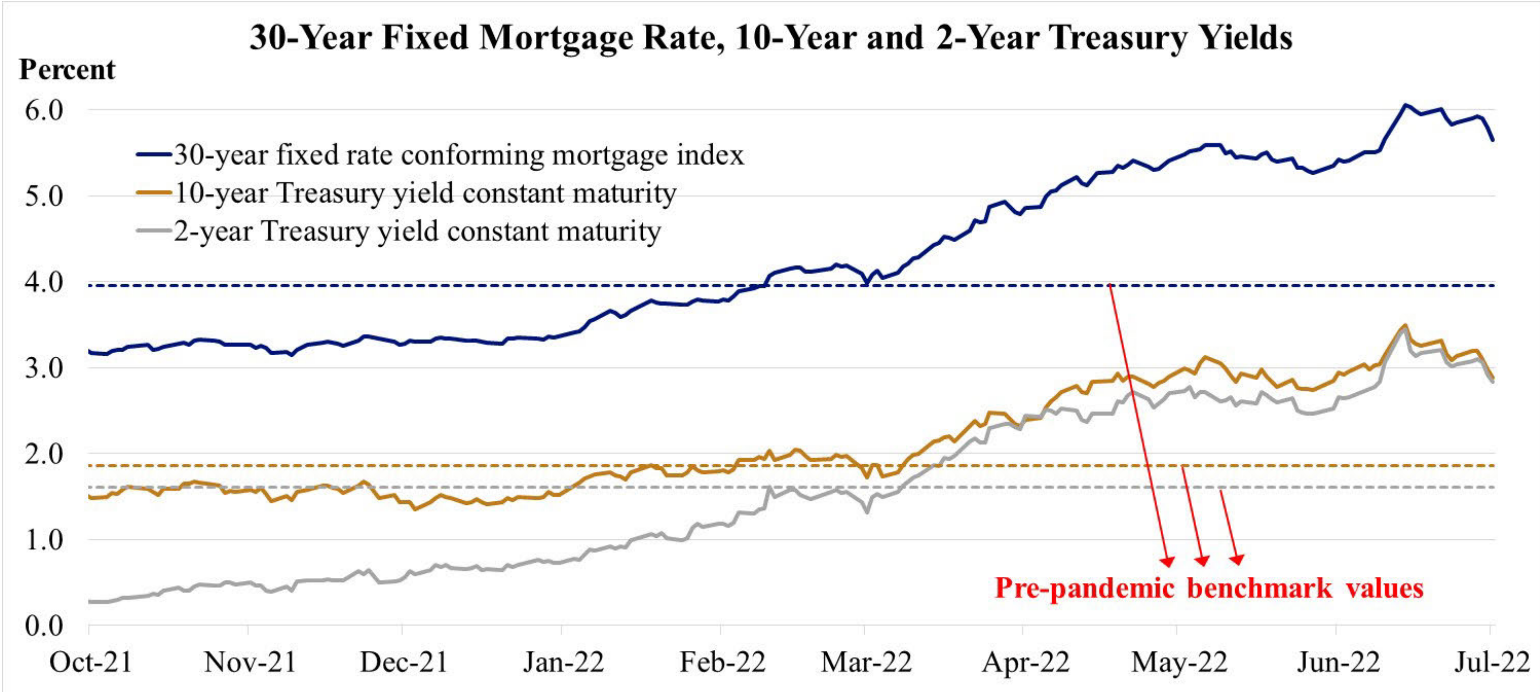
The Pre-Pandemic Benchmark

The pre-pandemic benchmark

- Before the pandemic, at the end of 2019:
  - The U.S. economy was growing at 2.6%, the headline PCE inflation rate was 1.5%, and the unemployment rate was 3.6%.[†]
  - The policy rate associated with these outcomes was 1.55%.[‡]
  - Policy was not expected to change much going forward. Accordingly, the 2-year Treasury yield was 1.61%.[‡]
  - Longer-term rates were moderate, with the 10-year Treasury yield at 1.86% and the 30-year fixed rate mortgage at 3.96%.[‡]
- This may provide a practical benchmark for where the constellation of rates may settle once inflation comes under control in the U.S.

[†] *Real GDP growth and inflation are Q4-over-Q4 values. Unemployment is the December 2019 value.*
[‡] *Interest rates are monthly averages of daily data for December 2019.*

Market pricing based on Fed credibility



Sources: Optimal Blue and Department of the Treasury. Last observation: July 1, 2022.

Market rates are above pre-pandemic benchmarks

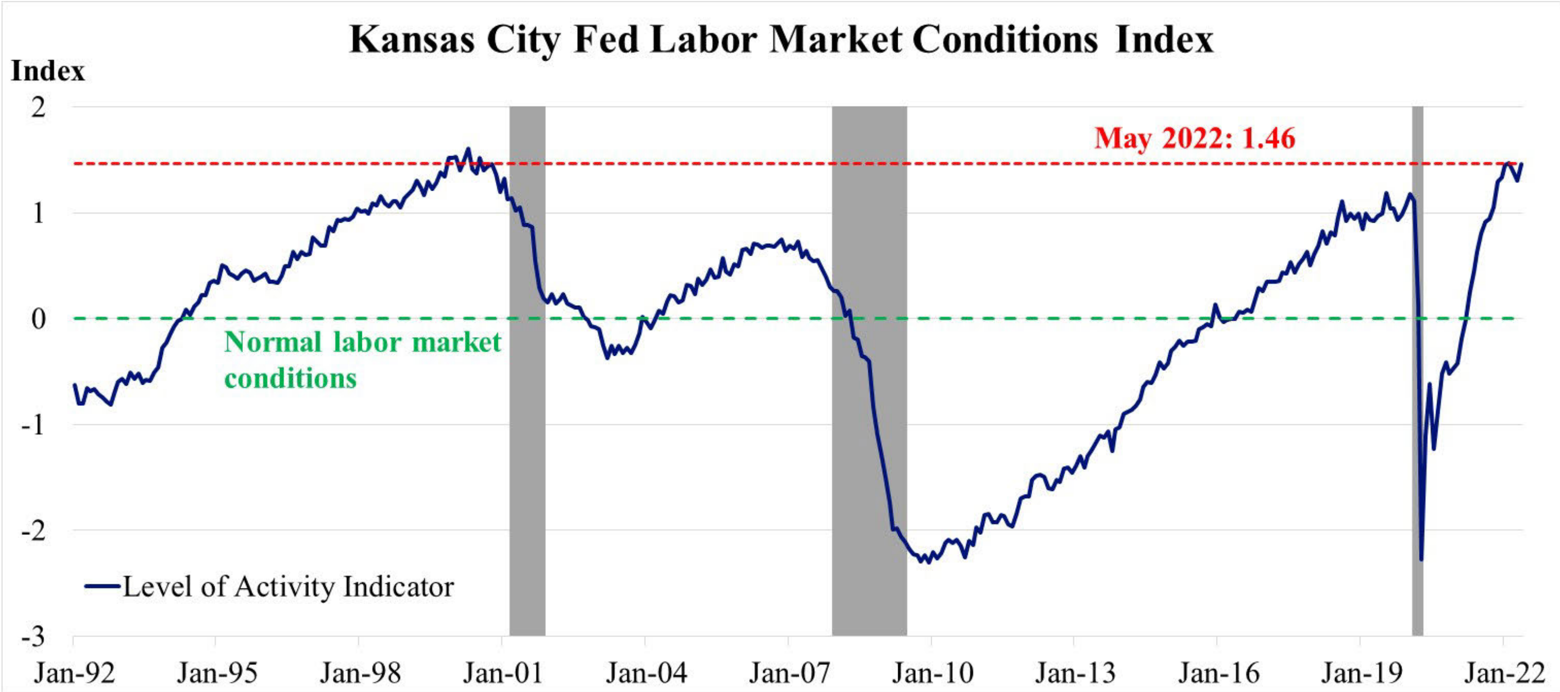
- The fact that market interest rates have moved above their pre-pandemic benchmarks while the policy rate has not can be read as an illustration of the effect of credible forward guidance.
- The Fed still has to follow through to ratify the forward guidance previously given, but the effects on the economy and on inflation are already taking hold.

Labor Markets Remain Robust

Robust labor markets

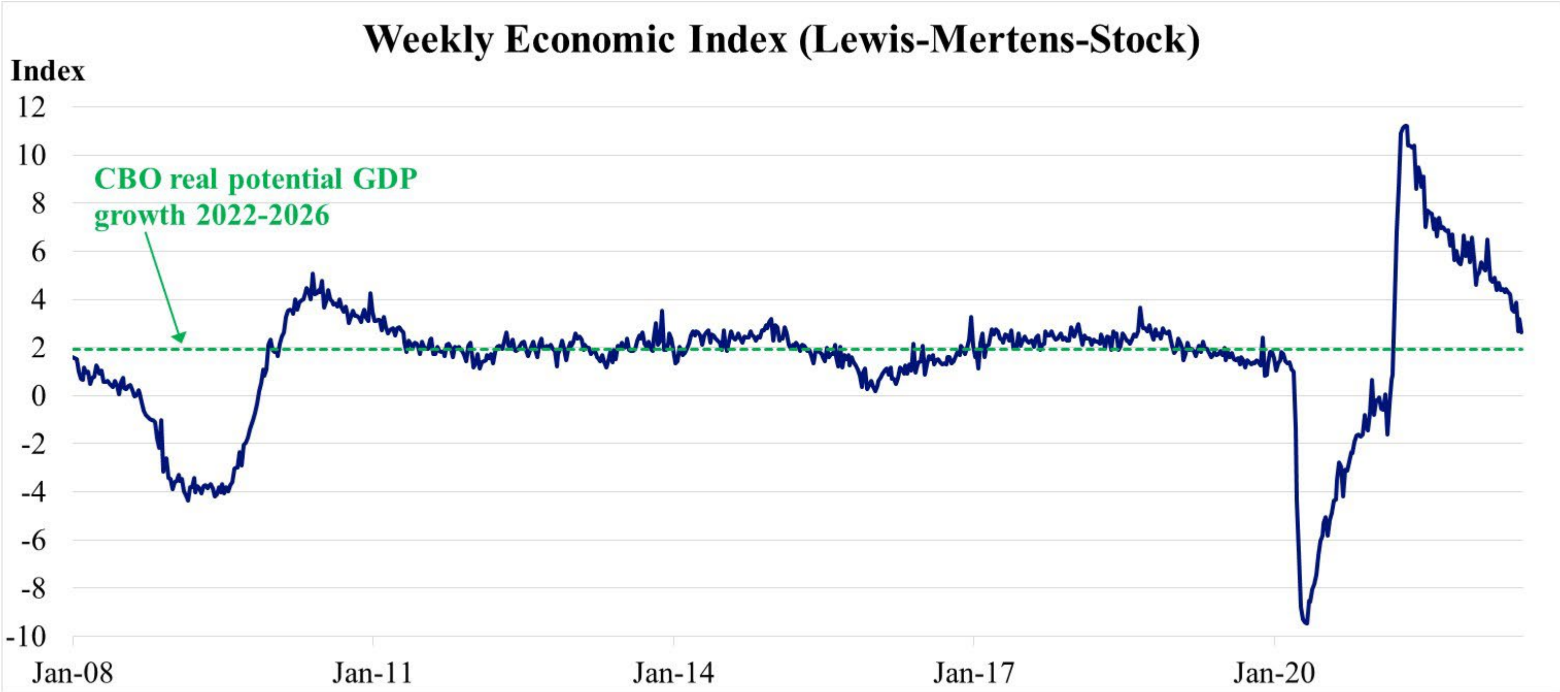
- U.S. labor markets remain robust, according to recent data and anecdotal reports.
- The Kansas City Fed's labor market conditions index, which aggregates various measures of labor market performance into a single metric, remains near highs last seen in 1999-2000.
- Real-time indicators of U.S. GDP growth suggest continued expansion in the quarters ahead.
- Risks remain substantial and stem from uncertainty around the Russia-Ukraine war and the possibility of a sharp slowdown in China.

Labor market conditions: as good as in 1999-2000



Source: Federal Reserve Bank of Kansas City. Shaded areas denote U.S. recessions. Last observation: May 2022.

Real GDP is growing faster than potential



Sources: Federal Reserve Bank of New York and Congressional Budget Office. Last observation: Week ending June 25, 2022.

Banks and Financial Stability

U.S. banks are strong and expected to remain so

- The Fed's 2022 stress tests concluded that the 33 largest U.S. banks could absorb significant losses in a "severely adverse" economic scenario and remain well-capitalized, able to continue lending to households and businesses.[†]
- Regional and community banks are also strong, according to a Fed review of banking conditions.[‡]

[†] *See Board of Governors of the Federal Reserve System,* 2022 Federal Reserve Stress Test Results*, June 2022.*
[‡] *See Board of Governors of the Federal Reserve System,* Supervision and Regulation Report*, May 2022.*

Financial system vulnerabilities appear moderate

- The Fed's *Financial Stability Report* highlighted four areas of potential vulnerability:[†]
    1. Asset valuations: Moderate concern.
    2. Leverage in nonfinancial sectors: Low concern.
    3. Leverage in financial institutions: Low concern.
    4. Funding risks: Moderate concern.

[†] *Board of Governors of the Federal Reserve System,* Financial Stability Report*, May 2022.*

Near-term risks to financial stability

- In early 2022, New York Fed staff surveyed a broad range of contacts, who expressed particular concern about these near-term risks to financial stability:[†]
  - Russia's ongoing war in Ukraine.
  - Elevated and persistent inflation.
  - The possibility that stresses in China, including in the real estate sector, could spill over to the U.S.
  - The possibility that inflationary pressures and adverse external shocks could lead to stresses in other emerging market economies (EMEs) that could affect the U.S.

[†] *See Section 5 of Board of Governors of the Federal Reserve System,* Financial Stability Report*, May 2022.*

Conclusion

Conclusion

- Inflation in the U.S. is far above target and is at levels last seen in the 1970s and early 1980s.
- The Fed has raised the policy rate, promised to raise the policy rate further in the future, and begun passive balance sheet reduction.
- Fed credibility along with forward guidance on these dimensions is helping the Fed move policy more quickly to the degree necessary to keep inflation under control.
- The Fed recently reported stress test results indicating that the largest banking institutions in the U.S. remain on solid financial footing.

Connect With Us

Visit stlouisfed.org

Browse publications featuring expert **research and analysis**

Discover free **economic education** resources for all learners

Find **community development** tools that support an economy for all

Explore the **Economy Museum** online and see how to visit in person

Follow @stlouisfed on Twitter, Instagram, LinkedIn and more

Keep up with President Jim Bullard's latest remarks

Get timely economic data from FRED®