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Is the Fed “Behind the Curve”? Two Interpretations

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How Monetary Policy Got Behind the Curve and How to Get Back
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Any opinions expressed here are my own and do not necessarily reflect those of the Federal Open Market Committee.

Introduction

Key themes

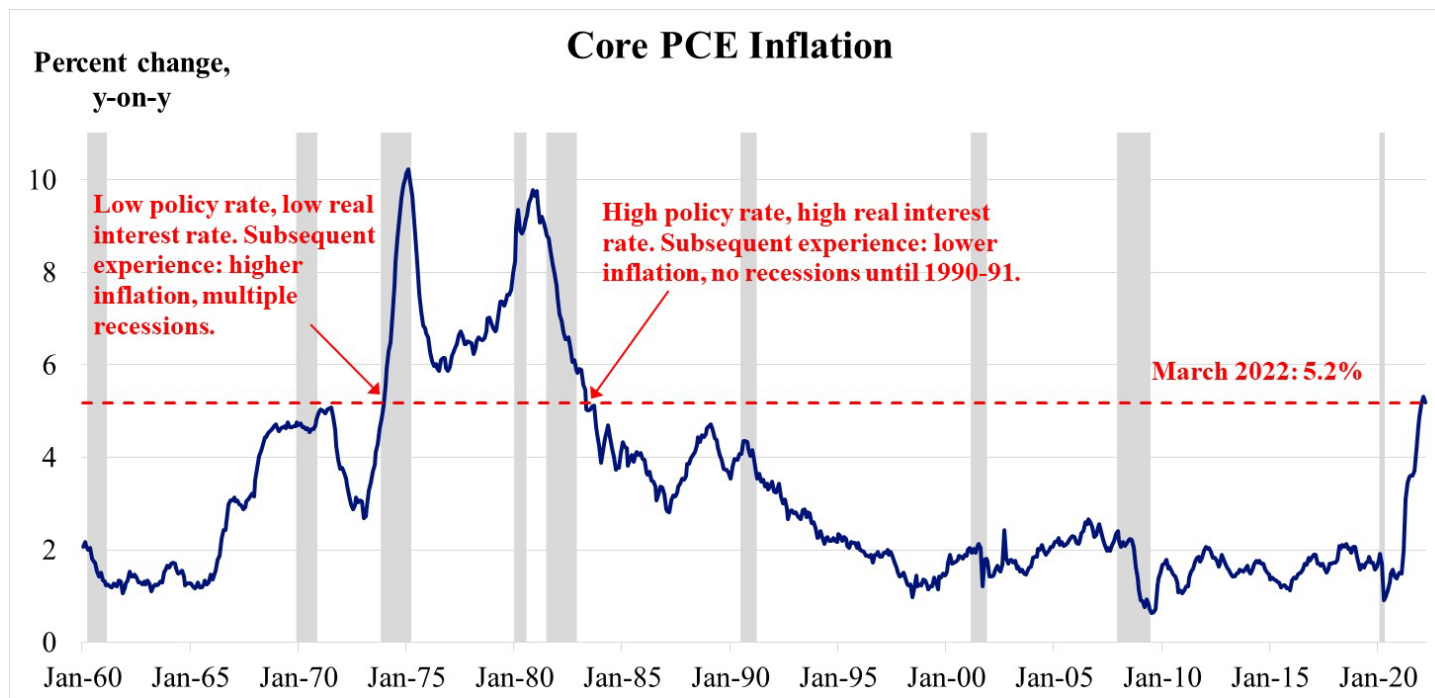
- U.S. inflation is exceptionally high, comparable to that in 1974 and 1983.
- Standard Taylor-type monetary policy rules, even if based on a minimum interpretation of the persistent component of inflation, still recommend substantial increases in the policy rate. This provides one definition of “behind the curve,” and the Fed is far behind.
- However, all is not lost. Modern central banks are more credible than their 1970s counterparts and use forward guidance.
- Credible forward guidance means market interest rates have increased substantially in advance of tangible Fed action. This provides another definition of “behind the curve,” and the Fed is not as far behind based on this definition.

Inflation Is Comparable to 1974 and 1983

Core inflation is comparable to 1974 and 1983

- Core personal consumption expenditures (PCE) inflation from one year earlier was 5.2% in March, which is the most recent reading.
- There have been two other times since 1960 when this measure of inflation has been close to this level.
- One was 1974, and the other was 1983.

Core PCE inflation since 1960



Source: Bureau of Economic Analysis. The gray shaded areas indicate U.S. recessions. Last observation: March 2022.

Monetary policy in 1974

- The 1974 FOMC, which was looking at a core PCE inflation rate similar to today's, liked to talk about nonmonetary factors affecting inflation.
- The FOMC kept the policy rate relatively low in the face of rising inflation.
- The associated ex-post real interest rate was relatively low.
- The subsequent experience was that core PCE inflation was above 5.2% for nearly 10 years.
- The real economy was also volatile with multiple recessions.

Monetary policy in 1983

- The 1983 FOMC, which was also looking at a core PCE inflation rate similar to today's, had a different approach to monetary policy and spoke more about monetary factors affecting inflation.
- The FOMC kept the policy rate relatively high in the face of declining inflation. The associated ex-post real interest rate was relatively high.
- The subsequent experience was that core PCE inflation was below 5.2% for the next 10 years.
- The real economy also stabilized with no recession until 1990-91.
- The contrast between the 1974 and 1983 experiences convinced many that it was important to avoid getting “behind the curve” on inflation.

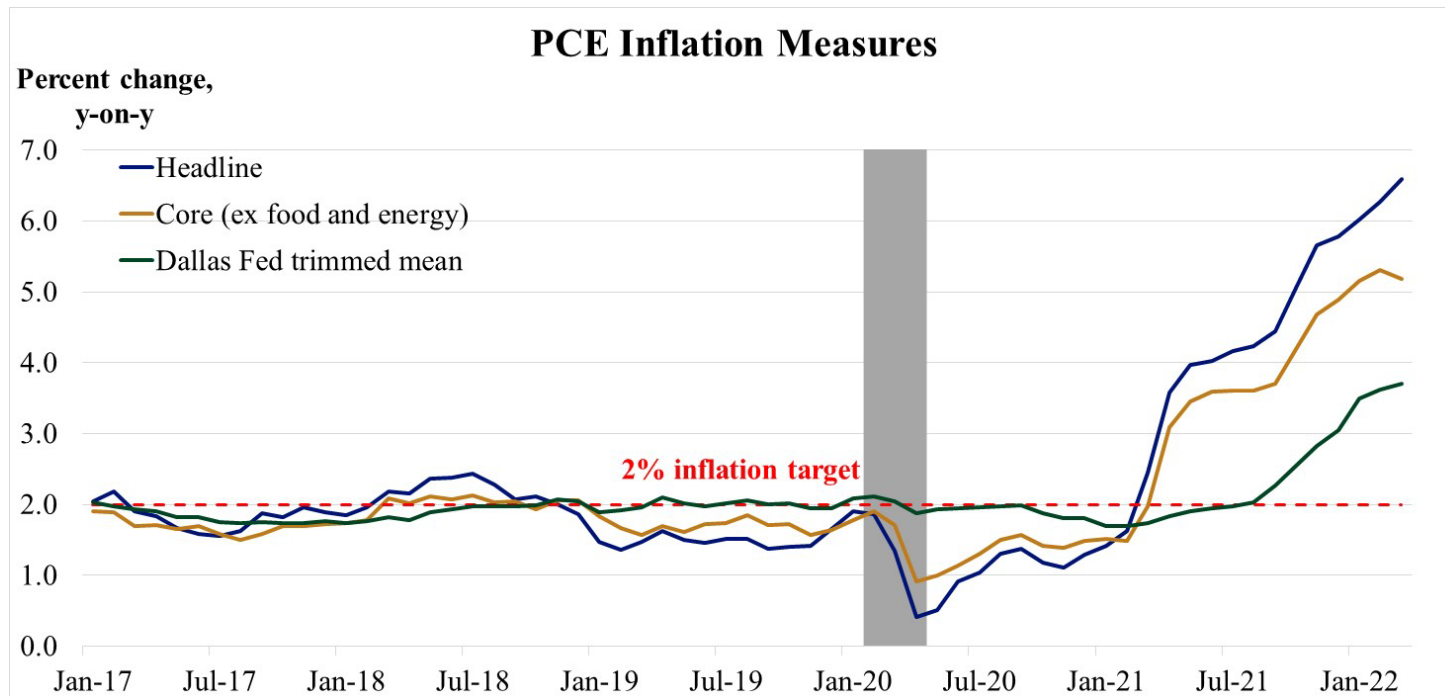
First Interpretation of “Behind the Curve”

Interpreting inflation

- The Fed has a statutory mandate to provide stable prices for the U.S. economy.
- Associated with this mandate is an inflation target of 2%, stated in terms of the headline PCE inflation rate, which was 6.6% in March measured from one year earlier.
- Because of particularly large movements in food and energy prices recently, some may argue that the Fed should consider the core PCE inflation rate instead, which, as we have seen, is currently 5.2%.
- Still others might argue that the truly persistent factors driving inflation are better captured by the Dallas Fed trimmed mean inflation rate, which was 3.7% in March measured from one year earlier.[†]

[†] For more on inflation persistence, see M. Almuzara and A. Sbordone, “[Inflation Persistence: How Much Is There and Where Is It Coming From?](#)” Federal Reserve Bank of New York Liberty Street Economics blog, April 20, 2022.

Inflation well above target



Sources: Bureau of Economic Analysis and Federal Reserve Bank of Dallas. The gray shaded area indicates U.S. recession. Last observation: March 2022.

A generous interpretation

- In my definitions of “behind the curve,” I will use the most generous (lowest) interpretation of the persistent component of current inflation, which is the 3.7% Dallas Fed trimmed mean value.
- This will help us define “behind the curve”: The idea is to measure the degree to which the current level of the policy rate is less than some minimally reasonable level.
- We should keep in mind that this minimal definition excludes some inflation that is actually occurring, and that the Fed’s inflation target is ultimately stated in terms of headline inflation.[†]

[†] See J. Bullard, “[*Measuring Inflation: The Core Is Rotten*](#),” *Federal Reserve Bank of St. Louis Review*, July/August 2011, 93(4), pp. 223-33.

Taylor-type monetary policy rules

- John Taylor (Stanford University) is famous for developing a “Taylor rule” which has been widely accepted in monetary policy discussions over the last 30 years.[†]
- A Taylor-type policy rule with generous assumptions will give us a minimal recommended value for the policy rate given current macroeconomic conditions.
- We will then compare this minimal recommended rate to the actual policy rate to get a measure of the degree to which U.S. monetary policy is “behind the curve.”

[†] See J.B. Taylor, “[*Discretion versus Policy Rules in Practice*](#),” Carnegie-Rochester Conference Series on Public Policy, December 1993, 39, pp. 195-214; and J.B. Taylor, “[*A Historical Analysis of Monetary Policy Rules*](#),” in J.B. Taylor, ed., Monetary Policy Rules. Chicago: University of Chicago Press, 1999, pp. 319-41.

Ingredients in a Taylor-type rule calculation

- In addition to an inflation measure, we need three ingredients in a non-inertial Taylor-type rule calculation:^{*}
 1. A value for the real interest rate (R^*); I will use an approximate pre-pandemic value of -50 basis points.[†]
 2. A parameter value describing the reaction of the policymaker to deviations of inflation from target; I will use a relatively low value of 1.25 .
 3. A parameter value describing the reaction of the policymaker to deviations of output from potential; I will use zero when the CBO output gap is positive, and 1 otherwise.[‡]

^{*} Adding inertia would not change the ultimate value of the policy rate but would suggest making a series of policy rate changes.

[†] For more on this topic, see J. Bullard, “[R-Star Wars: The Phantom Menace](#),” Feb. 26, 2018, remarks delivered at the 34th Annual National Association for Business Economics (NABE) Economic Policy Conference in Washington, D.C.

[‡] See the FOMC’s “[Statement on Longer-Run Goals and Monetary Policy Strategy](#),” adopted effective Jan. 24, 2012; as reaffirmed effective Jan. 25, 2022.

A generous policy rule benchmark

- All the choices I have outlined can be interpreted as generous—that is, as tilting toward a lower recommended policy rate.
- The notion of “behind the curve,” as I am defining it, is the position of the policy rate relative to this minimalist benchmark.
- The minimalist rule can be stated as:

$$R_t = R^* + \pi^* + 1.25(\pi_t - \pi^*) + \min(ygap_t, 0),$$

where R_t is the recommended policy rate; $R^* = -0.5$; $\pi^* = 2.0$; π_t is Dallas Fed trimmed mean inflation measured from one year earlier; and $ygap_t$ is the output gap, constructed by applying Okun’s law to deviations of the unemployment rate from the median Summary of Economic Projections longer-run value.

- This rule is consistent with the pre-pandemic policy rate.

A “behind the curve” calculation

- With these values in the minimalist policy rule, one concludes that the recommended policy rate is the following:

$$-0.5 + 2.0 + 1.25 * (3.7 - 2.0) = 3.63\%$$

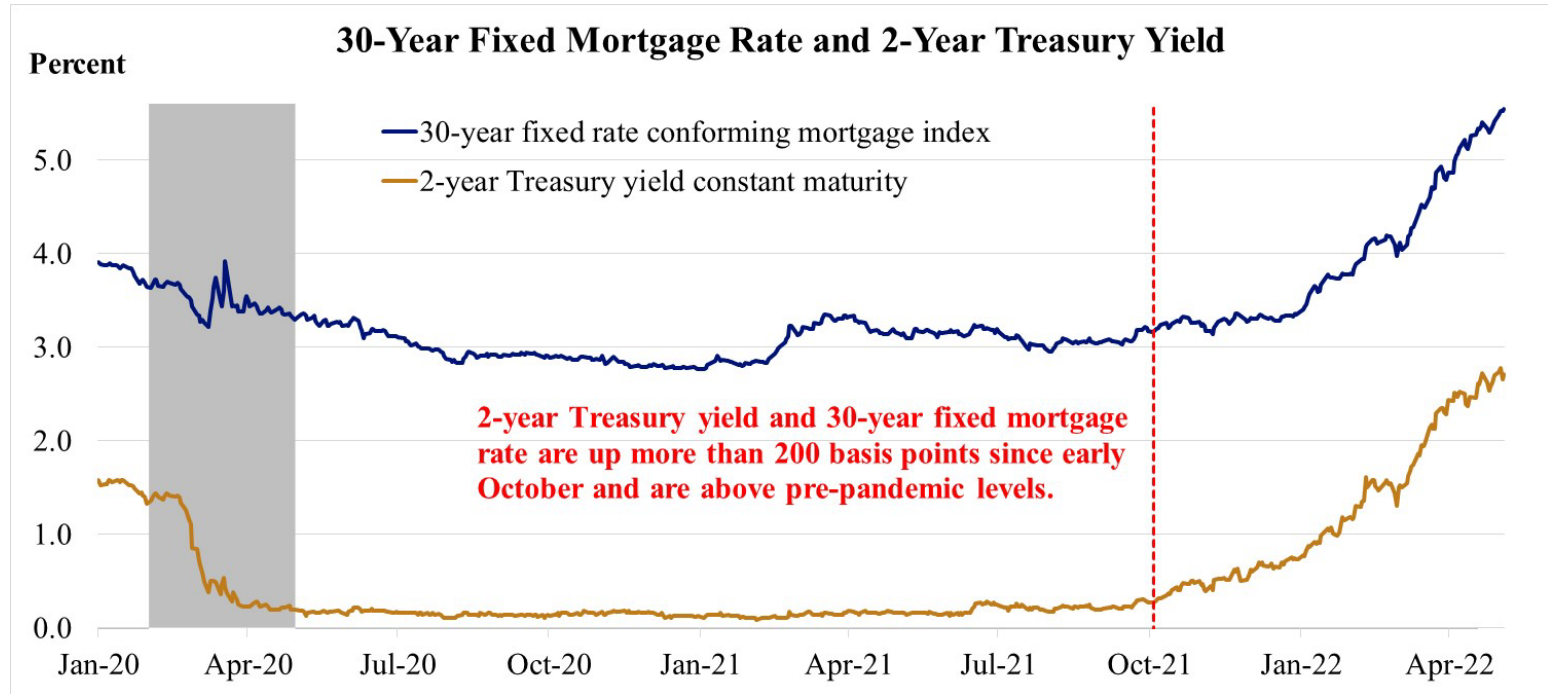
- The current value of the policy rate is 87.5 basis points.
- One concludes that the current policy rate is below the minimalist recommendation by 275 basis points.
- This provides one definition of the idea that the Fed is “behind the curve.”
- A higher value for R^* or a broader definition of inflation would suggest considerably higher recommended policy rate values, and the Fed would be further behind the curve.

Second Interpretation of “Behind the Curve”

Credibility and forward guidance

- Modern central banks have considerably more credibility than they did in the 1970s, much of it stemming from an explicit commitment to inflation targeting.
- They also make more use of forward guidance.
- As a result, indications of future policy rate increases are incorporated into current financial market pricing, before policy actions are taken.
- This has been a key factor in current market pricing, as the 2-year Treasury yield and the 30-year mortgage rate have increased substantially.

Market pricing based on Fed credibility



Sources: Optimal Blue and Department of the Treasury. The gray shaded area indicates U.S. recession. Last observation: May 5, 2022.

Not as far behind the curve

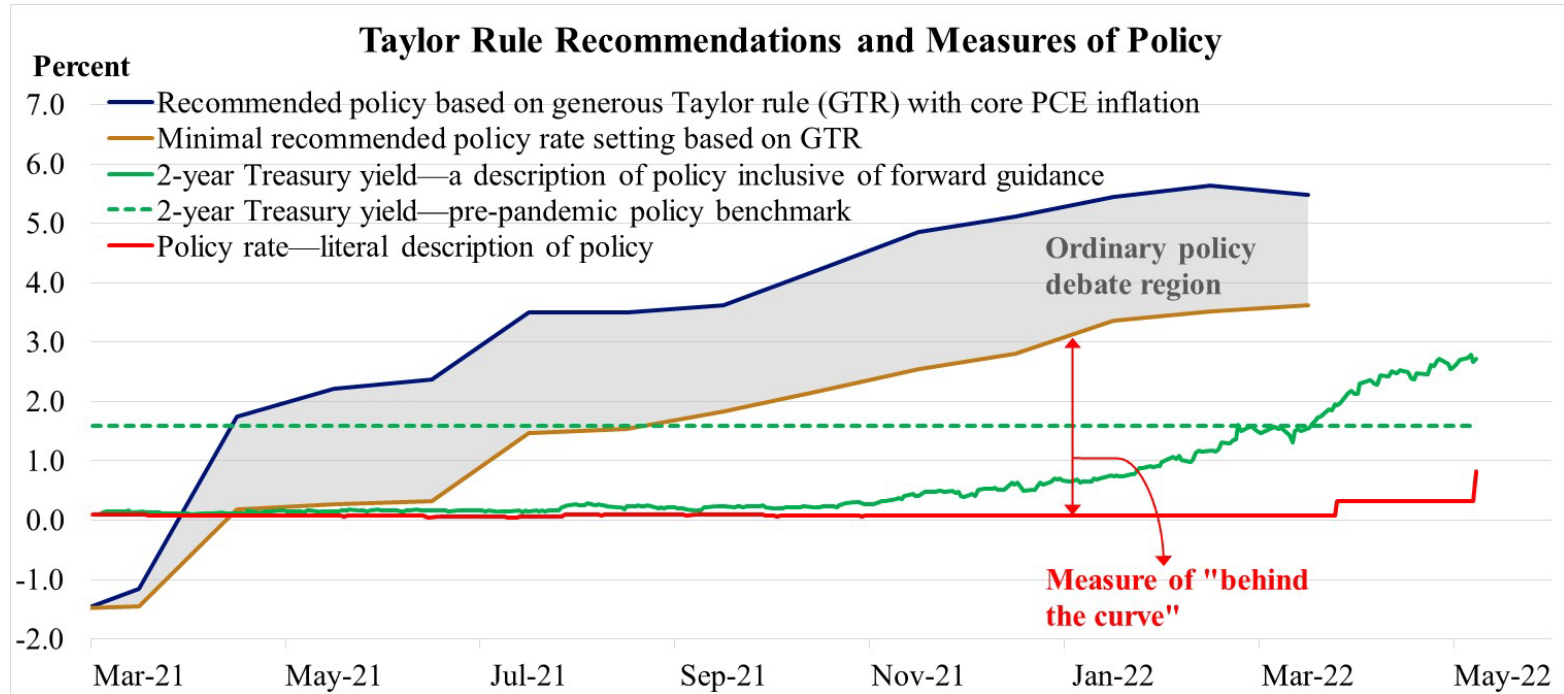
- Let's now return to the minimal Taylor-type rule calculation, which recommended a policy rate of 3.63%.
- In light of the forward guidance that has been given by the Fed since the fourth quarter of 2021, the 2-year Treasury yield may provide a better representation of where Fed policy is likely to be in the near future.
- The value of the 2-year Treasury yield as of May 5 was 2.71%, about 90 basis points shy of the rate recommended in the simple Taylor-type rule calculation.
- This suggests the Fed is not as far “behind the curve,” although it would still have to raise the policy rate to ratify the forward guidance.

But ... still behind the curve

- Recall that the recommended policy rate of 3.63% from the simple Taylor-type policy rule calculation involved some choices.
- In particular, a higher value for R^* or a broader definition of inflation would lead to the rule recommending a much higher value for the policy rate.
- Therefore, the second interpretation probably still leaves the Fed behind the curve but by less than it appears based on the first interpretation.[†]

[†] For additional analysis of Taylor-type rules and the role of Fed credibility in the current circumstance, see D.H. Papell and R. Prodan, “[Policy Rules and Forward Guidance Following the Covid-19 Recession](#),” unpublished manuscript, University of Houston, April 12, 2022. They conclude that the FOMC is currently about 100-125 basis points behind their rule recommendation.

Defining “behind the curve”



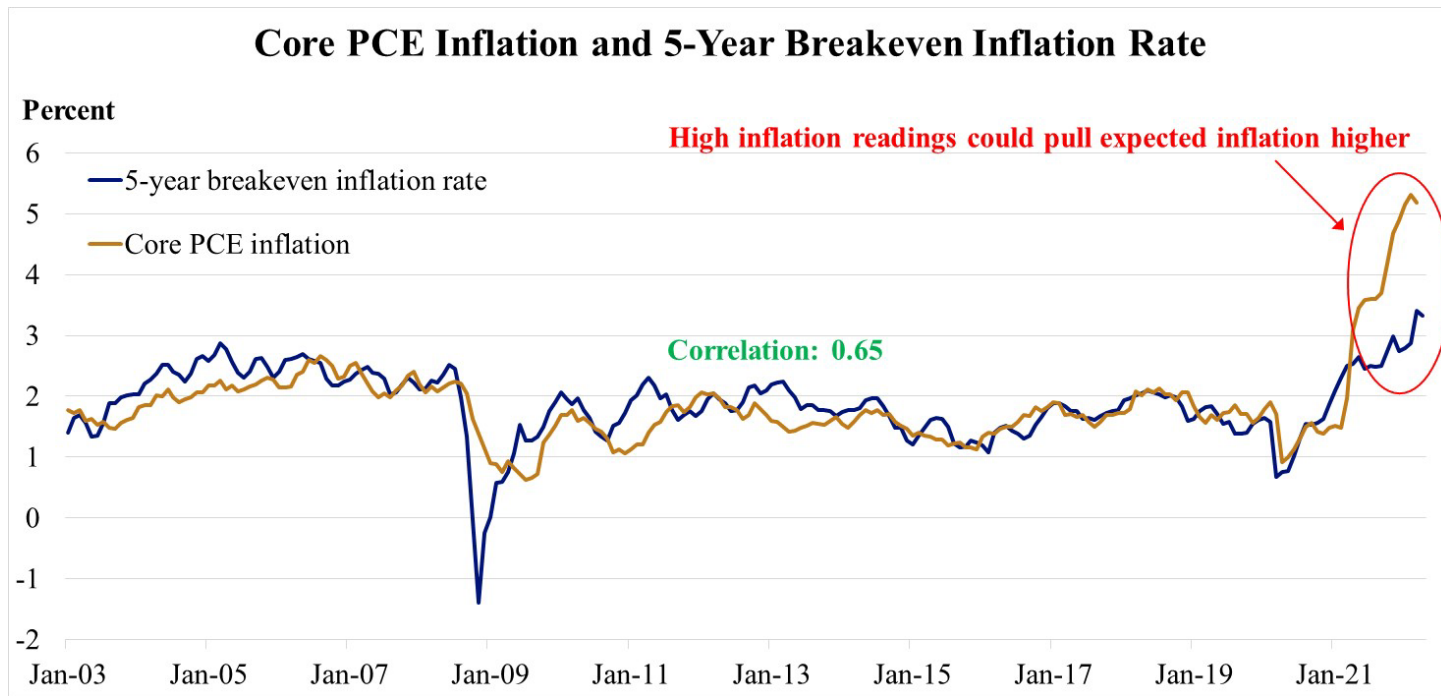
Sources: Bureau of Economic Analysis, Congressional Budget Office, Department of the Treasury, Federal Reserve Bank of New York and author's calculations. Last observations: March 2022 and May 5, 2022.

Risks to Inflation Expectations

Inflation expectations

- One might argue that the current situation is more about waning Fed credibility with respect to its inflation target.
- According to TIPS markets, straight-read inflation expectations are rising. The 5-year inflation compensation measure was 3.23% as of May 5.
- In economic theory, expected inflation and actual inflation should be closely related.
- The current divergence between actual inflation readings and TIPS-based expected inflation will have to be resolved, possibly resulting in still higher inflation expectations.

Actual and expected inflation



Sources: Federal Reserve Bank of St. Louis and Bureau of Economic Analysis. Last observations: March 2022 and April 2022.

Conclusion

Two interpretations

- Generously defined Taylor-type monetary policy rules, even if based on a minimum interpretation of the persistent component of inflation, still recommend substantial increases in the policy rate. By this first interpretation of “behind the curve,” the Fed is far behind.
- The first interpretation does not take into account Fed credibility or its use of forward guidance.
- Credible forward guidance means market interest rates have increased substantially in advance of tangible Fed action. By this second definition of “behind the curve,” the Fed is not as far behind, but it must now increase the policy rate to ratify the forward guidance previously given.

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