FEDERAL RESERVE BANK of ST. LOUIS

The FOMC's Substantial Turn during 2019

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Introduction

Key themes

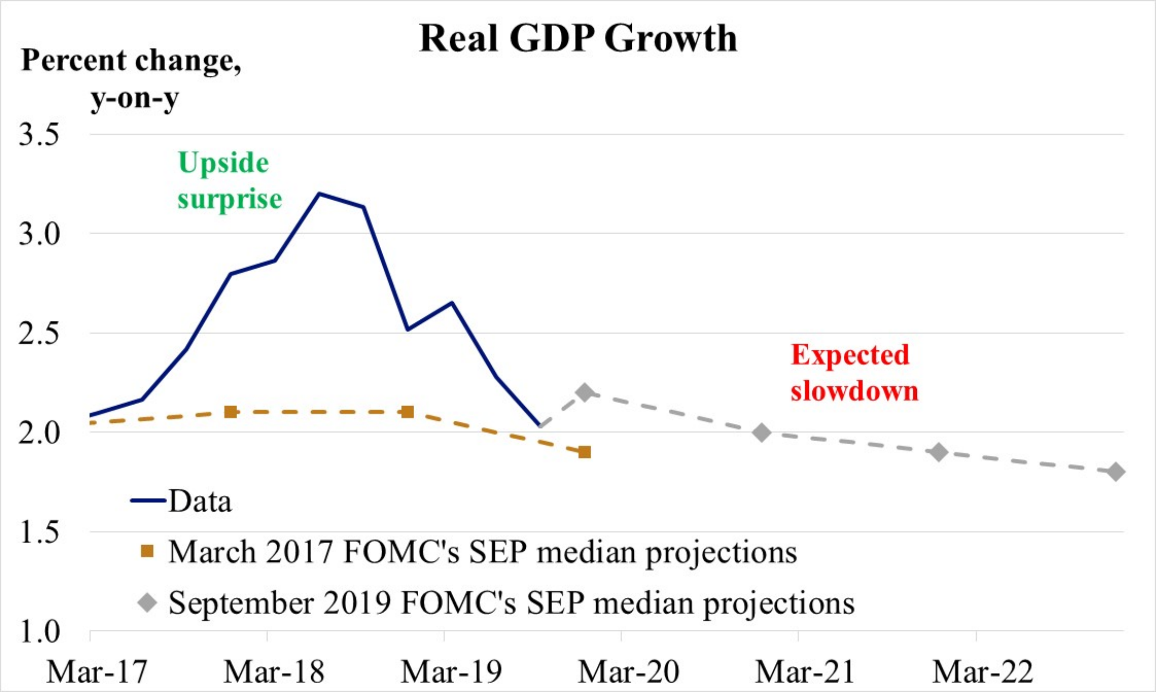
- The U.S. economy has been slowing down in 2019 after relatively rapid growth during 2017 and 2018.
- The economy faces downside risk that may cause the slowdown to be sharper than expected.
- A sharper-than-expected slowdown may make it more difficult for the Federal Open Market Committee (FOMC) to achieve its 2% inflation target.
- The FOMC has tried to help insure against this downside risk by dramatically altering the path of monetary policy during 2019.

A Slowing U.S. Economy

Slower growth

- According to the most recent 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.
- The key risk is that this slowing may be sharper than anticipated.

U.S. real economic growth



Sources: Bureau of Economic Analysis and Federal Reserve Board. Last observation: 2019-Q3.

Downside Risks to Growth

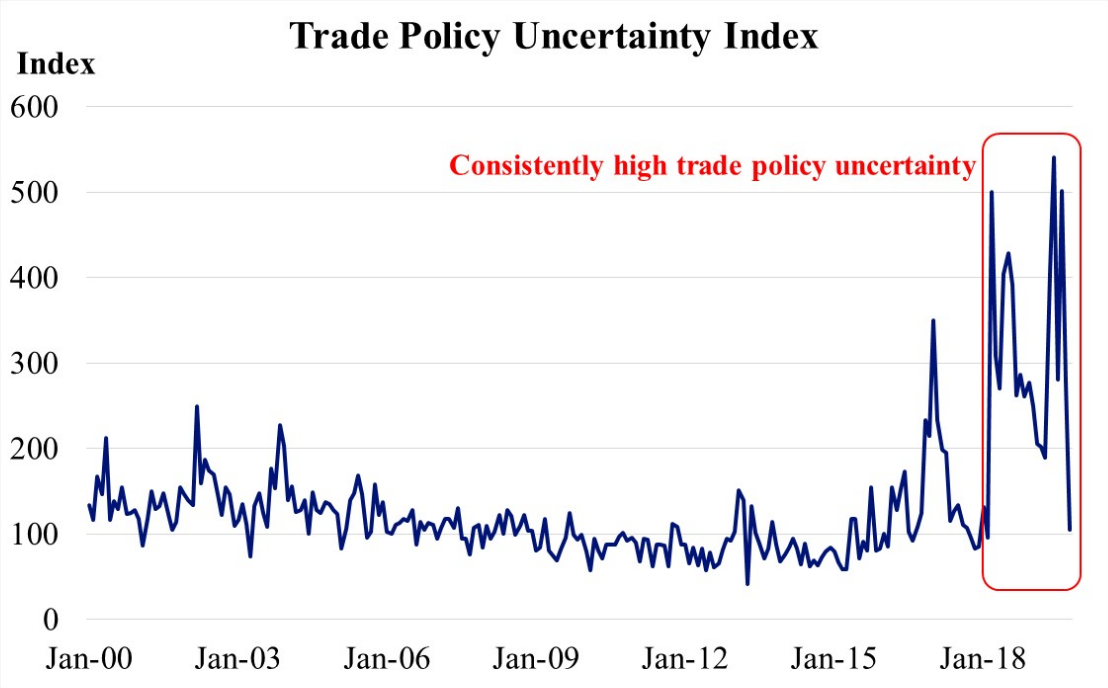
Insuring against downside risks

- It remains possible that a sharper-than-expected slowdown could materialize in the quarters ahead.
- Downside risks to growth include the effects of magnified global trade policy uncertainty.
- The FOMC’s adjustment toward lower rates in the face of trade policy uncertainty may help facilitate somewhat faster growth in 2020 than what might otherwise occur.

Ongoing trade disputes

- Ongoing developments suggest that it will be difficult to reach a stable global trade regime over the forecast horizon.
- Trade regime uncertainty 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.

High trade policy uncertainty



Source: www2.bc.edu/matteo-iacoviello/tpu.htm. For details, see D. Caldara, M. Iacoviello, P. Molligo, A. Prestipino and A. Raffo, "The Economic Effects of Trade Policy Uncertainty," Federal Reserve Board International Finance Discussion Paper No. 1256, September 2019. Last observation: October 2019.

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.
- 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.

Slowing global growth

- Trade policy uncertainty creates a disincentive for global investment.
- Accordingly, the global growth environment looks weaker in recent quarters.
- Slower global growth may feed back into slower growth in the U.S.

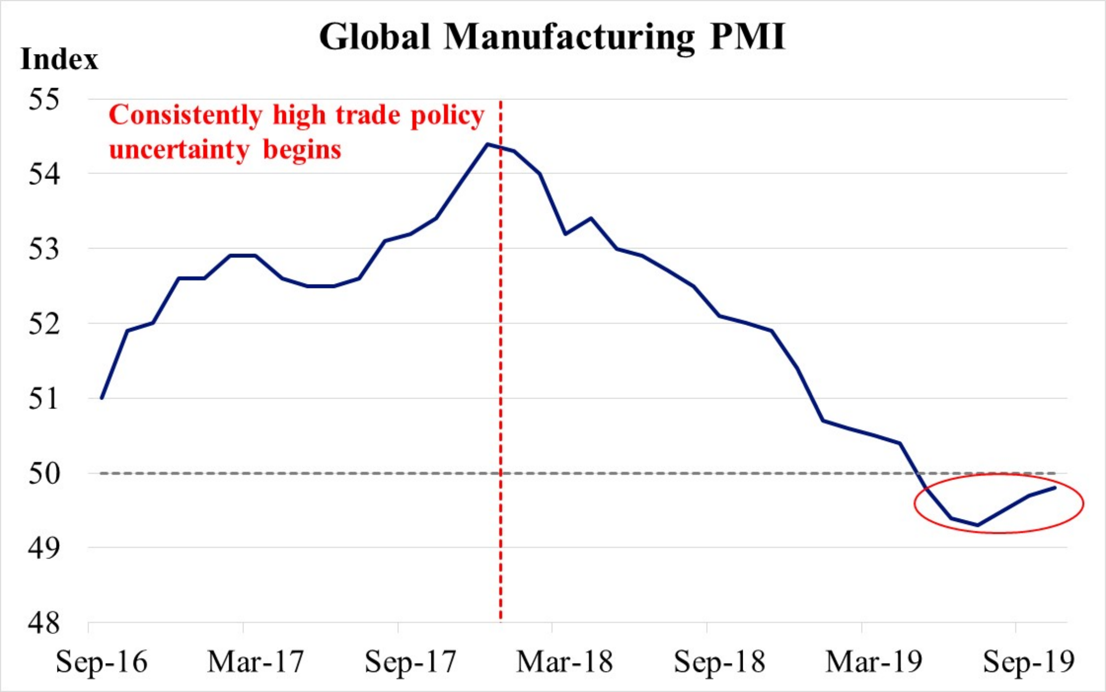
Slowing global growth: The OECD outlook

	2018* (1)	2019 projected in May 2019 ** (2)	2019 projected in Sept. 2019 * (3)	Worsening projections: Difference (3) − (2)	2018-2019 slowdown: Difference (3) − (1)
U.S.	2.9%	2.8%	2.4%	−0.4%	−0.5%
Euro area	1.9%	1.2%	1.1%	−0.1%	−0.8%
U.K.	1.4%	1.2%	1.0%	−0.2%	−0.4%
Japan	0.8%	0.7%	1.0%	+0.3%	+0.2%
China	6.6%	6.2%	6.1%	−0.1%	−0.5%

Growth rates are year-over-year; differences are expressed in percentage points.

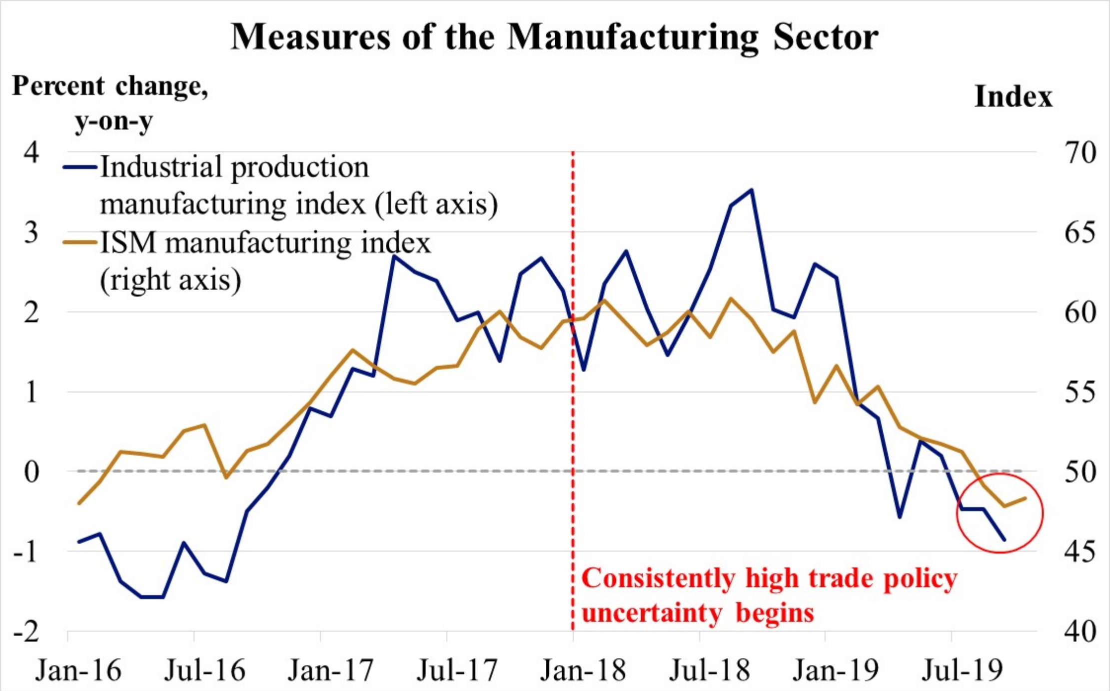
*Sources: * Organisation for Economic Co-operation and Development,* Interim Global Economic Outlook Assessment, *September 2019;*
*** Organisation for Economic Co-operation and Development,* Global Economic Outlook, *May 2019.*

Global manufacturing contracting



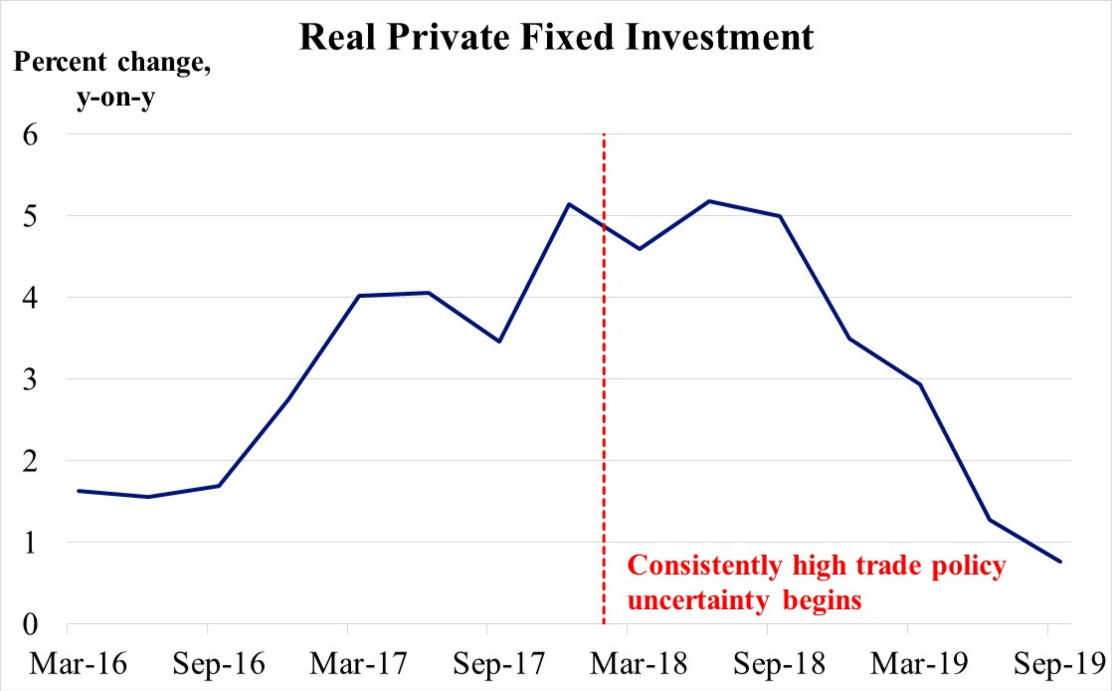
Source: IHS Markit/JPMorgan Chase. Last observation: October 2019.

U.S. manufacturing stalling



Sources: Federal Reserve Board, Institute for Supply Management and author's calculations. Last observations: September 2019 and October 2019.

U.S. business investment slowing



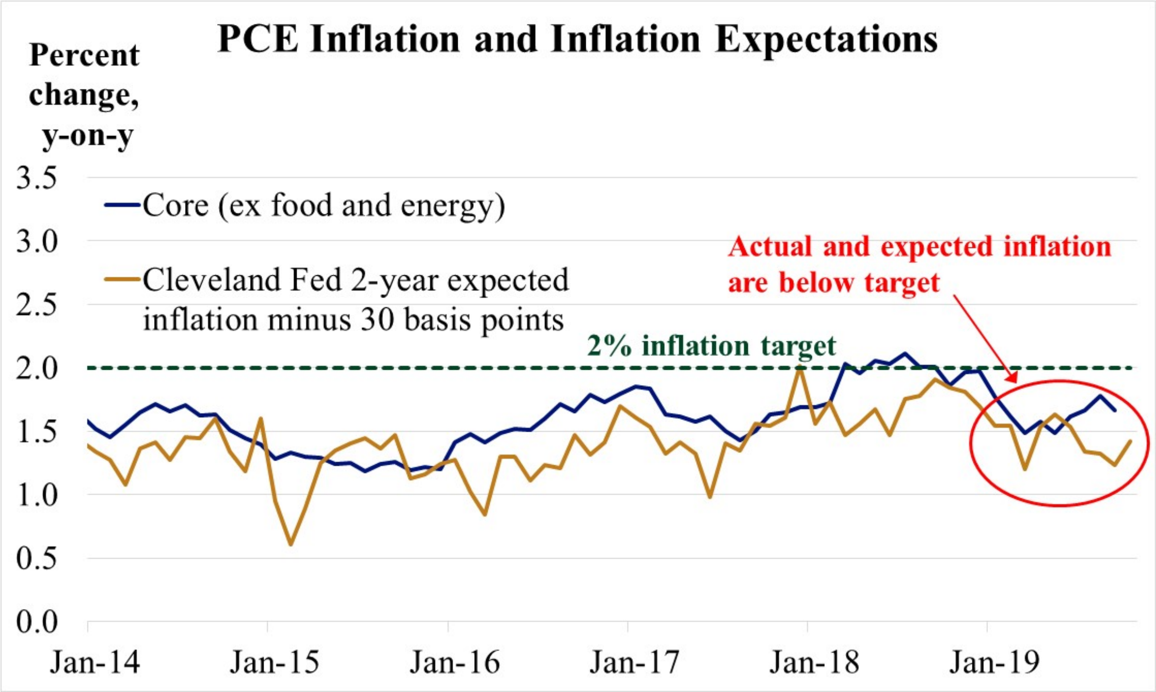
Source: Bureau of Economic Analysis. Last observation: 2019-Q3.

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 on the real growth rate of the U.S. economy.
- The FOMC’s insurance rate cuts in 2019 may help re-center inflation and inflation expectations at the 2% target sooner than otherwise.

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: September 2019 and October 2019.

A Turnaround in U.S. Monetary Policy

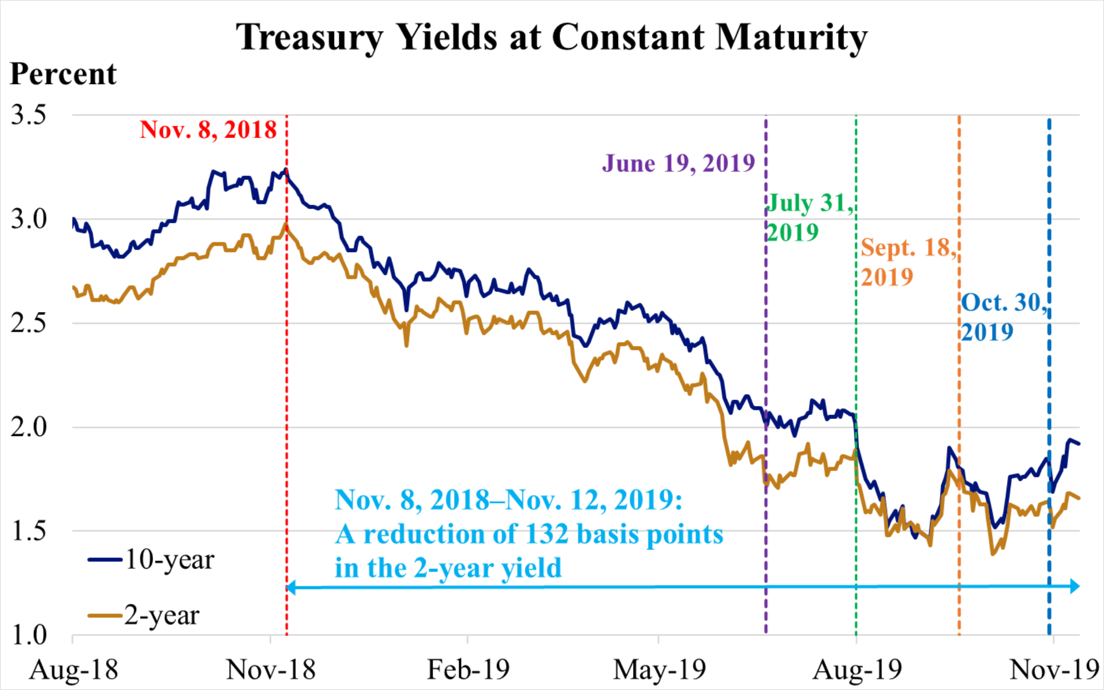
U.S. monetary policy in 2019

- The FOMC has been cognizant of these developing downside risks during 2019.
- During the first half of the year, 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.
- In June, the FOMC indicated that a lower policy rate might be warranted.
- The FOMC then made reductions in the policy rate at three successive meetings, most recently on Oct. 30.

Interest rates are dramatically lower

- What was the effect of this turnaround in U.S. monetary policy?
- The effect has been much larger than the three latest rate reductions alone would suggest because the expectation as of late last year was that the FOMC would actually raise rates further in 2019.
- The following chart captures more of the true magnitude of the change in policy during 2019.

Effects of the change in monetary policy



Source: Federal Reserve Board. Last observation: Nov. 12, 2019.

Interpretation

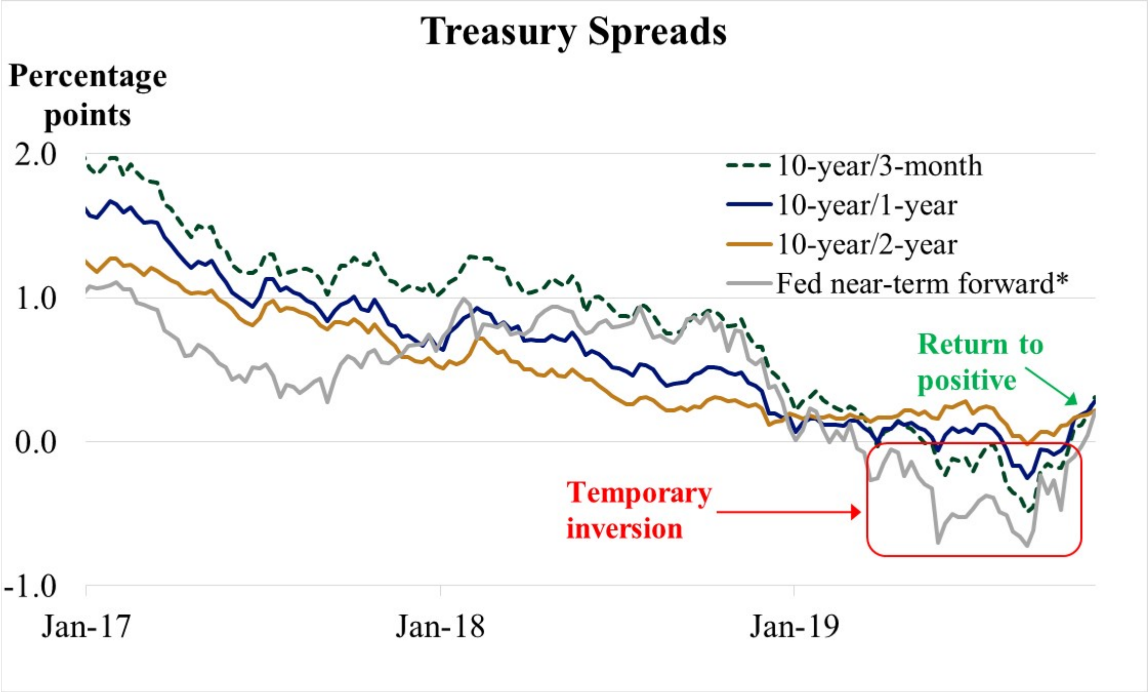
- One straightforward reading of these events is that the outlook for shorter-term interest rates influenced by the FOMC, as embodied in the two-year yield, dropped by 132 basis points during the last 12 months because of FOMC actions.
- This is a very large change over this time frame.
- Furthermore, these policy actions fed through to longer-term U.S. 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.

Yield Curve Measures Turn Positive

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 U.S. Treasury yield curve were temporarily inverted during 2019.
    - However, in part due to FOMC policy, the 10-year yield is now above the effective federal funds rate.
    - This return to a more normal state of affairs may be a bullish factor for 2020.

Temporary yield curve inversion



Sources: Federal Reserve Board, Bloomberg and author's calculations. Last observation: Week of Nov. 6, 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

U.S. monetary policy today

- The FOMC has been facing a slowing U.S. economy with some downside risk due to ongoing global trade regime uncertainty.
- Meanwhile, U.S. inflation and inflation expectations have continued to fall short of the FOMC's 2% target.
- The FOMC has taken actions that have changed the outlook for shorter-term U.S. interest rates considerably over the last 12 months, ultimately providing more accommodation to the economy.
- Key measures of the U.S. Treasury yield curve have now returned to a more normal, positive slope, possibly a bullish factor for 2020.

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