FEDERAL RESERVE BANK *of* ST. LOUIS

Three Questions for U.S. Monetary Policy

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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 in this talk

- The U.S. remains in a slow-growth regime.
- Inflation in the U.S. has surprised to the downside this year.
- U.S. labor market performance has been good.
- Implications for near-term U.S. monetary policy: The current level of the policy rate is likely to remain appropriate over the near term.

Questions for U.S. monetary policy

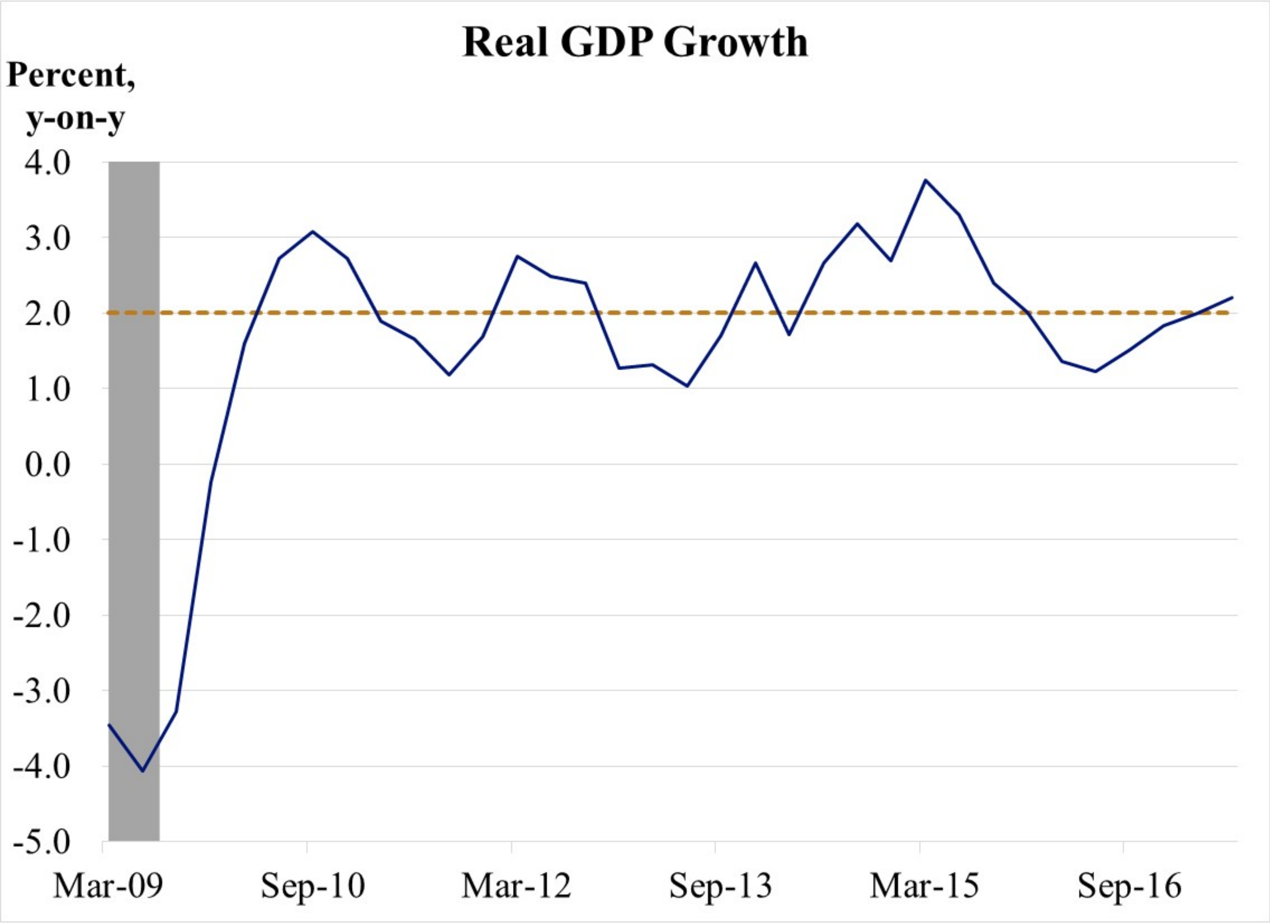
- Is U.S. economic growth poised for a rebound in the second half of 2017, as compared to the first half?
- Is the downside inflation surprise in the first half of 2017 likely to reverse in the second half of 2017?
- Will continued strong performance of U.S. labor markets put upward pressure on inflation?
- The answer to all these questions:
  - *"Probably not."*

Will Real GDP Growth Be Higher in the Second Half of 2017?

U.S. real GDP growth in 2017

- The data since the financial crisis suggest that the U.S. has converged to 2 percent real GDP growth.
- The current estimate for U.S. real GDP growth in the first half of 2017 is 2.1 percent at an annual rate.
- Second-quarter real GDP growth showed some improvement from the first quarter, but not enough to move the U.S. economy away from a regime characterized by 2 percent trend growth.
- The 2 percent growth regime appears to remain intact.

The 2 percent growth regime since the Great Recession



Source: Bureau of Economic Analysis. Last observation: 2017-Q2. The shaded area indicates NBER recession.

Will growth be faster during the second half of 2017?

- During the summer, there was some hope that the second half of 2017 would display faster growth, perhaps at a 3 percent pace.
- Since then, two developments have dampened those hopes.
    - One is that some macroeconomic data came in weaker than anticipated.
    - Another is that major hurricanes caused substantial damage in some parts of the country.
- The economy should rebound somewhat in the fourth quarter as hurricane damage is repaired.

Tracking estimates for 2017-Q3 U.S. real GDP growth have declined

Source	Date	Estimate*	Date	Estimate*	Diff.†
Blue Chip Consensus	Aug. 10	2.7%	Sept. 10	2.7%	0
Atlanta Fed GDPNow	Aug. 10	3.6%	Sept. 19	2.2%	–1.4
St. Louis Fed Economic News Index	Aug. 11	3.7%	Sept. 22	2.8%	–0.9
FRBNY Staff Nowcast	Aug. 11	2.0%	Sept. 22	1.6%	–0.4
Macroeconomic Advisers	Aug. 11	2.8%	Sept. 22	1.7%	–1.1
CNBC Moody's Consensus (median)	Aug. 15	2.6%	Sept. 20	2.4%	–0.2

* *percent change from the previous quarter, annualized*
† *percentage points*

Estimates of hurricane damage

Source	Reduction in 2017-Q3 real GDP growth estimate due to hurricanes Harvey and Irma*
Goldman Sachs	–0.8
Macroeconomic Advisers	–0.7
Moody’s	–0.5
Oxford Economics	–0.4

** percentage points*

Source: S. Liesman, “Hurricanes Irma, Harvey will have a significant negative impact on third-quarter GDP growth,” CNBC, Sept. 13, 2017.

Bottom line for real GDP growth

- Real GDP growth has not differed meaningfully from 2 percent during recent years.
- Hopes for faster growth in the second half of 2017 have been tempered by weaker macroeconomic data and by hurricane damage.
- There will be some rebound in the fourth quarter due to rebuilding after storm damage, but whether this will be significant enough to move second-half real GDP growth meaningfully above 2 percent remains to be seen.
- My answer is “probably not.”

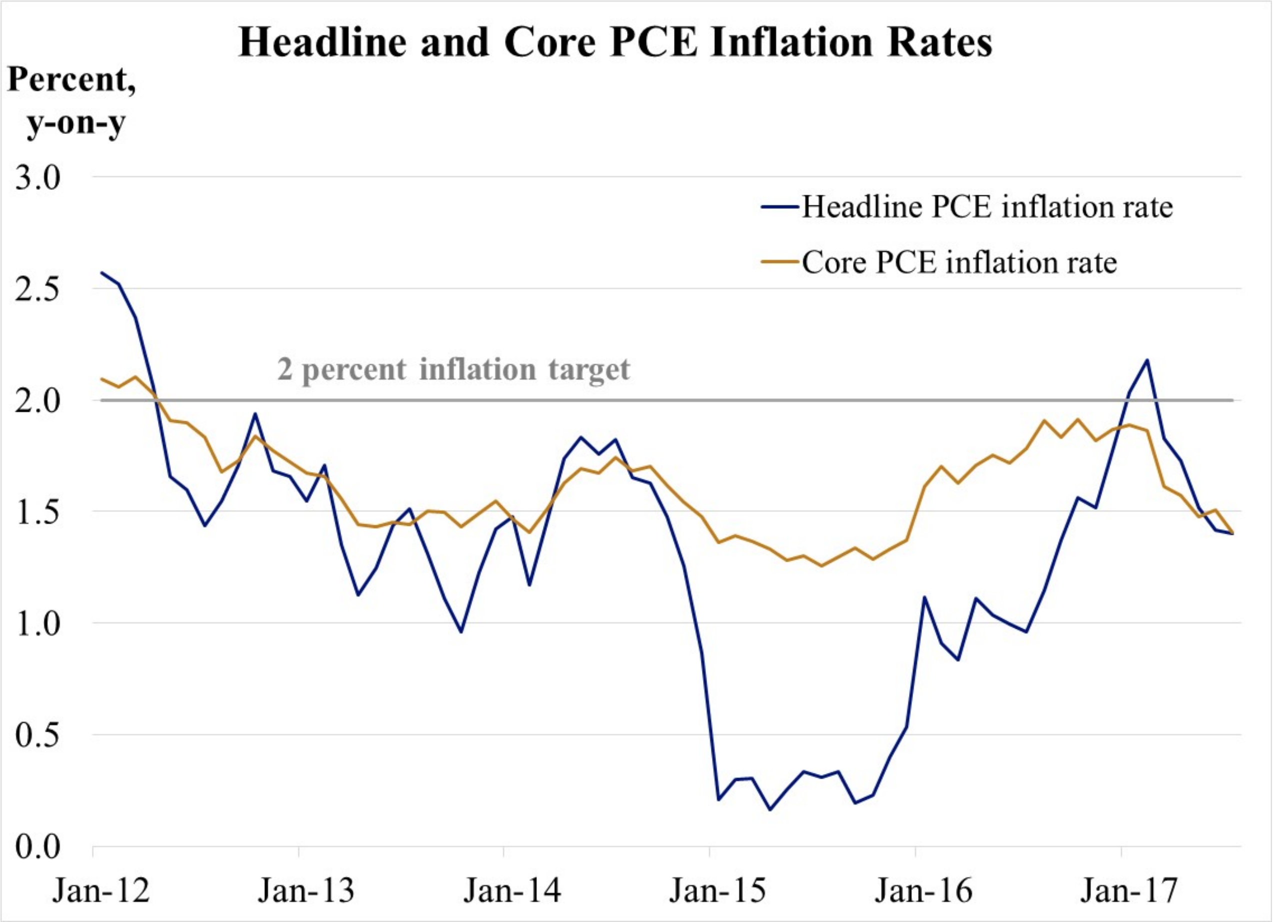
Will the Low-Inflation Trend Reverse Itself?

U.S. inflation in 2017

- The U.S. inflation rate has been below the 2 percent inflation target since 2012.*
- Inflation data during 2017 have surprised to the downside and call into question the idea that U.S. inflation is reliably returning toward target.

* *The inflation target is in terms of the annual change in the price index for personal consumption expenditures (PCE).*

U.S. inflation since 2012



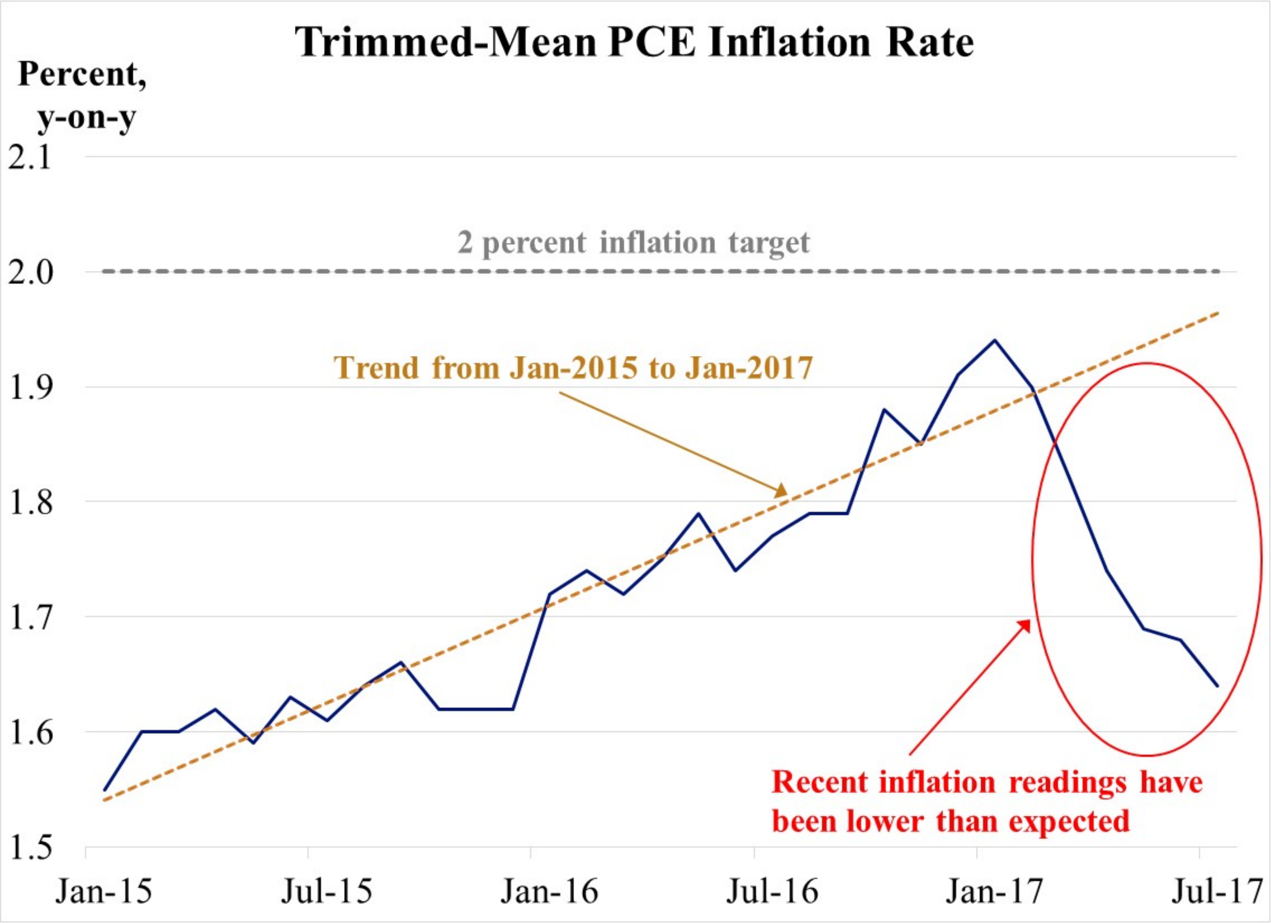
Source: Bureau of Economic Analysis. Last observation: July 2017.

Inflation readings are lower in 2017

Inflation measure	Dec-2016	Last obs.	Difference
Sticky CPI (FRB of Atlanta)	258	210	-48
Median CPI (FRB of Cleveland)	250	215	-35
Core CPI	220	170	-50
Trimmed-mean PCE (FRB of Dallas)	191	164	-27
Core PCE	187	141	-46

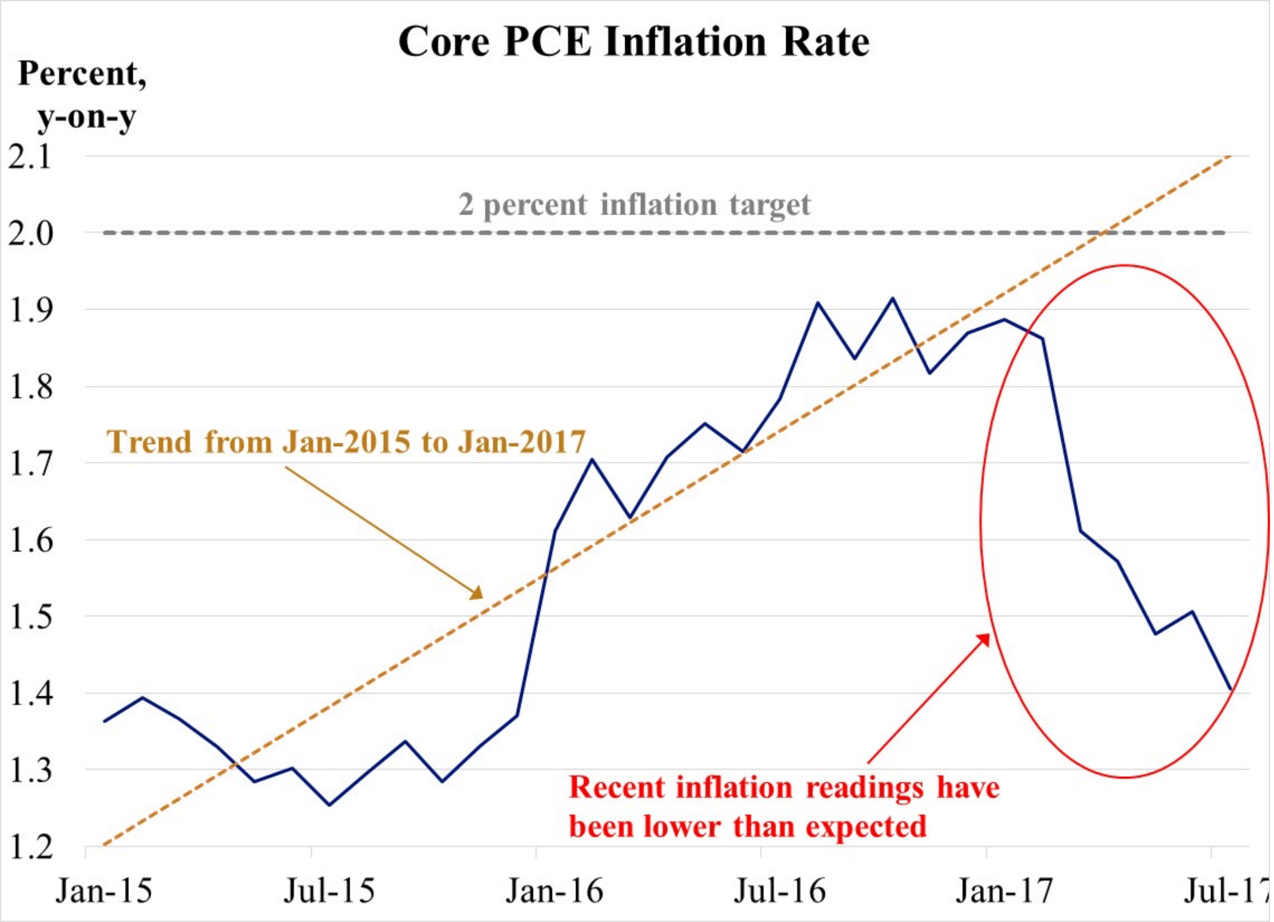
Values are expressed in basis points. Inflation rates are measured as percent changes from one year earlier.
Sources: Bureau of Labor Statistics, FRB of Cleveland, FRB of Atlanta, Bureau of Economic Analysis, FRB of Dallas and author's calculations. Last observation: July 2017 (PCE) and August 2017 (CPI).

Trimmed-mean PCE inflation lower than expected



Sources: FRB of Dallas and author's calculations. Last observation: July 2017.

Core PCE inflation lower than expected



Sources: Bureau of Economic Analysis and author's calculations. Last observation: July 2017.

Bottom line on the 2017 inflation surprise

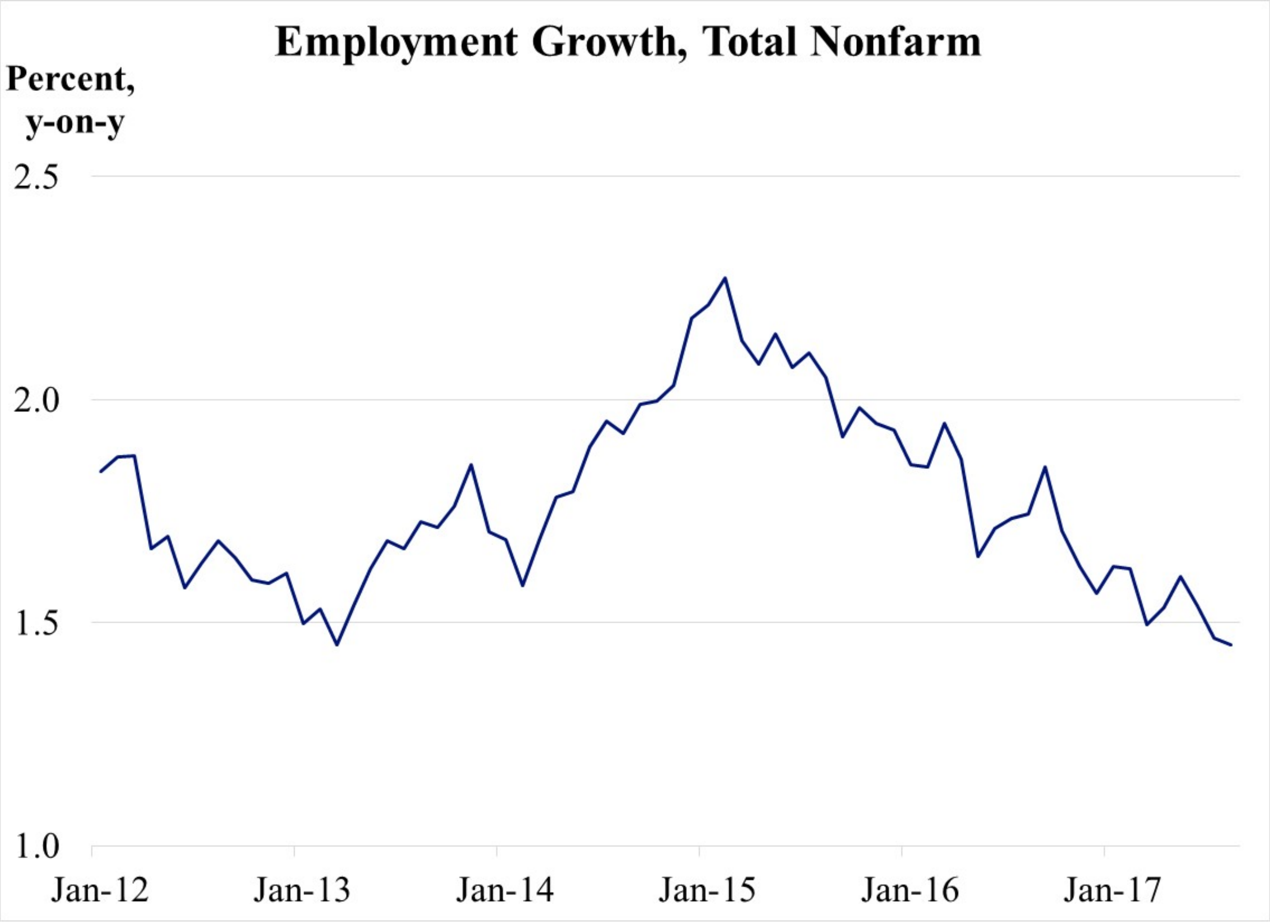
- Noise in the data might be expected to balance out, but over longer periods of time.
- The Federal Open Market Committee does make projections for core PCE inflation.
- The current median projection for core PCE inflation is 1.5 percent at the end of 2017.
- The answer to whether the low-inflation trend will reverse in 2017 is "probably not."

Are U.S. Labor Markets Signaling a Meaningful Rise in Inflation?

U.S. labor market performance

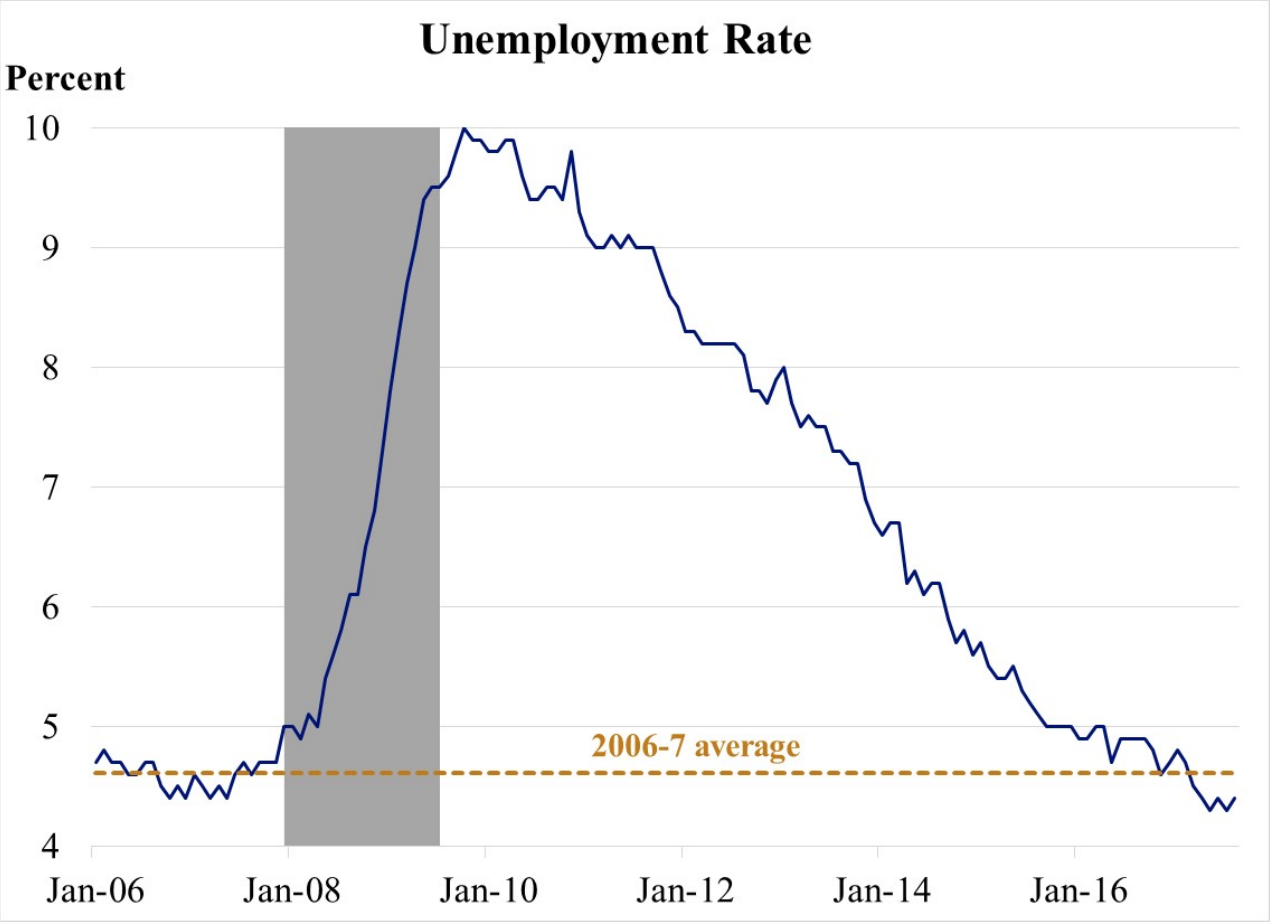
- The pace of growth in employment has been at or above expectations in recent months.
- The unemployment rate is relatively low.
- These are sometimes cited as factors that will eventually drive the inflation rate higher.

Employment growth has slowed to the lowest rate since 2013



Sources: Bureau of Labor Statistics and author's calculations. Last observation: August 2017.

The unemployment rate is low



Sources: Bureau of Labor Statistics and author's calculations. Last observation: August 2017.

Will low unemployment drive inflation higher?

- The U.S. unemployment rate was 4.4 percent in the August reading.
- Does this mean that U.S. inflation is about to increase substantially?
- The short answer is no, based on current estimates of the relationship between unemployment and inflation.

The estimated influence of unemployment on inflation

- Let's consider one study, Blanchard (2016), which estimates a Phillips curve relationship for the U.S.*
- Let's suppose the unemployment rate continued to fall from current levels.
- How much would the inflation rate increase according to these estimates?

** See O. Blanchard, 2016, "The U.S. Phillips Curve: Back to the 60s?" Peterson Institute for International Economics,* Policy Brief No. PB16-1.

The estimated influence of unemployment on inflation

If the unemployment rate was …	The predicted core PCE inflation rate would be …
4.4% *	1.4% *
4.0%	1.5%
3.5%	1.6%
3.0%	1.7%

* *current value (August 2017 for unemployment, July 2017 for inflation)*

- Bottom line: Even if the U.S. unemployment rate declines substantially further, the effects on U.S. inflation are likely to be small.

Conclusion

Conclusion

- Recent data indicate that U.S. real GDP growth remains consistent with the low-growth regime of recent years.
  - Hurricane effects will add uncertainty to the interpretation of macroeconomic data in the months ahead.
- U.S. inflation has surprised to the downside in recent months, and the surprise is unlikely to reverse during 2017.
- Low unemployment readings are probably not an indicator of meaningfully higher inflation over the forecast horizon.
- The current level of the policy rate is appropriate given current macroeconomic data.

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