U.S. Monetary Policy: A Case for Caution

James Bullard
President and CEO

Springfield Area Chamber of Commerce
Springfield Business Development Corp. Meeting

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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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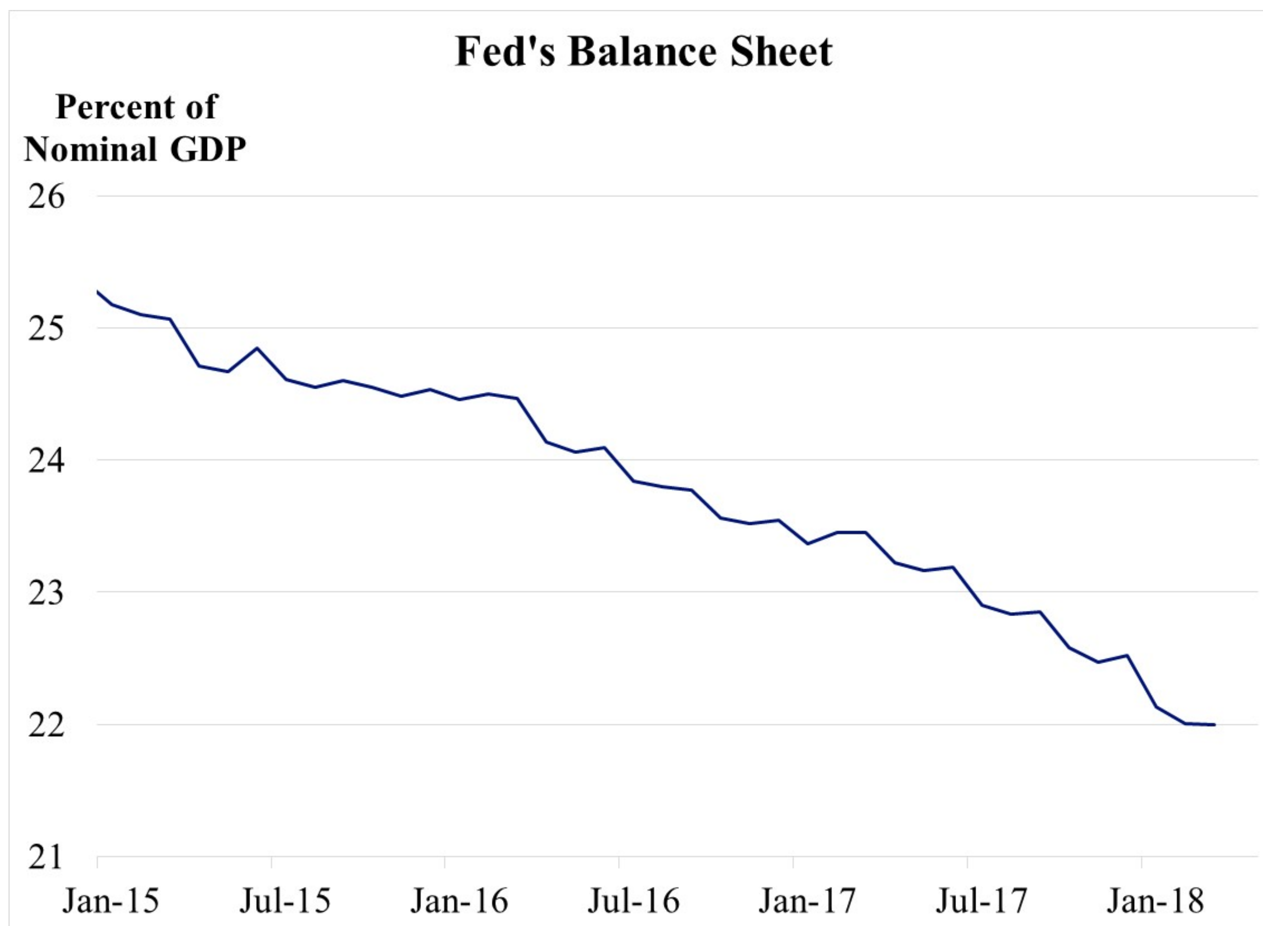
Introduction

The monetary policy situation

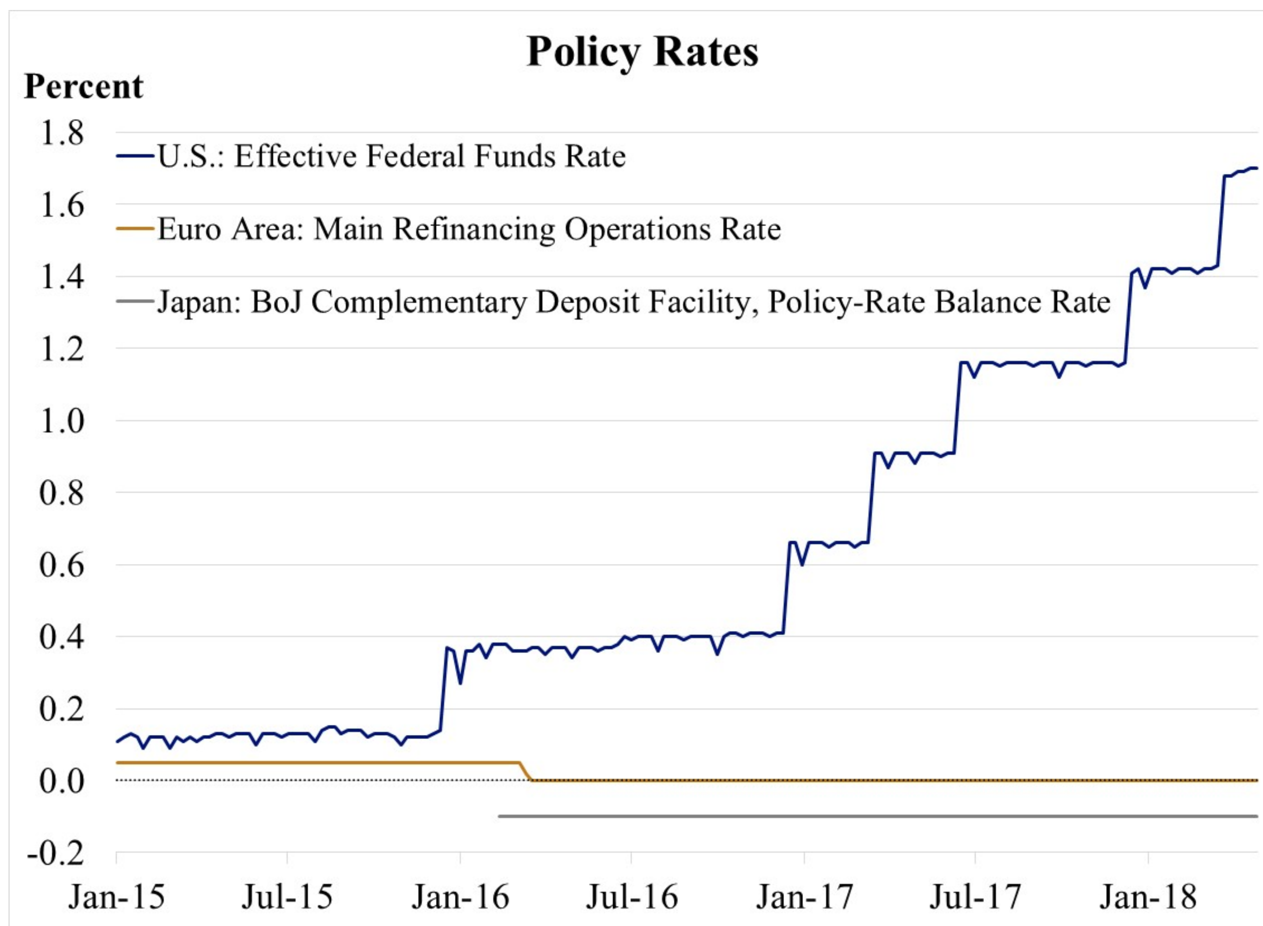
- U.S. monetary policy has been normalizing during the last 2½ years.
  - The Federal Reserve's balance sheet has been shrinking relative to U.S. gross domestic product (GDP).
  - The Fed's policy rate—the federal funds rate target—has been increasing relative to policy rates in key foreign economies.

Fed's balance sheet has been shrinking



Sources: Federal Reserve Board, Bureau of Economic Analysis and author's calculations. Last observation: March 2018.

Fed policy rate increasing versus ECB and BoJ



Sources: Federal Reserve Board, European Central Bank and Bank of Japan. Last observation: Week of May 2, 2018.

Today's key monetary policy question

- How far can the Fed go along the current normalization path?
  - This talk offers some reasons for caution in raising the policy rate further given current macroeconomic conditions.

Five reasons for caution

- I will discuss five reasons why I think caution may be justified in deciding whether to raise the policy rate further in the near term. These reasons relate to the following areas:
  - Inflation expectations
  - The neutral policy rate
  - The flattening yield curve
  - Room to grow business investment
  - Labor markets in equilibrium

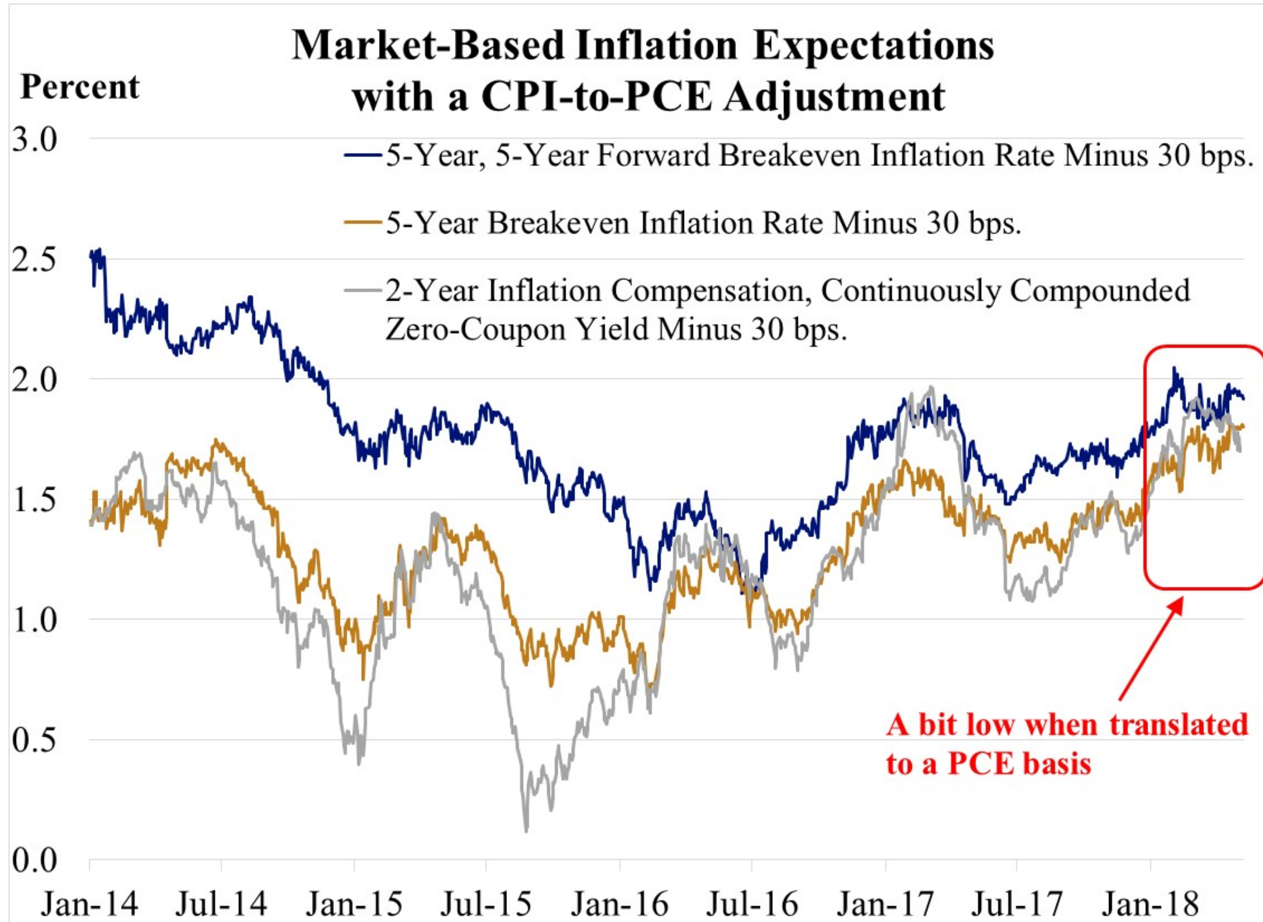
1. Inflation Expectations Remain Low

Inflation expectations still low

- Market-based measures of inflation expectations remain centered below the Federal Open Market Committee's 2 percent target, inhibiting the Committee's ability to maintain the credibility of the target.*
- Technical matter:
  - The market-based measures are for CPI inflation, and so we adjust them downward somewhat to roughly translate into PCE inflation.
  - Historically, PCE inflation has run somewhat lower than CPI inflation.

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

Inflation expectations remain a bit low



Sources: Federal Reserve Board and author's calculations. Last observations: May 8 (breakeven inflation rates) and May 4, 2018.

Bottom line for inflation expectations

- Market-based inflation expectations can be interpreted as saying that financial markets do not believe the Fed will quite hit the PCE-based inflation target, even over a period as long as the next five years.
- This is a market judgment that already prices in all current macroeconomic developments, including a market expectation of future Fed policy, which tends to be more dovish than the Committee's policy rate outlook.*
- This suggests that financial markets believe there is currently little inflationary pressure in the U.S.

** The median appropriate policy rate path projections from the March 2018 Summary of Economic Projections are as follows: 2.1% (end of 2018), 2.9% (end of 2019), 3.4% (end of 2020) and 2.9% (longer run).*

2. The Current Policy Rate Is Neutral

Policy rate at neutral

- The Fed's policy rate setting is likely neutral today, putting neither upward nor downward pressure on inflation.
- This suggests that it is not necessary to change the policy rate to keep inflation at target.

The trend short-term safe real rate

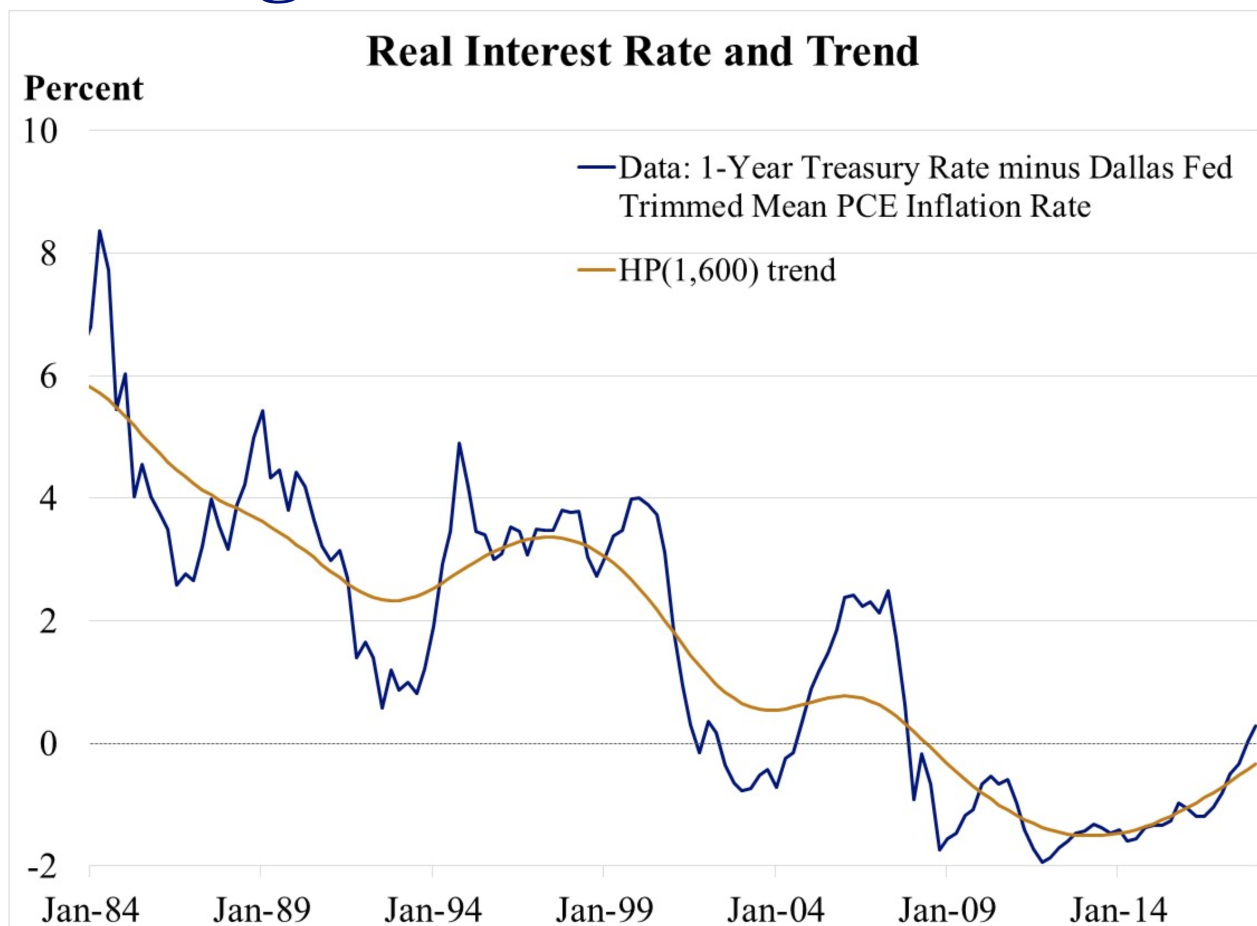
- I discussed the trend short-term safe real interest rate, the so-called "r-star," at a conference earlier this year under the title "R-Star Wars." *
- That talk described the longer-term trends in short-term safe real interest rates, which are independent of Fed actions.
- Those trends were described as driven by at least three factors: productivity growth, labor force growth and the demand for safe assets.
- All three trend factors are pushing the real interest rate to low levels relative to historical experience since the 1980s.

** See J. Bullard, "R-Star Wars: The Phantom Menace," remarks delivered at the 34th Annual NABE Economic Policy Conference, Feb. 26, 2018.*

The trend short-term safe real rate is low

- The level of the trend short-term safe real rate, r-star, is a starting point for where the nominal policy rate should appropriately be set.
- The "R-Star Wars" analysis suggests that r-star remains in negative territory.
- That analysis also suggests that the nominal policy rate set by the FOMC is already pressing against the upper bound of a neutral setting.

The trend short-term safe real rate remains negative



Sources: Federal Reserve Board, FRB of Dallas and author's calculations. Last observation: 2018-Q1.

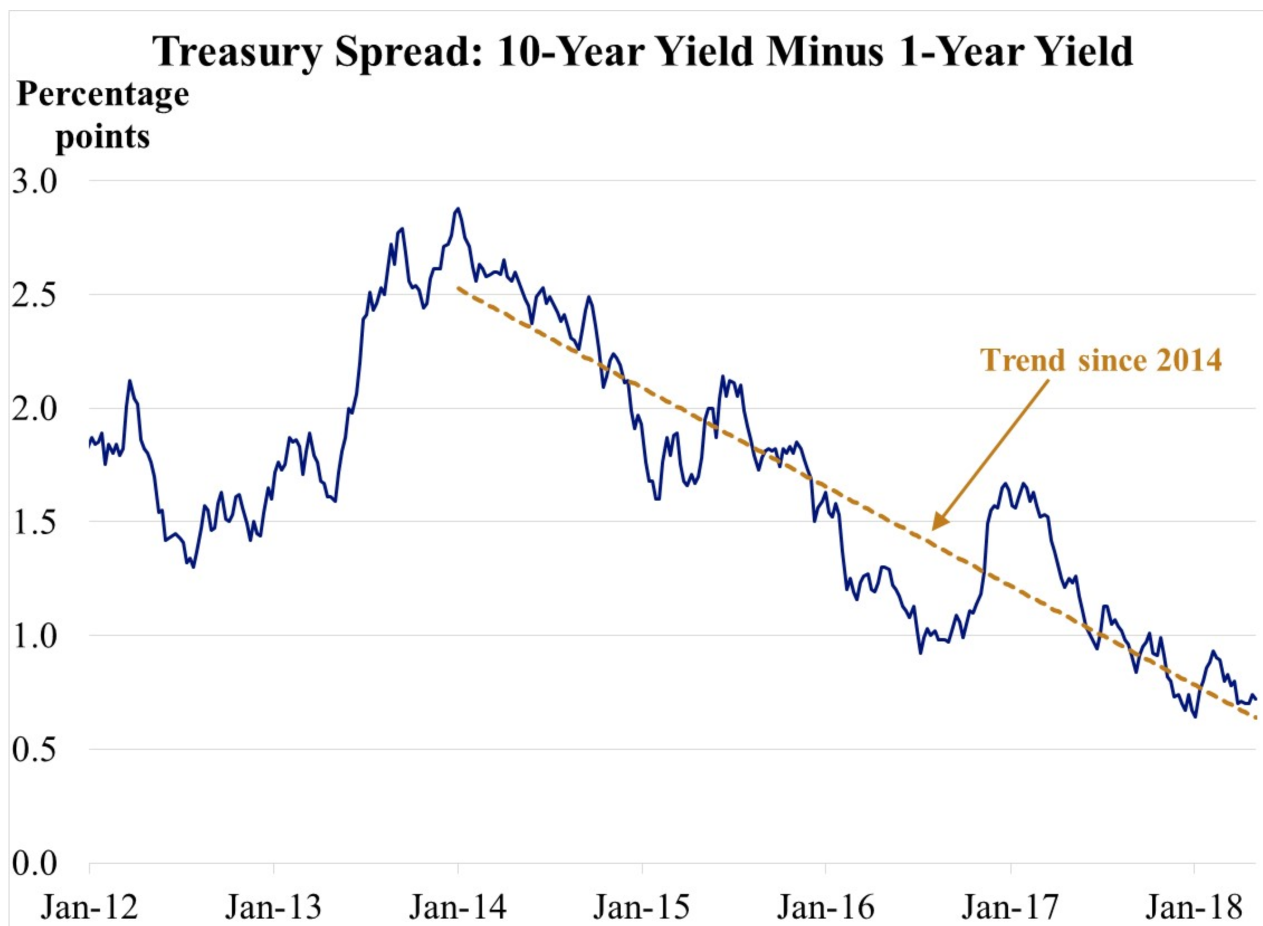
3. The Yield Curve Is Relatively Flat

The slope of the yield curve

- The U.S. nominal yield curve has been flattening since 2014.*
  - The spread between 10-year and one-year Treasury yields was close to 300 basis points at the beginning of 2014.
  - That same spread is currently (week of May 2) only 72 basis points.
- The flattening is due to rising short-term yields vis-à-vis relatively stable or slowly rising long-term yields.

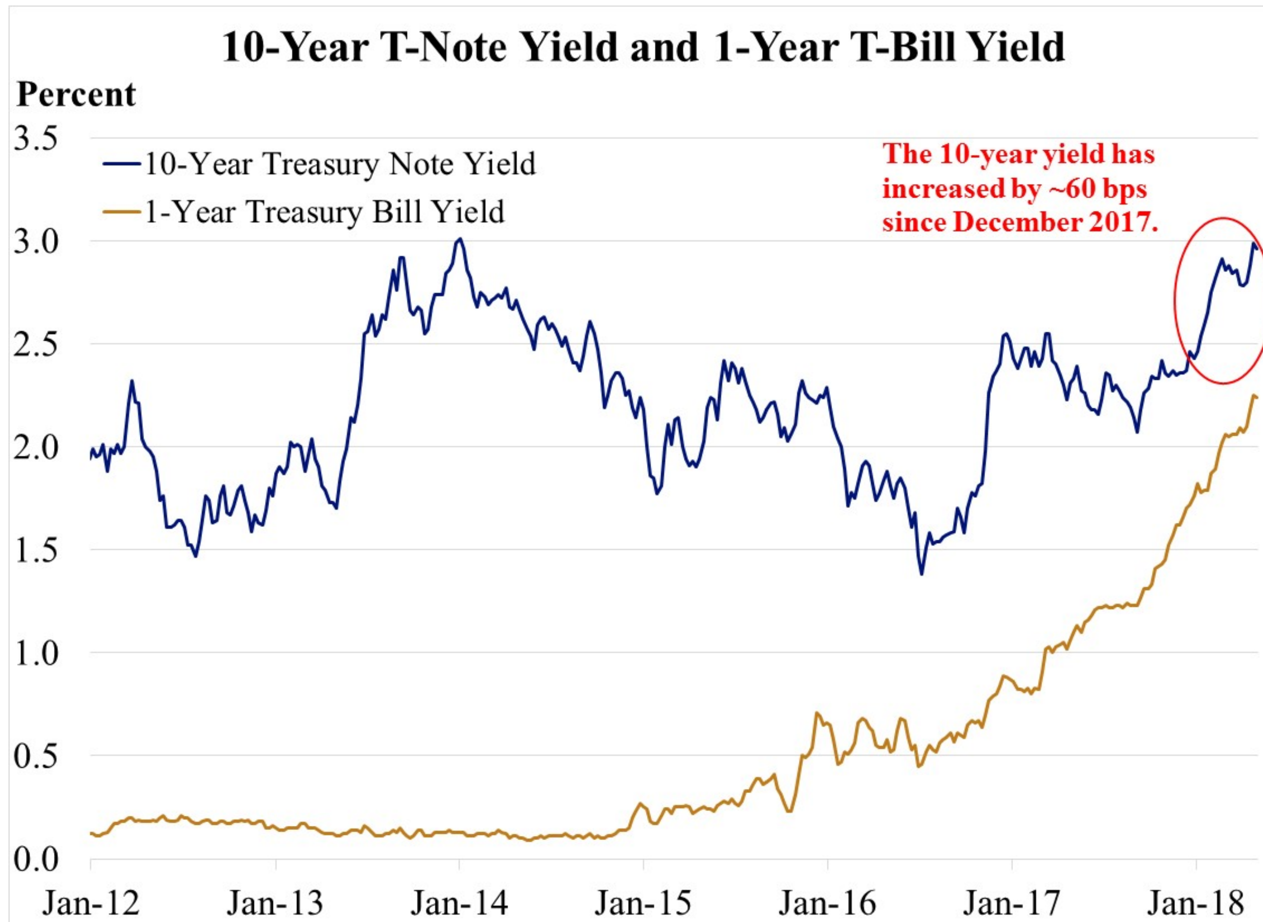
** See J. Bullard, "The U.S. Economy Three Months into 2018," remarks delivered at the Arkansas Bankers Association & Arkansas State Bank Department's Day with the Commissioner, April 4, 2018.*

Nominal yield curve flattening



Sources: Federal Reserve Board and author's calculations. Last observation: Week of May 2, 2018.

Flattening due to rising short-term rates



Sources: Federal Reserve Board and author's calculations. Last observation: Week of May 2, 2018.

Possible yield curve inversion

- It is possible that the nominal yield curve will invert sometime in the next year.
- If the yield curve does invert, research by the San Francisco Fed suggests that the signal of an impending economic downturn would be strong.*
- In my view, it is unnecessary for the FOMC to be so aggressive as to invert the yield curve.

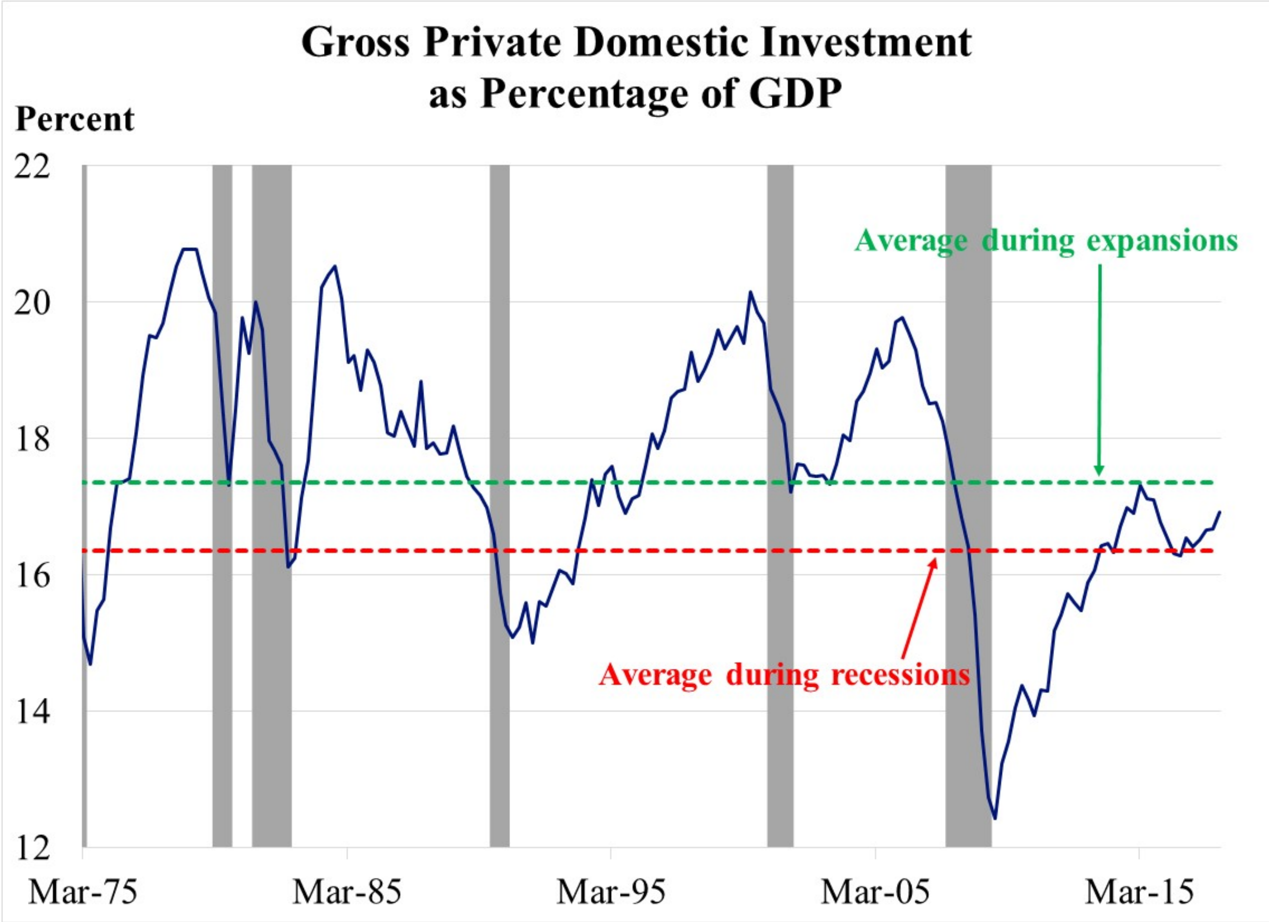
** See M.D. Bauer and T.M. Mertens, "Economic Forecasts with the Yield Curve," FRB of San Francisco* Economic Letter *2018-07, March 5, 2018.*

4. Business Investment Has Room to Grow

Investment rates have been low

- During the last decade, the investment component of U.S. GDP has been disappointingly low.
- The corporate tax reform recently signed into law was meant in part to address the dearth of investment.
- To the extent the corporate tax reform is successful today and over the next few years, the economy could grow more rapidly without inflationary side effects.
- For this reason, I would caution against translating faster real GDP growth into increased inflationary pressures.
- The following chart suggests that current investment rates remain below levels associated with expansions in the past.

Investment share of GDP remains low



Sources: Bureau of Economic Analysis and author's calculations. Last observation: 2018-Q1. The shaded areas indicate NBER recessions.

5. Labor Markets Are in Equilibrium

Labor markets in equilibrium

- Labor markets were dislocated by many measures during the aftermath of the 2007-2009 recession.
- It has taken many years for those dislocations to dissipate.
- We could now describe the U.S. labor market as approximately being in equilibrium.
- This means that, after many years, the suppliers of labor (households) are on the same footing in the labor market as the employers of labor (firms).
- This is an appropriate situation that the Fed should not disturb.

Labor markets and inflation

- Labor market outcomes are not tightly associated with inflation.
- The compensation paid to hire and retain workers is a relative price. When this compensation increases, firms have increased incentives to substitute away from labor and toward capital investment.
- This effect keeps the labor market in equilibrium without inflationary consequences.
- The empirical relationship between labor market outcomes and inflation has been weak in recent years.

Conclusion

Summary

- In this talk, I have outlined five reasons for caution in raising the policy rate further based on the current macroeconomic situation.

1. Inflation expectations are still low

- First, inflation expectations on a PCE basis remain centered somewhat below the Committee's 2 percent target, inhibiting the Committee's ability to maintain the credibility of the target.
- By keeping the policy rate steady, the FOMC may be able to appropriately re-center inflation expectations at the target outcome for the next several years.

2. Policy rate setting is neutral

- Second, the Committee's current policy rate setting is already pushing against the upper bound of the neutral level today, according to my "R-Star Wars" analysis.
- It is not necessary to go above the current level since both inflation and inflation expectations are either at or somewhat below target.

3. Yield curve inversion is possible

- Third, the yield curve could invert later this year or early next year if the Committee continues increasing the policy rate and longer-term yields do not move higher.
- Yield curve inversion is a reliable bearish signal for the U.S. economy, according to recent research by the San Francisco Fed.
- It is unnecessary to press policy rate normalization to the point of inverting the yield curve since inflation and inflation expectations are either at or below target.

4. Investment has room to grow

- Fourth, investment in the U.S. economy as a fraction of GDP remains low and has room to grow.
- To the extent corporate tax reform is successful on this dimension now and over the next several years, faster real economic growth may not be associated with higher inflation.

5. Labor markets are in equilibrium

- Fifth, U.S. labor markets were dislocated during the 2007-2009 recession and have now recovered to a state that could be described as equilibrium.
- It is not necessary to disrupt this equilibrium to keep inflation under control given the current macroeconomic circumstances.
- To the extent labor compensation rises, firms will have to decide whether to hire more labor or to substitute with capital.
- This is an equilibrium process, not an inflationary one.

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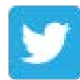

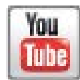

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