A Cautionary Note on U.S. Monetary Policy Normalization

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

• U.S. monetary policy has been normalizing during the last 2½ years.
  o The Federal Reserve’s balance sheet has been shrinking relative to U.S. gross domestic product (GDP).
  o 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

Fed policy rate versus ECB and BOJ

Today’s key monetary policy question

- How far can the Fed go along the current normalization path, given the likely paths of other key economies?
  - This talk offers a few reasons for caution in raising the U.S. policy rate further given current global macroeconomic conditions.
Three reasons for caution

• I will discuss three 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:
  o Market-based inflation expectations in the U.S.
  o The neutral policy rate in the U.S.
  o The flattening U.S. yield curve
U.S. Market-Based Inflation Expectations Remain Somewhat Low
Inflation expectations still low

• Market-based measures of inflation expectations remain centered below the Federal Open Market Committee’s (FOMC’s) 2 percent target, inhibiting the Committee’s ability to maintain the credibility of the target.*

• Technical matter:
  o The market-based measures are for CPI inflation, and so we adjust them downward somewhat to roughly translate into PCE inflation.
  o 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 25 (breakeven inflation rates) and May 18, 2018.
A market-based judgment

- 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 somewhat more dovish than the Committee’s policy rate outlook.*

*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).
Re-centering inflation expectations

• These developments suggest that financial markets believe inflationary pressure in the U.S. is likely to be muted over the forecast horizon.

• To the extent market-based inflation expectations have increased recently, it may be due in part to developments in global crude oil markets, a factor that should ultimately have only temporary effects on inflation.

• A reasonable policy going forward may be to temper the pace of normalization in order to re-center inflation expectations at the Committee’s 2 percent target.
The Current U.S. Policy Rate Is Neutral
The Fed’s policy rate setting is likely at the longer-run neutral level today, putting neither upward nor downward pressure on inflation.

This suggests that it may not be necessary to change the policy rate to keep inflation at target.
The trend short-term safe real rate

• I discussed the U.S. 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 U.S. 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 global demand for safe assets.

• All three trend factors are pushing the real interest rate to low levels relative to historical experience since the 1980s.

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 U.S. 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 next chart shows the simplest version of that analysis, which merely places a Hodrick-Prescott trend through the raw data.
The trend U.S. short-term safe real rate remains negative

The global trend in short-term safe real rates

• A similar, very simple analysis can be carried out for the eurozone and Japan.
• One could do a more extensive analysis to get the trend component, but I think the message would likely be very similar.
• Both the BOJ and the ECB appear to be somewhat more accommodative than the Fed, according to this metric.
Low safe real rates: A global phenomenon

The U.S. Yield Curve Is Relatively Flat
The slope of the yield curve

• The U.S. nominal yield curve has been flattening since 2014.*
  o The spread between 10-year and one-year Treasury yields was close to 300 basis points at the beginning of 2014.
  o That same spread is currently (week of May 16) only 76 basis points.

• The flattening is due to rising short-term yields vis-à-vis relatively stable or slowly rising long-term yields.

Nominal yield curve flattening

Treasury Spread: 10-Year Yield Minus 1-Year Yield

Percentage points

Sources: Federal Reserve Board and author’s calculations. Last observation: Week of May 16, 2018.
Flattening due to rising short-term rates

10-Year T-Note Yield and 1-Year T-Bill Yield

The 10-year yield has increased by ~70 bps since December 2017.

Sources: Federal Reserve Board and author’s calculations. Last observation: Week of May 16, 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.

An inverted yield curve helps predict recessions

Sources: Federal Reserve Board and author’s calculations. Last observation: Week of May 16, 2018. The shaded areas indicate NBER recessions.
International evidence on yield curve inversion and recessions

• The international evidence on the relationship between yield curve inversions and subsequent recessions is not as strong as it is for the U.S. alone.*

• One reason for this may be that the U.S. is a large and relatively closed economy, while many other nations have smaller and more open economies.

• Smaller and more open economies may partially import longer-term interest rates from abroad that are not necessarily reflective of those nations’ economic prospects.

Conclusion
Summary

• In this talk, I have outlined some reasons for caution in the U.S. monetary policy normalization process.
• Inflation expectations in the U.S. remain somewhat low, suggesting that further normalization may not be necessary to keep inflation near target.
• The current level of the U.S. policy rate appears to be neutral, meaning it is putting neither upward nor downward pressure on inflation.
• The U.S. nominal yield curve could invert later this year or in 2019, which would be a bearish signal for U.S. macroeconomic prospects.
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