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A Successful Normalization, With Challenges Ahead

April 11, 2019

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Bullard went on to discuss the macroeconomic challenges facing the FOMC during 2019, including weak feedback from labor markets to inflation. He also noted that inflation expectations remain somewhat low and parts of the Treasury yield curve are inverted. "These market-based signals indicate that the FOMC needs to tread carefully going forward in order to sustain the economic expansion," he added.

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St. Louis Fed's Bullard Discusses Successful Normalization, With Challenges Ahead

Tupelo, Miss. –Federal Reserve Bank of St. Louis President James Bullard

discussed [“A Successful Normalization, With Challenges Ahead”](https://www.stlouisfed.org/-/media/project/frbstl/stlouisfed/files/pdfs/bullard/remarks/2019/bullard_cdf_tupelo_11_april_2019.pdf)on Thursday in a presentation at the Community Development Foundation of Tupelo.

Bullard began by noting that the Federal Open Market Committee (FOMC) indicated at its most recent meeting that, if the economy evolves about as expected, the current level of the policy rate—the federal funds rate target range—will be appropriate through 2019. The FOMC also announced the Fed’s balance sheet reduction program will end this autumn.

“These events mark the end of monetary policy normalization in the U.S.,” he said. “The campaign has been largely successful: Nominal short-term interest rates have been raised from near-zero levels, and the size of the Fed’s balance sheet has been reduced as the economic expansion has continued.”

While normalization has come to an end, the conduct of monetary policy has not, Bullard pointed out. “The FOMC may elect to adjust monetary policy going forward, but any such adjustments would be in response to incoming macroeconomic data and not part of an ongoing normalization strategy,” he said.

Challenges Ahead
Bullard went on to discuss the macroeconomic challenges facing the FOMC during 2019. Particularly, he pointed out that the FOMC may miss its inflation target on the low side in 2019 based on current readings of market-based inflation expectations, following seven years of inflation mostly below target.

Bullard also noted that the U.S. labor market is performing well, but feedback from labor markets to inflation is very weak. Furthermore, he said, “the Treasury yield curve has flattened significantly, and a meaningful and sustained yield curve inversion would send a bearish signal for the U.S. economy.”

Market-Based Inflation Expectations Are Low

Bullard pointed out that the FOMC has a stated inflation target of 2 percent. "An important component of monetary policy is to be able to keep the actual inflation rate close to the target," he explained. "In this quest, inflation expectations are both an important theoretical variable and also an important market-based evaluation of current monetary policy."

The FOMC has missed its personal consumption expenditures (PCE) inflation target for much of the period since 2012, Bullard noted. "Market-based measures of inflation expectations suggest that financial markets believe the FOMC will again miss its PCE inflation target to the low side in 2019 and, indeed, for the next five years," he said.

Feedback from Labor Markets to Inflation Is Weak

Bullard noted that many have argued that inflation is coming because labor markets are strong. He explained that U.S. monetary policymakers and financial market participants have long relied on the Phillips curve—the correlation between labor market outcomes and inflation—to guide monetary policy.

"However, these correlations have broken down during the last two decades, so they no longer provide a reliable signal," Bullard said, pointing out that policymakers have to look elsewhere to discern the most likely direction for inflation.

"It is no longer enough to merely cite strong labor markets and simply assert that inflation must be around the corner," he said, adding that theoretical Phillips curves may still exist, even when empirical Phillips curves have disappeared. He noted that this is a key issue for central banks in the modern era.

Meaningful and Sustained Yield Curve Inversion Threatening

Bullard then discussed U.S. yield curve issues and consequences of inversion. "A meaningful and sustained inversion of the Treasury yield curve would be a bearish signal for the U.S. economy," he said.

An inversion would suggest that financial markets expect less inflation and

less growth ahead for the U.S. economy than does the FOMC, which influences the short end of the curve, Bullard explained, adding that inversions have been associated with recessions in the postwar U.S. data.

“To be sure, yield curve information is not infallible, and inversion could be driven by other factors unrelated to future macroeconomic performance,” he said. “Nevertheless, the empirical evidence is relatively strong. Therefore, both policymakers and market professionals need to take the possibility of a meaningful and sustained yield curve inversion seriously.”

Conclusion
The normalization of U.S. monetary policy has come to a close at an appropriate point, Bullard concluded. “Going forward, the FOMC may adjust monetary policy, but any changes would be in response to incoming macroeconomic data and not part of an ongoing normalization strategy,” he said.

The FOMC faces challenges, Bullard added, in that inflation expectations remain somewhat low and parts of the Treasury yield curve are inverted. “These market-based signals indicate that the FOMC needs to tread carefully going forward in order to sustain the economic expansion,” he said.

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- **April 5, 2019**. Article. "The St. Louis Fed's Focus on Women in Economics," Federal Reserve Bank of St. Louis *Regional Economist*, First Quarter 2019.
  Related article in the *St. Louis Fed On the Economy* blog, April 8, 2019.

  The St. Louis Fed's Focus on Women in Economics

  Economics is a male-dominated field. Women are underrepresented starting at the undergraduate level, and the gap widens carrying forward to advanced careers in economics.

  For example, one study found that more than half of undergraduates who earned bachelor's degrees in any discipline from 2011-2015 were women, but less than one-third of those who majored in economics were women.The authors looked at four-year, not-for-profit colleges and universities in the U.S. See Bayer, Amanda; and Wilcox, David. " [The Unequal Distribution of Economic Education: A Report on the Race, Ethnicity, and Gender of Economics Majors at US Colleges and Universities.](https://www.federalreserve.gov/econres/feds/files/2017105pap.pdf)" Finance and Economics Discussion Series 2017-105, Board of Governors of the Federal Reserve System, October 2017. Another study found that women earned about 31 percent of doctorates in economics in 2014.These numbers are based on data for U.S. citizens and permanent