Remarks on the Current Stance of U.S. Monetary Policy

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June 3, 2019
Chicago, Ill.

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

- Global trade disputes may be more protracted and more difficult to resolve than previously envisioned.
- The U.S. economy is expected to grow more slowly in 2019.
- Inflation expectations appear to be too low to be consistent with the inflation target of the Federal Open Market Committee (FOMC).
- The Treasury yield curve has moved more decisively toward inversion.
- These considerations suggest a downward adjustment in the policy rate—the federal funds rate target range—may be warranted soon.

Protracted Trade Disputes

The effects of protracted trade disputes

- Recent developments in global trade negotiations suggest that it may be more difficult to reach a stable global trade regime than previously thought.
- This is likely to chill global investment and feed 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.

U.S. monetary policy and trade

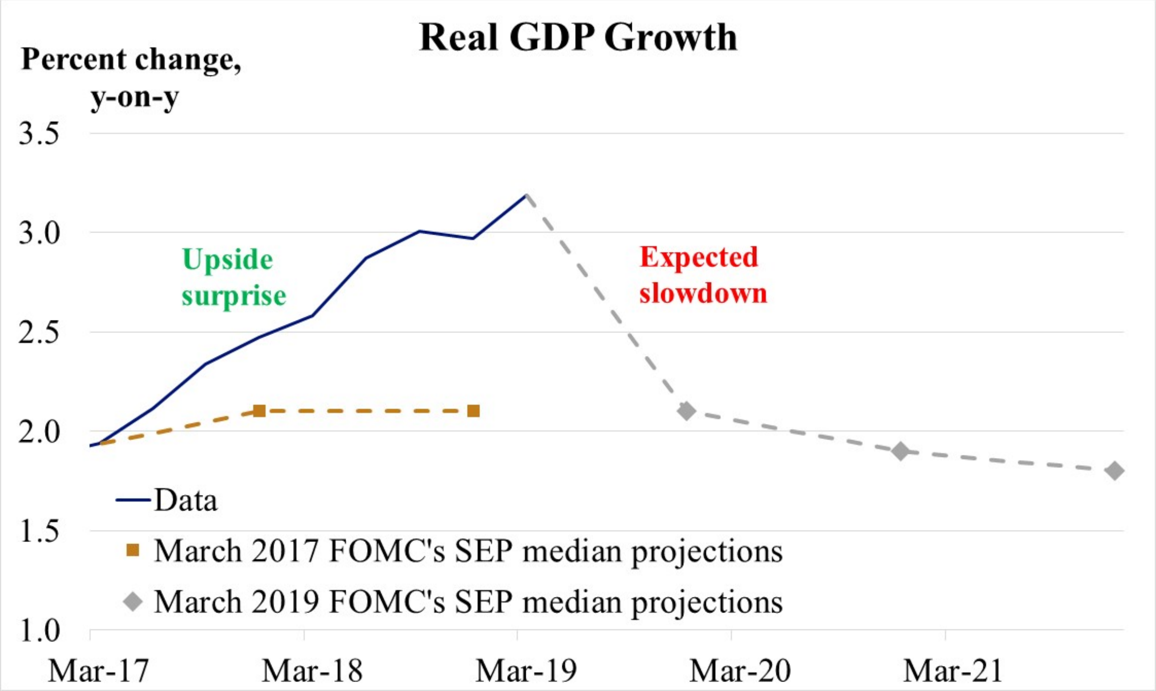
- U.S. monetary policy cannot reasonably react to the day-to-day give-and-take of trade negotiations.
- However, an environment of elevated uncertainty surrounding the global trade regime may be a negative factor for global growth that could feed back to U.S. macroeconomic performance.

U.S. Economy Expected to Slow in 2019

Slower growth

- U.S. real GDP has been growing at a 3.2% pace over the last year.
- However, growth for 2019 as a whole is expected to be slower.
- To the extent global trade uncertainties have become more severe, this slowing may be sharper than previously anticipated.

U.S. real economic growth



Sources: Bureau of Economic Analysis and Federal Reserve Board. Last observation: 2019-Q1.

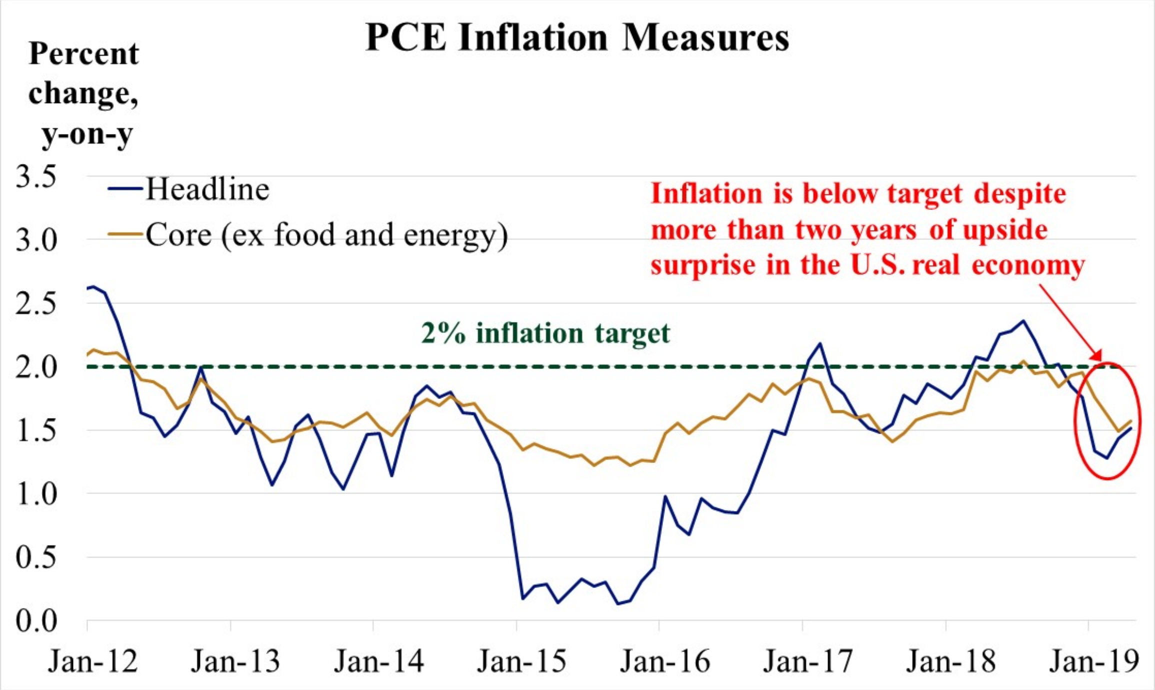
Inflation Expectations Remain Low

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).
- Market-based inflation expectations are below target.*
- This is occurring despite more than two years of upside surprise in the U.S. real economy.
- This is clearly concerning for the credibility of the inflation target.

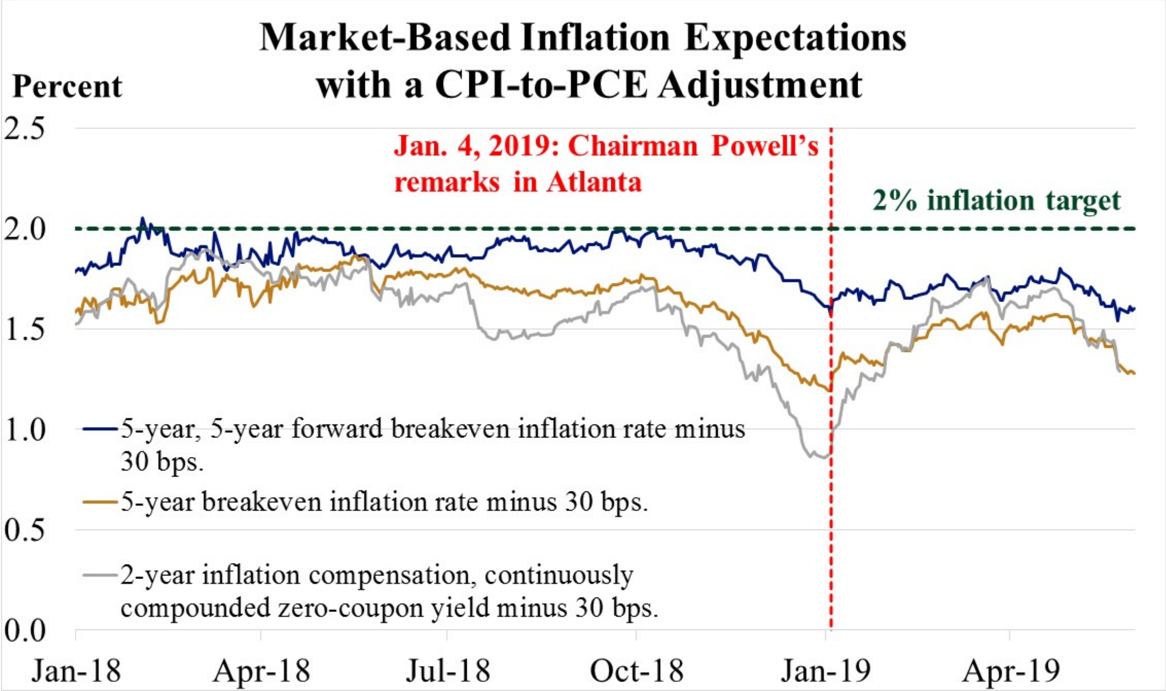
** Inflation-protected securities trade based on consumer price index (CPI) inflation. I subtract 30 basis points from market-based measures of inflation expectations to roughly translate to a PCE inflation basis.*

PCE inflation is below target



Source: Bureau of Economic Analysis. Last observation: April 2019.

Real-time inflation expectations are low



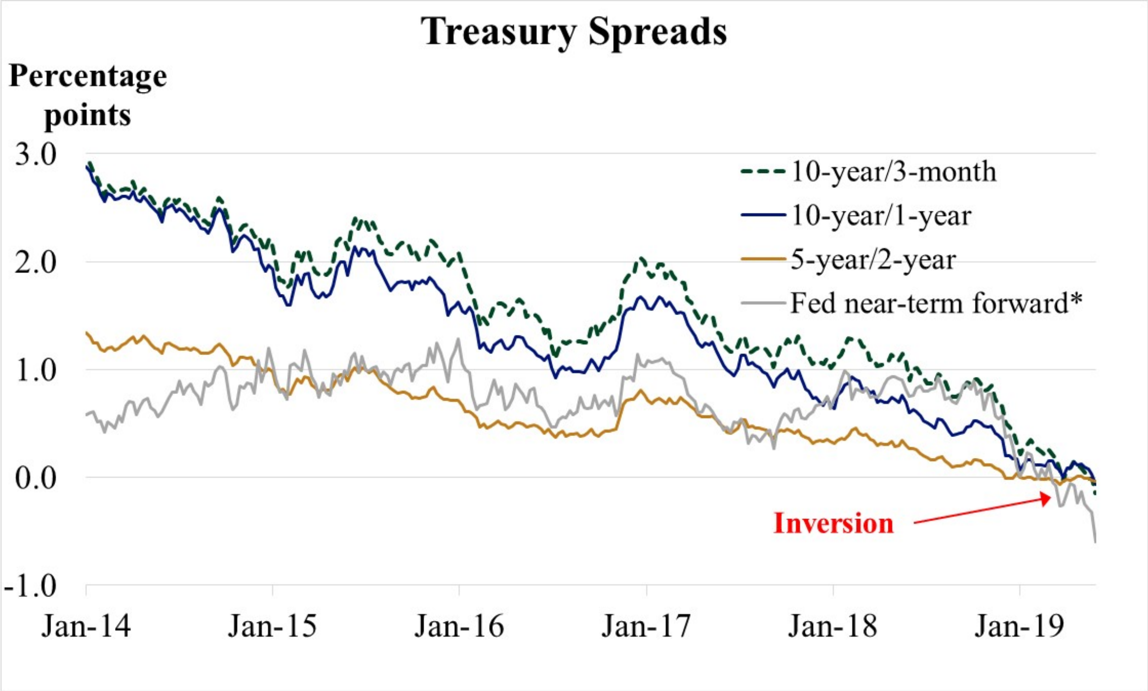
Sources: Federal Reserve Board and author's calculations. Last observations: May 31 and May 24, 2019.

Yield Curve Issues

Yield curve inversion—a predictor of recession?

- 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 Treasury yield curve are inverted today, and this inversion has become more pronounced in recent trading.
  - In particular, the 10-year yield is below the effective federal funds rate.
- Financial markets appear to expect less growth and less inflation going forward than the FOMC does, a signal that the policy rate setting may be too restrictive for the current environment.

Yield curve inversion more pronounced



Sources: Federal Reserve Board, Bloomberg and author's calculations. Last observation: Week of May 29, 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.*

Current Monetary Policy Tactics

A potential monetary policy response

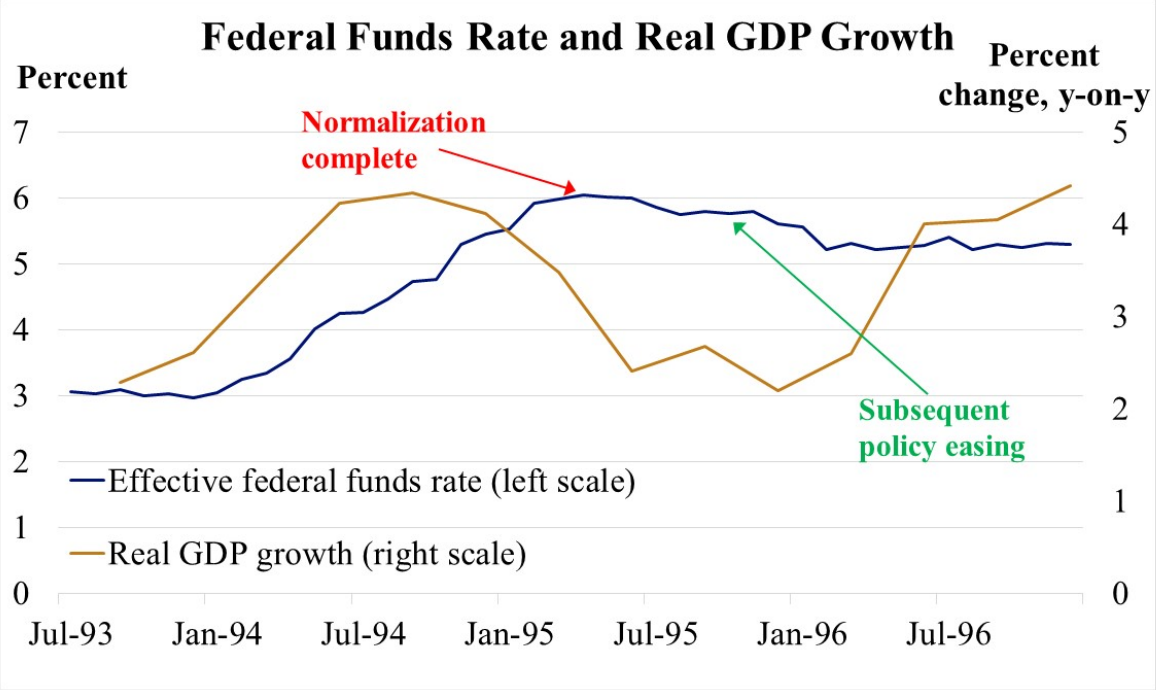
- The FOMC faces a slowing economy with some downside risk due to escalating global trade regime uncertainty.
- Meanwhile, actual PCE inflation and market-based inflation expectations both remain below target.
- A downward adjustment of the policy rate may help re-center inflation and inflation expectations at the 2% target, and simultaneously provide some insurance in case the slowdown is sharper than expected.
- Even if the sharper-than-expected slowdown does not materialize, a rate cut would only mean that inflation and inflation expectations return to target more rapidly.

An Analogy to the Mid-1990s

The mid-1990s as a useful analogy today

- Monetary policy was successfully normalized in the mid-1990s.
- The policy rate was increased 300 basis points between early 1994 and early 1995, similar to the 225 basis point normalization that ended in December 2018.
- The FOMC subsequently lowered rates somewhat.
- The economy did not enter a recession but instead boomed during the second half of the 1990s.
- This example shows that policy rate normalization can be accomplished without damaging the prospects for an extended period of growth.

The mid-1990s normalization



Sources: Federal Reserve Board and Bureau of Economic Analysis. Last observations: December 1996 and 1996-Q4.

Conclusion

Conclusion

- The FOMC faces an economy that is expected to grow more slowly going forward, with some risk that the slowdown could be sharper than expected due to ongoing global trade regime uncertainty.
- In addition, both inflation and inflation expectations remain below target, and signals from the Treasury yield curve seem to suggest that the current policy rate setting is inappropriately high.
- A downward policy rate adjustment may be warranted soon to help re-center inflation and inflation expectations at target and also to provide some insurance in case of a sharper-than-expected slowdown.

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