

Price Stability: A Main Street Perspective

Remarks by

Esther L. George
President and Chief Executive Officer
Federal Reserve Bank of Kansas City

October 6, 2019
National Association for Business Economics Annual Meeting
Denver, Colorado

The views expressed by the author are her own and do not necessarily reflect those of the Federal Reserve System, its governors, officers, or representatives.

Thank you and welcome to Denver — one of three branch cities in the Tenth Federal Reserve District, headquartered in Kansas City. Our Denver Branch serves Colorado, Wyoming, and northern New Mexico and provides valuable insight into local and regional economic conditions through contacts and relationships fostered by our Branch staff and Board of Directors. The Federal Reserve’s founders knew that the long-term success and credibility of the institution would rely on its ability to serve the diverse interests, geographies, and industries that make up the U.S. economy. By maintaining close regional relationships throughout our District, including Colorado, we are able to ensure that a regional perspective can be represented at policy meetings in Washington, D.C.

In addition to providing regional economic insights, the Branch engages in the supervision and regulation of financial institutions, provides cash services to these institutions, and promotes financial education and community development through a variety of programs. Our Denver Branch is located just a few blocks from this location, and we hope that you’ll join us for a reception at the Branch tomorrow evening.

This afternoon I would like to focus my remarks on how I view the Federal Reserve’s inflation objective in relation to its dual mandate for price stability and maximum employment.¹ As I hear from many academics, financial market participants, and central bankers, there appears to be considerable angst over the fact that inflation has fallen persistently below the Fed’s inflation objective of 2 percent. It has given rise to increased interest in alternative monetary policy strategies that might better anchor inflation at 2 percent and is one reason why the Federal Reserve has embarked on an unprecedented public review of its monetary policy strategy, tools, and communications.

¹ I would like to thank Kansas City Vice President and Economist George Kahn for his assistance in preparing these remarks.

Viewed from the perspective of Main Street, however, stakeholders show little concern about inflation running below the Fed's target. They see the U.S. economy is currently in a good place. The unemployment rate is near a 50-year low, inflation is low and stable, and the economy is growing near potential. In the midst of the longest business cycle expansion in history, inflation running a few tenths of a percent below 2 percent is, in itself, not a compelling justification for providing additional monetary policy accommodation.

In my comments today, I will focus on three issues related to inflation dynamics, particularly as they relate to the Fed's price stability mandate. First, what explains low inflation in the United States? Second, is low inflation currently a problem? And third, to the extent low inflation is a problem, how should the Fed respond?

What Explains Low Inflation in the United States?

To begin, let me discuss some of the factors that may be contributing to continued low inflation in the United States. As the economic expansion enters its 11th year, questions continue to linger whether inflation will eventually accelerate in the midst of an ever more mature expansion.² While the dynamics of inflation during this expansion have surprised many observers, including myself, my current outlook for inflation remains fairly benign.

Throughout much of this year, lower-than-expected readings on inflation, as measured by the personal consumption expenditure (PCE) price index, have led 12-month measures of inflation to decline relative to last year. PCE inflation currently stands at 1.4 percent as of August 2019, down from 2.3 percent in August 2018. Core PCE inflation, which strips out the volatile food and energy components from the consumption basket, also moved lower over the past year.

² The National Bureau of Economic Research dates the start of the recovery in June 2009.

Core PCE inflation declined to 1.8 percent at an annual rate in August 2019 from 2.0 percent in August 2018.

Inflation moved lower over the past year despite the unemployment rate edging below 4 percent. This recent behavior of inflation suggests to me that factors other than the domestic labor market may be driving inflation. For example, I see global inflationary trends as an important factor keeping inflation pressures muted in the United States.

The Federal Open Market Committee (FOMC) adopted its numerical, longer-run objective of a 2 percent annual change in the PCE price index in 2012. Since then, this measure of U.S. inflation has averaged about 1.4 percent. However, the United States is not alone in terms of falling short of its longer-run inflation target. Several other major foreign economies also have struggled to reach their longer-run inflation objectives, including the euro area and Japan.³ More broadly across the globe, inflation declined throughout the last decade. Among nearly 200 countries in the IMF's database of international statistics, the share of countries with inflation above 2 percent has, in recent years, declined to levels last witnessed in the 1960s.⁴

While there are certainly some specific challenges shaping inflation in each economy, including where they stand in their own business cycle, these recent patterns suggest some common forces are likely keeping global inflation trends subdued. First, we've witnessed the widespread adoption of inflation targets in advanced and emerging economies. As more central banks pursue policies to keep inflation low, other countries export less inflation globally. This factor may be at work in the United States recently as import price inflation currently remains

³ The United Kingdom is one advanced economy that has recently experienced above target rates of inflation amid a rapid and large depreciation of their currency following the Brexit vote.

⁴ The International Monetary Fund's International Financial Statistics database and Federal Reserve Bank of Kansas City research staff calculations. Of 193 countries and areas, the share with a 3-year moving average of inflation above 2 percent declined from 97 percent at the end of 2008 to 51 percent as of the end of 2018. While the database covers 198 countries and areas, data on inflation is missing for five of them.

lower than during 2004-2007 — a period in which the unemployment rate also reached its cyclical low but inflation was running slightly *above* 2 percent.

Second, changes in commodity price dynamics may have significant consequences for global inflation. Unlike past decades, the advent of nimble U.S. oil production seems likely to keep energy prices in check even amidst oil supply disruptions and shortages. As a result, oil price inflation has been lower in recent years than in the 2004-2007 period, possibly helping explain why the current low unemployment rate is failing to generate as much inflation in the United States as in past expansions. The global nature of commodity markets suggests that these developments are likely to affect inflation outcomes in the United States as well as other countries.

And third, the e-commerce induced disruption to global retail represents a global factor which may weigh on inflation, although its exact effects are difficult to quantify. Comparing to the 2004-2007 period, the share of U.S. retail sales accounted for by non-store retailers has doubled from around 7 percent to nearly 15 percent. As major retailers compete for global market share, perhaps at the cost of margins, retail price inflation is likely to remain tame.

Beyond these longer-term global trends, the rapidly changing trade environment threatens the rise of global supply chains, and I see the persistent effects from the ongoing trade dispute as disinflationary for the United States. In particular, the uneven effects of the changes in trade policy on our trading partners, coupled with the safety and security of the U.S. dollar in an era of uncertainty, has generally led to a rise in the foreign-exchange value of the dollar against other currencies. These forces, along with ongoing geopolitical risks, likely further reinforced the strength in the U.S. dollar over the past year. As a result, I expect that global disinflationary trends, embodied in low import price inflation, will continue to weigh on U.S. inflation.

In addition to global factors, domestic factors also are at play. For example, recent research at the Federal Reserve Bank of Kansas City highlights that, after growing rapidly at roughly 7 percent per year over the 1980-2004 period, college tuition prices have slowed markedly, averaging much closer to 2 percent over the last few years.⁵ Other staff analysis highlights that inflation for medical care services, a fairly large and important component of the personal consumption expenditure price index, has also been substantially weaker over the last decade.⁶ These sector-specific factors, such as changes in state appropriations to higher education or changes to the Medicare reimbursement rates for doctors, are important drivers of changes in the inflation rates for these various components. Given that these idiosyncratic, sector-specific factors are unlikely to be directly affected by changes in labor market slack, some components of inflation may remain muted even if the overall economy is operating at or near potential. Such factors are beyond the reach of monetary policy to control.

Is Low Inflation Currently a Problem?

While I have suggested a number of reasons why inflation has been low in the United States, should we be concerned that inflation is running persistently a few tenths of a percent below the Fed's objective of 2 percent? My answer to that question is based partly on my interactions with business and community leaders but, in addition, depends on the broader economic circumstances that coincide with low inflation.

As I listen to business and community leaders around my region, I hear few complaints about inflation being too low. In fact, I am more likely to hear disbelief when I mention that

⁵ Brent Bundick and Emily Pollard, "[The Rise and Fall of College Tuition Inflation](#)," Federal Reserve Bank of Kansas City *Economic Review*, First Quarter, 2019.

⁶ Presentation by A. Lee Smith at the BLS Data User's Conference.

inflation is as low as measured in a number of key sectors. This leads me to the observation that inflation as experienced by households and businesses is fundamentally different from inflation as viewed by many financial market participants and economists. Households see the prices of everyday goods such as food, energy, rents, and health care rising and don't understand why the Fed would be concerned that inflation is too low. Their short-run expectations for inflation are driven largely by changes in retail gasoline prices while their longer-run expectations, as measured by the University of Michigan, have been fairly stable. (Expected changes in prices during the next 5 years have fluctuated between 2.3 and 2.6 percent since April 2016 and are currently at 2.4 percent.)

Businesses see their labor and other input costs rising, and with limited pricing power, see their profit margins squeezed. For them, the product prices they charge are determined by structural factors such as global competition and technological disruption that don't necessarily respond to monetary policy, while their costs are driven by tight labor and commodity market conditions. In the August survey of small businesses conducted by the National Federation of Independent Business, only 1 percent of respondents said inflation was their single most important problem, compared with 27 percent who said "quality of labor" and 9 percent who said "cost of labor." I would also point out that in the last NABE outlook survey (June 2019), your outlook panelists' median forecast for core PCE price inflation for each quarter of 2020 was 2.0 percent at an annual rate — right at the Fed's longer-run objective.

Philip Lowe, the governor of the Reserve Bank of Australia, summed it up well at our Jackson Hole symposium when he said "...many people in our communities are incredulous that we would be too worried over whether inflation was 1.6 per cent, 2.0 per cent or 2.2 per cent. They ask, 'haven't you got something more important to worry about?'"

Beyond this view of inflation from Main Street, I also keep in mind the Fed's dual mandate. Unlike some central banks, we are tasked not only with achieving price stability, but in addition, we have a mandate to achieve maximum employment. In circumstances where the unemployment rate is high and inflation is low, as was the case throughout much of the recovery from the Great Recession, policymakers typically ease policy to bring both variables in line with their longer-run objectives. Low inflation can be a symptom of economic slack, and accommodative policy tends to reduce unemployment and increase inflation. In these circumstances, the direction of policy is clear and policymaker consensus is relatively easy to achieve.

In other circumstances — such as we have today — with both unemployment and inflation low relative to their longer-run objectives, the policy response is not so clear. On one hand, easing policy might lift inflation, but at the cost of further tightening an already hot labor market and perhaps fostering financial imbalances. And given the reduced responsiveness of inflation to economic slack, it might take a considerable dose of monetary accommodation to nudge inflation upward. On the other hand, tightening policy might limit the overheating of labor markets, but at the cost of putting further downward pressure on inflation.

In these circumstances, where the objectives are not complementary, the FOMC's Statement on Longer-Run Goals and Monetary Policy Strategies lays out the framework of a "balanced approach" in promoting them. In particular, we take into account the magnitude of the deviations and the potentially different time horizons over which employment and inflation are projected to return to mandate-consistent levels.

Not surprisingly, under this balanced approach, there may be disagreement about a number of the factors that determine appropriate policy. For example, policymakers may

disagree about the amount of slack in labor markets or the relative costs of deviations of inflation and unemployment from their objectives. From my perspective, the deviation from our inflation objective is currently small, but given structural changes in inflation dynamics, trying to quickly return inflation to 2 percent by adjusting interest rates could require aggressive actions that would misallocate resources and create financial imbalances.

My dissent at the last two FOMC meetings was based in part on balancing our objectives for price stability and maximum employment. I dissented from the Committee's decision to lower the target range for the federal funds rate in July and September because the moderation of economic growth in 2019 has been in line with my own outlook that calls for a gradual decline to a trend level over the medium term. With moderate growth, record low unemployment, and a benign inflation outlook, maintaining an unchanged setting for policy would have been appropriate, in my view. There are certainly risks to the outlook as the economy faces trade policy uncertainty and weaker global activity. Should incoming data point to a broadly weaker economy, adjusting policy may be appropriate to achieve the Federal Reserve's mandates for maximum sustainable employment and stable prices.

But in the absence of more evidence that the downside risks may be realized, muted inflation alone would not warrant a policy response. Rather than focusing too narrowly on achieving a precise point target of 2 percent inflation, I find it more realistic to accept that there will be both temporary and persistent fluctuations around this long-run target and, as long as they don't exceed a reasonable threshold — perhaps as big as 50 or even 100 basis points — they should be tolerated, depending on broader economic conditions. Keeping our sights set on low and stable inflation is key, with 2 percent as our North Star and longer-run inflation objective.

When is Low Inflation a Concern and What Can Be Done About It?

So when should we be concerned about low inflation and what can be done about it? As I've suggested, in current circumstances, concern about low inflation seems unnecessary. While I do not see a case for deliberately easing policy to boost inflation, the Fed's 2 percent inflation target also should not be viewed as a ceiling. Rather, it seems reasonable to allow modest unexpected shocks to inflation — perhaps stemming from import prices — to demonstrate to the public a commitment to achieving our inflation goal on a symmetric basis.

In contrast, if conditions change so that the goals of policy are no longer in conflict, policymakers should be prepared to adjust policy as necessary. For example, if weaker global demand and trade policy uncertainty were to materially weaken my modal outlook for growth, providing additional monetary accommodation may be warranted. Such a response to changing economic conditions would support both the economic expansion and help offset further downward pressure on inflation.

Were a more-severe downturn to hit the economy, policymakers are keenly aware that little policy space remains with the federal funds rate currently at 1¾ to 2 percent. The prospect of such a situation makes the Fed's reevaluation of its policy strategies and objectives a timely undertaking. The review has several parts, including a series of Fed Listens events around the country designed to help policymakers better understand the perspectives of people from diverse backgrounds and with varied interests. In fact, we'll host such an event in Kansas City this week. A few months ago, the Chicago Fed held a conference that brought together a distinguished group of academics, financial market experts, and labor leaders to share their perspectives on how the Federal Reserve can best achieve its mandate. Finally, the FOMC, supported by staff throughout the Federal Reserve System, is devoting time at its regular meetings to assess lessons

learned in the aftermath of the Great Recession. Whether or not we ultimately make any changes to our framework, this review is essential in my view to the credibility of our decision-making, our commitment to transparency, and our collective learning about the changing landscape. I hope the exercise will become a regular feature of the Committee's policy framework.

Conclusion

In closing, the U.S. economy is currently in a good place with low inflation, low unemployment, and an outlook for continued moderate growth. In these circumstances, I am not concerned that inflation is running a bit below our objective of 2 percent. Persistently muted inflation is the result of a confluence of temporary and structural factors that are not particularly responsive to interest rate adjustments. Therefore, a degree of flexibility in how we interpret our price stability mandate seems appropriate. Should conditions change, however, and we find ourselves again at the zero lower bound, a fundamentally different strategy may be needed. In anticipation of that possibility, now is a good time for a thorough review of policy strategies, tools, and communications.