St. Louis Fed's Bullard Discusses a Strategy for Extending the U.S. Economy's Expansion

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CHICAGO – Federal Reserve Bank of St. Louis President James Bullard gave remarks Wednesday titled “What Is the Best Strategy for Extending the U.S. Economy's Expansion?” The remarks were given at the CFA Society Chicago’s Distinguished Speaker Series Breakfast.

In his talk, Bullard discussed a possible strategy for extending the U.S. economic expansion. His preferred approach relies on placing more weight on financial market signals, such as the slope of the yield curve and market-based inflation expectations, than has been customary in past U.S. monetary policy strategy. He explained that the empirical relationship between inflation and unemployment has largely broken down over the last two decades, leaving monetary policymakers without a clear guidepost for action.

“U.S. monetary policymakers should put more weight than usual on financial market signals in the current macroeconomic environment due to the breakdown of the empirical Phillips curve,” he said. “Handled properly, current financial market information can provide the basis for a better forward-looking monetary policy strategy.”

He also noted that these signals could help the Federal Open Market Committee (FOMC) better identify the neutral policy rate.

“The flattening yield curve and subdued market-based inflation expectations suggest that the current monetary policy stance is already neutral or possibly somewhat restrictive,” Bullard said.

**The Disappearing Phillips Curve**

While the FOMC did not name an explicit inflation target of 2 percent until January 2012, Bullard argued that the FOMC behaved as if it had a 2 percent target well before that date. Around 1995, the U.S. inflation rate reached 2 percent, and U.S. inflation expectations stabilized near that value, he said.
This coincided with a global movement among central banks toward inflation targeting. “Once inflation expectations began to stabilize around this international standard, the empirical relationship between inflation and unemployment—the so-called ‘Phillips curve’—began to disappear,” he noted.

While the conventional wisdom in current U.S. monetary policy is based on the Phillips curve and suggests that the policy rate should continue to rise in order to contain any increase in inflationary pressures, Bullard explained that in the current era of inflation targeting, neither low unemployment nor faster real GDP growth gives a reliable signal of inflationary pressure. “Continuing to raise the policy rate in such an environment could cause the FOMC to go too far, raising recession risk unnecessarily,” he said.

**Using Financial Market Signals: The Yield Curve and Market-Based Inflation Expectations**

Bullard then discussed an alternative set of signals. In particular, he said that an alternative to the Phillips curve is to place more emphasis than usual on financial market information.

The yield curve is quite flat, he pointed out, and an inversion would suggest a very different outlook at the Fed versus in the market. “The yield curve information suggests that financial markets do not see excessive real growth or excessive inflationary pressure over the forecast horizon,” he said.

Meanwhile, market-based inflation expectations, adjusted to a personal consumption expenditures (PCE) basis, remain somewhat below the FOMC’s 2 percent target. The inflation compensation data derived from Treasury inflation-protected securities (TIPS) “suggest that markets do not expect the FOMC to achieve the 2 percent inflation target on average on a PCE basis over the next decade,” he said.

**Strengths and Weaknesses of Financial Market Information**

“More directly emphasizing financial market information naturally constitutes a forward-looking monetary policy strategy,” Bullard said.

“One of the great strengths of financial market information is that markets are forward-looking and have taken into account all available information when determining prices,” he explained. Thus, he added, markets have made a judgment on the effects of the fiscal package in the U.S., ongoing trade discussions, developments in emerging markets, and a myriad of other factors in determining current prices.
Financial markets are also pricing in future Fed policy, which creates some feedback to actual Fed policy if policymakers are taking signals from financial markets, he pointed out. He added that this has to be handled carefully: Ideally, Fed communications and market-based expectations of future Fed policy would be close to each other.

Generally speaking, markets have currently priced in a more dovish policy than indicated by the FOMC's Summary of Economic Projections, Bullard said, noting markets expect the FOMC to be more dovish than announced but still not enough to achieve the inflation target.

“Financial market information is not infallible, and markets can only do so much in attempting to predict future macroeconomic performance,” Bullard added. “Nevertheless, the empirical evidence on yield curve inversion in the U.S. is relatively strong, and TIPS-based inflation expectations have generally been correct in predicting subdued inflationary pressures in recent years.”

**Risks and Opportunities**

Bullard also discussed some risks for monetary policy. “Yield curve inversion would likely increase the vulnerability of the economy to recession,” he said. Also, an inflation outbreak “is possible but seems unlikely at this point,” he said, adding “by closely monitoring market-based inflation expectations, the FOMC can keep inflationary pressure under close surveillance.” Regarding financial stability risks, he noted that those are generally considered moderate at this juncture.

As for the opportunities, Bullard pointed out that the current economic expansion dating from the 2007-2009 recession has been long and subdued on average. “The slow pace of growth suggests the expansion could have much further to go,” he said. In addition, he said, “the strong performance of current labor markets could entice marginally attached workers back to work, increasing skills and enhancing resiliency before the next downturn.”

Bullard also addressed another long-standing issue in macroeconomics, which is how to think about parameter uncertainty, or more broadly, model uncertainty. The established view is that when model parameters are in doubt, policy should be more cautious than otherwise. In contrast, recent work suggested that in some cases of model uncertainty, policymakers may want to be more aggressive than otherwise. “This remains an important unresolved issue, but how to handle parameter uncertainty has been a concern for the FOMC for years,” he said.