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The First Steps Toward Disinflation in the U.S.

James Bullard
President and CEO

Power Up Little Rock: U.S. Economy and Monetary Policy
Little Rock Regional Chamber

July 7, 2022
Little Rock, Ark.

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

Introduction

Key themes

- U.S. inflation is comparable to levels seen in the 1970s.
- U.S. inflation expectations could become unmoored without credible Fed action, possibly leading to a new regime of high inflation and volatile real economic performance.
- The Fed has reacted by taking important first steps to return inflation to the 2% target.
- Market interest rates have increased substantially, partially in response to promised Fed action.
- U.S. labor markets remain robust, and output is expected to continue to expand through 2022.

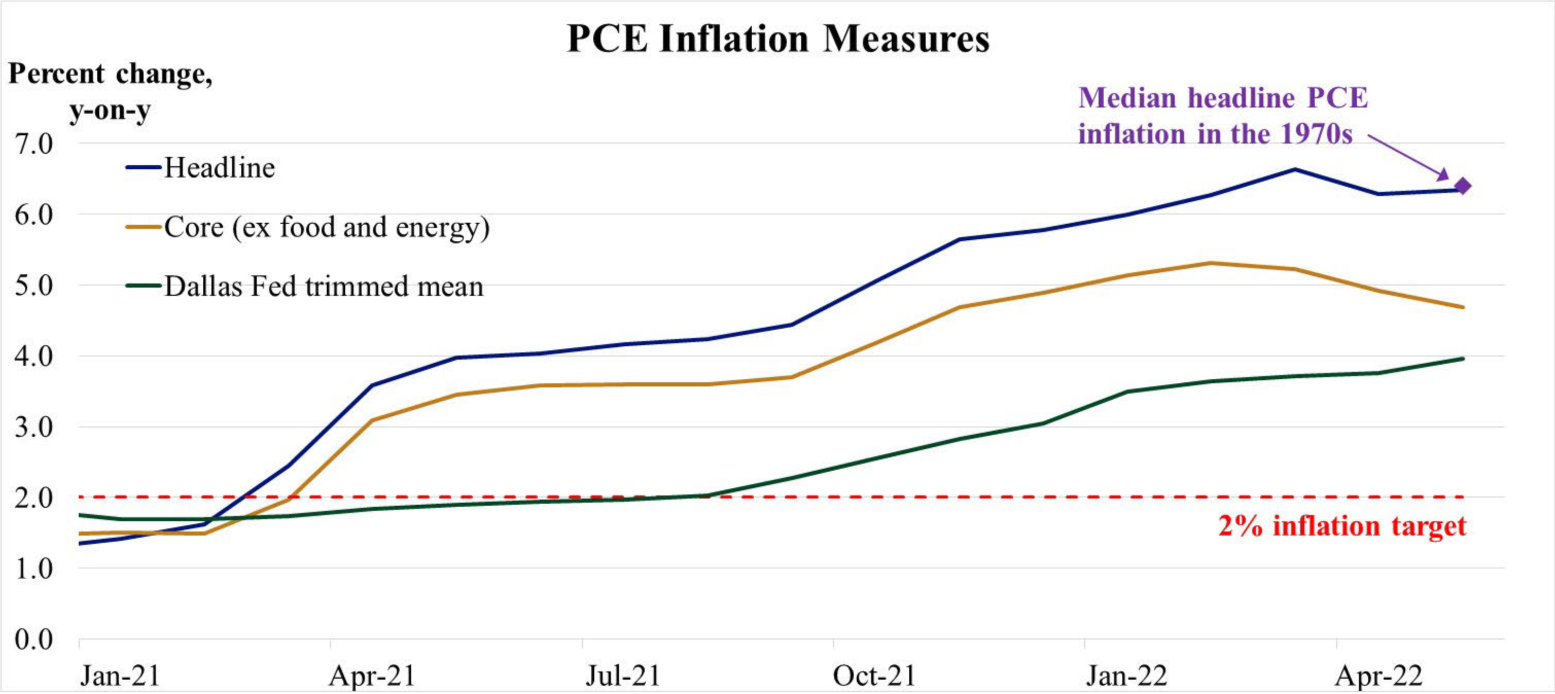
Inflation Is Comparable to 1970s Levels

U.S. inflation is far above target

- The Fed has a statutory mandate to provide stable prices for the U.S. economy.
- The FOMC has an associated inflation target of 2%, stated in terms of headline personal consumption expenditures (PCE) inflation.
- The current inflation rate on this measure is 6.3%.[†]
- Because food and energy prices can be particularly volatile, analysts sometimes refer to core PCE inflation, which is currently 4.7%.[†]
- The Dallas Fed trimmed mean inflation rate measures only the middle portion of the price change distribution, and by this measure inflation is 4.0%.[†]

[†] *Inflation figures are year-over-year percentage changes for the month of May 2022.*

Inflation is comparable to 1970s levels



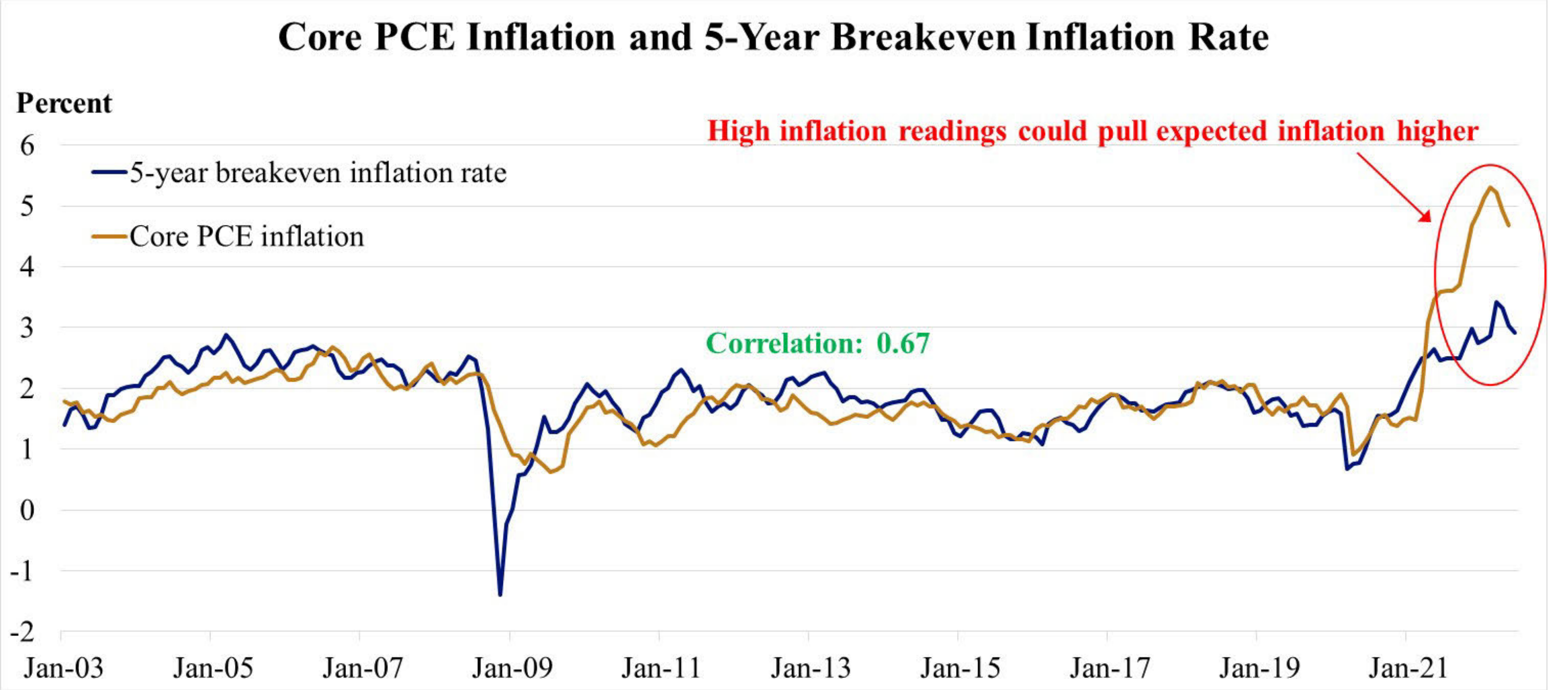
Sources: Bureau of Economic Analysis and Federal Reserve Bank of Dallas. Last observation: May 2022.

Risks to Inflation Expectations

Inflation expectations

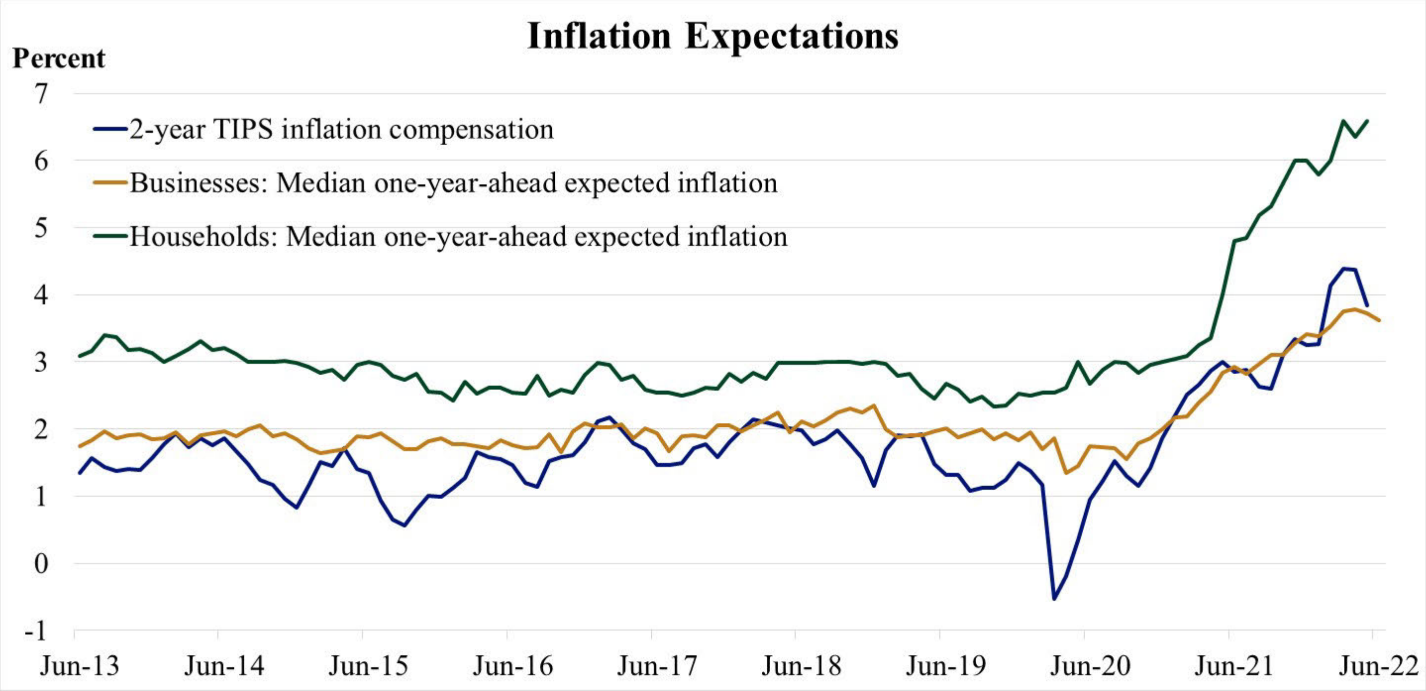
- The current U.S. macroeconomic situation is straining the Fed's credibility with respect to its inflation target.
- In economic theory, expected inflation and actual inflation should be closely related.
- The current divergence between actual inflation readings and TIPS-based expected inflation will have to be resolved, possibly resulting in still higher inflation expectations.
- In the 1970s, inflation expectations became unmoored, and it took years for the Fed to bring inflation back to lower levels. The real economy was also volatile during this process.

Actual and expected inflation



Sources: Federal Reserve Bank of St. Louis and Bureau of Economic Analysis. Last observations: May 2022 and June 2022.

Inflation expectations have been rising



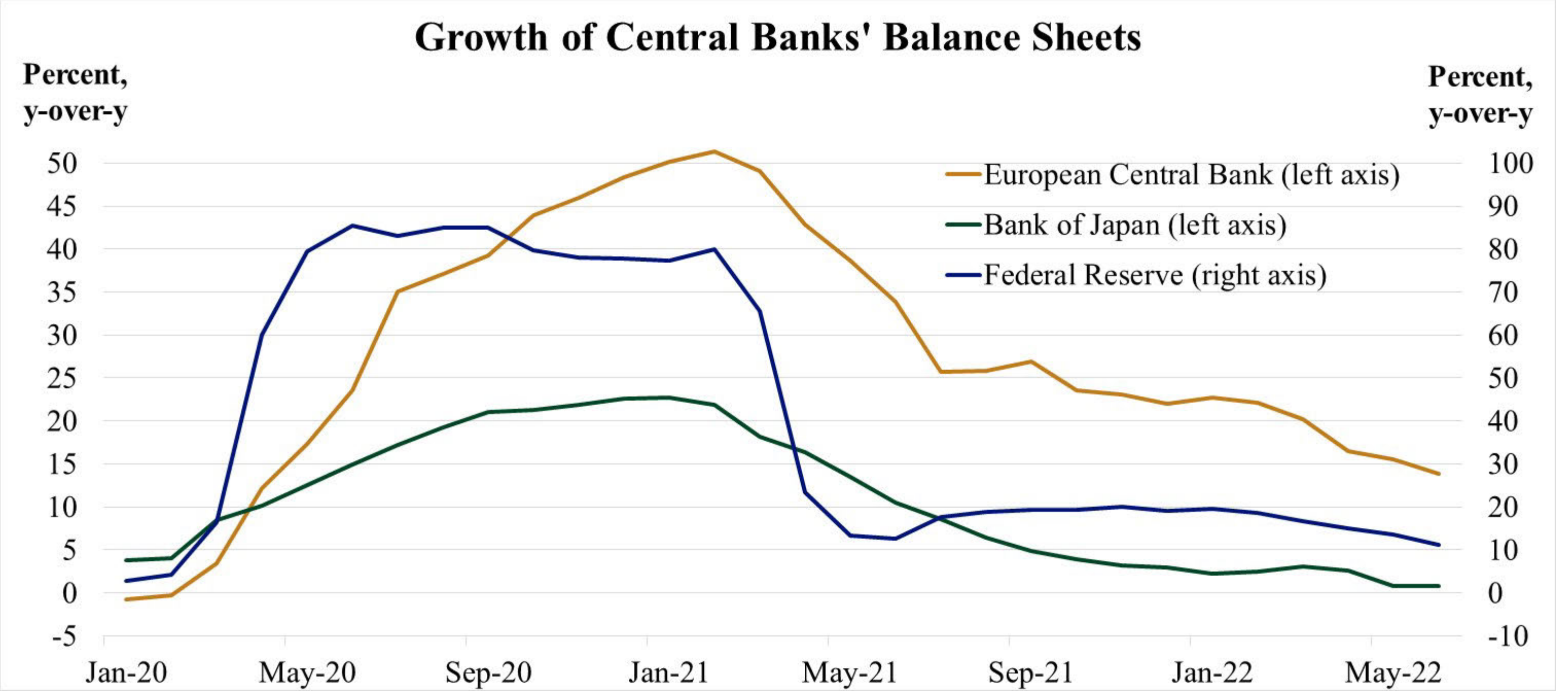
Sources: Board of Governors of the Federal Reserve System, Federal Reserve Bank of Atlanta and Federal Reserve Bank of New York. Last observations: May 2022 and June 2022.

What the Fed Has Done So Far

The FOMC’s moves so far

- Beginning in the second half of 2021, the Fed began to move in a more hawkish direction to take better control of inflation risks.
- With respect to the policy rate: The FOMC has increased the rate’s level at the last three meetings and is poised to make further increases at coming meetings.
- With respect to the balance sheet: The FOMC has ceased asset purchases and has begun to allow passive runoff, known in markets as quantitative tightening, or QT.
- Foreign central banks are simultaneously increasing their policy rates and allowing their balance sheets to shrink.

Approaching global quantitative tightening



Sources: Board of Governors of the Federal Reserve System, European Central Bank, Bank of Japan and author's calculations. Last observation: June 2022.

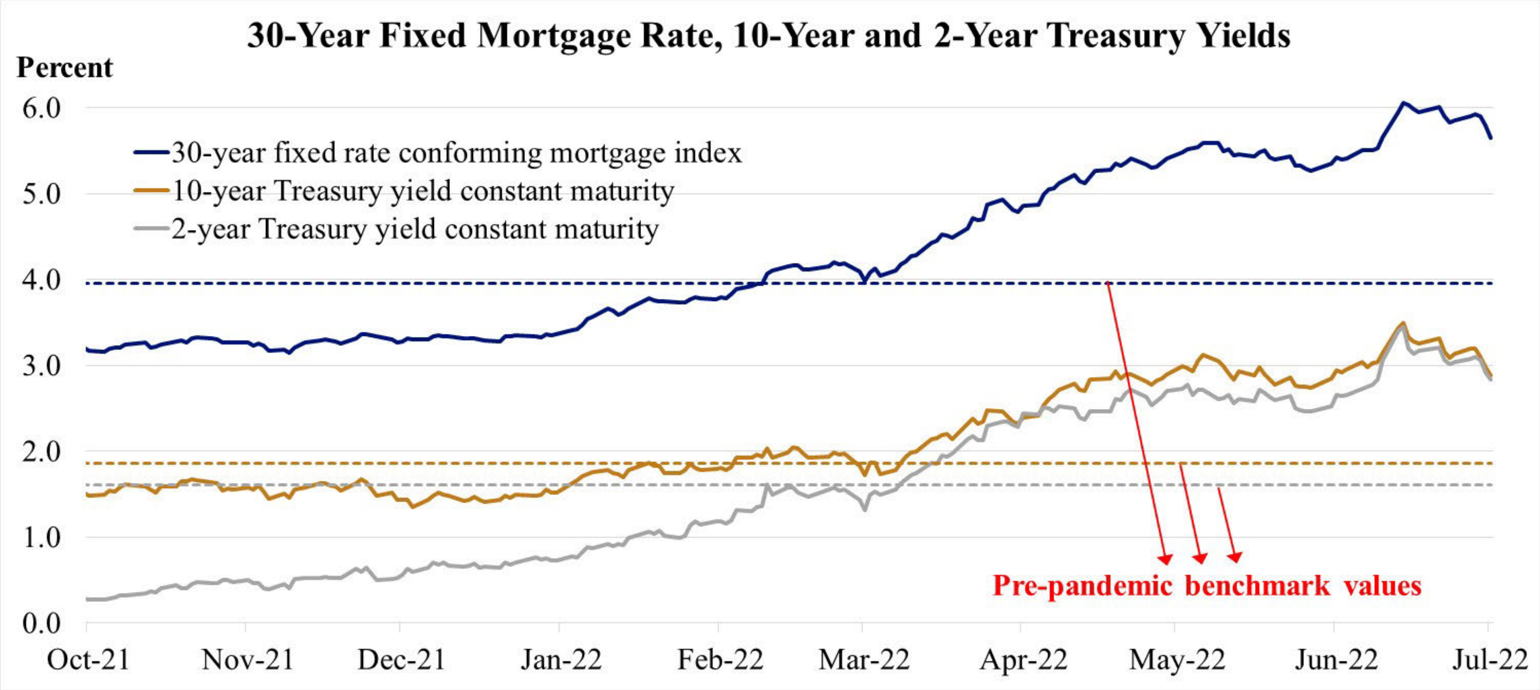
The Pre-Pandemic Benchmark

The pre-pandemic benchmark

- Before the pandemic, at the end of 2019:
  - The U.S. economy was growing at 2.6%, the headline PCE inflation rate was 1.5%, and the unemployment rate was 3.6%.[†]
  - The policy rate associated with these outcomes was 1.55%.[‡]
  - Policy was not expected to change much going forward. Accordingly, the 2-year Treasury yield was 1.61%.[‡]
  - Longer-term rates were moderate, with the 10-year Treasury yield at 1.86% and the 30-year fixed rate mortgage at 3.96%.[‡]
- This may provide a practical benchmark for where the constellation of rates may settle once inflation comes under control in the U.S.

[†] *Real GDP growth and inflation are Q4-over-Q4 values. Unemployment is the December 2019 value.*
[‡] *Interest rates are monthly averages of daily data for December 2019.*

Market pricing based on Fed credibility



Sources: Optimal Blue and Department of the Treasury. Last observation: July 1, 2022.

Market rates are above pre-pandemic benchmarks

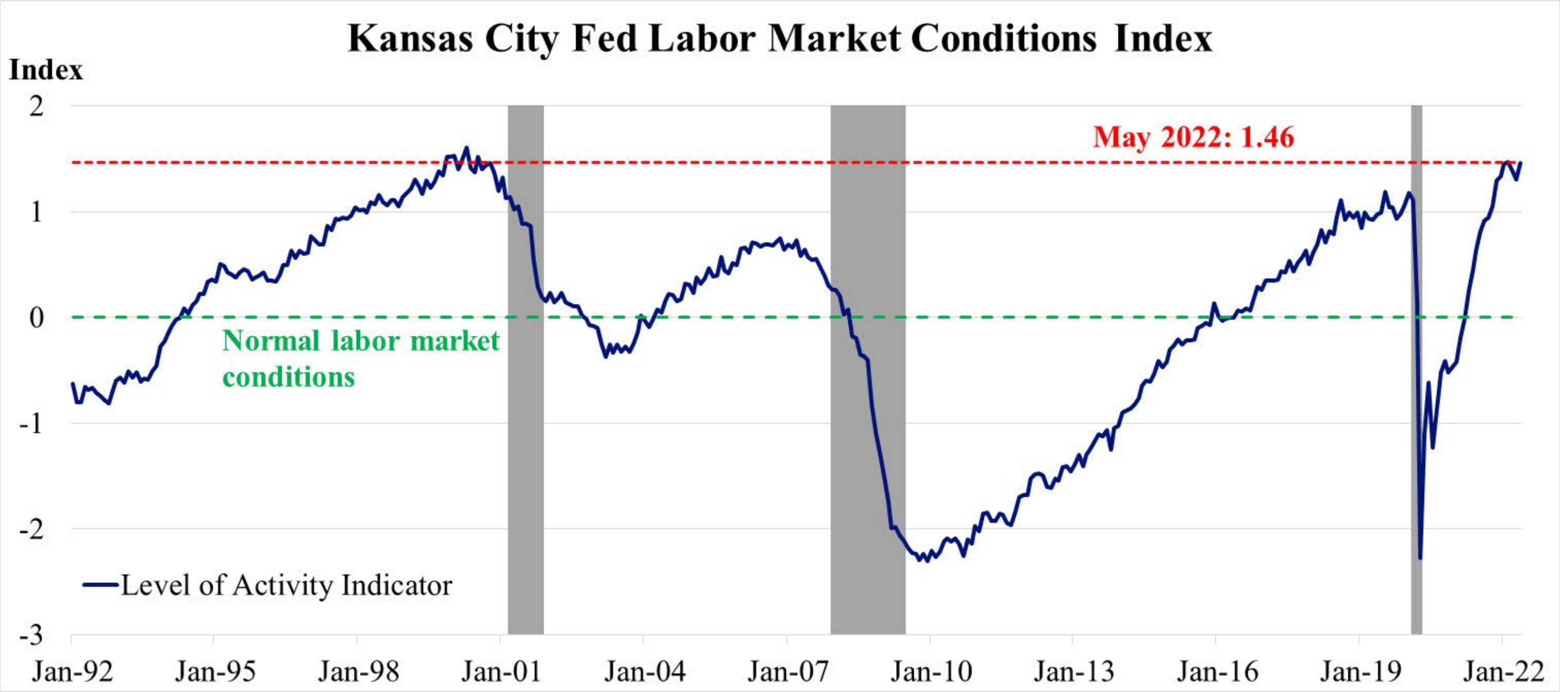
- The fact that market interest rates have moved above their pre-pandemic benchmarks while the policy rate has not can be read as an illustration of the effect of credible forward guidance.
- The Fed still has to follow through to ratify the forward guidance previously given, but the effects on the economy and on inflation are already taking hold.

Labor Markets Remain Robust

Robust labor markets

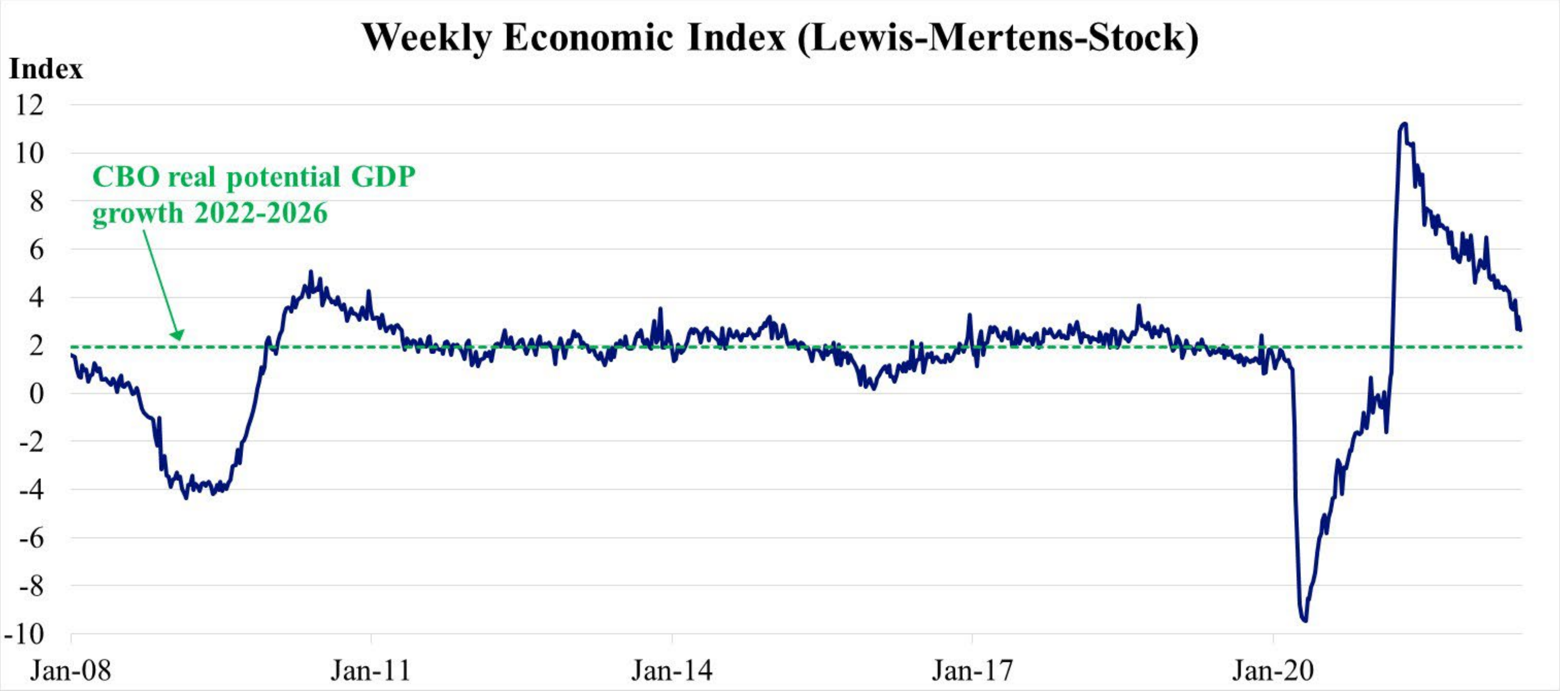
- U.S. labor markets remain robust, according to recent data and anecdotal reports.
- The Kansas City Fed’s labor market conditions index, which aggregates various measures of labor market performance into a single metric, remains near highs last seen in 1999-2000.
- Real-time indicators of U.S. gross domestic product (GDP) growth suggest continued expansion in the quarters ahead.
- Risks remain substantial and stem from uncertainty around the Russia-Ukraine war and the possibility of a sharp slowdown in China.
- There is presently a discrepancy between GDP and gross domestic income (GDI).

Labor market conditions: as good as in 1999-2000



Source: Federal Reserve Bank of Kansas City. Shaded areas denote U.S. recessions. Last observation: May 2022.

Real GDP is growing faster than potential

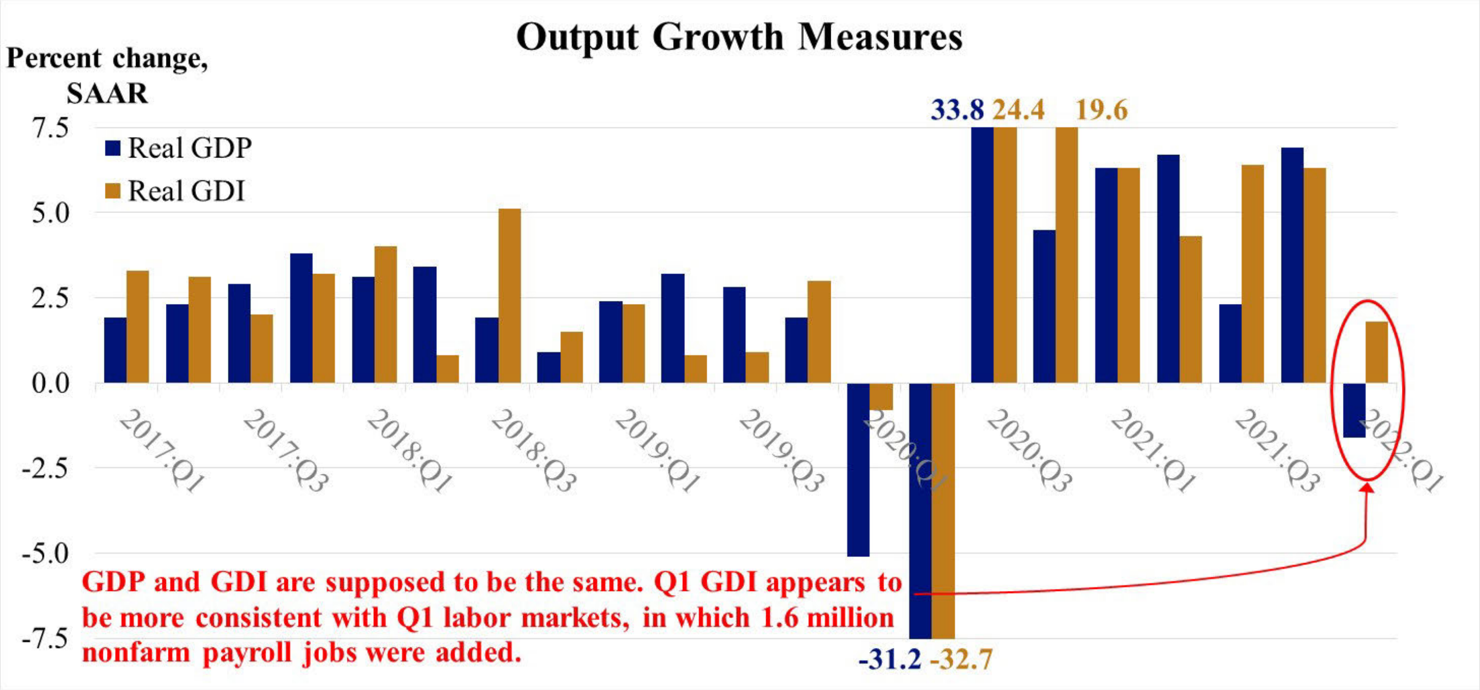


Sources: Federal Reserve Bank of New York and Congressional Budget Office. Last observation: Week ending June 25, 2022.

GDP versus GDI

- U.S. GDP, the total value of goods and services produced domestically, is supposed to equal U.S. GDI, the total value of income earned domestically.
- However, these two numbers do not match, and this is called a "statistical discrepancy."
- Because of this discrepancy, these two measures of output provide conflicting views of recent economic conditions: GDP suggests a declining economy, but GDI points to a growing economy.
- At this point, it appears that the GDI measure is more consistent with observed labor markets, suggesting the economy continues to grow.

Statistical discrepancy



Source: Bureau of Economic Analysis. Last observation: 2022:Q1. Note: SAAR is the seasonally adjusted annual rate.

Conclusion

The first steps toward disinflation

- Inflation in the U.S. is far above target and is at levels last seen in the 1970s and early 1980s.
- This situation is risking the Fed's credibility with respect to its inflation target and associated mandate to provide stable prices in the U.S.
- The Fed has raised the policy rate, promised to raise the policy rate further in the future, and begun passive balance sheet reduction.
- Forward guidance on these dimensions is helping the Fed move policy more quickly to the degree necessary to keep inflation under control.

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