St. Louis Fed

St. Louis Fed's Bullard Presents "Getting into the Zone"

Press Release

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LOUISVILLE, Ky. — Federal Reserve Bank of St. Louis President James Bullard presented "Getting into the Zone" (PDF) on Thursday at an event hosted by Greater Louisville Inc.

Inflation remains unacceptably high, Bullard said, well in excess of the Federal Open Market Committee's target of 2%. During 2022, the FOMC has been moving toward policy settings that will put meaningful downward pressure on inflation to return it to the target, he said.

"This approach has included significant increases in the policy rate as well as a program of balance sheet reduction," Bullard said. "Thus far, the change in the monetary policy stance appears to have had only limited effects on observed inflation, but market pricing suggests disinflation is expected in 2023."

Bullard noted that the most recent FOMC statement refers to ongoing increases in the policy rate to reach a level that is "sufficiently restrictive." He then gave his views on the question of what would be a sufficiently restrictive policy rate for the current macroeconomic environment.

"My approach to this question is based on 'generous' assumptions—assumptions that tend to favor a more dovish policy over a more hawkish one," he said. "Even under these generous assumptions, the policy rate is not yet in a zone that may be considered sufficiently restrictive."

Monetary Policy Rules

Bullard used Taylor-type monetary policy rules to obtain recommendations for the value of the policy rate given current macroeconomic conditions. He noted that a Taylor-type policy rule with generous assumptions will give a minimal recommended value for the policy rate, while less generous assumptions will give an upper bound for a desirable target range for the policy rate. The recommended "zone" is the area between the two bounds, he said.

He discussed four values that are needed for a Taylor-type rule: 1) a value for the short-term safe real rate of interest that would prevail if economic output was at potential and inflation was at target (which is commonly called R-star, or R^*); 2) a value for the size of the inflation gap; 3) a value describing how strongly the central bank should react to deviations of inflation from target; and 4) a value for the size of the output gap. Given that real output is currently above potential, the output gap didn't factor into his calculations, Bullard noted.

For the generous Taylor-type rule specification, Bullard used assumptions that tend to recommend a lower policy rate value. In particular, he used the Dallas Fed trimmed-mean personal consumption expenditures (PCE) inflation rate in the inflation gap measure, an approximate pre-pandemic value for R^* of -50 basis points, and a relatively low value of 1.25 for the parameter describing the policymaker reaction to deviations of inflation from target.

For the less generous specification, Bullard used core PCE inflation (which excludes food and energy prices), a higher value for R^* of +50 basis points, and a value of 1.5 for the parameter describing the reaction of the policymaker to deviations of inflation from target.

Bullard illustrated the results of his calculations in a chart, which showed that the policy rate remains below what could be considered a sufficiently restrictive zone.

“The chart suggests that while the policy rate has increased substantially this year, it has not yet reached a level that could be justified as sufficiently restrictive, according to this analysis, even with the generous assumptions,” he said. “To attain a sufficiently restrictive level, the policy rate will need to be increased further.”

Related Issues

Bullard then discussed some caveats and related issues. One he discussed is whether the recommended zone for the policy rate could decline. That zone could decline as new data arrive, particularly if inflation decreases in the months and quarters ahead, he noted, adding that market expectations are for declining inflation in 2023.

Caution is warranted, however, as both financial markets and the FOMC’s Summary of Economic Projections have been predicting declining inflation just around the corner for the past 18 months, Bullard said.

He also discussed financial stability risks. He noted that the policy rate has been increased by 75 basis points per meeting at the last four meetings, as part of a front-loading strategy.

“It is possible that increased financial stress could develop in such an environment,” he said. “However, the transparency with which these [policy rate] increases have been delivered, along with forward guidance, seems to have allowed for a relatively orderly transition to a higher level of interest rates so far.”

He noted that the St. Louis Fed’s financial stress index is so far indicating a relatively low level of financial stress despite the higher policy rate this year.