Is Low Inflation a Problem for the United States?

Remarks by

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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. I’m delighted to be here.

My remarks today will focus on a question that garners a great deal of attention for those who follow Fed policy. It is a question about whether the current level of inflation is too low. Of course, understanding the drivers of inflation dynamics is an essential part of the Federal Open Market Committee’s (FOMC) work.

As central banks have done in other countries, the Federal Reserve announced last November its plans to review its monetary policy strategy, tools and communications practices. This review strikes me as appropriate given the changes that occur over time in our economy, but it may be especially important now in a low interest rate environment. I look forward to the ideas that may come forward as part of this review, even as I offer a few preliminary thoughts of my own today on the Federal Reserve’s price stability mandate, and the FOMC’s inflation objective and policy strategies. Before I do that, I’ll begin with my views on the economic outlook for the nation and monetary policy settings.

Economic Outlook

Last year, the U.S. economy enjoyed robust growth boosted by accommodative monetary and fiscal policies. As the stimulus from these policies wanes, and with slower foreign growth, I expect to see a slower pace of growth – somewhere in the neighborhood of the economy’s longer-run trend of roughly 2 percent.

As you know, real gross domestic product (GDP) – our broadest, if not the timeliest, measure of economic activity – came in at a stronger-than-expected annual growth rate of 3.2 percent in the first quarter. However, beneath this robust headline number, real final sales to domestic purchasers grew at a more modest 1.3 percent rate – a clear slowing from its pace in recent years. In contrast, inventory investment and net exports contributed a combined 1.7 percentage points to overall growth. Inventories and net exports are volatile and difficult to predict. Based on this underlying data, I would expect to see less contribution from these sectors in coming quarters and a greater contribution from domestic final sales.

My outlook for continued but somewhat more moderate growth is tied to expectations that job gains, wage increases and consumer confidence will remain supportive of consumer spending. Total nonfarm payroll employment increased by 263,000 in April after increasing 189,000 in March. Over the last three months, job gains have averaged 169,000 per month, well above the estimated number required to keep the unemployment rate steady. As a result, we have seen a further decline in the unemployment rate to 3.6 percent in April, the lowest rate since December 1969.

As the job market has tightened, labor compensation has steadily accelerated. Average hourly earnings have climbed from an annual growth rate of roughly 2½ percent in 2017 to 3 percent last year, and 3.3 percent in the first quarter of this year. With low rates of inflation, workers are beginning to see significant gains in real wages. Although consumer confidence was buffeted early in the year by the government shutdown and financial market volatility, it bounced back in the spring and remains near its post-recession high. I am also encouraged to see a relatively high personal saving rate (6.5 percent in March 2019), which suggests consumers have the wherewithal to maintain spending in the event of a temporary adverse shock.

Another reason I expect the economy to maintain its forward momentum in 2019 is that business spending has picked up following the sharp slowdown in 2015-16. While I don't expect to see the same robust growth of business fixed investment that we saw last year, I do expect to see it make a positive contribution to overall growth. The waning of the fiscal stimulus, higher interest rates, and lower oil prices will all contribute to a slower pace of activity. Still, business optimism remains high, and the outlook for sales and profits over the medium term remains solid.

As always, there are risks to the outlook, and this generally positive outlook has several prominent downside risks. Over the medium term, I see the biggest risks coming from trade policy uncertainty and slower growth abroad, particularly in China, the euro area, and the United Kingdom. To the extent slower foreign growth and waning fiscal and monetary stimulus represent a stronger headwind than I am building into my baseline forecast, we could see somewhat slower growth. Right now the data are noisy, and we need more time and evidence to judge whether this risk materializes.

Finally, the current outlook for inflation appears to be benign and, in my view, broadly consistent with our price stability mandate. While inflation has declined over the course of this year, last year at this time it was near 2 percent. On a month-to-month basis, movements in inflation are typically dominated by transitory factors such as changes in energy and import prices. More fundamentally, to the extent beneficial supply side developments such as increased productivity growth may be pushing inflation down, they promote higher real wages and, ultimately, higher standards of living.

Outlook for Monetary Policy

At its April meeting the FOMC maintained the target range for the federal funds rate at 2¼ to 2½ percent and indicated that it could be patient as it determines whether future adjustments to the target range may be appropriate. I supported that decision. This wait-and-see approach is appropriate because we have not seen upward pressures building on inflation, even though we have experienced above trend growth and a further tightening of labor markets.

Over the course of this year, I will be looking for evidence on the amount of slack, if any, that remains in labor markets; signs that businesses are changing their pricing behavior; and evidence that longer-run inflation expectations could be signaling a lack of confidence in the Fed's ability to achieve its longer-run inflation objective of 2 percent. I'll also be evaluating the stance of policy relative to the estimates of the long-run neutral policy rate – the interest rate consistent with price stability and maximum employment. This rate has apparently declined over the past decade, but its precise level is uncertain and subject to change.

The Balanced Approach

Fostering a strong labor market while maintaining price stability is of course the core of the Federal Reserve's dual mandate from Congress. With the unemployment rate at an historic low level and inflation currently running under the FOMC's objective, a longer-run policy issue is whether the persistent undershoot of the inflation objective is undermining its credibility and causing inflation to be anchored at too low a level. Some have expressed concern that if inflation expectations fall persistently below the 2 percent objective, that the extent we could lower real interest rates by reducing our target for the federal funds rate – the Fed's key policy tool – would be diminished. This could limit the accommodation we could provide in a future downturn because interest rates cannot fall below a lower bound of roughly zero percent.

At the time the FOMC adopted its 2 percent inflation objective in 2012, monetary policy was highly accommodative, unconventional policy tools were being deployed, and inflation was running above 2 percent. Since then, inflation has run persistently below 2 percent. I have not viewed this as a major concern given that, aside from the effects of wide fluctuations in energy prices, inflation has remained low and relatively stable. Since 2012, core PCE inflation has fluctuated in a range of roughly 1½ to 2 percent, except during 2015 when a strong dollar pushed core inflation somewhat below 1½ percent.

As long as inflation was below its objective and unemployment was above its longer-run level, it was appropriate to run an accommodative policy to promote the movement of both variables back toward their longer-run sustainable levels. Accommodative policies tend to lower unemployment and, generally speaking, increase inflation.

But with the unemployment rate now below its longer-run level, should we still be concerned about inflation running slightly below target? 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 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 financial market participants and many 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 January 2018 and are currently at 2.3 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 April 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 24 percent who said "quality of labor" and 8 percent who said "cost of labor."

In contrast, financial market participants see inflation and inflation expectations as key drivers of monetary policy decisions. They look at past, current, and expected future inflation relative to target to form a view about the policy path that they then use to price financial market instruments. If they perceive the 2 percent inflation objective as a line in the sand that the Fed does not want to overshoot, they may come to expect inflation to run below 2 percent over the longer run. This concern has led to calls for the Fed to ease rates to push inflation and inflation expectations higher in an effort to maintain the credibility of the target and preserve policy space. But even if such a policy were effective, how is policy space preserved if rates have to be cut to boost longer-run inflation expectations?

Even with these concerns, I supported the FOMC's decision to adopt a 2 percent longer-run objective for inflation in 2012, and I support it today. I believe it has been effective in helping anchor longer-run inflation expectations. Arguably, though, adopting a point estimate instead of a range has placed considerable attention on a precise target and has exaggerated the precision with which monetary policy can achieve this goal.[1] It would seem reasonable that even

[1] Jon Faust and Eric Leeper describe the "disparate confounding dynamics" of inflation that makes it difficult to explain movements in inflation with a small number of "conventional summary statistics for headline aggregates" and "complicates the nature of appropriate monetary policy," in "The Myth of Normal: The Bumpy Story of Inflation and Monetary Policy," *Inflation Dynamics and Monetary Policy*, Federal Reserve Bank of Kansas City, Jackson Hole Economic Policy Symposium, August 2015, https://www.kansascityfed.org/~/media/files/publicat/sympos/2015/2015faust_leeper.pdf?la=en.

somewhat persistent deviations from the objective, if they are limited to, say 50 basis points above or below, may be acceptable taken in the context of broader economic conditions.

The FOMC anticipated that its objectives for employment and inflation could move in different directions. It addresses this issue in its annual “Statement on Longer-Run Goals and Monetary Policy Strategy,” noting that when its objectives are not complementary, the Committee follows a balanced approach in promoting them, taking 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.

What this means is that we should not focus on one leg of the mandate without consideration for the other. For example, cutting interest rates today to boost inflation to 2 percent at some point in the future would likely cause labor markets to tighten further, leading to a reallocation of resources into the most interest sensitive sectors. Given the current unresponsiveness of inflation to labor market tightness, it might take a considerable further easing of policy and considerable further tightening of labor market conditions to have the desired impact on inflation. And given the lags with which monetary policy operates, it may take a considerable period of time. In the meantime, lower interest rates might fuel asset price bubbles, create financial imbalances, and ultimately a recession.

In current circumstances, with an unemployment rate well below its projected longer-run level, I see little reason to be concerned about inflation running a bit below its longer-run objective. Moreover, I am not convinced that a slight undershoot of inflation below objective requires an offsetting overshoot of the objective. As I mentioned earlier, the current benign inflation outlook gives us the opportunity to test our assumptions about the degree of slack in the economy and the level of the neutral rate of interest.

Conclusions

With the current outlook for the economy remaining positive, monetary policy settings look appropriate to me. As we look ahead, however, there is a legitimate concern that monetary policy "space" could be limited in response to a future downturn because of the low level of interest rates.[2] This has led some to argue for a higher inflation target or the adoption of some kind of a price-level target. While I see little value in pursuing a higher inflation target given the credibility we have built over the last decade around 2 percent, the Federal Reserve will be seeking ideas and input on alternative policy strategies next month at a conference hosted by the Chicago Fed.[3] It will be an opportunity to learn more about the pros and cons of different approaches for our monetary policy strategy, tools, and communications practices.

The current level of inflation may perplex central bankers and financial market participants, but in the context of a growing economy and job gains, it doesn't demand a Fed policy response in my view. Steering what is currently a low and stable rate of inflation up by 20-50 basis points to reach a precise numerical target, while disregarding the labor market, the other leg of our dual mandate, strikes me as a degree of fine-tuning that goes beyond our span of control.

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[2]Other government policies that focus on productivity growth and labor force participation might contribute to faster trend growth and a higher natural rate of interest, thereby providing additional monetary policy space. Moreover, the prospect of a future return to the zero lower bound suggests that, along with monetary policy, fiscal policies need to be on the menu of possible counter-cyclical options.

[3] Former Federal Reserve Chair Janet Yellen discussed possible monetary policy responses to a future recession, including the use of an aggressive policy rule for setting the funds rate in advance of hitting the zero lower bound (ZLB), and asset purchases and forward guidance at the ZLB in "The Federal Reserve's Monetary Policy Toolkit: Past, Present and Future," *Designing Resilient Monetary Policy Frameworks for the Future*, Federal Reserve Bank of Kansas City Economic Policy Symposium, August 2016. https://www.kansascityfed.org/~/media/files/publicat/sympos/2016/2016yellen.pdf?la=en.