

# STRATEGIES *for* MONETARY POLICY



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CHAPTER ELEVEN

**DISCUSSION OF KEY ISSUES  
IMPACTING ACHIEVEMENT  
OF THE FED'S 2%  
INFLATION OBJECTIVE**

*Robert S. Kaplan*

In our May 2019 meeting, the Federal Open Market Committee (FOMC) left the federal funds rate unchanged in a range of 2.25 to 2.5 percent. In the post-meeting statement, we commented that, on a 12-month basis, overall inflation and inflation for items other than food and energy have declined and are running below 2 percent. The statement also noted that we “continue to view sustained expansion of economic activity, strong labor market conditions, and inflation near the Committee’s symmetric 2 percent objective as the most likely outcomes.”

BACKGROUND

Headline personal consumption expenditures (PCE) inflation, the Federal Reserve’s preferred inflation measure, has been running below our 2 percent target for a substantial portion of the time period since 2012.<sup>1</sup> At the Dallas Fed, we particularly focus on the Dallas Fed Trimmed Mean measure of core PCE inflation, which filters out extreme upside and downside moves in inflation components. We believe this measure is a useful indicator of underlying inflation trends. The trimmed mean is currently running at

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1. Data are from the Bureau of Economic Analysis (BEA).

approximately 2.0 percent on a trailing 12-month basis and has been in a range of 1.4 to 2.0 percent over the past seven years.<sup>2</sup>

The unemployment rate is currently 3.6 percent and has been below the Congressional Budget Office estimate of full employment for two years.<sup>3</sup> At the Dallas Fed, we particularly focus on the U-6 measure of unemployment, which measures the level of unemployed, plus “marginally attached workers” who indicate that they would like a job but have stopped looking for one, plus people working part time who would prefer to work full time. This measure now stands at 7.3 percent, and is below its 2006 prerecession low of approximately 7.9 percent.<sup>4</sup>

Dallas Fed economists expect GDP growth of approximately 2.25 percent in 2019. While this is slower growth than in 2018, it should be sufficient to further tighten the labor market and cause the rate of wage growth to modestly pick up over the course of 2019. Our economists also expect that, despite some recent weakness in headline and core inflation readings, the headline PCE and Dallas Fed Trimmed Mean measure of core PCE inflation are likely to firm, ending the year in the range of 2 percent.

Some observers have suggested that, with this tight of a labor market, there should be greater wage pressure than the 3.2 percent recent reading of average hourly earnings growth over the past year.<sup>5</sup> They argue that they would have expected wage pressure to have translated into greater price pressure. As most of you know, the Fed has initiated a review of its framework and communication strategy to explore whether there are actions we could take to improve our ability to achieve and maintain our dual-mandate objectives of maximum employment and price stability.

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2. As of March 2019. Federal Reserve Bank of Dallas. For a further description of the trimmed mean PCE inflation rate, see Dolmas (2005).

3. As of April 2019. Bureau of Labor Statistics (BLS).

4. As of April 2019. BLS.

5. As of April 2019. BLS.

With all this as background, and in light of our ongoing framework review, I thought it would make sense to step back and explore some of the potential issues raised by recent weakness in headline and core inflation measures. In particular, I will focus my remarks on labor slack, inflation expectations, and structural forces with regard to how they may be impacting the Fed's ability to meet its 2 percent inflation objective.

### LABOR SLACK

A number of economists have argued that there may be more slack in the U.S. labor market than standard measurements are capturing. They believe that there may be more scope to attract and retain previously under-represented groups in the workforce. To support this argument, it is worth noting that, since 2015, increases in labor force participation have disproportionately come from under-represented groups. For example, the participation rate of the prime-age female population with less than a high school education has increased significantly, as has the participation rate for black males and Hispanic females.<sup>6</sup>

It is also worth noting that the prime-age labor force participation rate in 2018 was 82.0 percent versus 83.1 percent in 2008 and 84.1 percent in 1998.<sup>7</sup> If we compare U.S. prime-age labor force participation to other developed countries, we find that the U.S. participation rate lags behind many of these countries, although this gap has begun to close somewhat since early 2015.

Is it possible that the strength of the labor market is drawing in workers who have been on the sidelines—particularly under-represented groups—and is also encouraging workers to stay in

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6. Richter, Atkinson, and Russell (2019).

7. Prime-age indicates 25–54 years old. Yearly value is an average of monthly values. The 12-month average as of April 2019 was 82.2 percent (BLS).

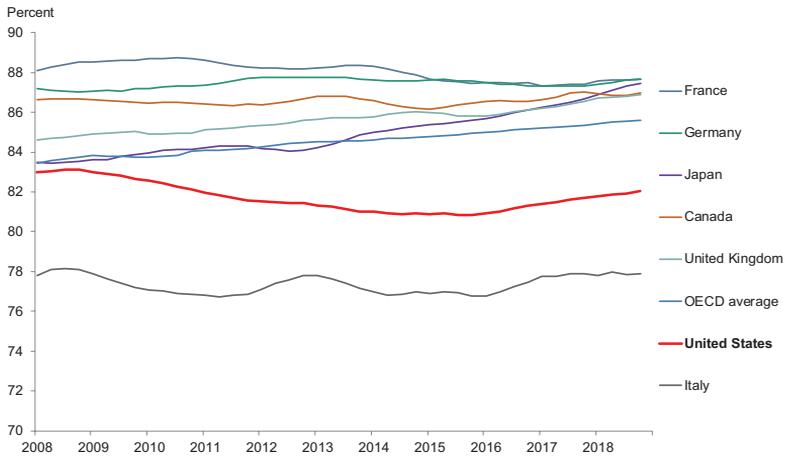


FIGURE 11.1. Prime-Age Labor Force Participation Rates, Ages 25–34

Note: Organization for Economic Cooperation and Development (OECD) average includes data for all OECD countries, except Belgium, Lithuania, and Luxembourg.

Sources: OECD, Haver Analytics.

the labor force?<sup>8</sup> Is it possible that improvements in skills training, child care availability and transportation availability have drawn, and could still draw, more sidelined workers back into the workforce—and keep them in the workforce?

It's important to recognize that gains in labor force participation act to slow the decline of the unemployment rate. Additionally, recent research—including work done by Richard Crump, Stefano Eusepi, Marc Giannoni, and Ayşegül Şahin—has argued that changes in demographics, especially the aging of the workforce, the aging of firms, as well as the increase in the attachment of women to the labor force, may have contributed to a decline in the natural rate of unemployment.<sup>9</sup>

If this is the case, we may look back five years from now and conclude that the natural rate of unemployment was simply lower than

8. Barnichon (2019).

9. Crump et al. (2019).

we had been historically accustomed, and that one of the reasons for the perceived surprising lack of inflation pressure was due to an excessively high estimate of the equilibrium level of unemployment. In this explanation, the Phillips curve may be alive and well, but the intercept is simply lower than we have previously understood. If this is true, central bankers need to be vigilant to the possibility that there is still the potential for inflation readings to firm substantially, with a time lag, if the degree of full employment overshoot becomes more sizeable and persists for an extended period of time.

### INFLATION EXPECTATIONS

Another debate relates to the Fed's ability to manage longer-run inflation expectations. As you all know, the Fed has clearly articulated a 2 percent PCE inflation target. Many would argue that the Fed has done a reasonably good job in helping to anchor inflation expectations. They would cite the fact that surveys of professional forecasters' inflation expectations are close to 2 percent, and they would suggest that this is not a coincidence; it is a reflection of the Federal Open Market Committee's policy actions and communications, which have been aimed at achieving and maintaining full employment while anchoring longer-run inflation expectations at our 2 percent objective.

However, other economists contend that, due to an extended period of inflation running below our 2 percent target, expectations may have drifted somewhat lower. This downward drift might be reflected in the University of Michigan survey for inflation expectations over the next five years, which has gone from an average of 2.9 percent in 2013 to 2.5 percent in the twelve months ending April 2019.<sup>10</sup> These economists argue that the Fed may need

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10. For example, looking across individuals in the University of Michigan survey, Sandor Axelrod, David Lebow, and Ekaterina Peneva find that lower experienced or perceived inflation correlates with lower expected inflation. See Axelrod, Lebow, and Peneva (2018).

to do more to help keep inflation expectations well-anchored. In particular, has the Fed done enough to convince the public that it is committed to a symmetrical 2 percent inflation target? Are there changes to the Fed's policy framework, communication strategy, or other actions the Fed could take to help better anchor inflation expectations at the Fed's 2 percent target?

### STRUCTURAL FORCES

An additional area of exploration deals with structural changes in the U.S. and global economies. In particular, are the forces of technology, technology-enabled disruption, and, to some extent, globalization, limiting the pricing power of businesses and muting inflation?

Dallas Fed economists recognize that we are living through a period of acceleration in the trend of technology replacing people. We are also seeing the proliferation of new models for selling goods and services—often technology-enabled (think Amazon, Airbnb, Uber, or Lyft)—that replace traditional models for delivering these goods and services. These new models are often enabling consumers to buy products and services at prices that are dramatically below those of incumbent competitors. To take advantage of this trend, large-platform companies are increasingly bundling products and services—sometimes with little or no gross margin—in order to gain market share.

All this is being facilitated by the fact that the consumer now has in the palm of his or her hand more computing power than most companies did just fifteen years ago. Consumers are able to use this new technology to shop for goods and services at lower prices, often with greater convenience.

The impact of these trends means that companies, depending on the industry, often have much less pricing power than they did

historically. In response, companies are investing even more in technology that replaces people and, increasingly, taking actions to achieve greater scale in order to effectively manage the investment and margin implications of these trends. The net result is that, in a range of industries, if there is wage pressure, companies are just as likely to see margin erosion versus being able to pass these costs on to the customer.

As a result of these trends, we are seeing a record level of merger activity by companies in order to get more scale to compete in this environment.<sup>11</sup> Companies are using increased debt issuance to fund merger activities to achieve greater scale and are also using increased debt issuance to fund accretive share repurchases in order to soften the margin dilution they are experiencing.<sup>12</sup> Activist investors are increasingly pressuring companies to take steps to merge and fund accretive share repurchases or face replacement of their boards of directors and/or their executive teams.

The workforce is also experiencing the impact of this trend. Highly educated and skilled workers are often seeing the benefits of technology and disruption—depending on their company or industry. However, those workers with a high school education or less—who lack specific skills training—are increasingly seeing their jobs restructured or eliminated. This is leading to increasing wealth and income inequality.

This discussion would suggest that powerful structural changes in the economy may be an important aspect of more muted price pressures. Further, there may be some evidence in recent productivity statistics that new technology and greater economies of scale could be helping to dampen growth in unit labor costs.

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11. Thomson Reuters (2018).

12. Data are from Standard and Poor's (S&P) Global Market Intelligence's Leveraged Commentary and Data (LCD). Also see Reuters (2018).

## IMPLICATIONS

The Fed's 2 percent inflation target is symmetrical—that is, we don't want inflation to run persistently below or above our 2 percent target. Sustained deviations from our inflation target could increase the likelihood that inflation expectations begin to drift or become unanchored. This could, in turn, make it more difficult for the Fed to achieve its dual-mandate objectives of full employment and price stability.

In this context, the various issues raised in this essay merit further discussion and attention. As the Federal Reserve conducts its ongoing review of our monetary policy framework and communication strategy, the challenge will be to explore potential options for enhancing our policy approach so that we can better achieve our dual-mandate objectives.

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