Fed Goals and the Policy Stance

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

Introduction

Approaching normal conditions

- The U.S. economy is approaching normal conditions in terms of the main macroeconomic goals assigned to the Federal Reserve.
- However, the policy stance of the FOMC has not begun to normalize yet.
- It will take a long time to normalize monetary policy.
- If macroeconomic conditions continue to improve at the current pace, the normalization process may need to begin sooner rather than later.

Two goals, two tools

- The Fed has two main macroeconomic goals, stable prices and maximum employment.
  - The issue of financial stability also looms large.
- The Fed also has two main tools:
  - The short-term policy interest rate, including forward guidance.
  - Quantitative easing, the purchasing of government securities and mortgage-backed securities (MBSs).
- The goal variables are close to normal, but the tools are not.

Risks for the U.S. economy

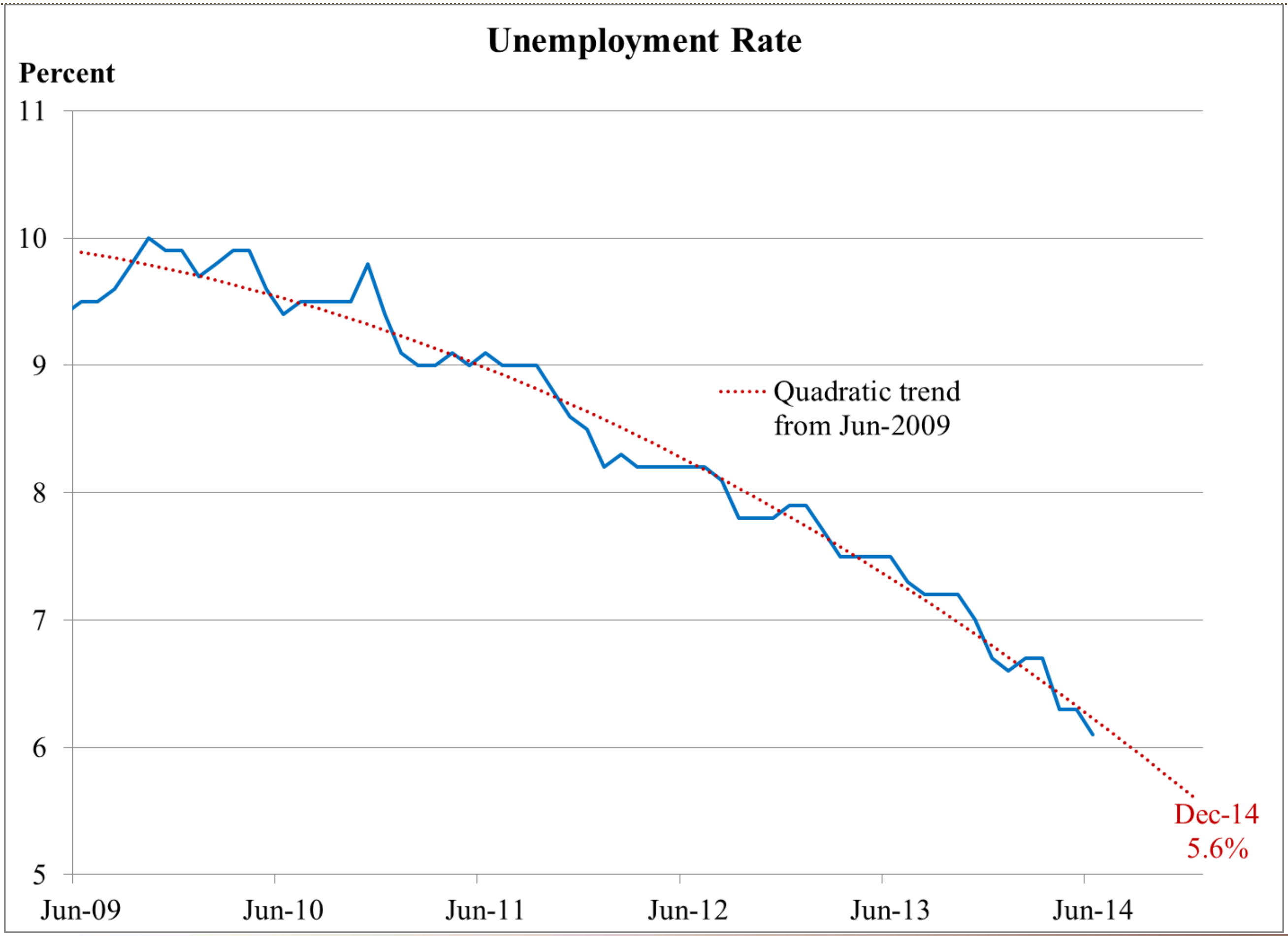
- The mismatch between the situation with respect to goals and the situation with respect to tools is not causing problems for the economy today, but may cause problems going forward.
- The objective is to execute policy normalization over the next few years without creating excessive inflation or substantial financial stability risks.

Unemployment

Unemployment: Much closer to normal

- Over the past five years, unemployment in the U.S. has been high.
- However, unemployment today is about 1.4 percentage points lower than it was one year ago.
- Moreover, unemployment is only 0.3 percentage points above the median unemployment rate of the period from January 1960 to June 2014.

Unemployment rate with a quadratic trend projection

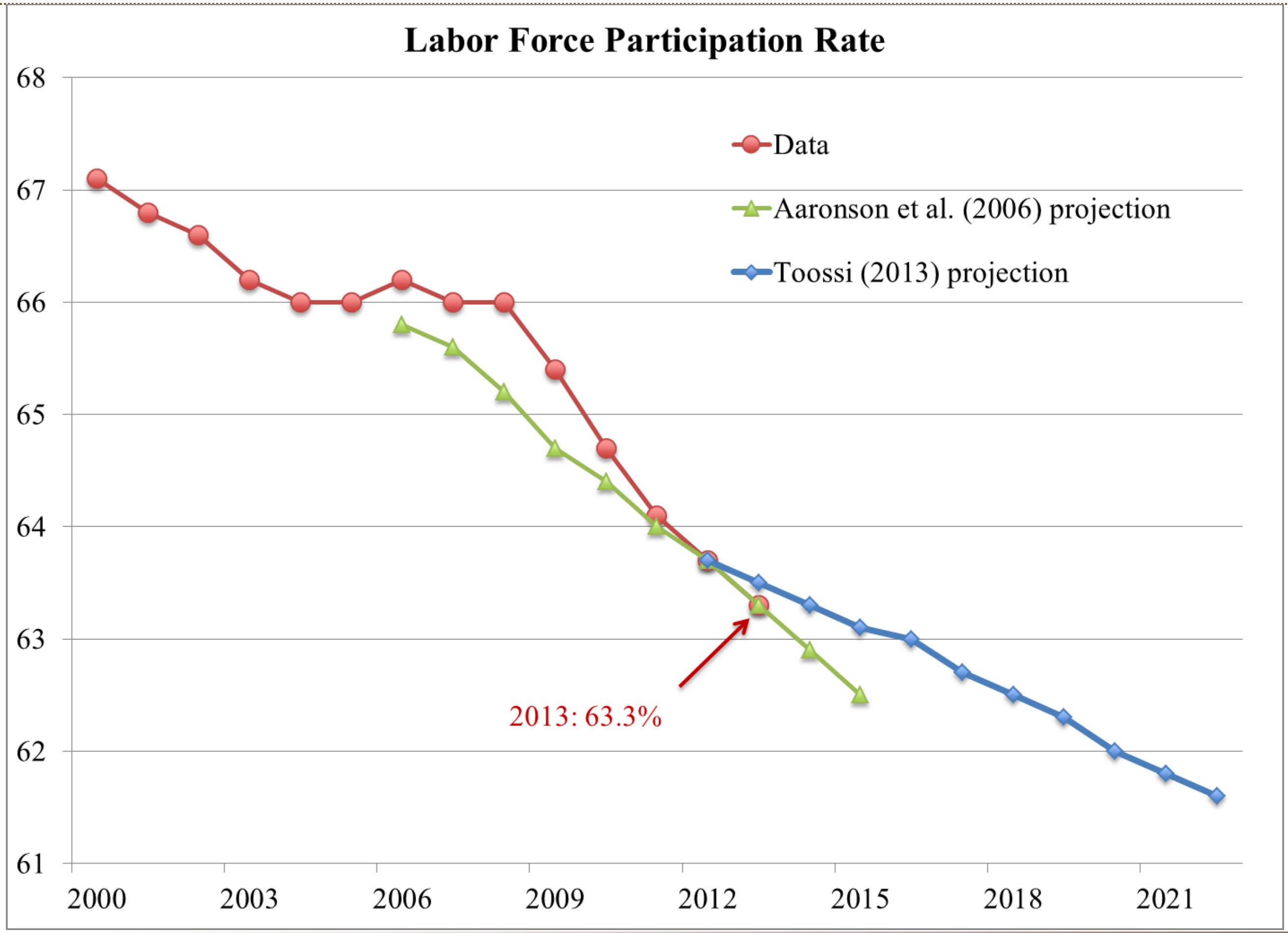


Source: Bureau of Labor Statistics. Last observation: June 2014.

Caveat: What about labor force participation?

- A smaller fraction of the population is participating in the labor market than during the 1980s and 1990s.
- Some commentary has suggested this is a worrisome development, and that labor force participation may turn higher soon.
- I interpret lower labor force participation as a relatively benign development driven mostly by demographics, and I project that labor force participation may decline further in the years ahead.

Labor force participation: Data and projections



Source: Bureau of Labor Statistics. Last observation: 2013. Aaronson et al., 2006, *Brooking Papers on Economic Activity*, 1, pp. 69-134; Toossi, 2013, *Monthly Labor Review*, December 2013, pp. 1-28.

The future of U.S. labor force participation

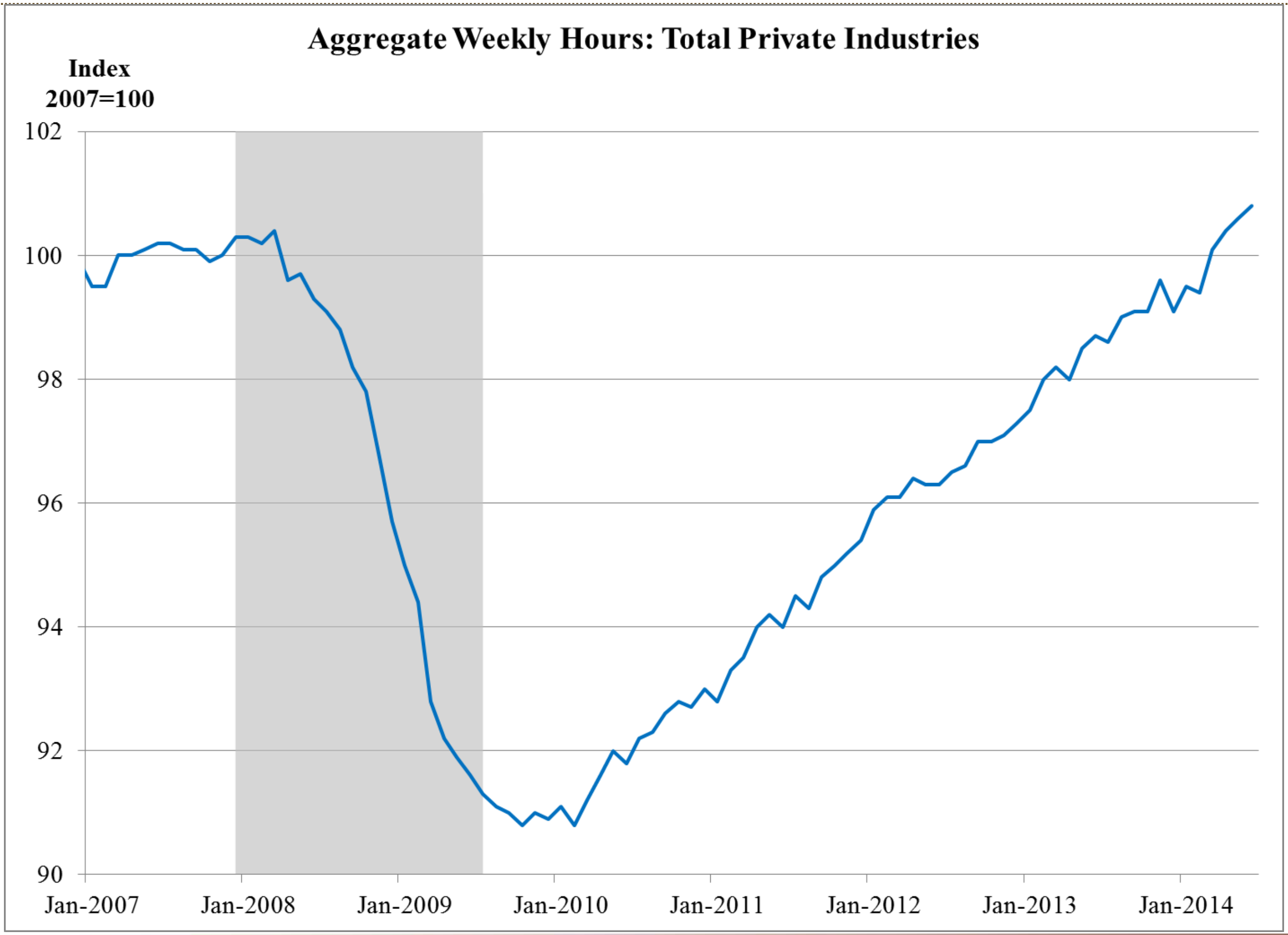
- These projections suggest that U.S. labor force participation is unlikely to rise on a sustained basis in the years ahead.
- This suggests we should not expect an influx of workers coming back into the labor force, driving unemployment higher or slowing declines in unemployment.
- Instead, unemployment is likely to continue declining so long as the economy remains relatively robust.*

* See J. Bullard, February 2014, *The Rise and Fall of Labor Force Participation in the U.S.*, remarks delivered at the Exchequer Club, Washington, D.C.

Hours worked

- Hours worked might be a better way to think about the amount of labor being supplied to market work.
- The index of aggregate hours worked has fully recovered to its pre-recession peak and seems poised to go higher.
- This view of the labor market also helps address the issue of part-time versus full-time jobs.

Hours worked: Fully recovered, poised to go higher



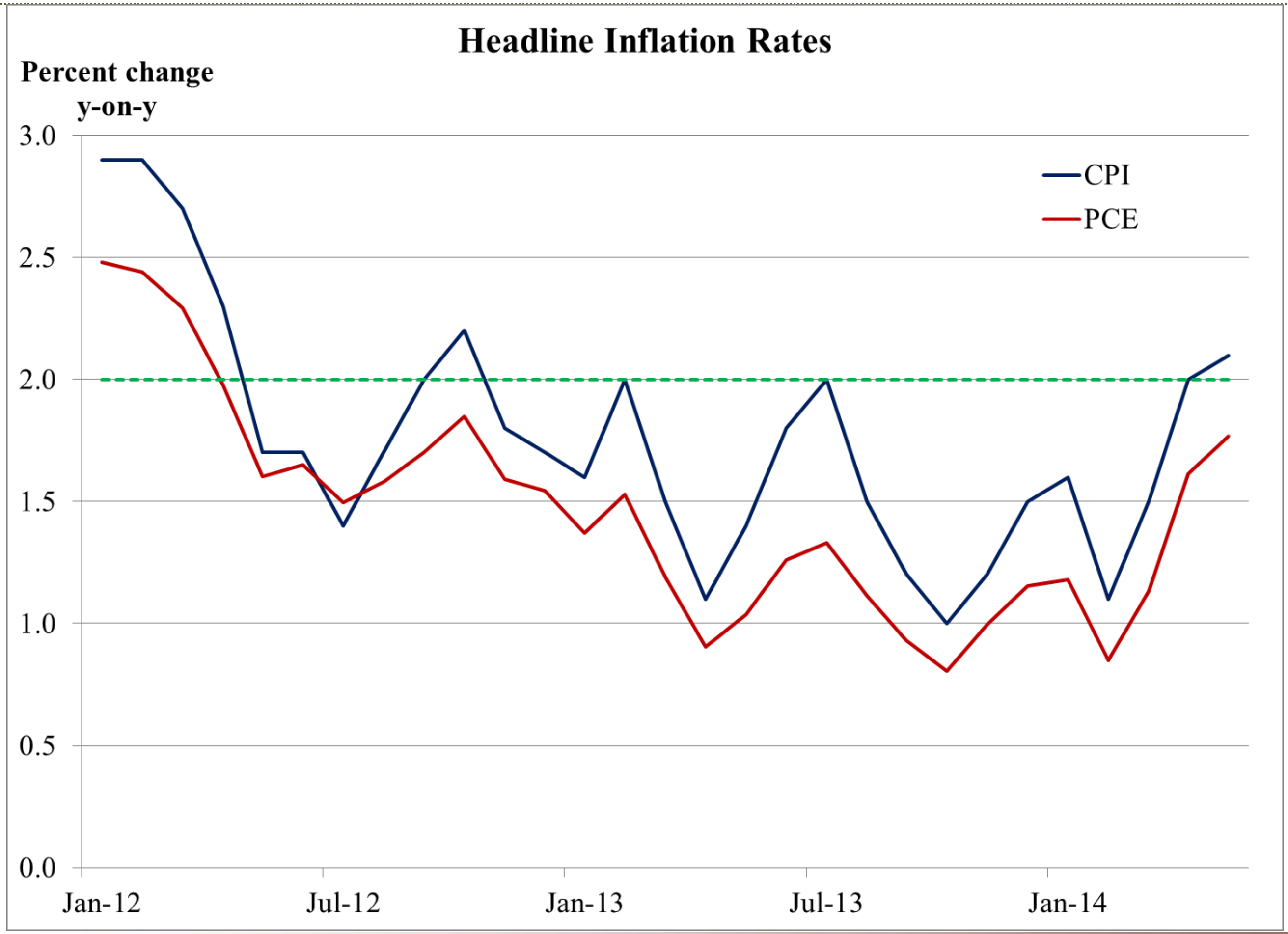
Source: Bureau of Labor Statistics. Last observation: June 2014.

Inflation

Inflation: Low but rising

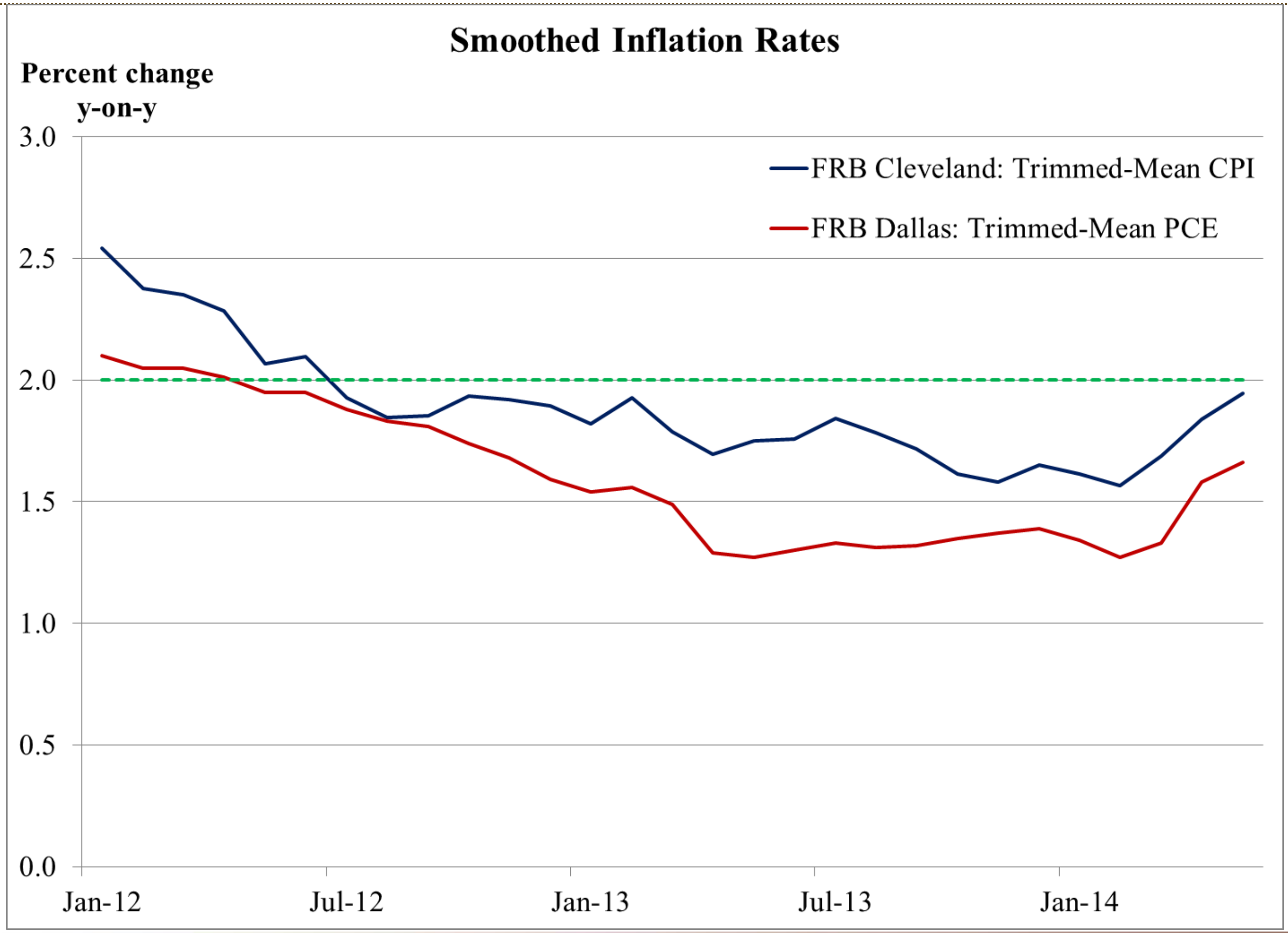
- The FOMC has an inflation goal of 2 percent.
- Inflation has been surprisingly low from 2013 Q2 through 2014 Q1.
- However, recent readings on inflation have moved closer to target.

Headline inflation



Source: Bureau of Labor Statistics and Bureau of Economic Analysis. Last observation: May 2014.

Smoothed inflation



Source: FRB Cleveland and FRB Dallas. Last observation: May 2014.

Summary of Goals

An objective function

- The distance of the economy from the FOMC's goals can be measured with a simple objective function:

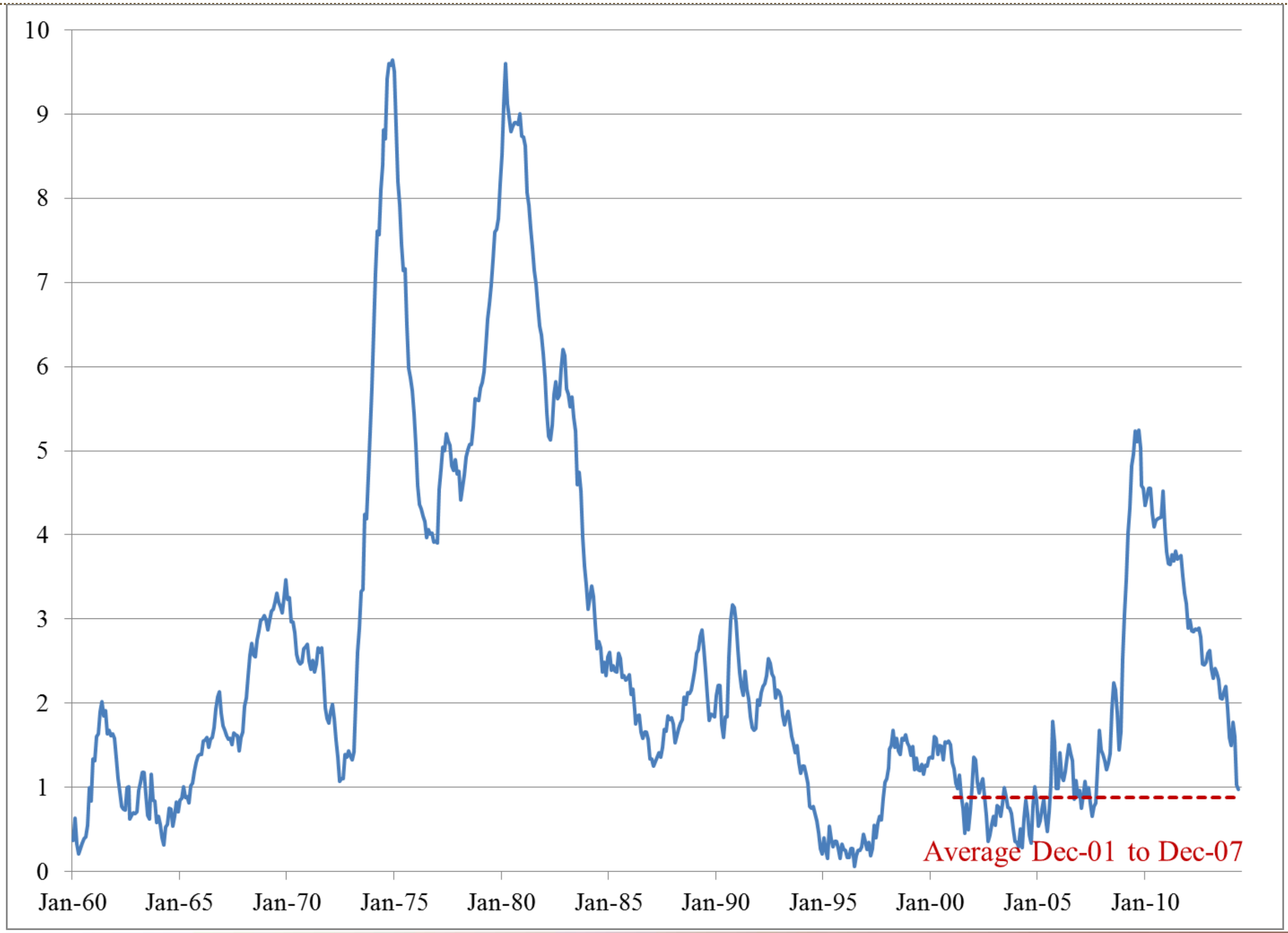
$$\text{Distance from goals } = (\pi - \pi^*)^2 + (u - u^*)^2.$$

  - π is inflation and π^* is the target rate of inflation, in percentage points.
  - u is the unemployment rate and u^* is the long-run average rate of unemployment.
- This version puts equal weight on inflation and unemployment and is sometimes used to evaluate various policy options.

Using the objective function

- Set $\pi^* = 2$, the FOMC's inflation target.
- For π I will use the year-over-year PCE headline inflation rate.
- Set $u^* = 5.35$, the midpoint of the central tendency of the June FOMC Summary of Economic Projections.
- Take the square root of the objective function values for better scaling.
- Lower values are better.
- How far away is the FOMC from its goals?

Square root of objective function value since 1960



Source: Bureau of Economic Analysis, Bureau of Labor Statistics and author's calculations. Last observation: May 2014.

The objective function value is low

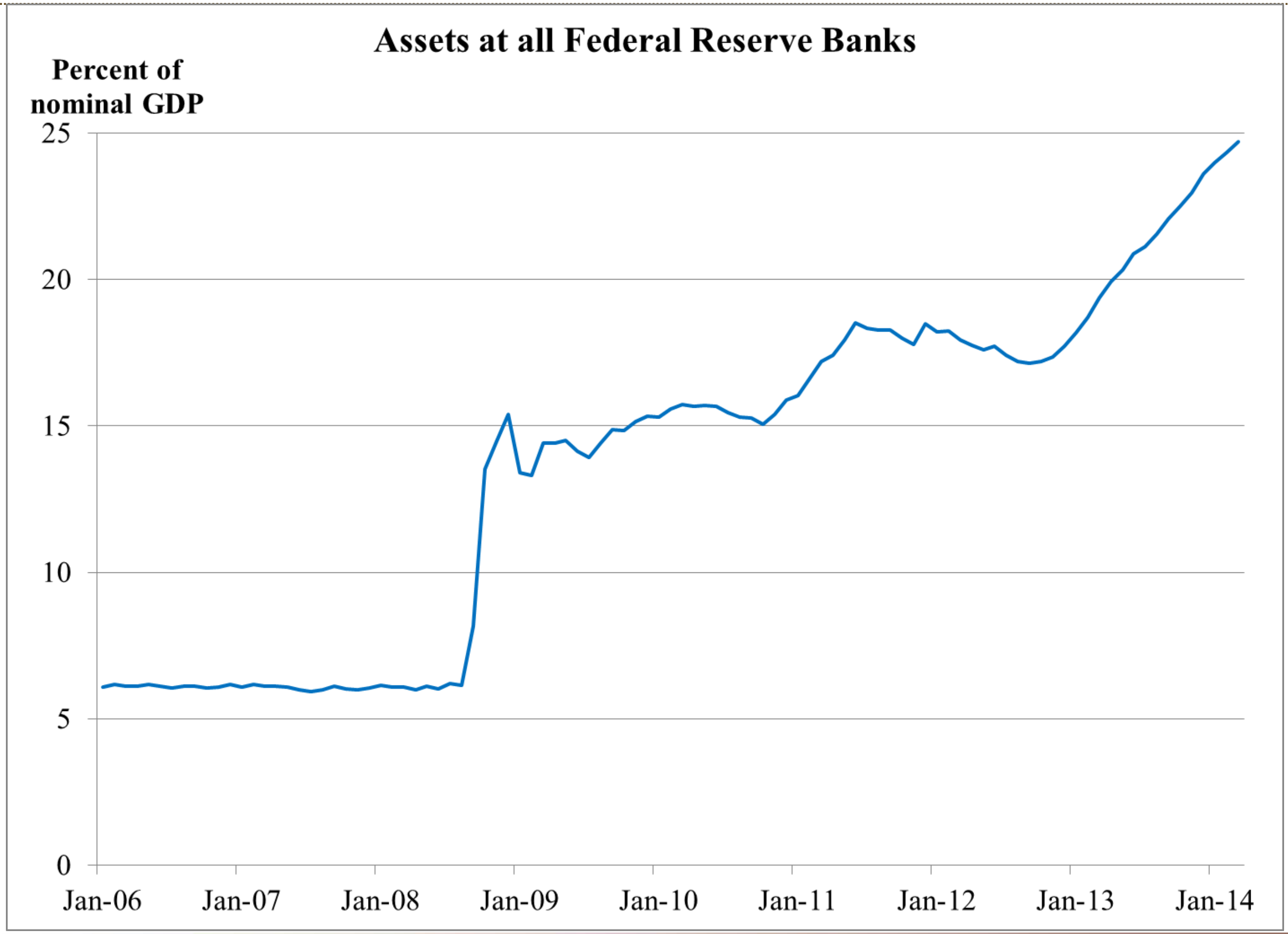
- Currently, the objective function shows a low value that is close to pre-crisis levels.
- The FOMC is closer to its macroeconomic targets today than it has been most of the time since 1960.
- Let's turn to monetary policy tools: How close are they to normal?

Monetary Policy Stance: How Close to Normal?

The monetary policy stance

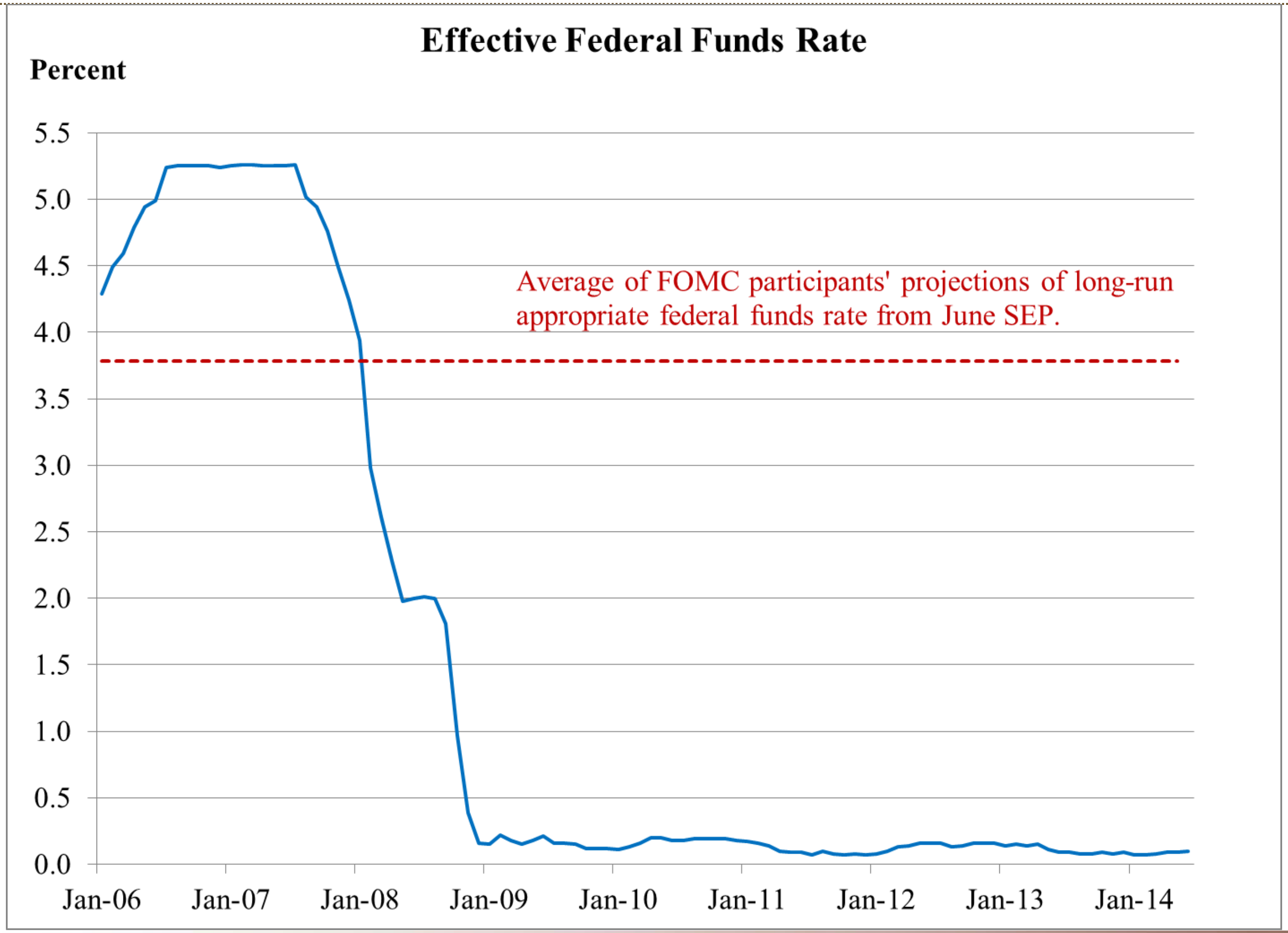
- The reaction of monetary policy to the crisis was to lower the policy rate to zero, and to implement outright asset purchases.
- While the FOMC began tapering the pace of asset purchases in January 2014, the two main policy actions have not been reversed so far.
  - The Fed balance sheet is still large and increasing.
  - The policy rate remains at the zero lower bound.

The Fed balance sheet remains large



Source: Federal Reserve Board, Bureau of Economic Analysis and author's calculations. Last observation: March 2014.

The policy rate remains low



Source: Federal Reserve Board and author's calculations. Last observation: June 2014.

A measure of the monetary policy stance

- Suppose we tried to measure the distance of the monetary policy stance from normal.
- This can be measured with a simple function:

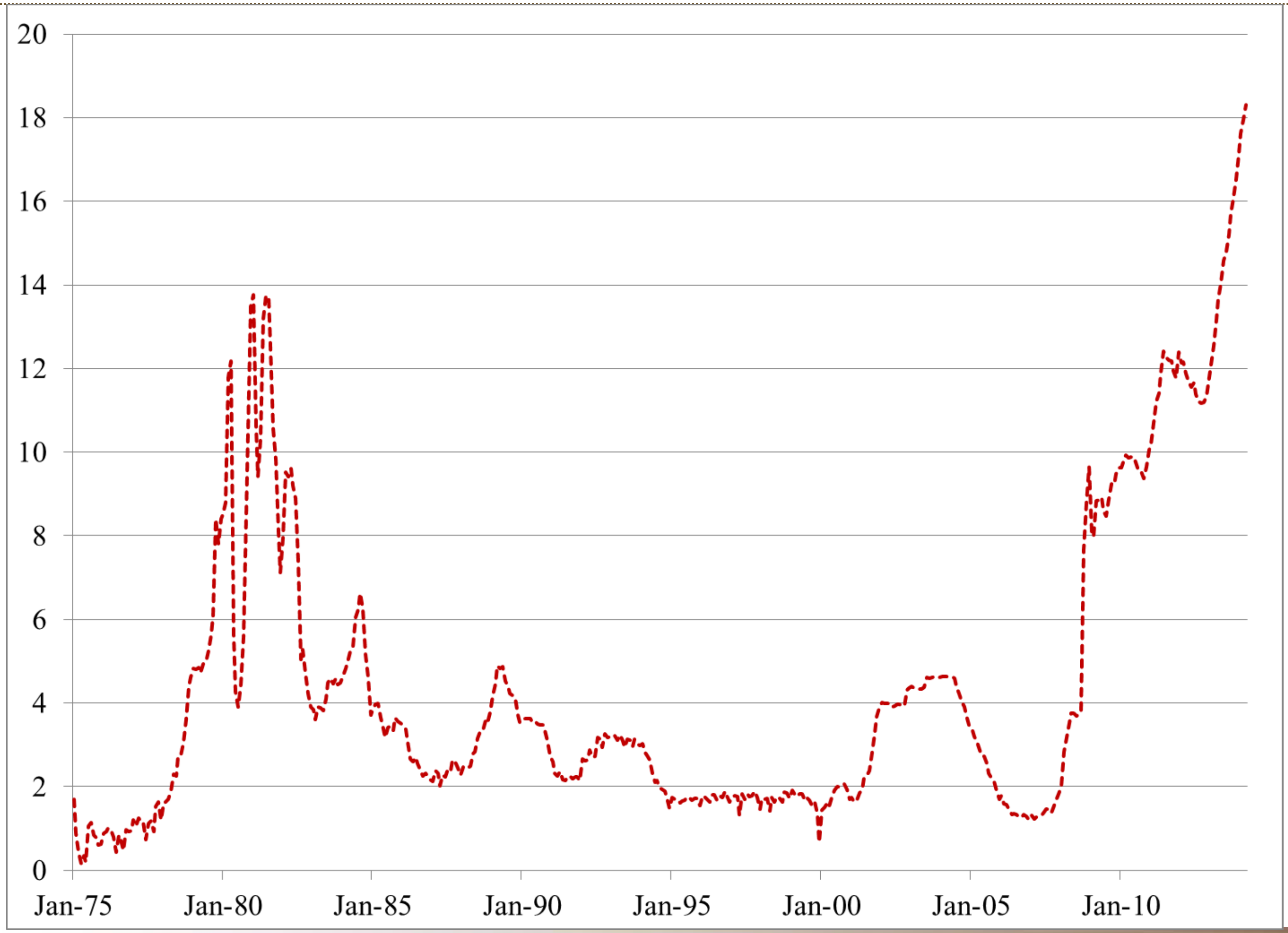
$$\text{Distance from normal } = (r - r^*)^2 + (b - b^*)^2.$$

  - r is the policy rate and r^* is the normal level, in percentage points.
  - b is the size of the Fed balance sheet relative to GDP, and b^* is the long-run average size of the balance sheet as a percent of GDP.
- This version puts equal weight on the policy rate and the balance sheet.

Using the measure of the policy stance

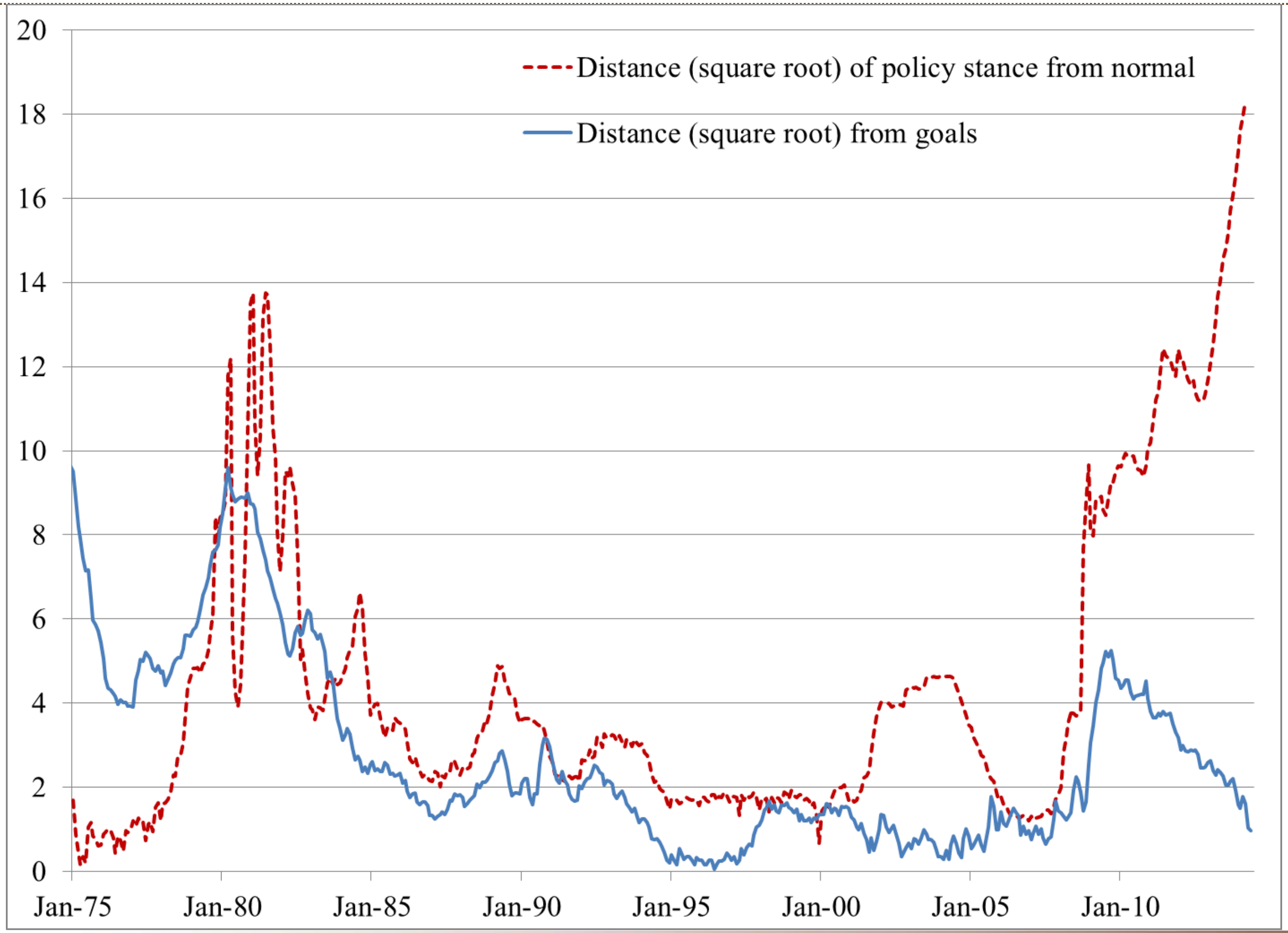
- For the policy rate r we can use the federal funds rate.
- Set r^{*} = 5.5 percent, the average value from January 1975 to March 2014.
- Set $b^{*} = 7.4$ percent, the average value from January 1975 to March 2014.
- Take the square root of the objective function values for better scaling.
- Lower values are better.
- How far away is the monetary policy stance from normal?

Square root of distance of policy stance from normal



Source: Federal Reserve Board, Bureau of Economic Analysis and author's calculations. Last observation: March 2014.

Distance of policy stance and goals from normal



Source: Federal Reserve Board, Bureau of Economic Analysis, Bureau of Labor Statistics and author's calculations. Last observation: May 2014.

The policy stance is far from normal

- Currently, the function measuring the distance of the policy stance from normal shows a high value, far from pre-crisis levels.

Mismatch

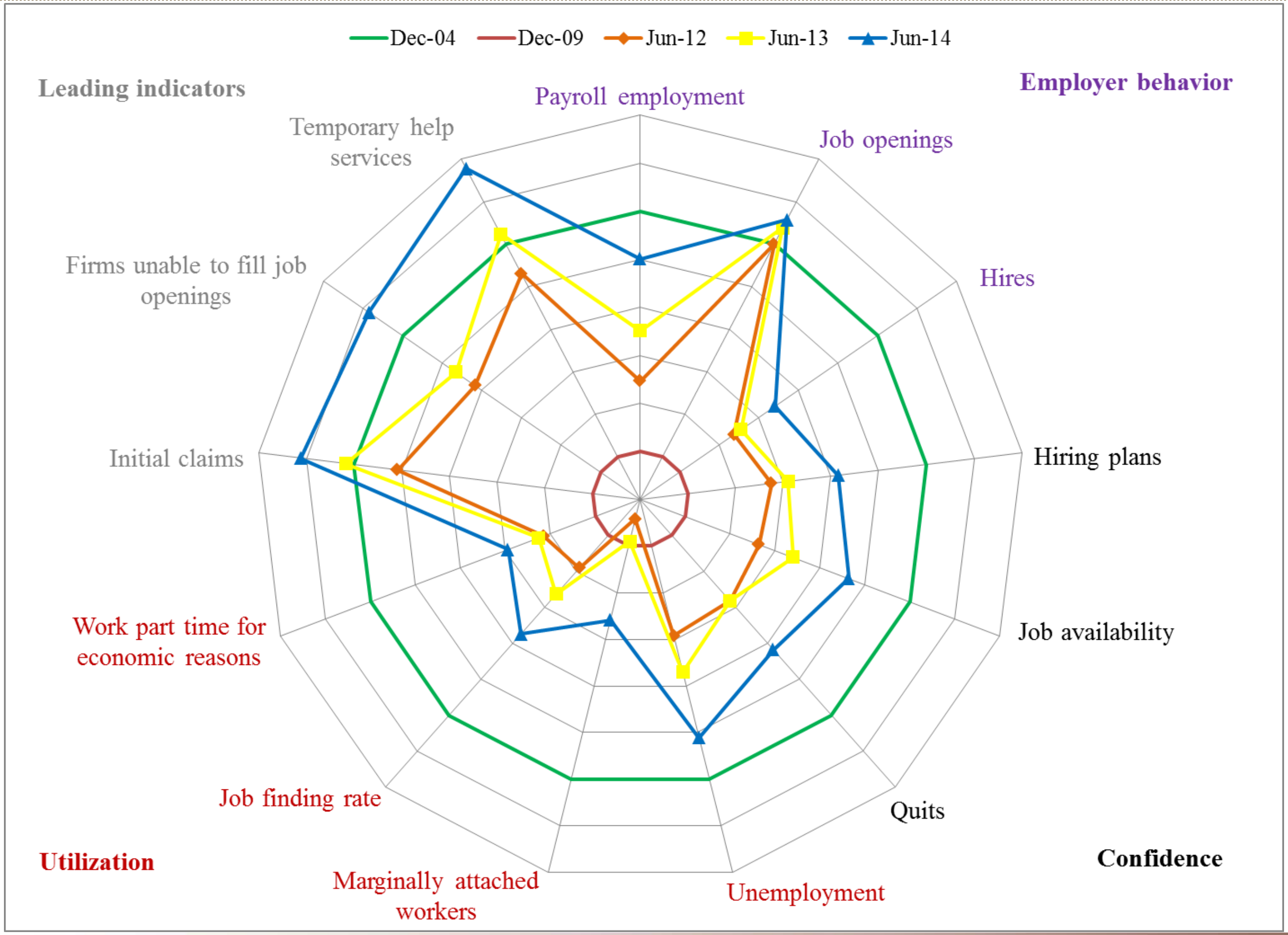
- The macroeconomic goals of the Committee are close to being met.
- However, the policy settings of the Committee are far from normal.
- While this mismatch is not causing macroeconomic problems today, it takes a long time to normalize policy and the mismatch may cause problems in the years ahead as the economy continues to expand.

Factors Mitigating the Mismatch

Leading reasons for caution in normalizing policy

- Why not begin normalizing policy right now? Three reasons:
  - Inflation has been surprisingly low for much of the past year.
  - Real GDP growth has generally been unexpectedly slow during most of the recovery, and Q1 GDP growth was negative.
  - Labor markets do not seem to be fully recovered, even though they are improving.

The labor market in one chart: Not fully recovered



Source: Bureau of Labor Statistics, Conference Board, National Federation of Independent Business, and author's calculations, based on a chart constructed by the FRB of Atlanta. Last observation: June 2014.

Conclusion

Normalizing monetary policy

- How quickly should the Committee move to return monetary policy to normal given improving macroeconomic conditions?
- Normalization will take a long time, and current policy settings are far from normal, suggesting an earlier start.
- Relatively low inflation and relatively weak labor markets have up to now suggested a later start.
- Stronger-than-expected data, rising inflation and rapidly improving labor markets may change this calculus in the months and quarters ahead.

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