How Far Is the FOMC from Its Goals?

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Any opinions expressed here are my own and do not necessarily reflect those of the Federal Open Market Committee.
Introduction
How far is the FOMC from its goals?

The FOMC is much closer to its goals than at any time in the past five years.

- Unemployment has continued to trend lower.
- Inflation is low but moving back toward target.

The monetary policy stance remains far from normal, despite recent reductions in the pace of asset purchases.

- Concerns remain about overall labor market performance.
- Until recently, inflation was unexpectedly low.
Much Closer to Goals
The FOMC is much closer to its goals

- Over the past five years, unemployment in the U.S. has been high and inflation has remained relatively low.
- The FOMC was a long way from its macroeconomic goals.
- This situation has led to an extraordinary monetary policy response.
- But today, the FOMC is much closer to its macroeconomic goals.
An objective function

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

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

  - \(\pi\) is inflation and \(\pi^*\) 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.
An objective function

- Set $\pi^* = 2$, the FOMC’s inflation target.
- For $\pi$ I will use the year-over-year PCE headline inflation rate.
- Set $u^* = 5.4$, the midpoint of the central tendency of the FOMC Summary of Economic Projections.
- How far away is the FOMC from its goals?
Objective function value since 1960

Square root scale

- In order to see the data somewhat more clearly, a better scale factor might help.

- Let’s take the square root of the objective function value.
Square root of objective function value since 1960

Has the FOMC been farther from its objectives?

Another way to look at this data is to ask: How often has the FOMC been as far from its objectives as it is today?

The answer is about 75 percent of the time.

That is, if we do this calculation for every month of data since 1960, 75 percent of the time the FOMC was in a worse position with respect to its goals than it is today.
The objective function value is closer to the FOMC's goals than it has been about 75% of the time since 1960.
The objective function value is below average

- Currently, the objective function shows a below-average value.
- The FOMC is closer to target today than it has been most of the time since 1960.
- But, perhaps this is just because the 1970s were times of dramatic misses, with inflation and unemployment both high?
- Let’s consider just the more recent data.
Objective function value since 2006

Square root of objective function value since 2006

Average since 2006

The objective function value is close to pre-crisis levels.

- If we just consider data since 2006, the objective function value is close to pre-crisis levels.
- In this sense, the macroeconomy is much closer to normal than it has been during the past five years.
- The monetary policy stance, on the other hand, is not close to pre-crisis levels.
Monetary Policy
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

The policy rate remains low

Source: Federal Reserve Board and author’s calculations. Last observation: May 2014.
Monetary policy

Question: If the FOMC is relatively close to its objectives, why is monetary policy so far from normal?

Two reasons:

- Labor markets do not seem to be fully recovered.
- Inflation is low.

I can illustrate these two points with two charts.
The labor market in one chart

Inflation is low but moving back to target

Challenges for the FOMC

- With inflation still below target, albeit rising, and unemployment still high, but falling, the Committee faces a classic monetary policy challenge.

- The challenge is this: How quickly should the Committee move to return monetary policy to normal given improving macroeconomic conditions?

- The debate on this topic is likely to garner significant attention as the economy continues to improve during 2014.
Conclusion
Conclusion

- The FOMC is much closer to its macroeconomic goals than it has been in the past five years.

- The monetary policy stance remains far from its pre-crisis settings.

- The likely reasons for this are: (1) Labor markets do not seem to be fully recovered, and (2) Inflation has been low.

- The Committee now faces a classic challenge concerning the appropriate pace of monetary policy normalization.