A Tame Taper

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Arkansas Day with the Bank Commissioner
16 May 2014
Little Rock, Ark.

Any opinions expressed here are my own and do not necessarily reflect those of the Federal Open Market Committee.
Introduction
Recent themes in U.S. monetary policy

- The taper has been tame compared to last summer.
- Looking through weak first quarter real GDP growth.
- The FOMC is much closer to its goals than at any time in the past five years.
- Inflation: Stabilized at a low level.
Tame Taper So Far
The taper tantrum

What happened during the “taper tantrum” in the summer of 2013?

- U.S. interest rates increased.
- Emerging-market currencies depreciated against the U.S. dollar.
- Capital flowed to the U.S.
- Emerging-market equity prices declined.
Longer-term U.S. interest rates increased

Emerging-market currencies depreciated

Emerging-market capital inflows reversed

Emerging Markets: Bond and Equity Fund Flows

Emerging-market stock indexes dropped

The actual taper

- The taper tantrum during the summer of 2013 was based on perceptions of Fed actions.
- The actual taper did not occur until December 2013.
- The FOMC has reduced its pace of asset purchases four times by $10 billion each time.
- Yet the effects on global financial markets have been much less striking.
Longer-term U.S. interest rates declined

Source: Federal Reserve Board. Last observation: week of May 9, 2014.
Most emerging-market currencies appreciated

Source: author’s calculations. Last observation: week of May 9, 2014.
Most emerging-market stock indexes increased

Source: author’s calculations. Last observation: week of May 9, 2013.
Interpreting the taper

- The FOMC took no explicit policy action at the June 2013 meeting, yet triggered a significant movement in global financial markets.
- Since December 2013, the FOMC has taken four explicit policy actions, yet triggered far less of a financial market response.
- One interpretation is that as of June 2013, it was premature to argue that the U.S. economy was strong enough to pull back on asset purchases.
- As of December 2013, better growth and employment data justified the taper decision.
Looking Through First-Quarter Data
First-quarter GDP growth

- The reported annualized U.S. real GDP growth rate for 2014 Q1 was close to zero.
- Some tracking estimates are calling for an even lower reading once revised data are taken into account.
- The weak first-quarter performance has been widely attributed to particularly cold and snowy winter weather.
Real GDP growth—recent data

Real GDP growth with forecasts for 2014

Interpreting Q1 GDP growth

While first-quarter GDP growth was weak, growth in coming quarters is still predicted to be robust.

The average quarterly pace of growth in 2014 may still be an improvement relative to 2013.
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.
- This situation has led to an extraordinary monetary policy response.
- But today, Fed goals are within sight.
- This helps to justify the FOMC’s tapering of asset purchases.
An objective function

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

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 Fed from its goals?
Objective function value since 1960

Objective function value since 2006

Distribution of objective function values

The objective function value is closer to the FOMC’s goals than it has been about 60% of the time since 1960.
Monetary Policy
Monetary policy

Question: If the Fed 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 remains low.

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

Inflation remains low

Conclusion
Conclusion

- The FOMC’s reductions in the pace of asset purchases have proceeded smoothly so far.
- First-quarter real GDP growth was weak, but forecasts for the remainder of the year are strong.
- The FOMC is much closer to its policy goals than it has been in the past five years.
- Inflation remains low.