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# 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?

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- 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

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- 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

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

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

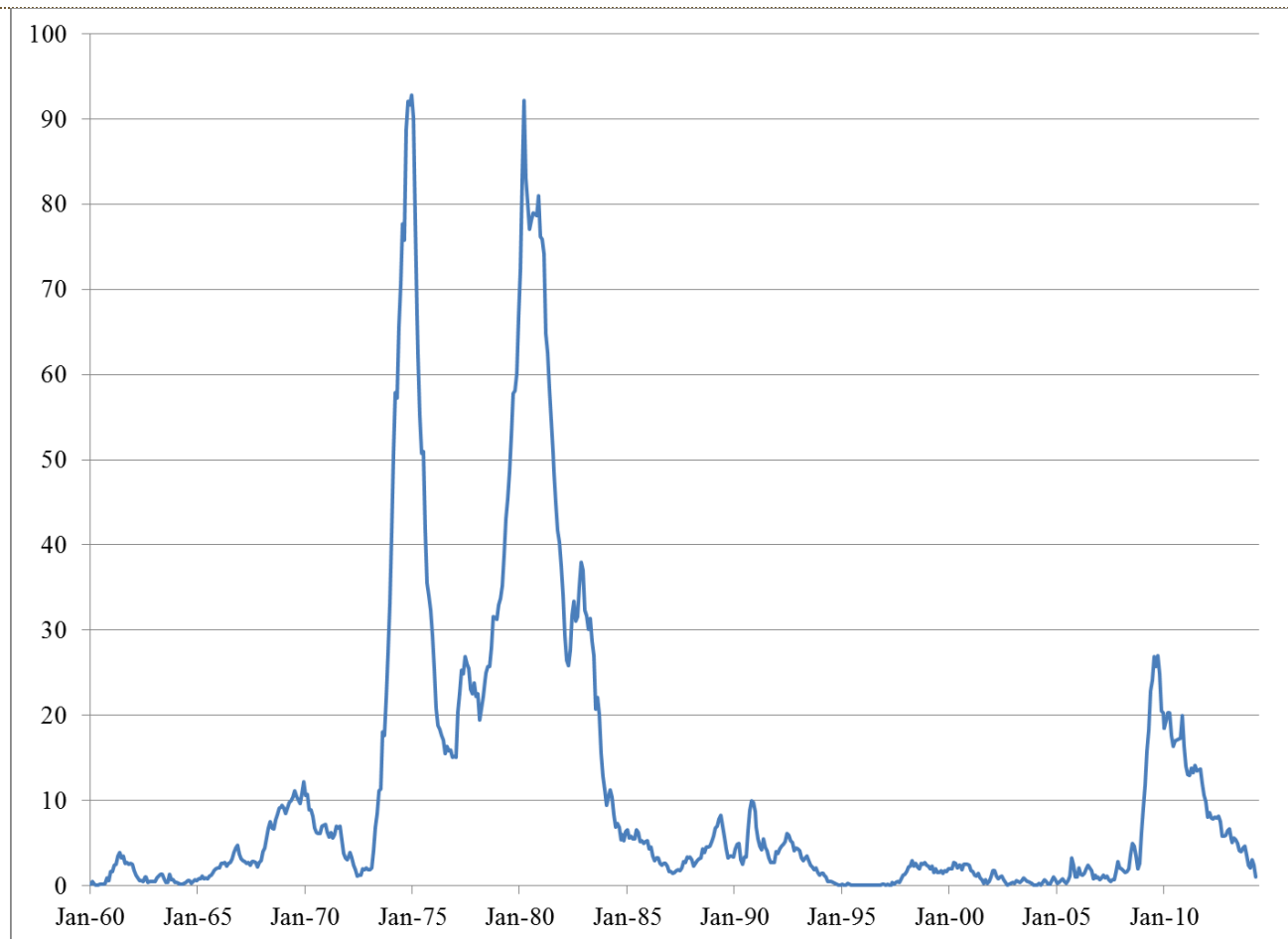
- $\pi$  is inflation and  $\pi^*$  is the target rate of inflation, in percentage points.
  - $u$  is the unemployment rate and  $u^*$  is the long-run average rate of unemployment.
- This version puts equal weight on inflation and unemployment and is sometimes used to evaluate various policy options.

## An objective function

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- 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



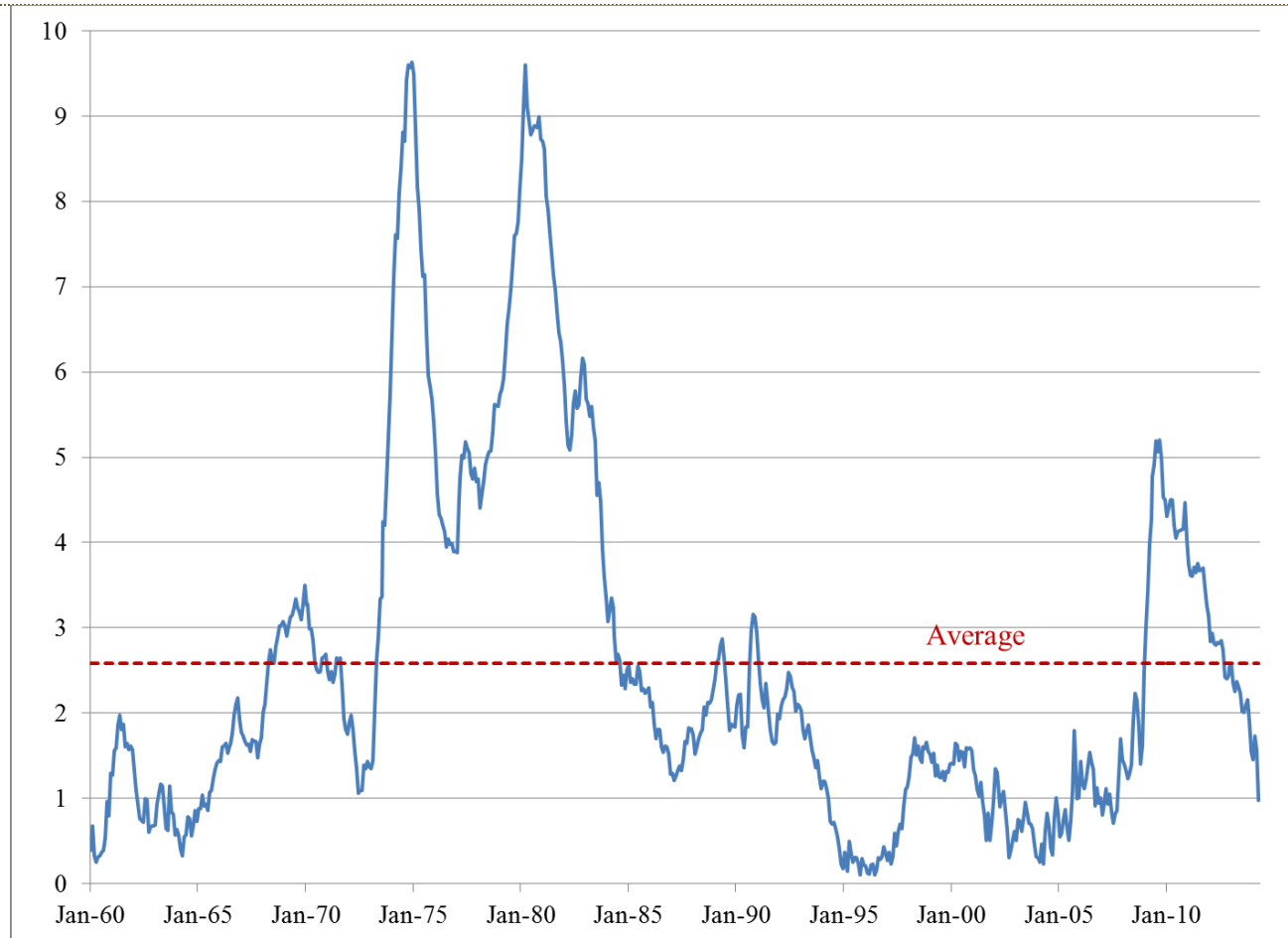


## Square root scale

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- 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

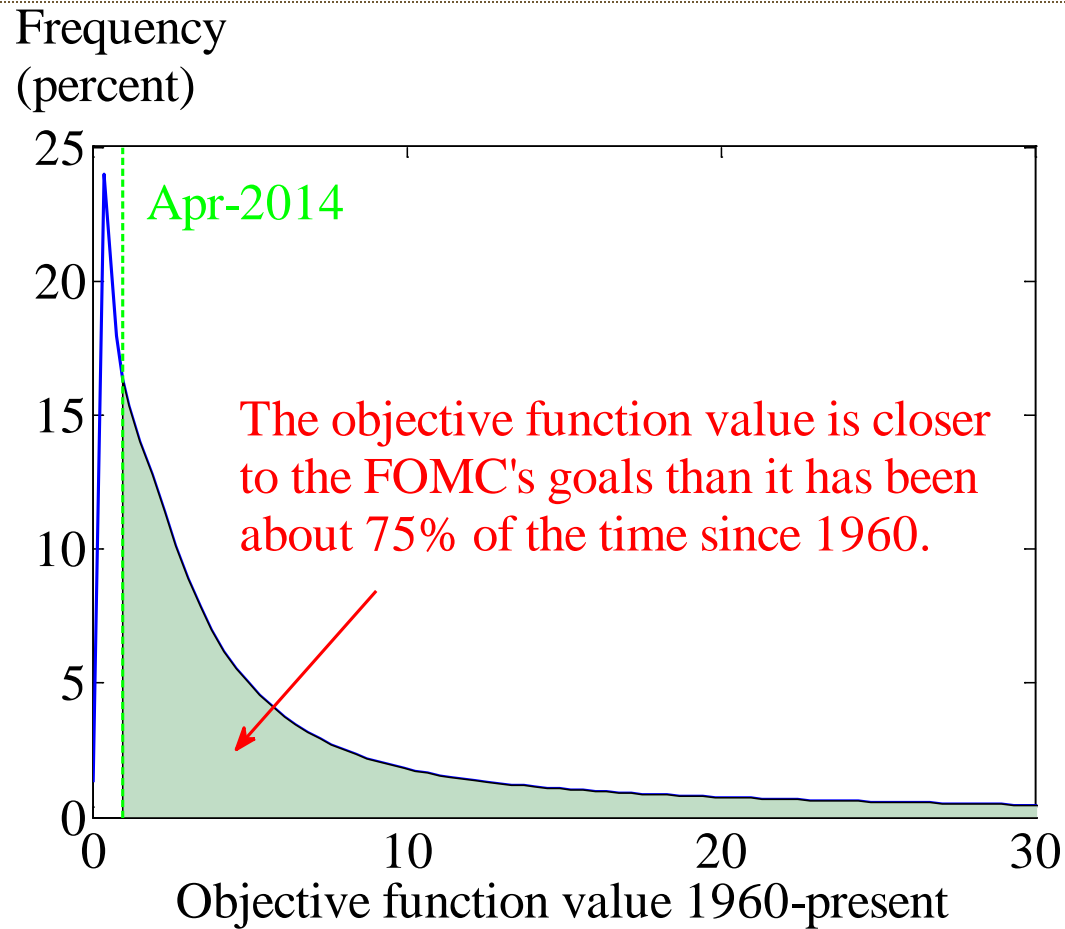


## Has the FOMC been farther from its objectives?

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- 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.

## Distribution of objective function values

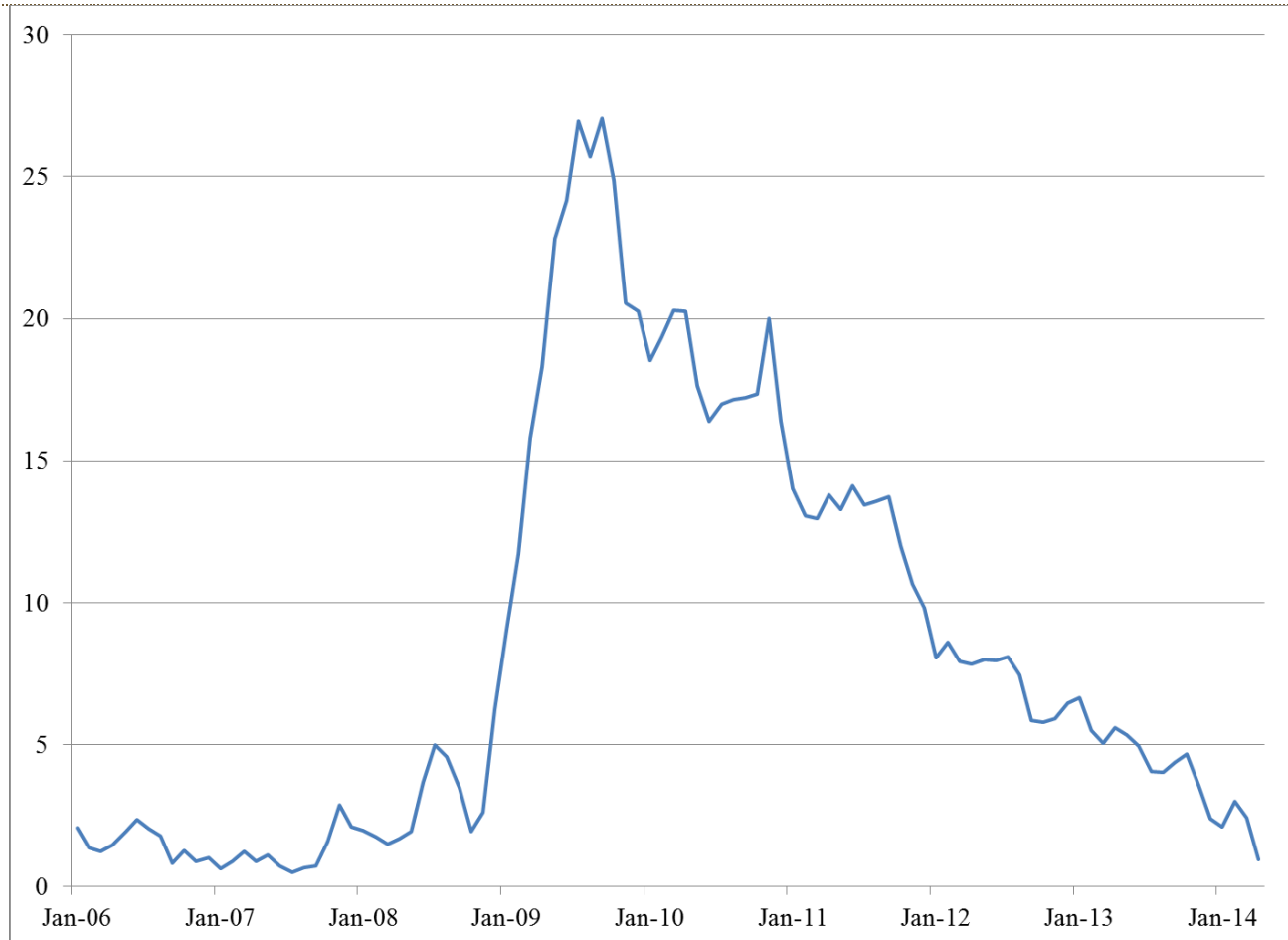


## The objective function value is below average

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- 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



## The objective function value is close to pre-crisis

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- 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.



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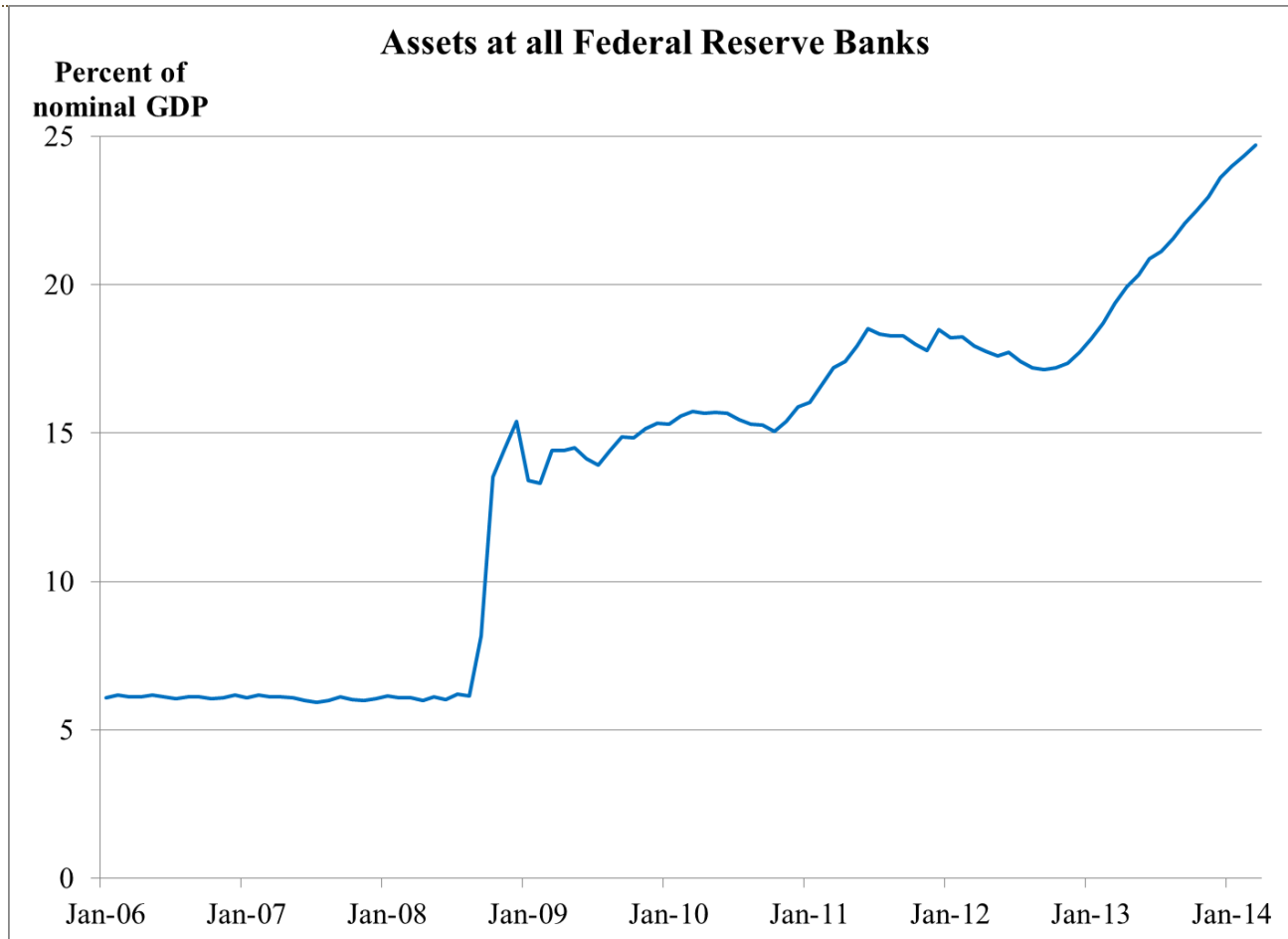
# Monetary Policy

## The monetary policy stance

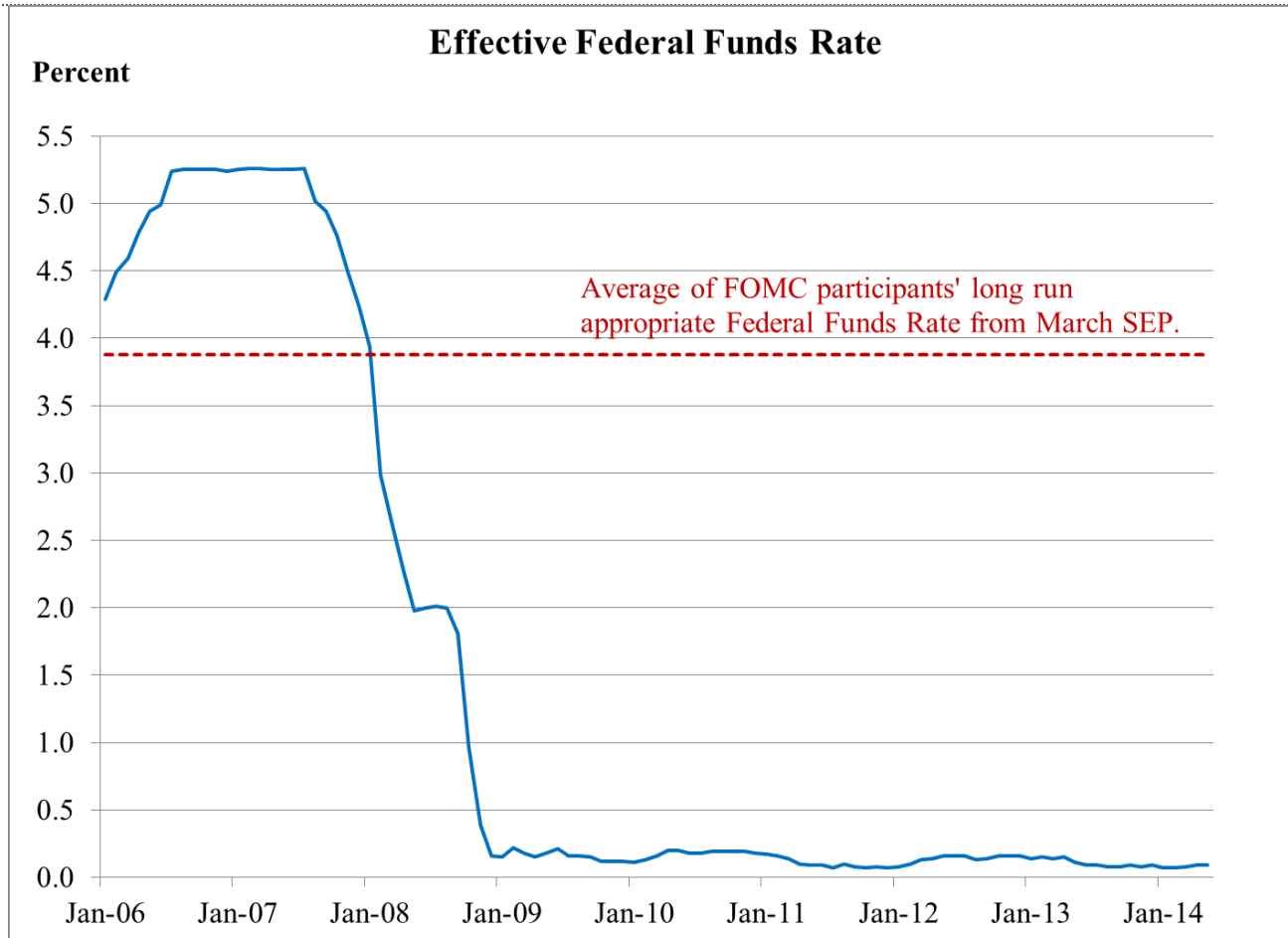
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- The reaction of monetary policy to the crisis was to lower the policy rate to zero, and to implement outright asset purchases.
- While the FOMC began tapering the pace of asset purchases in January 2014, the two main policy actions have not been 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

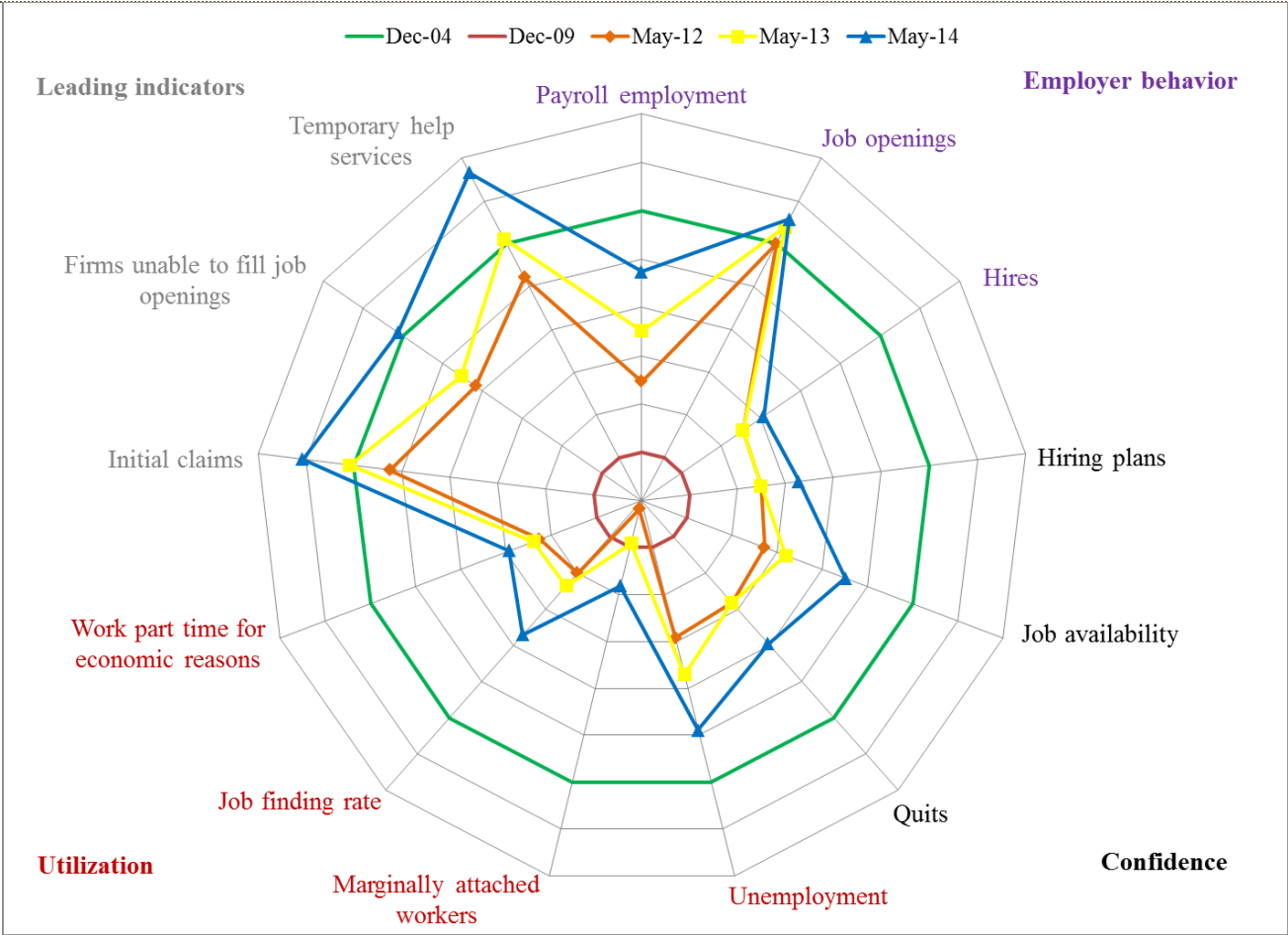


## Monetary policy

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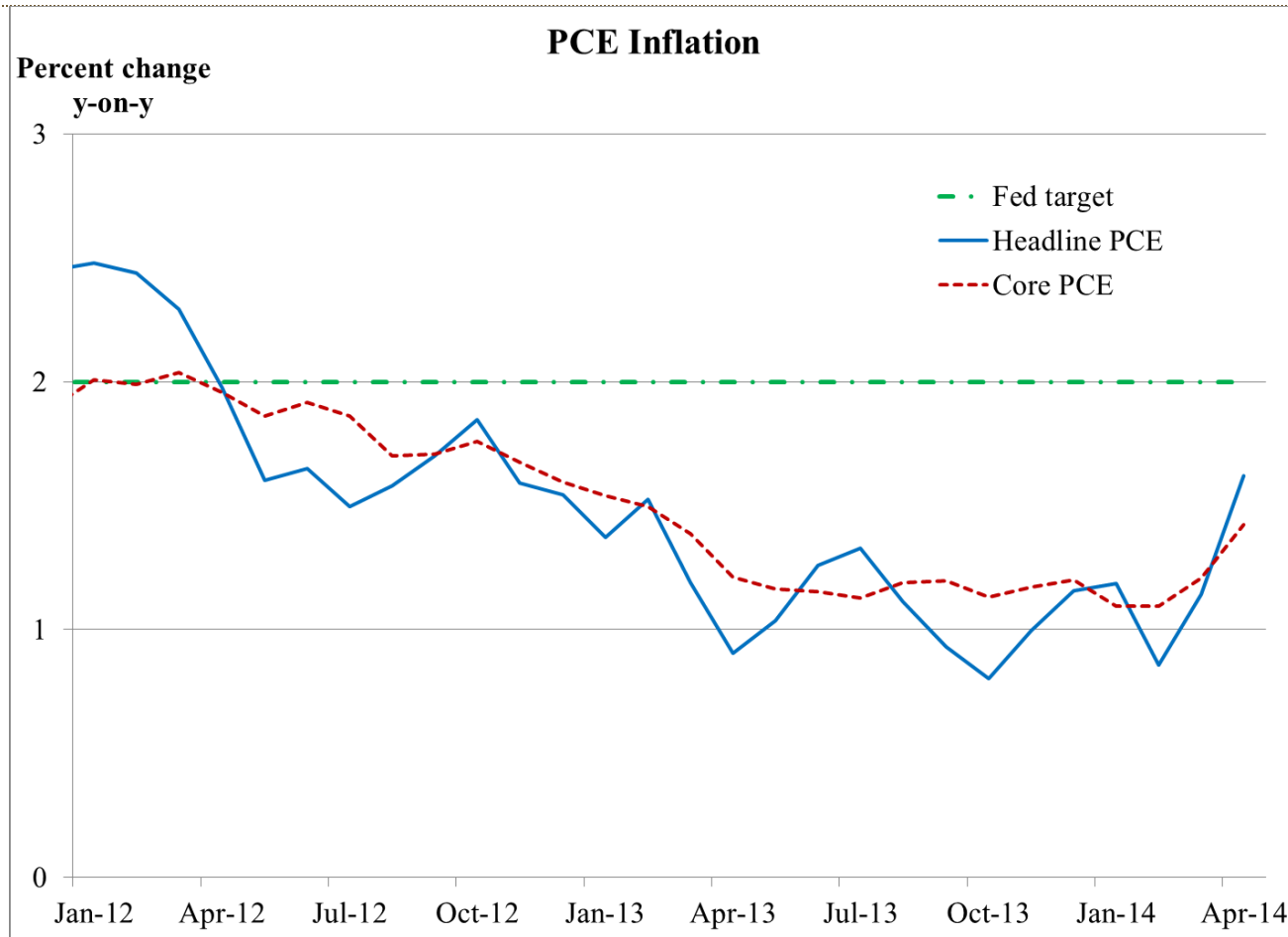
- Question: If the FOMC is relatively close to its objectives, why is monetary policy so far from normal?
- Two reasons:
  - Labor markets do not seem to be fully recovered.
  - Inflation is low.
- I can illustrate these two points with two charts.

# The labor market in one chart



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: May 2014.

## Inflation is low but moving back to target



## Challenges for the FOMC

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- 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.



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# Conclusion

## Conclusion

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- 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.



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