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

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.
Federal Reserve Bank of St. Louis
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Federal Reserve Economic Data (FRED)
research.stlouisfed.org/fred2/

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