The FOMC: Ahead on Results, Behind on Rates

James Bullard
President and CEO, FRB-St. Louis

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Any opinions expressed here are my own and do not necessarily reflect those of the Federal Open Market Committee.
Introduction
The monetary policy debate on QE3

- The FOMC is poised to end its controversial QE3 program this month.

- Now may be a good time to evaluate the program compared to expectations at the time it was launched.

- My assessment will suggest that the program has been more successful than the Committee anticipated, especially in terms of labor market outcomes.

- However, the Committee has not yet judged that the time is right to raise the policy rate off of the zero lower bound.
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 interest rate policy, including forward guidance.
  - Quantitative easing, the purchasing of government securities and mortgage-backed securities (MBS).

- The goal variables are close to normal, but the tools are not.
The QE3 program

- The open-ended asset purchase program known as QE3 was launched in September 2012.
- At that meeting, the FOMC also made macroeconomic forecasts for 2013 and 2014.
- These included a forecast for the policy rate, with projected liftoff before the end of 2014 by six participants if macroeconomic outcomes met expectations.
- Macroeconomic outcomes have exceeded expectations, yet the Committee has not proceeded with liftoff.
Interpretations as patience

- Why hasn’t the Committee moved on the policy rate?
- One interpretation is that the Committee is being very patient concerning liftoff.
- A policy rate liftoff in the first quarter of next year would exhibit considerable patience relative to the plans laid out in September 2012.
September 2012
The September 2012 projections

- The Committee produced projections in September 2012 for real GDP, inflation, unemployment and the policy rate.

- For real GDP and inflation, the actual outcomes during the past two years were not too different from what was expected.

- For unemployment, however, the outcomes have been far better than expectations.

- The policy rate was projected to be higher than it is today. This projection is made under an “appropriate monetary policy” assumption.
The evidence from September 2012

- Let’s consider first the outlook for real GDP as of September 2012.
- The Committee predicted moderately rapid economic growth during 2013 and 2014.
- This is roughly what happened.
Real GDP projections from September 2012

Source: Federal Reserve Board, Bureau of Economic Analysis, Macroeconomic Advisers and author’s calculations.
Real GDP projections from September 2012

Source: Federal Reserve Board, Bureau of Economic Analysis, Macroeconomic Advisers and author’s calculations.
Inflation projections from September 2012

- The Committee predicted subdued inflation at the launch of QE3 in September 2012.

- Inflation today continues to run somewhat below the Committee’s target of 2 percent.
Inflation projections from September 2012

Source: Federal Reserve Board, Bureau of Economic Analysis, Macroeconomic Advisers and author’s calculations.
Unemployment projections from September 2012

- The Committee projected that unemployment would still be relatively high at the end of 2014.
- On this dimension, there was a substantial surprise.
- Unemployment has turned out to be much lower than the Committee projected.
- Outcomes for the labor market have been far better than expected at the launch of QE3.
Unemployment projections from September 2012

Employment projections as of September 2012

- The Summary of Economic Projections does not include a projection for nonfarm payroll employment, a key macroeconomic labor market indicator.

- However, private sector forecasts indicate that this labor market variable has also considerably outperformed expectations as of September 2012.

- Private sector forecasts called for less employment growth than was actually observed during the past two years.
Nonfarm payroll employment projections from September 2012

Source: Bureau of Labor Statistics, Macroeconomic Advisers, and author’s calculations.
Monetary Policy Expectations as of September 2012
The economy outperformed

- The FOMC had a set of expectations for the economy in September 2012, and the economy outperformed those expectations.

- The FOMC also suggested a policy rate path that would be consistent with projected economic performance.

- In September 2012 six participants projected increases in the policy rate before the end of 2014. In September 2014 only one participant saw as appropriate a policy rate increase before the end of the year.
Mismatch between projections and reality

- Macroeconomic events since September 2012 suggest a higher policy rate path than the one projected at that time.

- Yet the likely policy rate path today remains below the one projected in September 2012, not above.

- I interpret this as a degree of patience on the part of the Committee with regard to policy rate liftoff.

- A liftoff date at the end of the first quarter of 2015 would already be well past what is called for by a standard monetary policy rule.
Policy rate projections from September 2012

Source: Federal Reserve Board and author's calculations.
Policy rate path suggested by the Taylor (1999) rule

\[ i_t = 2 + \pi_t + 0.5(\pi_t - 2) + Y_t \]
\[ Y_t = 2(5.35 - u_t) \]

Summary
Normalizing monetary policy

- How quickly should the Committee move to return monetary policy to normal given improving macroeconomic conditions?

- The Committee was surprised to the upside by the performance of the U.S. economy since September 2012.

- The policy rate normalization process remains far behind the schedule laid out at the launch of QE3.

- I interpret this as a degree of patience on the part of the Committee with respect to policy rate liftoff.