Dean Croushore Blog about Monetary Policy

August 20, 2013

Monetary Policy, Driven by Data

At the August 2013 meeting of the Federal Open Market Committee (FOMC), the Fed maintained its stance of Quantitative Easing (QE3) to the tune of $85 billion of asset purchases each month. The Fed has been attempting to communicate to the public that its policies will be driven by the data. As the economy improves, the Fed will make policy less accommodative. The Fed has said that it will continue its asset purchases until the unemployment rate falls below 6.5%, and as long as inflation remains contained below 2.5%. But, the Fed still plans to keep interest rates low for some time, even after the unemployment rate falls below 6.5%, to maintain an accommodative policy that will support economic growth.

The data have become interesting in two ways: (1) GDP growth is slightly higher in the recession and in 2012 than we thought it was before, and (2) inflation was lower in the recession and is slightly higher more recently.

First, let's look at GDP growth, which was changed by revisions to past data. Every July, the Bureau of Economic Analysis (BEA) uses new information that it has gathered to revise the GDP data for the previous three years. Periodically, the BEA makes changes in its methods for calculating GDP, as was the case this year. In particular, the BEA made two very significant changes: it began treating expenditures on research and development as fixed investment instead of production costs, and it began treating works of art, including motion pictures, as fixed investment, as well. These changes are quite logical from the viewpoint of economic theory, and make the treatment of those items more consistent with how the BEA treats other investments.

Chart 1 shows the growth rate of GDP for the past 5 years as measured both before and after the date revision. The largest changes occur in 2008 and 2009, during the recession. In those years, GDP growth was revised up somewhat. From the third quarter of 2008 to the second quarter of 2009, GDP growth was revised up about 0.5 percentage points. Also, the revisions show that GDP growth in 2012 was a bit stronger than we thought before. The average quarterly growth rate increased by over 0.5 percentage points for the year. Thus, the economy was not faring as poorly last year as we thought before.

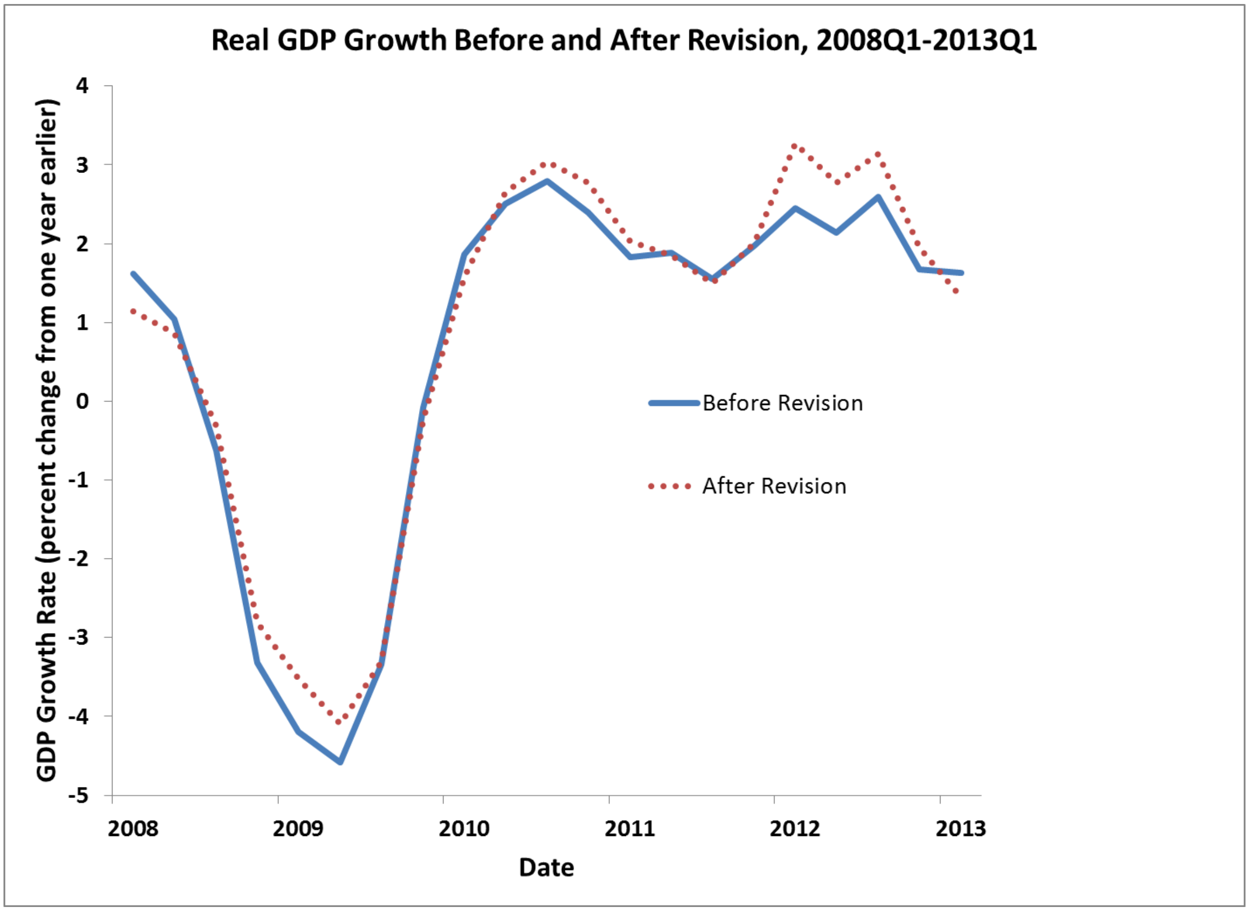

Chart 1. GDP Growth Before and After the Data Revision. The data show that GDP growth was higher in many years in the revised data than it was prior to the data revisions. The recession of 2007-2009 was not as bad as we thought it was before the data revision and GDP growth in 2012 was a bit stronger than we thought before.

Second, to examine inflation, let's look at the variable that the Fed uses most frequently, which is the PCE price index excluding food and energy prices. Inflation measured using this variable is called core inflation and is shown in Chart 2. Again, the figure has two lines, one showing what we thought the inflation rate was over time before the revision, and a second line showing the new measure of inflation. As you can see, the inflation rate was revised down from 2008 to mid-2011 and revised up from mid-2011 to early 2013. The Fed had been worried that inflation was getting too low at the end of 2012 and in early 2013, but now it appears to be a bit higher. The Fed had been worried about the very low inflation rate in 2009 and 2010, and it turns out that it should have been even more worried than it was!

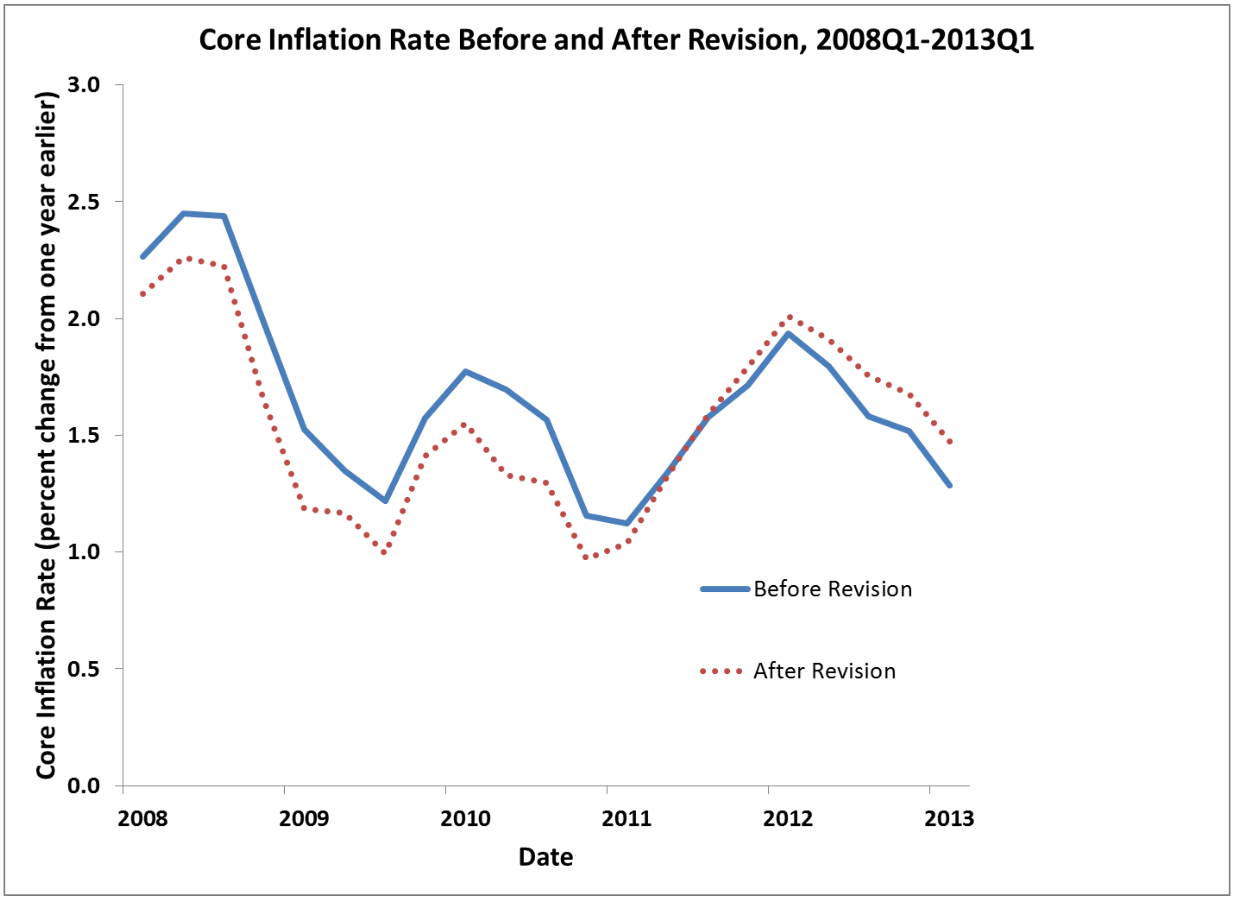

Chart 2. Core Inflation Rate Before and After the Data Revision. The data show that the core inflation rate was lower from 2008 to mid-2011 in the revised data than it was prior to the data revisions. The core inflation rate now appears to be slightly higher from mid-2011 to early 2013 than we thought before.

What do these data revisions imply about monetary policy? With inflation slightly higher, the Fed may see less need for quantitative easing than it did before, but the difference is very small, so this effect seems very minor. On the other hand, the faster real GDP growth in the past year implies that the economy is doing better than we thought before, so the revision may help lead the Fed to curtail quantitative easing more rapidly than it might have otherwise.