The Role and Limitations of Monetary Policy

Neel Kashkari

President and CEO

Federal Reserve Bank of Minneapolis

Minneapolis, MN

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Good morning. Thank you, Kathy, for that kind introduction. I commend you for your excellent judgment in selecting Mark Kennedy to lead the University of North Dakota as its new president. Congratulations, Mark, on this wonderful and well-deserved appointment, and thank you, and the Economic Club of Minnesota, for hosting this event and inviting me to address your members. Before I begin, I would just like to remind everyone that the views I express today are my own and not necessarily those of the Federal Open Market Committee.

In this speech, I am going to talk about monetary policy—not just about what policy I think is appropriate today, but also about how I am approaching the task of communicating about monetary policy in the context of important problems we face as a nation. I am going to spend some time talking about what monetary policy can do for society, and what it can't do, and why it's important that we understand those differences. I find forming my monetary policy views in the current economic environment easier than determining how to communicate them in a way that advances the Fed's policy goals.

One of the things I really like about my job is that it is multifaceted. There is a large management responsibility leading an organization of a thousand people. There is a deep policy component, as we craft policy recommendations for interest rates as well as for other important economic topics such as financial stability. And there is the public facing aspect, both representing the Bank across the Ninth Federal Reserve District and advocating for our public policy views.

As you can probably tell from our initiative to end too big to fail (TBTF), I am not shy about speaking my mind and advocating for policies I believe are in the best interest of the country. But I give careful consideration to whether drawing attention to an issue is the best way to positively influence that issue. In the case of TBTF, I believe we need to have a serious national conversation about whether we have done enough to address large bank failures. This is why we are having public symposiums to raise awareness and educate the American people while we educate ourselves.

But not every issue will be advanced by drawing more attention to it, and this is why I have been more hesitant to speak out about monetary policy, even though I do have views about the right course of action. I think market participants are too focused on the Fed, and I am reluctant to draw even more attention to short-term monetary policy decisions, when attention should be focused on solutions to longer-term issues.

When I think about the market's preoccupation with every short-term move the Fed might make, I am reminded of the Summer of the Shark in 2001. Sharks had gone crazy and were biting people seemingly every day. Television crews were camped out at beaches ready to catch the latest bite. What was causing the sharks to turn so viciously on their human neighbors? Was it some new solar activity driving them crazy? Were they under orders from the aliens in Star Trek who lost interest in the whales? No. It turns out the sharks weren't biting any more than usual. It was a slow news summer, and there was not much else to pay attention to.

[1] I thank Ron Feldman, Terry Fitzgerald, Jim Lyon, Ben Malin, Danita Ng, Jenni Schoppers, Sam Schulhofer-Wohl, and David Wargin for assistance in preparing these remarks.

Given all the attention market participants pay to every FOMC statement, one would think the Fed could control a lot. But the truth is that central banks can't influence many of the things that really matter to the long-term well-being of a society. We can't influence trend productivity growth. We can't influence competitiveness. We can't influence educational performance.

I think it is important to remind ourselves that central banks can really do only three things: (1) create a long-term stable monetary environment, (2) respond to an economic crisis and (3) influence short-term economic performance.

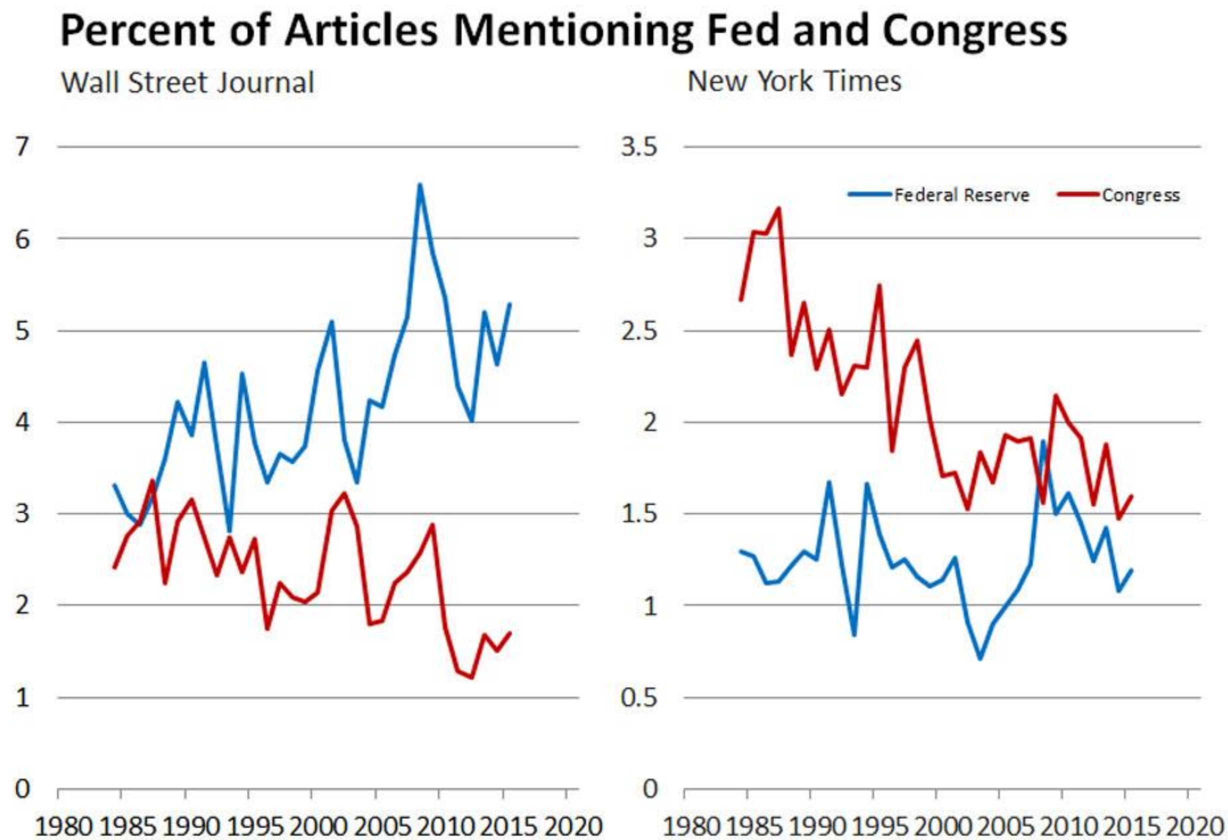
- Creating and maintaining a stable monetary environment is enormously important for society. Ensuring that inflation remains low and stable allows households and businesses to plan ahead and keeps borrowing costs low. Thus, by doing its inflation-stabilization job well over the long run, a central bank helps create the environment that allows an economy to flourish. We saw the damage caused to Main Street in the 1970s when the Fed failed to control inflation. It took bold action by the Volcker Fed to regain control and put the economy back on a stable course.

- The Federal Reserve was originally created by Congress in 1913 to help end the too-frequent occurrence of financial panics and crises. In response to the most recent financial crisis, the Fed brought extraordinary courage and creativity to stabilizing the financial system and preventing another Great Depression. If the Fed had failed to act, generations of Americans would have been even more negatively affected.

- Finally, between periods of crisis, the Fed's job is to keep unemployment and inflation low by adjusting interest rates. This is important in the short term, but it doesn't affect the underlying trajectory of the economy, although sometimes people think it can. For example, real interest rates today are very low by historical standards. Some people see these low long-term real interest rates as the result of decisions made by the Fed. The reality is they are not. Real interest rates have been falling around the world for the past few decades, largely driven by broader macroeconomic forces outside of any central bank's control: demographic trends, technological advancements and global fiscal policies. In the face of these long-term trends, it has been appropriate policy for the Fed to set lower interest rates to achieve the best possible results for inflation and employment—but the Fed is just keeping pace with broader global trends, not causing them.

So if the Fed doesn't shape the long-term trajectory of the economy, who does? Our legislative and executive branches of government can influence many of the important determinants of macroeconomic outcomes for Main Street. Our tax, spending and trade policies influence how much we produce and consume at home versus import from or export to other nations. The tax system affects incentives to work, save and invest. Congress also determines how much public money we dedicate to educating our workforce and to basic research, which can lead to tomorrow's breakthroughs. Ultimately, fiscal policy decisions like these will determine whether our children and grandchildren are better off than we are.

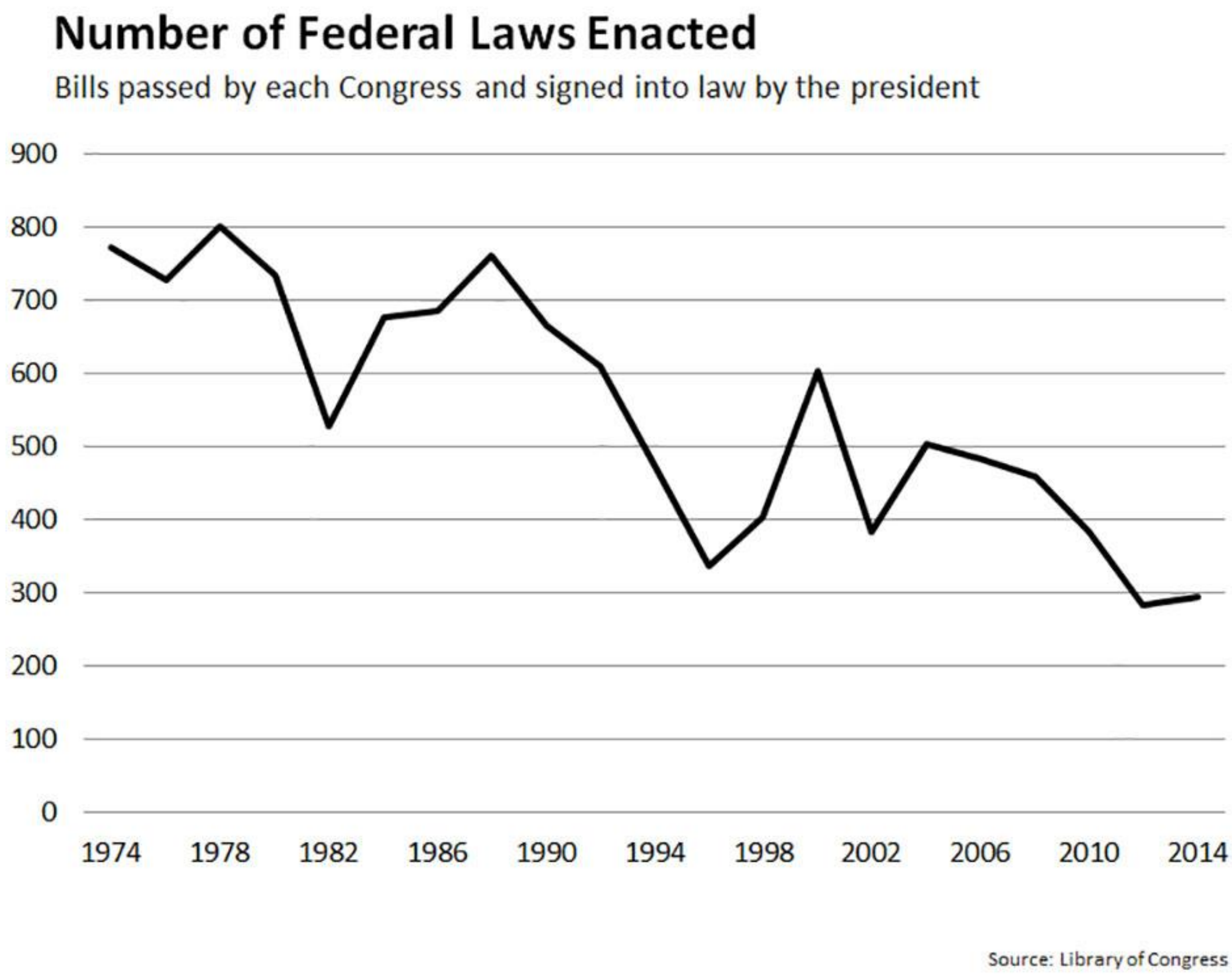
Despite this, people seem to be paying much more attention to the Fed. This chart shows the number of articles that mention the Federal Reserve versus the number of articles that mention Congress in the *New York Times* and the *Wall Street Journal* over the past three decades. You can see the trend for yourselves. The focus of news coverage has been shifting toward the Fed and away from Congress, despite the comparatively small influence the Fed has on long-term economic performance.



Source: Factiva; Minneapolis Fed calculations

Why is this so? I will offer two possible explanations, though there are probably others as well. First, the Federal Reserve is providing much more information to the public. This is a positive from the perspective of transparency, but the Fed might also be occupying more mindshare because there is simply more information to digest. For example, prior to 1994, the Fed didn't issue statements after FOMC meetings. Then it began issuing brief statements, sometimes just a few sentences, and not after every meeting. Today we issue five-paragraph statements after every meeting. Public communication from Federal Reserve officials has also increased substantially compared with prior decades. This increased transparency gives the public insight into the workings of the Fed, but it may not be costless if it is driving increased attention on each short-term decision the Fed makes. As an FOMC participant, I am going to focus my public comments on longer-term monetary policy issues and on explaining my own perception of the FOMC's collective thinking rather than on predicting the next move we might make.

A second possible explanation, especially in recent years, is that the lack of political consensus in Washington is leading to fewer policy actions by Congress and the executive branch. This next chart shows the decline in the number of bills passed by each Congress and signed into law by the president.



From a policy perspective, we are having an extended slow news summer, and market participants are left to focus on where the action is: the FOMC's short-term interest rate decisions. The truth is, whether the FOMC raises rates in June isn't going to be what determines whether our children and grandchildren are better off than we are.

Monetary policy objectives

Now let me turn to how the Federal Reserve approaches its monetary policy responsibilities. Congress has given the FOMC a dual mandate: to promote "price stability" and "maximum employment." In its Statement on Longer-Run Goals and Monetary Policy Strategy, the FOMC explains the implications of this mandate for both the short run and the long run.

In the short run, "*the Committee seeks to mitigate deviations of inflation from its longer-run goal and deviations of employment from the Committee's assessments of its maximum level."* Although these objectives are often complementary, when they are not, the Committee *"follows a balanced approach."* That is, the Committee puts weight on both objectives.

In the longer run, the statement clarifies what the FOMC's targets are (or are not). Specifically, the FOMC has interpreted its price stability mandate to mean keeping inflation close to 2 percent. This is a target, rather than a ceiling, which means persistent deviations above and below 2 percent are equally bad. However, the FOMC has *not* set a specific target for maximum employment.

The lack of a specific target for employment reflects the limitations of monetary policy, a point to which I'll return later. But first, let me turn to an assessment of current economic conditions and appropriate monetary policy. I'll conclude that, while the recovery has been encouraging, I still see room for some improvement.

Monetary policy outlook

Let's start with the Fed's maximum employment mandate.

The most widely known measure of labor market performance is the unemployment rate, which has largely recovered from its high level during and following the recession and, at 5.0 percent, is now close to the median FOMC participant's assessments of its long-run value. Other indicators, however, suggest that the economy is not yet at maximum employment. Involuntary part-time employment remains elevated from its prerecession levels, and compensation growth remains subdued, though recent data and anecdotes suggest that it may finally be starting to pick up.

Perhaps the most encouraging indication that further labor market improvements are feasible has been the sizable, and unexpected, recent increase in labor force participation. While the April employment data released last Friday showed a modest decline in labor force participation, the rate still rose from 62.4 percent last September to 62.8 percent in April, as the size of the labor force increased by almost 2 million people. Thus, although the unemployment rate edged down by only 0.1 percent over this period, the share of all adults who have a job increased from 59.3 percent to 59.7 percent. This is a very welcome development, especially given that some portions of our population—notably those with less education and certain minority groups such as African Americans and Hispanics—still have high unemployment rates. In recent years, conventional wisdom was that large numbers of people were permanently lost from the labor force due to the Great Recession, as the long-term unemployed became the permanently unemployable. Of course, we don't know for sure, but the recent data suggest that is not necessarily true. The strong job market is bringing many back into the workforce, which is unquestionably a good thing for those workers, their families and society as a whole.

Turning to the Fed's "price stability" mandate, the inflation rate of personal consumption expenditures, or PCE, has remained persistently below the FOMC's target of 2 percent for the past four years. This is true even when we set aside recent declines in oil prices and look at the core inflation rate, which excludes food and energy. Moreover, measures of inflation expectations provide little evidence that inflation is likely to increase above the 2 percent target in the near future. Inflation expectations measured in surveys of American families have remained generally stable, but tend to be in the lower part of their historical ranges. Measures based on financial market data also remain quite low.

What does all of this imply for the stance of monetary policy? In short, given the lack of notable price and wage pressures and the possibility of drawing more people back into the labor market, I believe the current accommodative policy stance is appropriate. The usual cost of stimulating the labor market through accommodative monetary policy would be an undesired increase in inflation. But in the current circumstances, with inflation running below the Fed's 2 percent target, an increase in inflation is actually desirable. Furthermore, while monetary policy's influence on the labor market may not be enormous at this point, we can have at least some impact. If we can continue bringing displaced workers back into the labor force, we should.

Fed watchers might conclude from these remarks that I am a so-called dove. But a year or two from now, if different economic conditions lead me to call for less accommodative policy, they might conclude that I have reversed myself and become a hawk. The truth is neither. The financial crisis taught me the limits of dogma. I learned humility and pragmatism the hard way.

Limits to monetary policy's influence on labor markets

Although monetary policy plays an important role in promoting maximum employment, it does not play the *most* important role. The reason the FOMC has not specified a fixed goal for employment is that, while long-run inflation is primarily determined by monetary policy, nonmonetary factors largely determine the maximum level of employment and the long-run growth rate of the economy. Sustained efforts by the Fed to boost employment and output beyond levels consistent with nonmonetary fundamentals would ultimately lead only to higher inflation. There would be little benefit to the real economy, and there could be some harm. Thus the FOMC cannot achieve any employment level it wants. Instead, it must assess what the maximum level of employment is, and then set policy to achieve it.

So, what are some of the nonmonetary factors that determine maximum employment? Rather than providing an exhaustive list, I will simply mention some factors that have been particularly relevant recently.

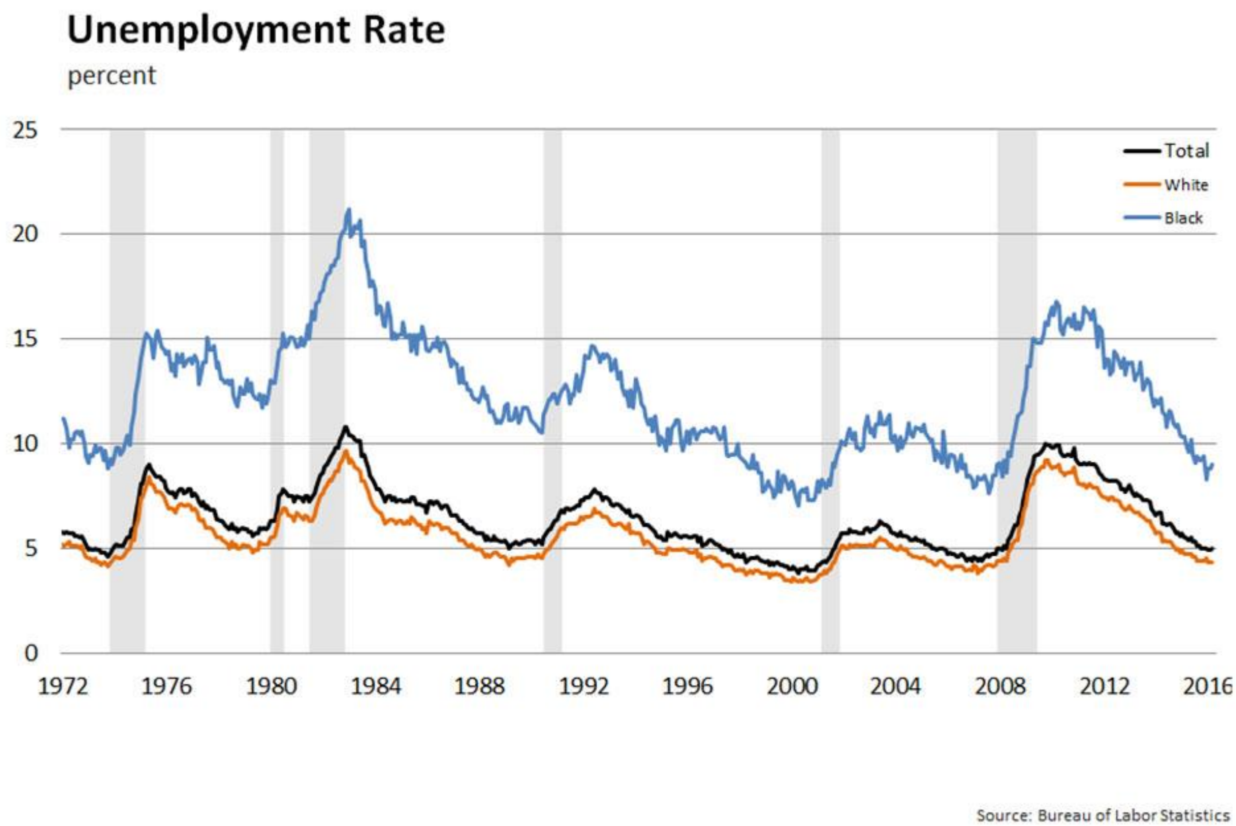
First, demographics noticeably shape labor supply. For example, labor force participation and the employment-to-population ratio have fallen in part because the baby boomers are reaching retirement age. As the FOMC assesses how much slack is left in the labor market, we compare these measures not to their prerecession levels, but to their levels adjusted for structural demographic changes.

Other factors, such as technological progress and the accumulation of physical capital, also affect the overall growth of the economy and labor demand, as firms will hire more workers when they are more productive. The recent low productivity growth is a development we are monitoring closely, which I will come back to in a moment.

Another important factor is the ease with which potential employers and employees find each other and the incentives they have to form a relationship. Labor market policies, including minimum wage laws, income taxes, unemployment benefits and the ease with which a match can be terminated, all affect these incentives.

The upshot of all of this is that, although monetary policy has contributed to the ongoing recovery in labor markets, it alone can get us only so far. Policy tools outside the Fed's control can significantly influence many of the determinants of maximum employment. For example, in the longer run, policies that improve educational outcomes and skill development could increase "maximum employment." So could policies that help all workers and firms to compete on a level playing field. Research conducted in part at the Minneapolis Fed has found that the government is requiring people to obtain a license to work in more occupations than ever. While the goal of such licensing is ostensibly consumer protection, often these requirements are really just barriers to competition. Relaxing unnecessary licensing requirements could help more people find jobs. In general, nonmonetary policy tools can have a larger, more direct impact on putting people back to work than monetary policy alone.

In addition, the distribution of jobs within society is largely determined by nonmonetary factors. For example, one very important societal problem in America is the large gap between white and black unemployment. Here is a graph of unemployment rates by race compared with the national average. As you can see, in both good times and bad, African Americans tend to have a vastly higher unemployment rate than the national average. Analysis by our staff at the Minneapolis Fed has found that differences in education, age and other demographics explain very little of this gap. If we compare two otherwise identical workers, one white and one black, the black worker is significantly more likely to be unemployed. These differences in labor market opportunities are a tragedy for our country and a waste of the skills of many Americans.



It is true that the Fed can in a small way help workers from disadvantaged groups, because when we provide monetary stimulus that raises employment nationwide, employment of all groups tends to rise. You can see that in the graph. But such stimulus has its limits because we must also maintain control of inflation. If we provided too much stimulus and lost control of inflation as in the 1970s, virtually all Americans would suffer. We might then have to raise interest rates aggressively to bring inflation back down—potentially causing a recession that could put out of work the very people we were trying to help. Nonmonetary policies are needed to address the root causes of the problems that unfairly leave some Americans behind.

Limits to monetary policy's influence on economic growth

Finally, let me return to a recent example of an issue that I mentioned briefly at the beginning of my remarks: the financial markets' obsession with the Fed's actions in the short term and why this is suboptimal.

The most notable economic development this year, in my view, has been the combination of rapid improvement in the labor market and very slow growth in output. The combination of slow output growth and rapid employment growth means that the average productivity of workers is growing slowly and sometimes even falling.

Now, this weak productivity could be a statistical fluke, but it has gone on long enough that it is likely to at least partly reflect real economic developments.

Moreover, it may be a troubling sign for the future of our economy. We don't know. On the one hand, it may just be a cyclical effect of the workers rejoining the labor force now being much less productive than those already working. On the other hand, the weaker productivity may reflect long-term underlying trends in the use of capital or the pace of technological progress that could herald slower growth for many years to come, which would be very costly for society.

At any rate, understanding what slower productivity growth means for economic growth is essential for policymakers, investors and the public. We must also remember that trend labor productivity is fundamentally outside the control of the Fed. An excessive focus on the next interest rate decision distracts us from important questions like this one.

Conclusion

In closing, I look forward to an era when the United States uses all of its policy tools to best achieve good economic outcomes for all members of our society. The Federal Reserve has a role to play, but we shouldn't be the only player nor the most important one. Thank you, and I look forward to your questions.