Still Room for Improvement

Greater Mankato Growth

Mankato, Minnesota

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Thank you for that generous introduction, and thank you for the opportunity to speak to you today.

My speech today focuses on the behavior of the labor market over the past nine years. I will document that, after several painful years of labor market stagnation, the United States experienced truly historic improvement in labor market performance in 2014. Unfortunately, these labor market gains have slowed markedly in 2015. This may suggest to some that there is little room for further improvement in labor market outcomes. I will argue that current and projected low inflation presents strong evidence to the contrary. There is room for more improvement—but we will only achieve those gains if we make the right monetary policy choices. I will describe what I believe those right choices to be.

I look forward to taking your questions at the end of my prepared remarks. For me, those questions are a highlight of my speaking engagements. As I will discuss, two-way communication between policymakers and citizens is a core function of the Federal Reserve System. Your questions are a key part of that two-way communication.

The views that I express today are my own and are not necessarily those of others in the Federal Reserve System.

Federal Reserve System basics

Let me begin with some basics about the Federal Reserve System. I like to tell people that the Fed is a uniquely American institution. What do I mean by that? Well, relative to its counterparts around the world, the U.S. central bank is highly decentralized. The Federal Reserve Bank of Minneapolis is one of 12 regional Reserve Banks that, along with the Board of Governors in Washington, D.C., make up the Federal Reserve System. Our Bank serves as the headquarters for Federal Reserve operations in the ninth of the 12 Federal Reserve districts, which includes Montana, the Dakotas, Minnesota, northwestern Wisconsin and the Upper Peninsula of Michigan.

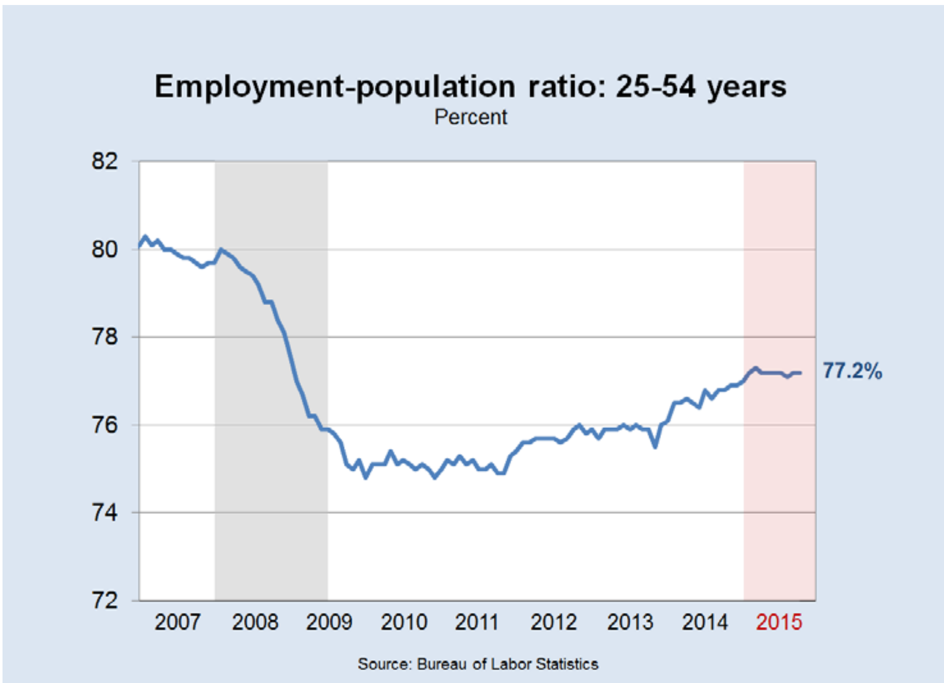
Eight times per year, the Federal Open Market Committee—the FOMC—meets to set the path of monetary stimulus over the next six to seven weeks. All 12 presidents of the various regional Federal Reserve Banks—including me—and the governors of the Federal Reserve Board contribute to these deliberations. However, the voting members of the Committee itself consist only of the governors, the president of the Federal Reserve Bank of New York and a rotating group of four other presidents. In this way, the structure of the FOMC mirrors the structure of our government, because representatives from different regions of the country—the various presidents—have input into FOMC deliberations.

This decentralized system has many desirable attributes. I believe one of the most important is that it facilitates two-way communication between the nation's central bank and the nation's citizens. We're engaging in one direction of this communication right now, as I tell you about key considerations regarding monetary policy. In the other direction, the Federal Reserve Bank of Minneapolis gathers valuable economic information from local contacts in a variety of ways. For example, a couple of weeks ago, I met with the Federal Reserve Bank of Minneapolis' Great Lakes Advisory Council—which includes business and community leaders from around the states of Minnesota, Wisconsin and Michigan—to gather exactly this kind of information. We also meet with business and community leaders from many other economic sectors through our other advisory councils and outreach programs. The public service of these people, and their many contacts, helps ensure that we have a deeper understanding of what is happening in the local economy.

But let me turn back to the FOMC and the making of monetary policy. I mentioned that the FOMC meets eight times per year. At those meetings, we decide on an appropriate stance of monetary policy for the economy. What is the FOMC seeking to achieve by varying monetary policy? Congress has charged the FOMC with making monetary policy to promote maximum employment and to promote price stability. The FOMC has interpreted the second goal, price stability, to mean keeping inflation close to 2 percent.

Employment over the past nine years

I now turn to the FOMC's performance with respect to its employment mandate over the past nine years—since December 2006. Many metrics are used to measure labor market performance. I will concentrate on what I see as a very basic metric: the fraction of prime-age people, those aged 25 to 54, who have a job. I focus on prime-age people as a simple way to strip out the demographic effect of the retirement of the baby boom cohort.



From December 2006 through December 2009, labor market performance deteriorated rapidly. The fraction of prime-age people who had a job fell from about 80 percent to 75 percent. Those people did not suddenly become disabled. Nor did they suddenly decide that they could have more fun playing video games than working. Rather, there was a large group of people with talents and skills who would have been employed in 2006, but were not being utilized by the U.S. economy three years later. In this sense, the 5-percentage-point decline in the employment-to-population ratio represents a dramatic and disturbing waste of America's valuable human resources.

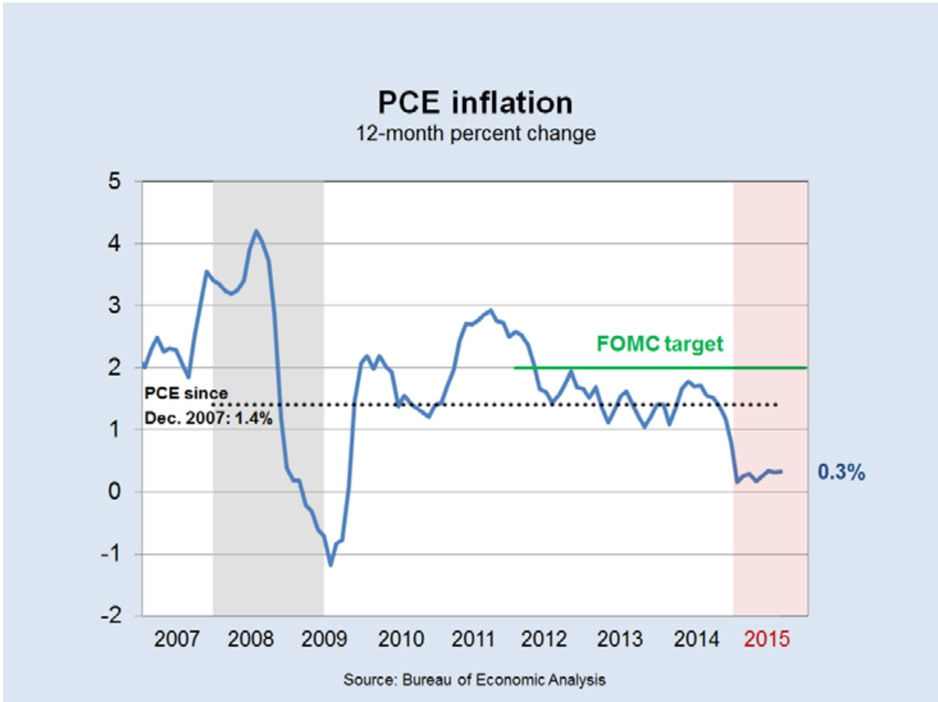
From the end of 2009 through December 2013, the share of prime-age people with a job rose very sluggishly to about 76 percent, still well below the pre-recession share. Employment data like these led more than a few observers to be concerned at the end of 2013 that the U.S. labor market was stuck in some kind of adverse "new normal." However, the fraction of people with a job rose dramatically in 2014—by 0.9 percentage points—the largest December-to-December increase in over a quarter century. 2013 was not a new normal.

Unfortunately, this progress has slowed sharply in 2015. The fraction of prime-age people with a job has risen only 0.2 percentage point since December 2014 and is unchanged from its January 2015 level of 77.2 percent. As a result, this key metric remains almost 3 percentage points below pre-recession levels.

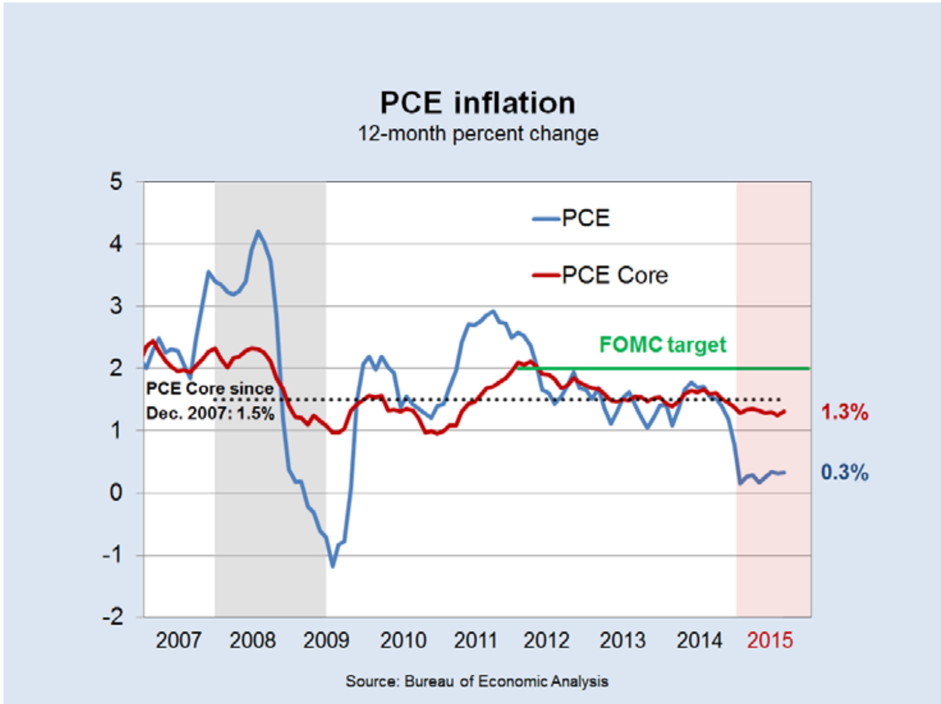
Good news from inflation data

As I mentioned earlier, Congress has charged the FOMC with making monetary policy so as to promote maximum employment and price stability. We saw rapid labor market improvement in 2014, but that rate of improvement has slowed noticeably in 2015. Does that mean that the FOMC is close to reaching the top of the hill—that is, close to achieving its maximum employment goal? In my view, the behavior of inflation clearly shows that the answer to this question is no: The FOMC can facilitate further improvement in labor market performance.

As I noted earlier, the FOMC has translated price stability to mean a personal consumption expenditures (PCE) inflation rate of 2 percent. Here's what inflation has looked like since the start of the Great Recession at the end of 2007. Over that period, inflation has averaged 1.4 percent. In addition, inflation shows little sign of returning to its 2 percent target. As of August, it was 0.3 percent on a 12-month basis, down from 0.8 percent in December 2014. It has been below 2 percent on a 12-month basis for well over three years.



I agree with those who say that the current low rate of inflation is attributable in part to the temporary downward pressure stemming from falling oil prices. However, even if we remove volatile food and energy prices and look at core inflation, we see little evidence of inflationary pressures. PCE core inflation has averaged 1.5 percent since the start of the recession and has fallen from 1.4 percent in December 2014 to 1.3 percent in the latest reading. With the exception of a few months in late 2011 and early 2012, PCE core inflation has been below 2 percent, on a 12 month basis, for nearly seven years.



These data tell us where inflation has been in the past. Monetary policy affects *future* prices and employment, with a lag that is generally thought to be about 18 to 24 months. So, when we make monetary policy, we need to know where inflation is going in the future. Both private sector and public sector forecasters are currently forecasting PCE inflation to remain below the FOMC's target over that 18- to 24-month horizon and beyond. In terms of the private sector, the median projection in the August Survey of Professional Forecasters is that PCE inflation will be below 2 percent in 2015, 2016 and 2017. In terms of the public sector, in June 2015, the Federal Reserve Board's staff outlook was that PCE inflation would remain below 2 percent into the next decade.[1] These forecasts are largely consistent with my own. As I have been saying for some time, based on what I perceive to be the likely evolution of FOMC policy, I don't expect PCE inflation to return to target until 2018 or later.

These inflation figures are often depicted as bad news—"Oh, my! The FOMC can't get inflation back to target!" But they are, I think, better understood as representing a huge opportunity. The FOMC has a free lunch. There would be little or no inflationary cost if the Committee were to aim for the kind of remarkable improvement in labor market conditions that we saw in 2014

[1] See Board of Governors (2015).

by adopting a more accommodative monetary policy stance. Of course, at any point in time, there are large uncertainties about the long-run level of employment in the economy. But I see low inflation and the strong labor market improvement in 2014 as being strong pieces of evidence against the hypothesis that the Great Recession caused permanent damage to the U.S. labor force. Without clear signs of such damage, I believe that it is most natural for the FOMC to treat the pre-recession year of 2006 as a key guidepost in formulating its employment objectives.[2] In a speech earlier this year,[3] I showed via some simple calculations that we will need at least three more years as good as 2014 to return to 2006 employment rates.

Thoughts on monetary policy tightening

The above discussion does raise one key question: Why has the rate of labor market improvement slowed so much in 2015 relative to 2014? In thinking about this question, I find the timing of monetary policy changes to be highly suggestive.

In mid-2013, the FOMC announced its intention to taper its ongoing asset purchase program. We can see that this announcement represented a dramatic change in policy from the sharp upward movements in long-term bond yields that it engendered. Personally, I interpret this policy change back in 2013 as the onset of what the Committee currently intends to be a long, gradual tightening cycle. As I noted earlier, we would typically expect that such a change in monetary policy should affect the economy with a lag of about 18 to 24 months. Viewed through this lens, the slow rate of labor market improvement in 2015 is not all that surprising.

I believe the FOMC should take actions to facilitate a resumption of the 2014 improvement in the labor market by adopting a more accommodative policy stance. Remember, inflation is low, and is expected to remain low, relative to the FOMC's target. In particular, I don't see raising the target range for the fed funds rate above its current low level in 2015 or 2016 as being

[2] The fraction of those aged 25 to 54 with a job declined slightly from 1999 to 2006. Some have argued that this seven-year statistical pattern is evidence of an ongoing long-term trend decline in employment that monetary stimulus cannot offset without generating undue inflation. However, I am unaware of any economic research that explains the sources of this decline in the 2000s and then documents that these underlying factors have continued to evolve in the same way since 2006.

[3] See Kocherlakota (2015).

consistent with the pursuit of the kind of labor market outcomes that we are charged with delivering. Indeed, I would be open to the possibility of reducing the fed funds target funds range even further, as a way of producing better labor market outcomes.

There is, of course, a risk that inflationary pressures could build up more rapidly than I (or others) currently anticipate. But the solution to this scenario is relatively simple: Raise interest rates. Given my current outlook, I believe that it would be appropriate to wait until 2017 to initiate liftoff and then raise the fed funds rate at about 2 percentage points per year. My preferred pace of tightening mirrors the pace of tightening from 2004 to 2006—a pace of tightening that is often seen as gradual. (In fact, some would argue, with the benefit of hindsight, that it was *overly* gradual.) In response to unanticipated inflationary pressures, the FOMC could simply react as it did in 1994, and raise the fed funds rate more rapidly than this gradual pace.

Conclusions

I am an economist, and economics is often, with good reason, called the "dismal" science. But the message I intend to leave you with today is one of hope and optimism.

From 2006 to 2009, we saw a marked deterioration in labor market performance. As recently as January 2014, it seemed like this loss of human resources might prove to be permanent. But the rapid growth in employment that we saw in 2014 shattered this hypothesis. The lesson of 2014 is clear: *We can do better*. Given 2014, and given how low inflation is expected to be over the next few years, I see no reason why the Committee should not aim to facilitate continued improvement in labor market conditions. Indeed, I currently see no reason why we should not aim for the kind of strong labor market conditions that prevailed at the end of 2006.

But we will get there only if we make the right choices. The FOMC can achieve its congressionally mandated price and employment goals only by being extraordinarily patient in reducing the level of monetary accommodation. Indeed, to best fulfill its congressional mandates, the Committee should be considering reducing the target range for the fed funds rate, not increasing it.

Thank you for listening.

References

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