Thoughts on Monetary Policy and Community Banks[1]

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[1] Thanks to Ron Feldman, David Fettig, Terry Fitzgerald and Sam Schulhofer-Wohl for their assistance with these remarks.

Thanks for the introduction, and thank you for the invitation to join you here today.

My speech today has two distinct parts. The first part has to do with monetary policy. There has been a great deal of recent public conversation about Federal Reserve accountability with respect to monetary policy. I view my talk as being a natural outgrowth of that dialogue. American monetary policymakers like me are employees of the public. As I'll describe, we are charged by the public's representatives with achieving certain objectives. In keeping with this employer-employee relationship, my remarks loosely mimic a standard performance evaluation of the kind that takes place in corporations all over America each year. I first provide an assessment of Federal Open Market Committee (FOMC) performance over the past three years relative to the Committee's monetary policy goals. I then turn to what I see as appropriate plans for the FOMC in 2015, given the Committee's goals.

My remarks differ in a key respect from many or possibly most other discussions about the FOMC. It is common to focus on *what actions the Committee has taken*, such as our decisions about asset purchases or interest rates. In my view, these discussions about what has been done are really tangential to monetary policy accountability. Accountability—in any endeavor, including monetary policy—is not about what actions have been taken. Rather, it's about the *results those actions achieve*—specifically, how well performance accords with the relevant objectives. Accordingly, my discussion of FOMC performance and plans is relentlessly goal-oriented.[2]

The second part of my speech has to do with community banks. It follows up on remarks that I made last year about improving supervision and regulation by tailoring rules and approaches to the actual risks posed by these entities. I'll discuss some recent beneficial changes along these lines and suggest some opportunities for further improvements.

[2] In speeches last month, I expressed some concerns about the reference policy rule contained in the proposed Federal Reserve Accountability and Transparency Act. I still have those concerns and will likely return to those themes in future remarks.

As I said, the second part of my speech is distinct from the first part about monetary policy. Nonetheless, I see them as entirely consistent with each other. In the first part, I will emphasize the need for monetary policy to achieve the macroeconomic goals set forth by Congress. In the second part, I will describe how tailoring of supervision and regulation can help facilitate the Federal Reserve's pursuit of these same objectives. Throughout my remarks today, please keep in mind that I will be expressing my own views, and they are not necessarily those of others in the Federal Reserve System.

I look forward to responding to, and learning from, your questions at the conclusion of my remarks.

Federal Reserve System objectives

Eight times per year, the Federal Open Market Committee—the FOMC—meets to set the path of interest rates over the next six to seven weeks. All 12 presidents of the various regional Federal Reserve banks—including me—and the seven governors of the Federal Reserve Board contribute to these deliberations. However, the Committee itself consists only of the governors, the president of the Federal Reserve Bank of New York and a rotating group of four other presidents. I'm not one of those four presidents this year. At FOMC meetings, we decide on the level of monetary stimulus for the economy. For now, I won't get into too many details of what that term "monetary stimulus" means except to make two high-level points. First, when the FOMC changes the level of stimulus, our actions tend to push inflation—that is, the rate of growth of prices—and employment in the same direction. Raising the level of stimulus puts upward pressure on both inflation and employment. Lowering the level of stimulus puts downward pressure on both inflation and employment. Second, the FOMC's actions only affect inflation and employment with a lag, usually thought to be about one-and-a-half to two years.

What is the FOMC seeking to achieve by varying the level of monetary stimulus? Congress has charged the FOMC with making monetary policy to promote price stability and to promote maximum employment. The FOMC has interpreted the first goal, price stability, to mean keeping inflation close to 2 percent. The FOMC's job is to vary monetary stimulus over time to meet these mandated objectives.

Maximum employment

With that context, I now turn to an assessment of the FOMC's evaluation over the past three years. I'll begin by showing you data on FOMC performance with respect to its maximum employment mandate over the past three years.

The best known measure of labor market performance is the unemployment rate.

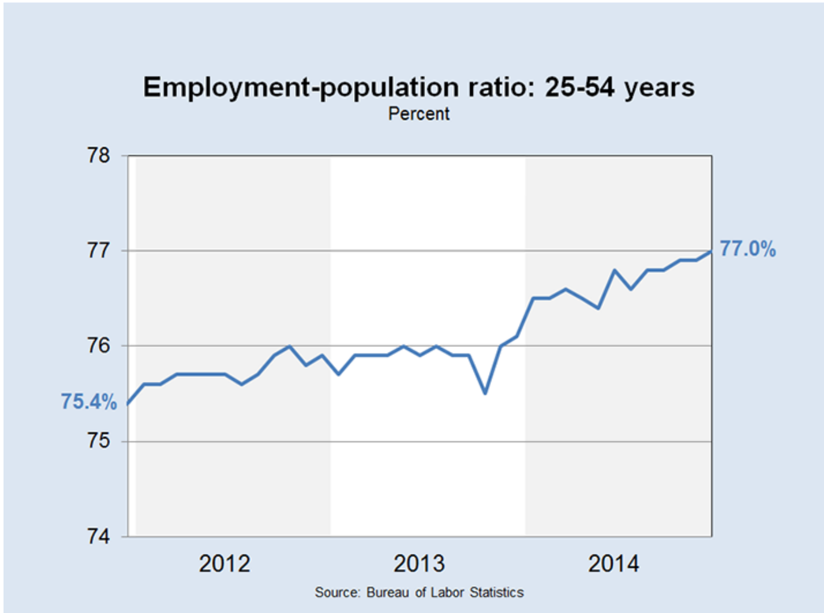
In December 2011, the unemployment rate was 8.5 percent. Since that date, the unemployment rate has fallen to 5.6 percent. The fall was especially rapid in 2014. However, the unemployment rate remains elevated compared to the FOMC's assessments of its long-run value.

The unemployment rate is the most widely known measure of labor market performance. But there are good reasons to view it as only one of many useful labor market metrics. Recall that, to estimate the unemployment rate, the Census Bureau asks people two questions: Are you working? And, if not, have you looked for work in the past four weeks? The unemployment rate measures the ratio of the second number—the recent job searchers—to the sum of the two numbers (the recent job searchers and the workers). This means that the unemployment rate can decline for two reasons: because more people are finding work or because fewer people are looking for work. Much of the decline in the unemployment rate over the past three years has occurred because the fraction of people who are looking for work has fallen. This characterization is borne out if we look at the evolution of the fraction of people over the age of 16 who have a job—what's called the employment-to-population ratio.

In December 2011, the employment-to-population ratio was 58.5 percent. It has risen, but only to 59.2 percent. Arithmetically, this means that people getting jobs accounts for well under one-half of the fall in the unemployment rate over the past three years.

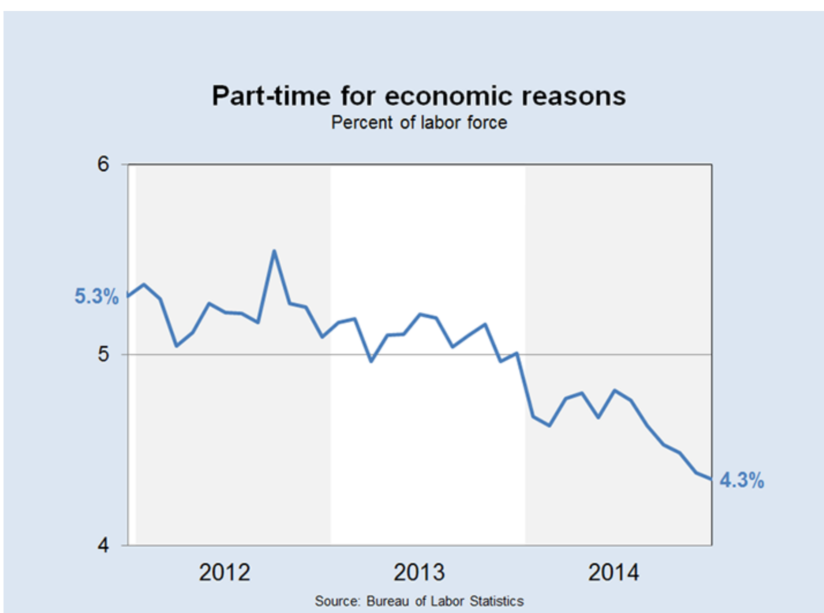
The good news is that the employment-to-population ratio did grow markedly in the past year. And this increase is especially notable given underlying demographic trends. As the baby boom birth cohort—born between 1946 and 1964—ages, the fraction of retirees in the population grows steadily. This demographic force, in and of itself, would have led to a decline in the employment-to-population ratio over the past three years.

One simple way to adjust for this demographic impulse is to focus on people in their prime working-age years. Here, I've plotted the fraction of the population aged 25 to 54 who have a job.



Again, we have seen steady improvement in this fraction over the past three years. The rate of improvement was especially marked in the past year.

Of course, just because someone has a job does not mean that they are necessarily fully employed. The Bureau of Labor Statistics reports each month on the number of Americans who are working part time, would like to work more hours, but are unable to obtain those additional hours. That fraction of the labor force has fallen over the past three years.



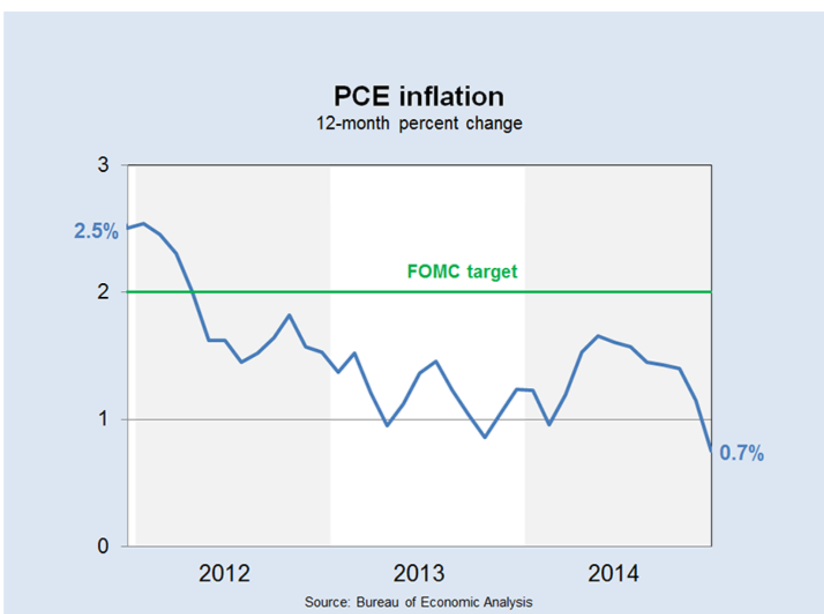
All told, these charts document improvement in all of these measures of labor market performance over the past three years. And in all three measures, the rate of improvement was especially rapid in the past year.

Should Americans view the FOMC's performance with respect to the maximum employment mandate as being satisfactory? That's a hard question to answer on the basis of these pictures alone. Employment growth is clearly better than no growth (or, worse, negative growth). But we are still left with the question: Should the FOMC have facilitated even faster employment growth? To answer this question, we need to examine the behavior of prices.

Price stability

Accordingly, I now turn to the FOMC's performance relative to its price stability objective. As I noted earlier, operationally, the FOMC has translated this objective into keeping the rate of increase of the price level—that is, the inflation rate—close to 2 percent. Even more specifically, the FOMC uses what's called the personal consumption expenditures (or PCE) price index to calculate inflation. This measure of inflation captures the rate of increase in all goods and services, including those related to food and energy.

Here's a graph of how PCE inflation has behaved over the past three years.

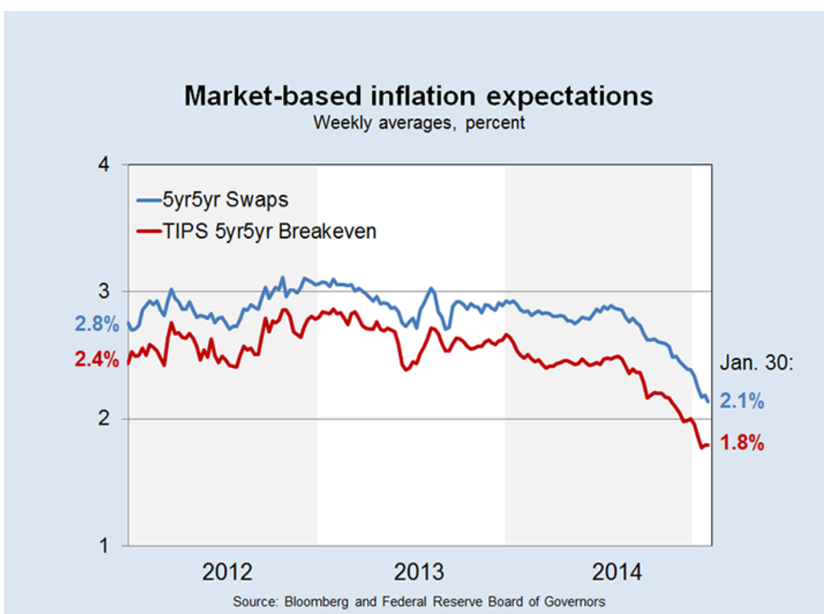


I see three main take-aways from this picture. First, PCE inflation has averaged 1.3 percent per year since December 2011. This is well under the FOMC's 2 percent target. Second, PCE inflation has been below 2 percent for a long time—over two-and-a-half years. Finally, there was little pickup in inflation last year.

The American public should certainly not expect the FOMC to hit its inflation target every month. But two-and-a-half years is a long time. The FOMC's performance in terms of price stability can be summarized pretty simply: The Committee has not provided sufficient stimulus to hit its inflation target.

This persistent underrun of the inflation target creates a risk to the credibility of the Committee's target. For monetary policy to be effective, it is critical that investors and other members of the public believe that the FOMC is in fact aiming at 2 percent inflation, and not at some higher or lower figure. Persistent deviations from the target may weaken those beliefs.

Recently, there have been signs of exactly this kind of reduction in FOMC credibility in financial market data. Here, we've plotted the behavior of two market-based measures of longer-term inflation expectations.



These series are not based on surveys. Rather, they are imputed from the prices of particular financial assets. They use those prices to construct measures of inflation expectations five to 10 years hence. Thus, the measure in late 2014 captures inflation expectations for the period 2019-2024. By looking this far ahead in time, we can strip away temporary, short-run influences on the economy and focus on market participants' beliefs about the FOMC's future intentions.

The main take-away is that both of these metrics have drifted downward over the past three years. Indeed, they have fallen especially sharply in the past few months. The FOMC, so far, has largely failed to take substantial policy action in response to these declines. That lack of a response creates additional downside risk to the credibility of the 2 percent inflation target.

I close my discussion of price stability by circling back to a question about the employment mandate that I posed earlier: Should the FOMC have stimulated more rapid employment growth? The data on inflation suggest an answer to this question. Recall that monetary stimulus pushes both employment and prices in the same direction. By providing somewhat more stimulus, the FOMC could have stimulated at least somewhat more employment growth, *without creating undue inflation*. I am sure that this faster employment growth would have been welcomed by the American public. So, even though employment grew, it seems that there was an improvement opportunity: The FOMC should have facilitated even faster employment growth.

My summary assessment is that the FOMC underperformed in the past three years with respect to the price stability mandate and the employment mandate. I'm sometimes asked, "What concrete actions could the FOMC have taken to provide additional stimulus?" I think one concrete action would have been *not* to reduce stimulus. In mid-2013, the FOMC began communicating about the eventual elimination of its asset purchase program that took place from December 2013 and October 2014. These communications, and the follow-up actions, served as a tightening of monetary policy. Accordingly, they were associated with sharp increases in market interest rates and sharp reductions in the rate of home mortgage refinancing.

Future choices

I've discussed FOMC performance over the past three years relative to the FOMC's objectives. I now want to turn to the question of how I believe monetary policy stimulus should evolve over the coming year so as to best achieve the FOMC's objectives. I will focus on the particular issue of how the FOMC should adjust the target range for the fed funds rate—the short-term interbank lending rate. As has been true for over six years, the target range is currently set between zero and a quarter percentage point. The main issue facing the Committee is: Should that target range be raised soon?

To answer this question, I find it helpful to return to my earlier analogy of a corporate performance evaluation. Many employees in America are evaluated in terms of their performance with respect to pre-assigned goals. They are given a great deal of latitude in terms of how to make choices that will achieve those objectives. The best employees, of course, are the ones who consistently use that flexibility to optimize their success with respect to their pre-assigned goals.

The FOMC—an employee of the public—also enjoys a great deal of latitude. To be a good employee, it should use that latitude to optimize its success with respect to achieving its macroeconomic goals. This *goal-oriented approach to monetary policy* would focus on keeping the economy as close as possible to the FOMC's objectives for prices and employment.

A goal-oriented approach has sharp implications for near-term monetary policy decisions. My own current assessment is that it will take a few years for inflation to return to 2 percent from its current low level. As I noted earlier, monetary policy affects prices with about a two-year lag. Raising the target range for the fed funds rate in 2015 would only further retard the pace of the slow recovery in inflation. It would also increase the risk of a loss of credibility, in the sense that the public could increasingly perceive the FOMC as aiming at a lower inflation target. Hence, given my current outlook for inflation, I anticipate that, under a goal-oriented approach, the FOMC would not raise the fed funds rate target this year.

Deciding not to reduce stimulus in 2015 would also be consistent with a goal-oriented approach to the employment mandate. Increases in stimulus would push upward on employment. Such an increase in employment is entirely consistent with the pursuit of maximum employment that Congress has mandated for the FOMC.

Admittedly, there has been considerable skepticism over the course of the past five years about the ability of monetary or fiscal policy to stimulate employment growth. I have expressed some of those concerns myself on occasion. But look at how rapidly employment actually grew in 2014! The job market is—finally—on a highly desirable upward trajectory. We are more likely to continue on that welcome trajectory if the FOMC does not tighten monetary policy in 2015.

Community Banks

In the rest of the talk, I will turn my attention to community banks. I see community banks as playing an important role in promoting the price and employment goals of the Federal Reserve. Supervision and regulation of these entities is, of course, necessary to mitigate the risk of taxpayer loss. But it is also necessary for the supervisory and regulatory framework to be appropriately structured to allow community banks to fulfill their necessary economic function.

I will build on remarks I made in the summer of 2014, where I discussed the need to better tailor supervision and regulation to the risks actually posed by community banks. In those remarks, I emphasized the benefits of a statutory approach to tailoring. I'm glad to be able to report that there has been progress along those lines since I spoke in the summer. In that speech, I also provided two additional tailoring options: one concerning regulation and one concerning supervision. We have seen progress on the regulatory options, and I will review those advances. I will conclude with additional thoughts on supervisory tailoring.

The statutory advance with respect to regulatory tailoring concerns an expansion in the number of small bank and thrift holding companies exempted from consolidated capital requirements. Late last year, Congress put the vast majority of holding companies, both bank and savings and loan holding companies, with $1 billion or less in assets under the Fed's small bank holding company policy. This means that approximately 25 additional holding companies in Minnesota will now avoid capital requirements. The Board of Governors issued an interim final rule and notice of proposed rulemaking on Jan. 29, 2015, to further implementation of the new law.

Comments on the rule and the proposal are due by March 4, 2015, and I encourage all of you to provide your feedback.

There are several features of this reform worthy of emulation:

- Congress exempted select small firms explicitly and clearly by statute. As I emphasized last summer, this is the best way to prevent regulatory creep.
- The reform has the potential to produce cost savings for small firms in multiple ways, including reduction in capital requirements and potential reductions in the costs of regulatory reporting.[3]
- The changes went into effect quickly. Legislation to make the change was introduced around the same time that Federal Reserve Governor Tarullo raised this reform option (around early November 2014).[4] Congress passed legislation increasing the asset size of holding companies under the policy from $500 million to $1 billion, which the president signed on Dec. 18, 2014.

I look forward to the Board of Governors continuing the rapid pace of implementation associated with this reform. In particular, I see benefits in extending the small holding company policy to some firms with assets of less than $10 billion. Some firms of that size are effectively large community banks, in terms of their overall risk profile. I am also encouraged by the seriousness with which the Federal Reserve and the other agencies are taking the regulatory review required under the Economic Growth and Regulatory Paperwork Reduction Act of 1996 (EGRPRA). I encourage the Minnesota Bankers Association and all banks in the state of Minnesota and the Ninth Federal Reserve District to continue to provide suggestions on tailoring regulation for community banks under that review.

But regulation is not the only area for tailoring. A second fruitful approach to additional tailoring concerns supervision. I worry that our current supervisory methods establish

[3] Firms covered by the small bank holding company policy file holding company regulatory reports only twice a year instead of four times a year for firms not covered by the policy.
[4] See the speech by Governor Daniel K. Tarullo, "A Tiered Approach to Regulation and Supervision of Community Banks," at the Community Bankers Symposium, Chicago, Nov. 7, 2014.

expectations that are too detailed across too many areas of bank operations and too wide a swath of banks. Alternatively, supervisors could concentrate on a smaller number of activities that we believe are correlated with bad outcomes. To be specific, supervisors could choose to focus on rapid loan growth, high lending concentrations, specific high-risk types of lending and wholesale funding strategies, and curtail some of the more detailed reviews at lower-risk institutions. This shift in focus might generate higher returns to society, in terms of improved safety and soundness per dollar spent, than detailed work programs. To be clear: I'm suggesting a tailored approach, and so supervisors would retain the more comprehensive, proscriptive approach for larger, systemically important banks.

Conclusion

Let me wrap up.

2014 was an outstanding year from the point of view of employment growth. Nonetheless, as I emphasized in my discussion, the sluggish behavior of prices over the past few years suggests that there is room for further improvement. I expect inflation to remain below 2 percent for a few years. That outlook gives the FOMC plenty of headroom in which to use monetary policy stimulus to facilitate continued labor market improvement. Better tailoring of community bank supervision and regulation, of the kind that I discussed today, would also help promote our price and employment objectives.

Thanks for listening. I look forward to your questions.