Opening Remarks

Town Hall Forum

Federal Reserve Bank of Minneapolis

Minneapolis, Minnesota

January 8, 2015

Narayana Kocherlakota
President
Federal Reserve Bank of Minneapolis

Thanks for joining us here tonight. The plan is for us to spend the bulk of our time answering your questions. However, I thought that it might be informative for me to kick things off with some remarks about monetary policy. I'll begin with a discussion of monetary policy objectives. I'll describe how the Federal Reserve has done relative to those objectives over the past three years. Then I'll turn to a brief analysis of what I anticipate will be appropriate monetary policy choices in 2015, in terms of achieving those objectives. Throughout my remarks tonight, 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.

Federal Reserve System objectives

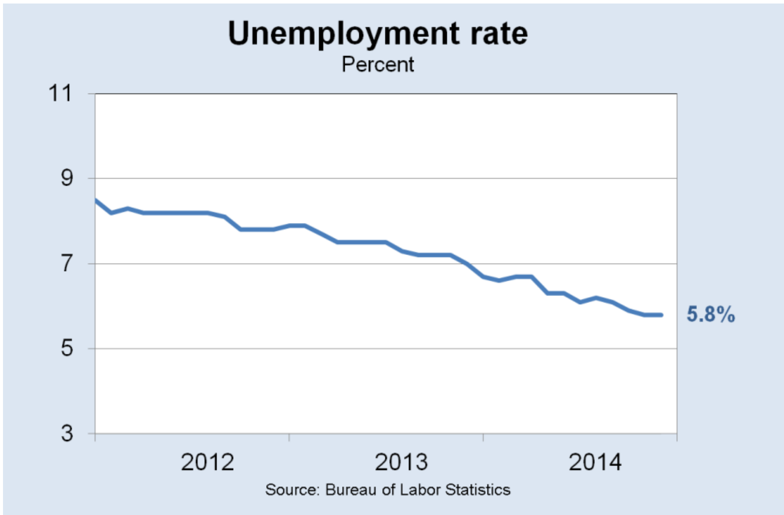
As you have heard, I have the privilege of serving on the Federal Open Market Committee, the monetary policymaking arm of the Federal Reserve. At FOMC meetings, we decide on the level of monetary stimulus for the economy. For now, I won't get into too many details of what that term "monetary stimulus" 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 5.8 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.

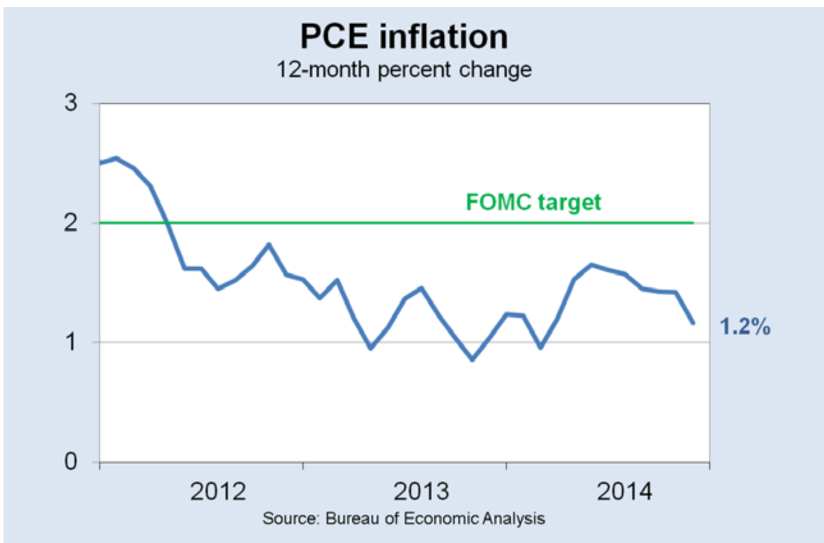
Should Americans view the FOMC's performance with respect to the maximum employment mandate as being satisfactory? That's a hard question to answer on the basis of this picture for at least a couple of reasons. First, there are other labor market metrics besides the unemployment rate, and many of these other metrics depict less labor market improvement in the past three years. (All of the metrics agree, though, that labor markets improved markedly in 2014.)

Second, regardless of how much we believe labor markets have improved in the past three years, we are still left with the question: "Would it have been appropriate for the FOMC to make choices that would have facilitated even faster improvement in labor market conditions?" To answer this question, we need to turn to 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, 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 price index, or PCE, 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 (less than) 1.4 percent per year over this time period. 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. 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 that target may weaken those beliefs. Recently, there have been signs of exactly this kind of reduction in FOMC credibility in declines in longer-term inflation expectations based on financial market data. 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 improvement in labor market conditions? 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 faster improvement in labor market conditions, *without creating undue inflation*. I am sure that this faster improvement in labor market conditions would have been welcomed by the American public. So, even though the unemployment rate fell, it seems that there was an improvement opportunity: Given how low inflation was, the FOMC could have, and should have, facilitated even faster employment growth.

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, that target range is currently set between zero and a quarter percentage point. The main issue facing the Committee is this: Should that target range be raised soon?

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 roughly 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 to the credibility of the FOMC's inflation target, in the sense that the public could increasingly perceive the FOMC as aiming at a lower inflation rate. Hence, given my current outlook for inflation, the FOMC can best achieve its macroeconomic objectives by not raising the fed funds rate target this year.

Deciding not to reduce stimulus in 2015 would also be appropriate in terms of the employment mandate. Increases in stimulus push upward on employment, and employment increases are always consistent with the pursuit of maximum employment that Congress has mandated for the FOMC.

Thanks for listening. And now, let's turn to the real focus of this evening: your questions.