

Back Inside the FOMC

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Thanks for the generous introduction. I'm delighted to have this opportunity to speak with you today, and of course I'm very pleased to make my first official visit to Missoula, here on the western edge of the Federal Reserve's Ninth District. My most recent speech was near the eastern tip of the district, in the Upper Peninsula of Michigan, and these trips reinforce not only the diverse nature of the district's economy for me, but also its natural beauty. And Missoula is certainly second to none in the district when it comes to natural beauty. Of course, that takes nothing away from the Upper Peninsula, or Minnesota, or the Dakotas, or Wisconsin, too, for that matter. You get the picture: We have the most beautiful district in the Federal Reserve System, and you can quote me on that.

Before I proceed, I want to acknowledge the presence of the board of directors for our Helena Branch, with whom I had the pleasure to meet this morning: John Franklin, a banker from Sidney; Tim Bartz, an accountant from Helena; Dave Solberg, a rancher from Billings; and Joe McDonald, the recently retired president of Salish Kootenai College in Pablo. In addition to these folks, there are former directors in attendance, as well as members of our advisory councils on small business, labor and agriculture. I won't name them all, or I would likely have to go through a list of many in this room. However, I think it's important for people to realize that the Federal Reserve is represented by dedicated citizens like these on all of our bank and branch boards of directors, and I will have more to say on this feature of our Federal Reserve System in a moment. Thanks to all of you for your service.

One of the benefits of these trips is that I get to hear how the economy is doing on the ground level, if you will. As you might imagine, we have a lot of data at our fingertips at the

Federal Reserve Bank of Minneapolis, but sometimes statistics don't tell the whole story. On that note, I'm especially looking forward to the question-and-answer session following my talk. I've learned much from the questions at my various speaking engagements and expect that I'll do the same today.

As you just heard, I became president of the Federal Reserve Bank of Minneapolis last October. Here's the start of a rather typical conversation that I would have had with my friends and relatives last fall. "Congratulations! That's fantastic. Now, what is it that you will do exactly?"

As it turns out, the job has a lot of interesting aspects. But I think I've been invited to speak here today because I help formulate monetary policy for the United States. So what I plan to do is give you some feel for how this part of my job works. In doing so, I'll highlight the Federal Reserve's quintessentially American structure. Unlike the central banks of other countries, you'll see that ours is specifically designed to draw upon the insights of small-town businesses, farmers and ranchers, and large manufacturers, among others, to formulate monetary policy. Before I proceed, I must remind you that any views I express here today are my own, and not necessarily those of others in the Federal Reserve System.

What do I mean by an American structure? 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 represents the ninth of the 12 Federal Reserve districts and 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 short-term 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. (Actually, in the August meeting, there were only five governors, and there are now only four after the retirement of Don Kohn. The good news is that the White House has nominated three excellent candidates for the three vacancies.) 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 (currently Cleveland, St. Louis, Kansas City, and Boston). I'll be on the committee in 2011.

In this way, the structure of the FOMC mirrors the federalist structure of our government. Representatives from different regions of the country—the various presidents—have input into FOMC deliberations. The input from the presidents relies critically on information they receive from their districts about local economic performance. We obtain this information through the work of our research staffs—but we also obtain it from business leaders in industries and towns, in my case, across the Upper Midwest. The Federal Reserve System is deliberately designed so that the residents of Main Street are able to have a voice in monetary policy.

So how, exactly, do the FOMC meetings work? In the remainder of my remarks, I'll take you inside an FOMC meeting. Its structure provides a perfect vehicle to communicate the key considerations confronting monetary policymakers in the United States.

The typical FOMC meeting features two so-called go-rounds, in which every president and every governor has a chance to speak without interruption. The first go-round is referred to as the economics go-round. The meeting participants describe their views on current economic conditions and their outlook for future economic conditions. The presidents' remarks will

typically include references to their own local economies, as well as the national and global situation.

As part of my contributions to the economics go-round in August, I discussed my outlook for GDP, inflation, and unemployment. In terms of GDP, I believe that a modest recovery is under way and is likely to continue. In terms of inflation, I expect a slight but welcome uptick over the next 18 months. Finally, in terms of unemployment, I see current and future problems in labor markets that may be difficult to combat using the tools of monetary policy.

I'll talk first about GDP. Real GDP growth has been positive in each of the past four quarters, and the government's second estimate is 1.6 percent for the second quarter of this year. Based on estimates from our Minneapolis forecasting model, I expect GDP growth to be around 2.5 percent in the second half of 2010 and close to 3.0 percent in 2011. Together over 2010 and 2011, I'm now predicting that GDP will grow around 2.8 percent per year. In contrast, in my first speech about seven months ago, I predicted that GDP would grow around 3.0 percent per year over 2010 and 2011. There is a recovery under way in the United States. But, as expected, it is a modest one.

Let me turn now to inflation. From the fourth quarter of 2009 through the second quarter of 2010, the change in the PCE price level was just over 0.5 percent, which works out to an annual rate of just over 1 percent. The Fed's price stability mandate is generally interpreted as maintaining an inflation rate of 2 percent, and 1 percent inflation is often considered to be too low relative to this stricture. I expect inflation to remain at about this level during the rest of this year. However, our Minneapolis forecasting model predicts that it will rise back into the more desirable 1.5-2 percent range in 2011.

So the news about inflation and GDP is in the "good, but certainly could be better"

category. However, the lack of vitality in the U.S. labor market can only be termed disturbing. The national unemployment rate remains at 9.6 percent in August. Private sector job creation remains weak—only 67,000 net private sector jobs were created in August. I do not expect the unemployment rate to decline rapidly, and so I expect it to be above 8.0 percent into 2012.

If one digs deeper into the data, the situation seems even more troubling. Since December 2000, the Bureau of Labor Statistics has been keeping data on the job openings rate, which is defined as the number of job openings divided by the sum of job openings and employment. Not surprisingly, when job openings rise, the unemployed can find jobs more readily, and the unemployment rate typically falls. The inverse relationship between the unemployment rate and the job openings rate was extremely stable throughout the 2000-01 recession, the subsequent recovery, and on through the early part of this recession.

Beginning in October 2008, this stable relationship began to break down, as the unemployment rate rose much faster than could be rationalized by the fall in job openings. Over the past year, the relationship has completely shattered. The job openings rate has risen by about 20 percent between July 2009 and June 2010. Under this scenario, we would expect unemployment to fall because people find it easier to get jobs. However, the unemployment rate actually went up slightly over this period.

What does this change in the relationship between job openings and unemployment connote? The disincentive effects of extended unemployment insurance benefits are one possible cause for this change. However, I suspect that these effects are not all that large. I am comfortable with the San Francisco Fed's 2009 estimate, which finds that the extensions of benefits have boosted the unemployment rate by 0.4 percent.

The bigger issue is mismatch. Firms have jobs, but can't find appropriate workers. The

workers want to work, but can't find appropriate jobs. There are many possible sources of mismatch—geography, skills, demography—and they probably interact in nontrivial ways. For example, there may be jobs available in eastern Montana and western North Dakota because of the oil boom. But a household in Nevada that is underwater on its mortgage may find it difficult to move to those locations.

Of course, the key question is: How much of the current unemployment rate is really due to mismatch? The answer seems to be a lot. I mentioned that the relationship between unemployment and job openings was stable from December 2000 through June 2008. Were that stable relationship still in place today, and given the current job opening rate of 2.2 percent, we would have an unemployment rate closer to 6.5 percent, not 9.6 percent.<sup>1</sup> Together with the San Francisco Fed's estimate of the impact of benefits, this analysis implies that over 2.5 percentage points of the current unemployment rate is attributable to mismatch.

This estimate is based on a rather aggregative view of the labor market. It is important to dig deeper to get a better understanding of the problem, and there is a considerable amount of research under way exploring the quantitative importance of the various forms of mismatch. For example, the International Monetary Fund has recently released a special study based on a new state-by-state measure of the gap between demand and supply for workers with different levels of educational attainment. The study examines the impact of this variable and the foreclosure rate on state-level unemployment. It estimates that 1.5 percentage points of the national

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<sup>1</sup> I use the following procedure to reach these conclusions. I calibrated parameters in Shimer's (2007) mismatch model to fit the average level of vacancies from December 2000 to December 2007 and the average level of unemployment over the same period. I obtained  $m = 210.5$  and  $n = 205.5$  to fit an average unemployment rate of 5.2 percent and an average vacancy rate of 2.9 percent. (The calibrated parameters differ from Shimer's own because of data revisions by the Bureau of Labor Statistics.) In June 2008, the unemployment rate was 5.5 percent and the vacancy rate was 2.7 percent; the model implied an unemployment rate of 5.5 percent and a vacancy rate of 2.6 percent if I set  $n = 204.2$ . In June 2010, the vacancy rate was 2.2 percent. I set  $n = 201.8$  to match that in the model. At that value of  $n$ , the model implied an unemployment rate of 6.3 percent. The value of  $m$  in Shimer's model has changed greatly.

unemployment rate is due to these two sources and their interaction. Thus, according to this study, these two types of mismatch alone can account for a significant fraction of my estimate of 2.5 percentage points.

Good economic policy is about using the right tool for the problem at hand. The mismatch problems in the labor market do not strike me as readily amenable to the kinds of monetary policy tools currently available to the Fed. But they may well be amenable to other types of policy tools, like job retraining programs or foreclosure mitigation strategies. As Chairman Bernanke said in his Jackson Hole speech in August, central bankers alone cannot solve the world's economic problems.

That was essentially my input into the economics go-round of the FOMC in August. GDP is growing, but more slowly than we would like. Inflation is a little low, but only temporarily. The behavior of unemployment is deeply troubling.

After the economics go-round, the FOMC meeting then transitions to its second phase, the policy go-round. Again, the meeting participants have a chance to speak in turn about what they perceive to be the appropriate policy choices for the committee. We all are committed to achieving the Fed's dual mandate to attain both price stability and maximum employment. The former objective is generally understood as keeping inflation in a tight range around 2 percent. The second part of the mandate is much more of a moving target. Employment is shaped by many determinants beyond the Fed's control: demographics, social custom, taxes, and so on. The Fed's job is to keep employment as high as possible, given these other factors.

Right now, the committee has to think about two quite distinct policy tools: short-term interest rates and balance sheet management. I'll talk about both in turn.

The federal funds rate—the key short-term interest rate set by the FOMC—has been set



at 0-25 basis points for over a year and a half. The FOMC's August statement contains the following key sentence:

“The Committee will maintain the target range for the federal funds rate at 0 to 1/4 percent and continues to anticipate that economic conditions, including low rates of resource utilization, subdued inflation trends, and stable inflation expectations, are likely to warrant exceptionally low levels of the federal funds rate for an extended period.” (See the FOMC statement at <http://www.federalreserve.gov/newsevents/press/monetary/20100810a.htm>.)

What do we learn from this rather long sentence? As you would hope, there is an intimate connection between my economics summary and what's in this statement. The unemployment rate is 9.6 percent, and measured inflation is low (below 2 percent). Market and survey measures of expected inflation are also low (also below 2 percent). In its statement, the FOMC is saying: We're keeping interest rates low to keep unemployment from going any higher, and we feel safe in doing so because there seems to be little threat of inflation.

Let me turn next to the issue of the Fed's balance sheet. The Federal Reserve has 2.3 trillion dollars of assets—over 2.5 times what it owned in September 2008. Over 2 trillion dollars of those assets are in Treasuries, debt issued by Fannie Mae and Freddie Mac, or mortgage-backed securities issued by Fannie Mae and Freddie Mac. These MBSs are backed by the U.S. government—the Federal Reserve faces no credit risk in holding them. But they do have another kind of risk called prepayment risk. If long-term interest rates are low, then many people prepay the mortgages in the MBS. The owners of the MBS—in this case, the Fed—get a large coupon payment and the MBS's principal falls. However, if long-term interest rates are high, then few people make these prepayments.

This kind of fluctuation in prepayments is at the heart of the FOMC's new policy action in August. Long-term interest rates have declined surprisingly fast since April. But the fall in long-term rates led more people to prepay their mortgages. As a result, MBS principal balances were falling. In this sense, the Fed's holdings of long-term assets were shrinking, leaving a larger share of the long-term risk in the economy in the hands of the private sector. According to estimates in a recent paper,<sup>2</sup> this extra risk in private hands could force up the risk premia on long-term bonds by around 20 basis points and be a drag on the recovery. The FOMC decided to arrest the decline in its holdings of long-term assets by reinvesting the principal payments from the MBSs into long-term Treasuries.

As I mentioned, I'm not a member of the FOMC during this calendar year and so I did not vote in the August meeting. However, I would have voted for the FOMC statement in August had I actually been a member of the committee.

So, I've taken you through a typical FOMC meeting and the monetary policy situation in the United States. My discussion may have struck you as rather techy and wonkish—maybe even verging on the nerdy. I'm sure that my colleagues will forgive me for saying that this nerdy quality mirrors the tone of the discussion within the committee itself. There is no inflated political rhetoric. We are unabashed technocrats, seeking to solve an unabashedly technical problem: How do we manage monetary policy so as to ensure lower unemployment and maintain inflation at an appropriate rate? We certainly disagree with one another on occasion. But our disagreements ultimately stem from different assessments of the complicated economic situation and not from political differences.

I believe that the apolitical nature of the FOMC's work hinges critically on another aspect of central bank structure, and that has to do with the Federal Reserve's relationship with the U.S.

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<sup>2</sup> See Gagnon et al. (2010).

Congress. On the one hand, the Federal Reserve is a creation of Congress. It has the power to amend the Fed's responsibilities, as the recent financial reform legislation certainly attests. The Senate approves the presidential appointments to the Board of Governors. Both chambers receive regular reports from the Board of Governors on the conduct of monetary policy, financial supervision, and the payments system. In addition, the Federal Reserve undergoes regular audits of its finances and various operations.

On the other hand, Congress has intentionally removed itself from the direct conduct of monetary policy by granting the Federal Reserve the independence to perform this function on its own. In effect, Congress has said that it does not want monetary policy unduly affected by political considerations. This independence is not only a hallmark of this country's central bank, but is also a characteristic of developed economies worldwide.

So I've talked about a lot of issues today, and I could certainly talk about a lot more. But I have a feeling that you've got plenty of questions, and we are likely to hit on many key topics. So I will stop here and happily take your questions.

Thank you once again for this opportunity.

## References

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