

Monetary Policy, Labor Markets, and Uncertainty

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Thank you for that generous introduction, and thank you especially for the opportunity to meet with this group today; it is truly a pleasure to be here in Sioux Falls. I'm especially pleased to be here because this marks my first official visit to South Dakota since I became president of the Minneapolis Fed. It also means that in 2010, I've visited all six states that encompass the Ninth District in the Federal Reserve's 12-district system.

I have had the pleasure of meeting with a number of business leaders from the Sioux Falls area prior to this event. I would like to thank you all for taking time from your busy schedules. Included in this group are current and former members of our bank's board of directors and advisory councils for small business and agriculture, and I would especially like to thank them all for their service to the Federal Reserve and, by extension, to the nation as a whole. As I will discuss more in a moment, one of the great benefits of taking trips like this is to meet with local residents to gain a deeper understanding of what is happening in the local economy. And one of the pleasures of giving talks like this is taking your questions at the end. I always learn a great deal from these discussions, and so I look forward to hearing from you at the close of my remarks.

In this speech, I will discuss current macroeconomic conditions and the Federal Open Market Committee's recent actions taken in response to those conditions. I'll move on to dive a little deeper into conditions in the U.S. labor market. I'll close by talking briefly about uncertainty and its drag on the economic recovery. The views I express here today are my own, and not necessarily those of my colleagues in the Federal Reserve System.

Let me start with some basic context about how monetary policy gets made in the United States. 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. As I mentioned, 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 September meeting, there were only four governors. The good news is that we were back up to six governors by the November meeting, and the White House has nominated Peter Diamond—who just won the Nobel Prize in economics—for the remaining vacancy.) 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.

With that backdrop, let me move on to discuss the FOMC's most recent deliberations. The foundation of the committee's discussions is what is called its dual mandate. By statute, the Federal Reserve is required to provide appropriate conditions for long-run economic performance by achieving both price stability and maximum employment. The former objective of price stability is generally understood as keeping inflation in a range of around 1.5 to 2.5 percent. The second part of the mandate—maximum employment—is more of a moving target, because employment is shaped by many determinants beyond the Fed's control: demographics, social custom, taxes, technology, and so on.

Over the first three quarters of this year, personal consumption expenditure (PCE) price inflation has averaged roughly 1 percent at an annualized rate. This rate is low relative to the FOMC's target of 2 percent. More troublingly, the inflation rate is drifting downward. Over the preceding two-year period (from the fourth quarter of 2007 through the fourth quarter of 2009), PCE inflation averaged 1.6 percent per year.

At the same time, unemployment is high: In October, it was 9.6 percent. Here, too, the trend is not comforting. The recession officially ended in June 2009, and in that month, unemployment was 9.5 percent. Unemployment has actually risen slightly during the course of the recovery.

Sufficient growth in output can steadily lower unemployment. But growth has been low in this recovery compared with most. As I mentioned, the recession officially ended in June 2009 and so has been over for five quarters. Over those five quarters, real gross domestic product (GDP) has grown at an annualized rate of under 3 percent. More alarmingly, growth

has been decelerating: In the past two quarters, it has averaged less than 2 percent at an annualized rate.

This is the economic situation that confronted the FOMC in its November meeting. Inflation and employment are both too low, and the pace of recovery is too slow. Economic growth is low and softening further. I think it is safe to say that, given this situation, the FOMC would have liked to have been able to cut its target interest rate. But this option is not available. The FOMC's target interest rate is already essentially at zero (more precisely, in a range between 0 and 25 basis points).

But the FOMC does have another policy instrument available: its balance sheet. As of the beginning of this month, the FOMC had a portfolio of roughly \$2.3 trillion. Over 2 trillion of those dollars are invested in Treasury securities or government-backed securities issued by Fannie Mae, Freddie Mac, and other government-sponsored enterprises. At its November 3 meeting, the FOMC announced that it plans to buy \$600 billion of long-term Treasuries in the open market by mid-2011. In exchange for those securities, it will credit the sellers' accounts at the Fed with more reserves. This kind of action is known as quantitative easing, or QE.

The main goal of QE is to lower the long-run *real* interest rate. Just to be clear, by real interest rate, I'm referring to the interest rate net of expected inflation. More specifically, suppose that the interest rate on a 10-year bond is about 2.5 percent and that people expect inflation to be around 2 percent per year over the next 10 years. Then, the real interest rate is about 0.5 percent per year for the next 10 years.

A low long-term real interest rate stimulates an economy in a number of ways. It spurs consumer spending by allowing consumers to borrow and refinance more cheaply. It makes

capital expenditures and hiring more profitable for corporations. Stock prices and house prices rise because those assets become relatively more attractive as investments. Households with these assets become wealthier and demand more consumption. All of these effects should lead to less unemployment and upward pressure on prices.

How does QE go about lowering long-term real interest rates? QE is a sufficiently novel monetary policy tool that different economists may well give different answers to this question. In my view, QE lowers long-term real interest rates in two distinct ways. The first is that QE is a form of nonverbal communication about the FOMC's future plans. Here's what I mean. The November FOMC statement says that the committee will keep the fed funds target range exceptionally low for as long as economic conditions warrant. The statement also predicts that exceptionally low fed funds rates are likely to be warranted for an "extended period" of time. In this way, the statement provides explicit communication about the FOMC's future plans for short-term rates and so also shapes the level of current longer-term interest rates.

QE provides a significant supplement to this explicit verbal communication. The use of QE indicates that the FOMC is likely to keep its target interest rate lower for an even longer period of time. Indeed, one could readily argue that buying \$600 billion of Treasuries is a much more convincing form of communication of the FOMC's plans than any words could ever be.

Thus, QE lowers long-term real interest rates by signaling the FOMC's intentions about future short-term rates. However, QE also lowers long-term real interest rates in a second, more direct, way. The holder of a long-term Treasury is exposed to interest rate risk, because the value of that bond fluctuates as interest rates vary. When the Fed buys \$600 billion of long-term bonds, the bond portfolio of the private sector is now less exposed to this kind of risk. As a

consequence, private investors will demand a lower premium for holding other bonds that are exposed to interest rate risk, and all long-term yields fall.

In this way, the change to the asset side of the Fed's balance sheet provides stimulus to the economy. But what about the liability side of its balance sheet? QE creates more reserves in banks' accounts with the Fed. The standard reasoning is that this kind of reserve creation is inflationary. Banks are only allowed to offer checkable deposits in proportion to their reserves. Economists view checkable deposits as a form of money because, like cash, checkable deposits make many transactions easier. In this sense, bank reserves held with the Fed are *licenses* for banks to create a certain amount of money. By giving out more licenses, the FOMC is allowing banks to create more money. More money chasing the same amount of goods—voila, inflation.

Given some of the criticisms of the Fed that have been voiced over the past three weeks, it is important to understand that this basic logic isn't valid in current circumstances. Banks have nearly \$1 trillion of excess reserves. This means that they are not using a lot of their existing licenses to create money. QE gives them \$600 billion of new licenses to create money, but I do not see why they would suddenly start to use the new ones if they weren't using the old ones.

Some observers have expressed concerns that \$1 trillion—which will shortly become over \$1.5 trillion—of excess reserves represent what they term “kindling” for some *future* inflationary fire. I believe that these concerns are misplaced for two reasons. First, the Fed has several tools with which to combat incipient inflationary pressures. Most obviously, it can raise the interest rate on excess reserves as a way of deterring banks from creating money with their licenses. Second, in recent public statements, Chairman Ben Bernanke has explicitly and firmly

committed the FOMC to maintaining low inflation. To use his exact words, he said that he has “rejected any notion that we are going to try to raise inflation to a super-normal level.”

As I mentioned before, I do not currently vote on FOMC decisions. I did express support for the FOMC’s decision at the recent meeting. As I have said on prior occasions, I believe that there are good reasons to suspect that the ultimate effects of any amount of QE are likely to be relatively modest. Nonetheless, the FOMC’s decision seemed to me to be a move in the right direction.

In the remainder of my prepared remarks, I’ll dig a little deeper into the behavior of the labor market. I’ll use that discussion as a springboard to talk about some longer-run uncertainties that I see as a drag on short-run and medium-term economic performance.

I’ll begin by reminding you of some terms that economists use to talk about labor markets. Every month, the Census Bureau interviews 60,000 households consisting of about 110,000 individuals. The bureau asks a host of questions, but there are two particularly important ones: Have you worked for pay or profit in the past week? If not, have you looked for work in the past four weeks? The former group is counted as the employed. The second group is counted as the unemployed. The sum of these groups is called the labor force. Anyone who answers no to both questions is regarded as being out of the labor force. Note that the Census Bureau pays no attention to whether the interviewee is collecting unemployment benefits or not.

With those definitions—employed, unemployed, and labor force—in mind, I’ll divide the unemployed further into two subgroups. Following the Bureau of Labor Statistics, I’ll refer to those people who have been unemployed for more than six months as being “long-term”

unemployed. By way of contrast, I'll use the term "short-term" unemployed to refer to those who have been unemployed for less than six months. I'll do so while realizing that this latter terminology is more than a little misleading. Most of us would think of someone who has been out of work for six months as having been unemployed for a long, not short, period of time.

In December 2007, at the start of the recession, 4.1 percent of the labor force was short-term unemployed. The recession generated a marked increase in this number. It officially ended in the second quarter of 2009, and in June of that year, 6.7 percent of the labor force was short-term unemployed.

Over the next 14 months, the recovery generated a noticeable increase in job openings. The short-term employment rate responded by regaining nearly half of its recession losses. By the end of October 2010, 5.6 percent of the labor force was short-term unemployed. So, if you only looked at this limited measure of unemployment, you would say: Well, the economy certainly has a long way to go. But we have made progress—in some sense, we're about halfway back. I should note, though, that this recovery in the six-months-and-under unemployment rate has definitely slowed since May.

The problem is that the long-term unemployment rate has not exhibited even this limited amount of progress. In December 2007, only around 0.9 percent of the labor force was long-term unemployed. By June 2009, that number had more than tripled: 2.8 percent of the labor force was long-term unemployed. By October 2010, 16 months into the recovery, that number had risen to 4 percent. This number is unprecedentedly high. As well, nearly three-fourths of the long-term unemployed had in fact been unemployed for over a year. Again, it is unprecedented in post-World War II U.S. history to have 3 percent of the labor force

unemployed for over a year. If history is any guide, this year-plus unemployment rate will only revert to prerecession levels after several years.

The recession has also had a big impact on the employment-population ratio. In March 2007, 63.4 percent of those over 16 had a job. That number has fallen to 58.3 percent. Other than last December, the employment-population ratio had not been this low since mid-1983—27 years ago. To understand how much the employment-population ratio matters, I think it's useful to think about it in a slightly different way. In March 2007, each working person supported 0.58 persons over the age of 16 in addition to themselves. In October 2010, each working person supports 0.72 persons over the age of 16 in addition to themselves. Essentially, every working person now has to support 24 percent extra people over the age of 16. This is a large increase in the burden that each worker faces. Will this fall in the employment-population ratio reverse itself over the next three or four years? I believe that the standard of living of many Americans depends on the answer to this question.

I've been emphasizing uncertainties in the labor market. More generally, I believe that overall uncertainty is a large drag on the economic recovery. One way to gauge the current level of uncertainty is to look at the level of the yields on Treasury inflation-protected securities—so-called TIPS bonds. A five-year TIPS bond has a yield of around –20 basis points. This means that people are giving up \$100 today in exchange for about \$99 of purchasing power in five years. Savers are willing to *lose* purchasing power over time rather than consume more today. Similarly, firms are willing to *lose* purchasing power over time rather than making more capital expenditures.

What explains this behavior on the part of firms and savers? The answer lies in uncertainty about the next five years. Some of it is intrinsic to the structure of the U.S. economy itself. I've discussed the importance of the employment-population ratio. Will the level of employment in 2015 look more like employment in 2000, 2007, or 2010? Will the level of housing prices in 2015 look more like housing prices in 2000, 2007, or 2010? My own assessment is that no policymaker or set of policymakers—no matter how gifted—has the tools available to resolve these uncertainties.

But part of the public's uncertainty has to do with the nature of future taxes and government spending. The federal debt in the hands of the public has gone up by over 50 percent over the past three years. At the same time, the U.S. government has taken on responsibilities for the debts of Fannie Mae and Freddie Mac. It has enacted a new health care plan. Do these changes mean that taxes will rise? If so, taxes on what forms of economic activity? Does it mean that government will cut back on its provision of important types of public goods or on entitlement programs? If so, what kinds of public goods or entitlement programs? Investors and savers need a lot more clarity about what those answers might be. Absent such clarity, the economic recovery will be slower than it otherwise would be.

I don't have the answers to these and other questions about long-run economic policy. However, I do feel from my travels around the Ninth District that the answers may lie within the Upper Midwest. It is certainly true that many parts of the district have found the recent recession to be a challenging time. Nonetheless, the district has generally fared better economically during the recent recession than the nation as a whole. Some of this relative success can be explained by strong markets for oil, minerals, and agricultural commodities. But

it is also true that many cities in the Ninth District—like Sioux Falls—are mostly removed from these economic phenomena—and yet they continue to perform well. We at the Minneapolis Fed are working hard at understanding the factors underlying the relative success of the District. We very much hope that they prove to be ideas or approaches that can be replicated at the national level.

Thanks for your attention. I look forward to taking your questions.