Monetary Policy Report to the People of Rochester, Minnesota[1]

Rochester Chamber of Commerce

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Thanks for the introduction, and thank you for the invitation to join you here today. It's a pleasure to be back in Rochester.

I'll begin my speech with some basics about the Federal Reserve System and the Federal Open Market Committee (the FOMC). But the bulk of my remarks should be viewed as a quarterly report of sorts. Your elected representatives, the Congress of the United States, have charged the Federal Reserve with achieving key macroeconomic goals. My speech will be a report to you, the people of Rochester, about how the FOMC is doing in terms of achieving those goals. Please keep in mind, though, 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 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 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 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 one of those four presidents this year. In this way, the structure of the FOMC mirrors the federalist structure of our government, because representatives from different regions of the country—the various presidents—have input into FOMC deliberations.

This basic federalist structure has a long history. In fact, this year is the centennial of the opening of the 12 Reserve Banks and the start of the work undertaken by the Federal Reserve System. It's been a fascinating hundred years, with many twists and turns along the way. I'm sure that many of you have questions about that journey—for example, how the heck did Minneapolis get chosen over Rochester as headquarters for the Ninth District? The answers to all of your questions—and probably more—are on a new website that the Fed has created at federalreservehistory.org. I encourage you to visit this site to learn more about the people, places and events that have shaped Federal Reserve history.

I won't say too much more about Fed history—perhaps to the relief of some of you!—but I do want to address one of the things that I think has changed the most over the Federal Reserve's history: our communication with the public. A hundred years ago, Congress created a system that was designed specifically so that the residents of Main Street would have a voice in monetary policy. Technology has changed a lot since 1914—I'm told that they didn't even have smartphones back then—and so the ways that we gather information from Main Street have changed. But this fact-finding is still an important part of the making of monetary policy. Indeed, earlier today, I met with southern Minnesota business leaders to gather exactly this kind of information.

Communication is a two-way street, however. During the past century, the Federal Reserve's communications to the public about its monetary policy actions have also evolved greatly. The pace of change was especially rapid in the past eight years under Chairman Bernanke's leadership. During that time, the Federal Reserve specified an explicit target for inflation, began holding regular press conferences and greatly expanded its use of forward guidance—that is, its communications about the likely future evolution of policy. So, as the Federal Reserve System plans for its second century, I would say that the importance of two-way communication is a key lesson from the System's first century. In order for the Fed to continue to be effective, it needs to communicate its policy decisions transparently to the public. Conversely, it also needs the public's input on how those policies are affecting them. Events like the one today, and my meeting with business leaders earlier today, are a key part of fostering that two-way communication.

With that background in mind, 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 the level of monetary stimulus for the economy. I won't get into too many details of what that term "monetary stimulus" means, although I'm more than happy to take questions about it later. For now, I'll just make three 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. Finally, over the long run, monetary policy is the prime determinant of the overall rate of inflation in the economy, but many factors beyond monetary policy affect the level of employment.

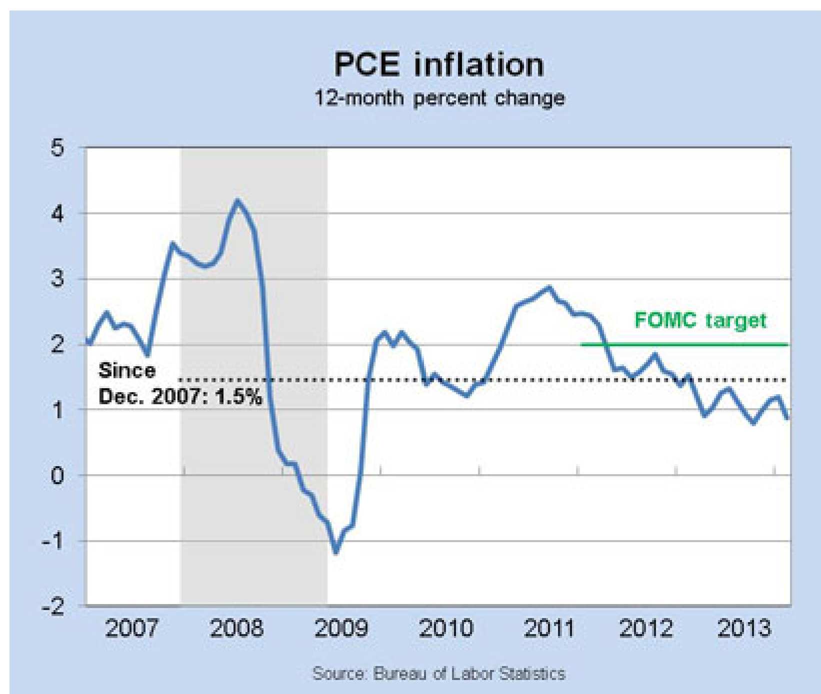
What is the FOMC seeking to achieve by varying the level of monetary stimulus? Congress has charged the FOMC with making monetary policy to promote price stability and to promote maximum employment. The FOMC has interpreted the first goal, price stability, to mean keeping inflation close to 2 percent.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

The remainder of my speech will take the form of a report to you about how the FOMC is doing in terms of meeting these goals set for us by your elected representatives in Congress.

Price Stability

I will start with price stability. Again, operationally, the FOMC has translated this 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 expenditure 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.

The Great Recession is dated as starting in December 2007. Here's a graph of how PCE inflation has behaved since that date.



The main take-away is that, since that date, the PCE inflation rate has averaged 1.5 percent per year. Furthermore, there has been a downward drift since early 2012. Currently, the PCE inflation rate is running near 1 percent.

So, inflation has been running too low over the past six-plus years to be consistent with price stability. The good news is that the FOMC does expect inflation to turn back toward 2 percent. However, I expect that return to 2 percent to take a long time—probably on the order of four years. And I'm not the only one forecasting a slow return to 2 percent inflation. Earlier this year, the Congressional Budget Office predicted that inflation will not reach 2 percent until 2019.

To sum up: The FOMC is undershooting its price stability goal.

Low Inflation: Why It Matters

I've told you that inflation has been, is and will be too low relative to the FOMC's target of 2 percent. But why should you care that inflation is too low? Isn't it a good thing when goods and services aren't as expensive to buy? The answer to this—very good—question is: You should care because below-target inflation signals a significant problem in our economy.

Let me explain what I mean. At a basic level, you should think of prices as a signal about how our economy is using its available resources. In 2012, I had an experience that brought home this intuition in a very clear way. I visited Williston, on the western edge of North Dakota. As it is today, when I visited Williston, it was in the heart of a major oil boom. That boom was pushing hard on the physical resources—like roads, water, housing—available to Williston and pushing hard on the human resources available to Williston. The result was relatively high inflation.

So, when inflation is high compared to the Fed's target, like it was in Williston, we know that demand is pushing hard on available resources. The converse is also true: Inflation is low compared to the Fed's target when the demand for goods and services is too low to fully use the available resources in society. The low inflation in the United States tells us that resources are being *wasted*.

What exactly are these wasted resources? There are multiple answers to this question—when demand is too low, lots of resources are left unused. But the biggest and most disturbing answer is our fellow Americans. There are many productive people in the United States available to work more hours, and our society is deprived of their production.

This key point is generally underappreciated. I've said that the FOMC is undershooting its price stability objective and is expected to continue to do so. But we should all keep in mind that this outcome—and especially the forecast for continued undershooting—typically means that the FOMC is also underperforming on its other objective of promoting maximum employment.

Maximum Employment

I've argued that the low inflation rate is a signal that the FOMC is underperforming with respect to its maximum employment objective. But we don't need to rely on this signal to reach this conclusion. We can readily see this underperformance in numerous key metrics of labor market performance.

I'll begin by showing you data on the evolution of the unemployment rate. In March 2007, the unemployment rate was 4.4 percent. It rose slowly throughout 2007 to reach 5 percent by the end of the year. The National Bureau of Economic Research dates the Great Recession as having begun in that month. In the wake of the recession, the unemployment rate reached a peak of 10 percent in October 2009.

Since that date—over four years ago!—the unemployment rate has fallen slowly to 6.7 percent. This is still unusually high relative to the past quarter century or so. The current unemployment rate is also high relative to most forecasts of its expected long-run level. Personally, I expect that, over the long run, the unemployment rate will converge to just over 5 percent. Basically, an unemployment rate of 6.7 percent means that the U.S. labor market is far from healthy.

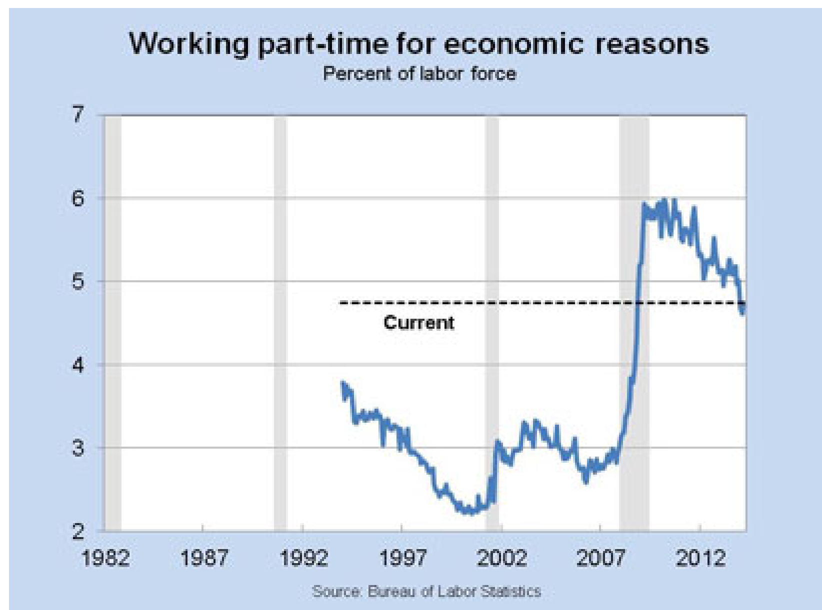
But I would say that this measure—troubling as it is—could well overstate the degree of improvement in the U.S. labor market. To estimate the unemployment rate, the Census Bureau asks people two questions: Are you working? And, if not, have you looked for work in the past four weeks? The unemployment 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. Most of the declines in the unemployment rate since October 2009 have 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 March 2007, the employment-to-population ratio was over 63 percent. The employment-to-population ratio fell sharply during the Great Recession and bottomed out at just over 58 percent in mid-2011. The percentage has risen little from this low point and remains lower than at any time between 1986 and 2007.

It is true that, even without the Great Recession, demographic forces would have led to some decline in the employment-to-population ratio since 2007. As the baby boom birth cohort—born between 1946 and 1964—ages, the fraction of retirees in the population grows steadily. But these

demographic forces are still not large enough to account for most of the decline in the employment-to-population ratio that I've described. One way to see this—but not the only way—is to focus on people who are outside the normal retirement age. Here, I've plotted the fraction of the population aged 25 to 54 who have a job. This ratio has improved from its low point, but also remains lower than at any time between 1986 and 2007.

Even among those who have a job, there are signs that the economy is significantly underemploying our human resources. 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, but remains unusually high.



To summarize what we learn from the charts: The good news is that the labor market *has* improved since the end of the Great Recession. The bad news is that the *rate* of improvement over the past four-plus years has been painfully slow. As a consequence, there is still significant underutilization of our country's most important resource—its people. We have to conclude that the FOMC is underperforming with respect to its goal of promoting maximum employment.

Conclusions

Earlier, I asked you to consider this speech as a report to you, the people of Rochester, on the FOMC's performance with respect to its two congressionally mandated objectives. We've seen that the FOMC is undershooting its price stability objective, in that inflation is running well below the FOMC's goal of 2 percent and is expected to remain that low for several years. The undershooting is problematic because it suggests that the American economy is wasting available resources, especially its human resources. We've seen strong evidence of this underutilization in the performance of key labor market metrics. Hence, the FOMC is also underperforming with respect to its maximum employment objective. We need to do better as a Committee—and I look forward to working with my colleagues to make that happen.

Thank you for listening. I'd be happy to take your questions.