Conversations with the Fed

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Thank you, Chris, for that introduction and thanks, especially, to all of you for coming tonight to this event. It is great to see so much interest in the Federal Reserve. I'll open things up with some brief remarks about the Fed and my macroeconomic outlook for 2013 and 2014. However, I'm very much looking forward to what I see as the main event this evening: answering your questions about the Federal Reserve and the economy.

But first—a disclaimer. As you will hear shortly, I'm one of the 19 people who have the privilege and honor to participate in the meetings of what's called the Federal Open Market Committee. FOMC meetings shape the course of monetary policy in the United States. But it's very important to understand that, in my remarks today, I'm telling you only my own views, and those perspectives are not necessarily those of any other FOMC participant.

Federal Reserve Structure and the Making of Monetary Policy

Let me begin with some background about the Fed. Relative to its counterparts around the world, the U.S. central bank is 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 our district includes Montana, the Dakotas, Minnesota, northwestern Wisconsin and the Upper Peninsula of Michigan.

As I mentioned, the Federal Open Market Committee—the FOMC—is the Fed's monetary policymaking body. It meets eight times per year. All 12 presidents of the various regional Federal Reserve banks travel from their home districts to Washington to contribute to monetary policy deliberations, along with the seven governors of the Federal Reserve Board. In

this way, representatives from different regions of the country have direct input into the setting of American monetary policy.

Congress requires the FOMC to make monetary policy so as to fulfill two mandates: promote price stability and promote maximum employment. It should be clear that these are both Main Street objectives. Promoting maximum employment means that the Fed is charged with doing what it can to ensure that Americans who want to work can do so. Promoting price stability means that the Federal Reserve is charged with keeping inflation close to a pre-specified target. Households and businesses engage in a large number of transactions—like mortgages or IRAs—that involve the exchange of dollars today for dollars in the future. Price stability ensures that they can have certainty about what those future dollars will be able to buy.

Now, in describing price stability, I've made reference to a "pre-specified target" for inflation. I haven't said what the pre-specified inflation target is. In choosing its inflation target, the FOMC weighed the costs of overly high inflation against the need to guard against potentially destructive negative inflation—so-called deflation. This assessment has led the FOMC to pick an inflation target of 2 percent. Similarly, most central banks around the world have opted for a low but still positive inflation target.

The FOMC acts to achieve its two mandates—maximum employment and price stability—by influencing interest rates through the purchase and sale of financial assets. When the FOMC raises interest rates, households and firms tend to spend less and save more. The fall in spending puts downward pressure on both employment and prices. Similarly, when the

FOMC lowers interest rates, households and firms tend to spend more and save less. This puts upward pressure on employment and prices.

However, these pressures on employment and prices from lower interest rates are not felt immediately. Instead, it typically takes a year or two for the effects of monetary policy adjustments to manifest themselves in inflation and unemployment. Hence, the FOMC's decisions about appropriate monetary policy necessarily hinge on the members' forecasts of the evolution of prices and employment over the next year or two—what we typically call our *medium-term* outlooks for inflation and unemployment.

So, a key part of my job as a monetary policymaker is to formulate a medium-term outlook for the U.S. economy. In the remainder of my remarks, I'll describe my two-year outlook for inflation, unemployment and economic output. I'll begin, though, by placing that outlook in the context of the evolution of these same variables over the past five years.

Past Five Years

Let's start by looking back at the evolution of national output—as measured by gross domestic product adjusted for inflation (real GDP). As you can see in this chart, national output fell dramatically during 2008 and the first half of 2009. Since the middle of 2009, the national economy has recovered at a moderate rate. Note, though, that output remains about 9 percent below where it would be if it had grown over the past five years in line with historical averages.

Given the sluggish recovery in national output, it is not surprising that labor markets are also healing slowly. This next chart shows the behavior of the unemployment rate over the past

five years. The unemployment rate, which was 5 percent in December 2007, reached 10 percent in the second half of 2009 (October). At the end of 2012, the national unemployment rate remained at 7.8 percent.

Finally, this next chart shows that inflation has also run below the Federal Reserve's 2 percent target. Over the past five years, the personal consumption expenditure (PCE) price index has grown at an average annual rate of 1.7 percent. Here, I should emphasize that the PCE price index is an index that includes *all* goods and services, including food and energy. So, I'm not talking about so-called core inflation—I'm talking about what's called headline inflation.

That's a brief review of the past five years. Real output remains well below what one would expect it to be in light of historical growth patterns in the United States. Unemployment remains well above 2007 levels. Inflation has averaged below the Fed's target.

With that review as background, let me turn to my macroeconomic outlook for the next couple of years. That outlook is predicated on the assumption that the FOMC's monetary policy choices over the next few years will be consistent with the forward guidance about asset purchases and the fed funds rate that the FOMC provided in its December statement. With that assumption about policy, my outlook for the next two years can be summarized as being an ongoing modest recovery. Let me quickly go through the charts again, only this time I will add my forecasts. First, I see output as continuing to grow slowly—at around 2.5 percent in 2013 and around 3 percent in 2014. Note that this growth will do little in terms of returning the economy to the historical trend. Consistent with this slow output growth, I expect unemployment to continue to fall only slowly, down to around 7.5 percent in late 2013 and

around 7 percent in late 2014. This level of unemployment will continue to constrain wage growth. Consequently, inflation pressures will remain subdued, as I expect PCE inflation to be only 1.6 percent in 2013 and 1.9 percent in 2014.

Conclusions

Let me wrap up.

Congress has charged the Fed with making monetary policy to achieve two Main Street objectives: keep inflation close to 2 percent and unemployment low. Monetary policy tools operate with a lag of a year or two. These lags mean that the FOMC's policy decisions are based on how it expects the economy to perform over the medium term. My own forecast, conditional on the FOMC's current monetary policy stance, is that inflation will run below the Fed's target of 2 percent over the next two years and the unemployment rate will remain elevated. This forecast suggests that, if anything, monetary policy is currently too tight, not too easy.

Thanks for listening. And I look forward to your questions.