Clarifying the Objectives of Monetary Policy[1]

Annual Meeting

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Introduction

Thank you for that generous introduction, and thank you all for joining us here today. This is a special day for us at the Federal Reserve Bank of Minneapolis, especially at the Helena Branch. Dave Solberg, a member of the Branch's board of directors, will complete his service at the end of this year. I would like to extend my personal thanks to Dave for his service to the Helena Branch and, more broadly, to the Federal Reserve. The time that our directors, and members of our advisory councils, devote to their work is truly valuable. Dave and his colleagues bring important insights about the economy from people on Main Street and on farms and ranches across the region. As I have said many times, we have no end of data at the Federal Reserve, but data are backward-looking, and we need all the information we can get to make judgments about the future course of the economy. So thanks again to Dave and to his colleagues on the board, as well as anyone else in the room who has served on a Federal Reserve board or council. We appreciate your service.

I'm planning to spend most of my time today talking about the objectives of monetary policy. As you will hear, the FOMC has made great progress in formulating, and communicating, the objectives of monetary policy to the public. I will discuss some of that progress and then move on to some ideas about how the Committee can make further improvements along these lines. I look forward to your questions, as well—I always learn a lot from Q&A sessions.

Before I start, though, I must remind you that the views I express today are my own and not necessarily those of my Federal Reserve colleagues.

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 Federal Open Market Committee—the FOMC—meets to make monetary policy. All 12 presidents of the regional Federal Reserve banks—including me—and the 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. The answers to all of your questions—and probably more—are on a 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 draw your attention to 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, 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. In my travels around the Ninth District, I often meet with local business leaders and citizens 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 eight years under Chairman Bernanke's leadership. 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 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 note that 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.

I can now turn to the main theme of the remainder of my speech: the goals that the FOMC seeks to achieve by varying the level of monetary stimulus.

Congressional Mandates

The natural starting point for our discussion of monetary policy goals is the Federal Reserve Act, the law in which Congress created the Fed and defined its purposes. Through the Federal Reserve Act, Congress requires the Federal Reserve to make monetary policy so as to promote effectively the goals of maximum employment, stable prices and moderate long-term interest rates. Most economists believe that if the Fed achieved the first two mandates (maximum employment and stable prices), it would automatically achieve the third (moderate long-term interest rates). Hence, monetary policymakers in the United States are usually described as having a dual mandate: to promote price stability and maximum employment.

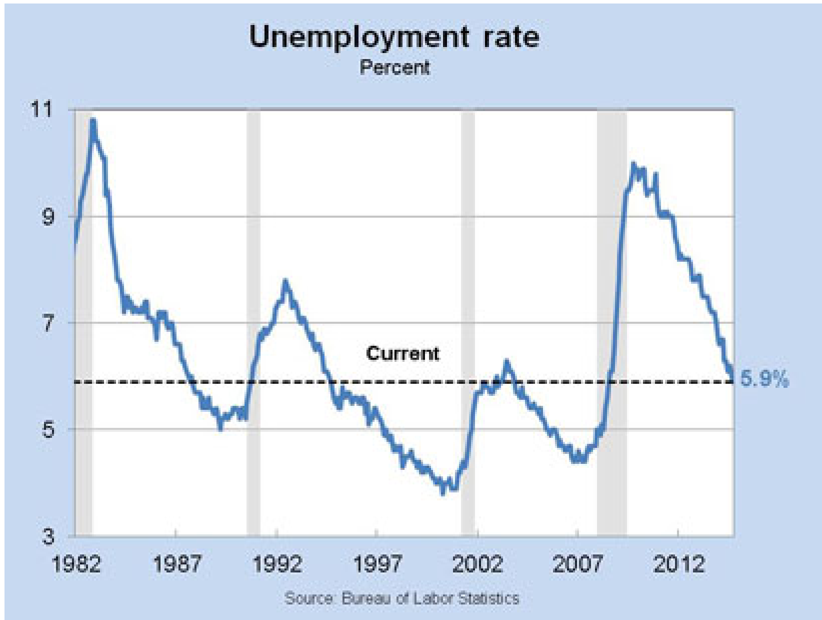
Congress' short overarching description of Federal Reserve objectives is the foundation for current monetary policymaking, but it does not address many specifics. In January 2012, in a key milestone in the evolution of the Fed's communications, the FOMC adopted a longer and more precise description of its long-run goals. I'll call this short but pathbreaking document the "framework statement." It contains a number of important ideas—and indeed I encourage all Americans to read the entire statement—but I'll stress three main elements.

The first element is that the framework statement explicitly translates the words "price stability" into a longer-run goal of a 2 percent annual inflation rate. Here, the term "inflation rate" refers specifically to the personal consumption expenditures (or PCE) inflation rate. This is a measure of the rate of increase in the prices of all goods and services, including those related to food and energy. The adoption of this explicit 2 percent target means that the American public need guess no longer about the Federal Reserve's inflation intentions—either on the upside or on the downside: 2 percent is our goal.

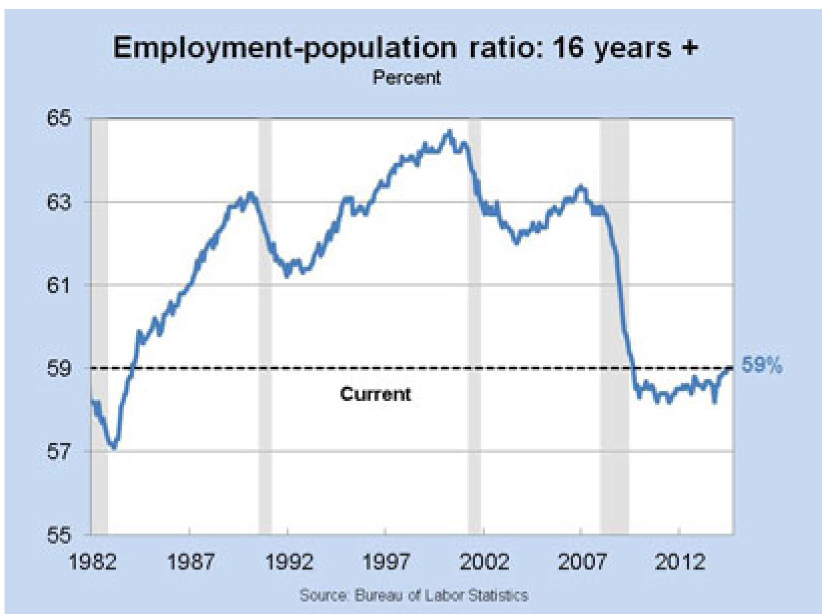
Second, the framework statement discusses the challenges in providing a similar fixed goal for employment. It quite rightly emphasizes that monetary policy is not a prime determinant of maximum employment, even in the long run. The Committee's policy stance is based on an ever-evolving assessment of the maximum level of employment in both the medium and the long term. My own assessment of the long-run unemployment rate, consistent with 2 percent inflation, is currently 5 percent—and that assessment has fallen greatly over the past 18 months.

Finally, the framework statement describes how the Committee weighs the two mandates—promoting maximum employment and promoting price stability—against one another. Importantly, it stresses that, from the point of view of monetary policy, the two mandates are typically *complementary*. As I noted earlier, monetary policy pushes employment and inflation in the same direction. But, as it turns out, most shocks that push employment down also tend to push inflation down over the medium run. Hence, monetary stimulus designed to raise employment will also help the FOMC pursue its inflation objective.

Indeed, the past few years provide a clear example of the complementarity of the FOMC's two mandates. In terms of the employment mandate, labor market outcomes have been distressingly weak. We can see this weak performance in a number of ways, but I'll use two particular metrics: the unemployment rate and the employment-population ratio. The unemployment rate rose rapidly beginning in 2007, peaked at 10 percent in late 2009 and has fallen only gradually to its current level of 5.9 percent.

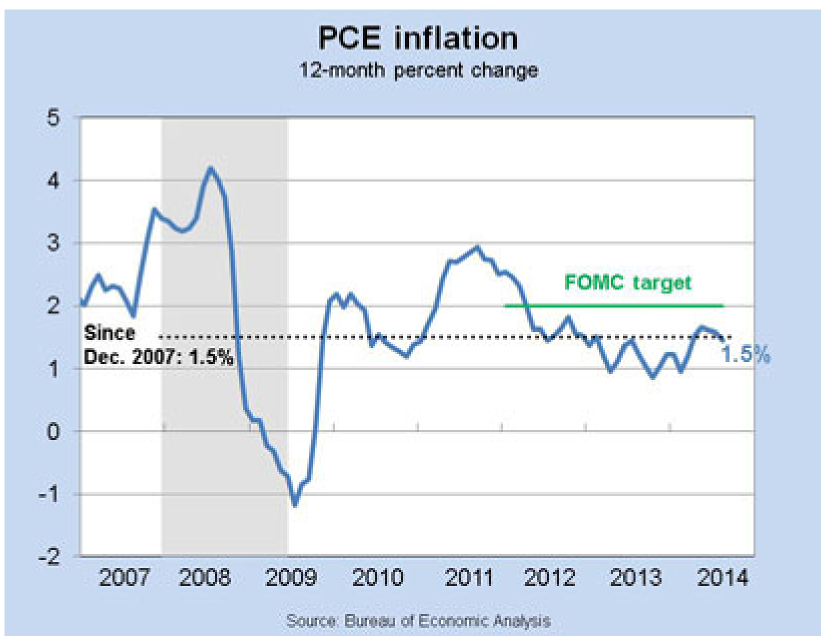


The second graph depicts the fraction of people over the age of 16 who have a job. That fraction fell sharply beginning in 2007 and has since risen only slightly.



To be clear, some of this slow recovery in employment can be attributed to a key demographic force: an increasing fraction of the people aged 16 and over reach retirement age every year. But the recovery in employment is a highly subdued one, even if we strip out this demographic effect by focusing only on those people aged 25 to 54.

So, employment has been below its maximum level over the past seven years. What about inflation? The following graph shows that PCE inflation has averaged 1.5 percent since the beginning of the Great Recession in 2007. So, inflation has also been low relative to the FOMC's target. And there is little sign of an uptick—over the past 12 months, inflation has been 1.5 percent.



Thus, the macroeconomic shock of 2007—the Great Recession—pushed both employment and inflation below the FOMC's goals. In this sense, the two mandates have been entirely complementary over the past seven years. Unfortunately, monetary policy has proven to be insufficiently accommodative to offset either the price or employment effects of this large shock.

Possible Improvements in the FOMC's Framework Statement

The framework statement was adopted by the FOMC in January 2012. It has been reaffirmed, with only minor wording changes, in January 2013 and again in January 2014. However, the minutes for the January 2014 meeting note that FOMC participants saw the coming year as an appropriate time to consider whether the statement could be improved in any way. I concur: The time is right to consider sharpening the FOMC's statement of its objectives in several ways.

I'd like to explain, and express support for, two particular clarifications related to the FOMC's formulation of the price stability mandate.

First, I believe the FOMC should be clear that its inflation objective is *symmetric*. Many observers emphasize the need to keep inflation from rising above 2 percent. But in my view, inflation *below* 2 percent is just as much of a problem as inflation *above* 2 percent. The central bank of Canada also has a 2 percent inflation target. Its language about symmetry is pretty clear, at least as central banking communications go: "the Bank is equally concerned about inflation rising above or falling below the target and will act … in order to bring inflation down, or to push it back up, to 2 per cent."[2] In my view, the FOMC should use similar language to characterize its inflation objective.

Why do I see symmetry as important? Without symmetry, inflation might spend considerably more time below 2 percent than above 2 percent. Inflation persistently below the 2 percent target could create doubts in households and businesses about whether the FOMC is truly aiming for 2 percent inflation, or some lower number. This kind of unmooring of inflation expectations would reduce the effectiveness of monetary policy as a mitigant against adverse macroeconomic shocks.

Second, I believe that the FOMC should consider articulating a benchmark two-year time horizon for returning inflation to the 2 percent goal. (Two years is a good choice for a benchmark because monetary policy is generally thought to affect inflation with about a two-year lag.) Right now, although the FOMC has a 2 percent inflation objective over the long run, it has not specified any time frame for achieving that objective. This lack of specificity suggests that appropriate monetary policy might engender inflation that is far from the 2 percent target for years at a time and thereby creates undue inflation (and related employment) uncertainty. Relatedly, the lack of a public timeline for a goal can sometimes lead to a lack of urgency in the pursuit of that goal. I believe that, if the FOMC publicly articulated a reasonable time

[2] "Monetary Policy," Bank of Canada, May 29, 2012, available at bankofcanada.ca/wp-content/uploads/2010/11/monetary_policy.pdf.

benchmark for achieving the inflation goal, the Committee would be led to pursue its inflation target with even more alacrity.

Some might argue that this kind of time horizon is impractical. In fact, many central banks incorporate a similar timing benchmark. For example, the Bank of Canada typically makes its monetary policy choices so that the inflation rate is projected to return to 2 percent within two years.[3] I say "typically"—there are certainly situations in which the Bank of Canada chooses policy so that inflation is projected to return to target more slowly (sometimes taking as long as three years) or more rapidly (sometimes as quickly as 18 months). But it continues to treat two years as a benchmark, in the sense that it feels compelled to explain *why* it is choosing a different time horizon.

To sum up: I've suggested that the FOMC clarify that its inflation target is symmetric and that the Committee typically seeks to achieve that target within a two-year horizon. Let me emphasize that these two suggestions represent clarifications, not alterations. The framework statement, as written, is completely consistent with the formulations of price stability that I've proposed. However, the problem with the current statement is that it is also consistent with other interpretations of price stability (such as a 10-year horizon for returning inflation to the desired target).

The additional clarity in the framework statement would help the public understand the likely evolution of monetary policy. I've suggested that the FOMC should clarify that it has a symmetric inflation objective, and a two-year horizon for achieving that objective. With those goals, it would be inappropriate for the FOMC to reduce its level of accommodation if its outlook is that inflation will be below 2 percent over the following two years. After all, if the FOMC were to tighten policy in such a situation, it would be deliberately delaying the progress of inflation toward the 2 percent objective. Such an action would weaken the credibility of the FOMC's stated two-year horizon.

This conclusion about appropriate monetary policy sheds light on the ongoing public conversation about whether the FOMC should begin targeting a higher range for the fed funds rate sometime in 2015. As you can see from the graph before you, inflation has been low for a long time. Inflation tends to be highly persistent, and so this long stay below target suggests that it will take some time for inflation to get back to 2 percent. Indeed, my benchmark outlook is that PCE inflation will not rise back to 2 percent until 2018. This sluggish inflation outlook implies that, at any FOMC meeting held during 2015, inflation would be expected to be below 2 percent over the following two years. It would be inappropriate for the FOMC to raise the target range for the fed funds rate at any such meeting.

To be clear: There is uncertainty about the evolution of the inflation outlook, and so this conclusion about the timing of lift-off is necessarily data-dependent. The language changes to

[3] "Monetary Policy," Bank of Canada, May 29, 2012, available at bankofcanada.ca/wp-content/uploads/2010/11/monetary_policy.pdf.

the framework statement that I've suggested would not tell the public exactly when interest rates are going to rise. But these changes would allow the public to have a better understanding of what kind of data would engender the first interest rate increase.

Conclusions

Let me wrap up.

Most of the conversation about monetary policy in this country concerns *what* the FOMC is doing—how many assets is the Committee buying this month? How low is the Committee keeping interest rates? These are, no doubt, important questions, especially for those in the financial sector. But I'd like to encourage more discussion of the more important question for most Americans: *How* is the FOMC doing in terms of meeting its mandated congressional goals? I hope that my remarks today about the FOMC's goals, and its communication about those goals, will be helpful in steering the conversation in this direction.

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