On the Objectives of Monetary Policy[1]

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Introduction

Thank you for that generous introduction, and thank you for the invitation to join you here today. This is my second trip to Marquette since becoming president of the Federal Reserve Bank of Minneapolis five years ago, and I'm glad to be back.

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—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, tomorrow, I will meet with Upper Peninsula 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 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, and my meeting with business leaders tomorrow, 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. I think that this point is often underemphasized in popular discussions of monetary policy.

The statement notes that there may be cases in which the mandates are not complementary—meaning that inflation is expected to be above target when the unemployment rate is expected to be unduly high. The framework statement explains that, in these circumstances, the FOMC will use a balanced approach to the two mandates when formulating monetary policy. In earlier speeches, I've discussed this language in some detail. In my view, this language implies that the FOMC is willing to allow inflation to run above 2 percent for some time to facilitate a faster decline in the unemployment rate.

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.

The minutes note two possible changes along these lines. I'd like to explain, and express support for, both of these.

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.

Another way to improve the FOMC's framework statement would be to describe more clearly how the mandated goals of maximum employment and price stability are linked with financial stability considerations. Many observers, including FOMC participants, have noted that the stance of monetary policy could affect the buildup of risks and risk sensitivities in the financial system. For example, it is sometimes argued that the current low interest rate policies designed to stimulate economic activity will also encourage households and corporations to accumulate large amounts of debt. We saw in 2007 that this kind of leverage, if undertaken in sufficient magnitudes, has the potential to create risks to employment and inflation.

Now, of course, regulators in this country and around the world—including those within the Federal Reserve itself—should do all they can to mitigate these financial system risks using their array of tools. But these efforts by regulators could prove to be imperfect, and so monetary policy may create financial stability risks to employment and inflation. The FOMC should be clear that, in accordance with its congressional dual mandate, it takes these kinds of financial

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

stability risks to employment and inflation into account when determining the stance of monetary policy. Fortunately, at this time, I do not see financial stability risks as being sufficiently material to affect the appropriate stance of monetary policy. But that conclusion could, of course, change as economic and financial conditions evolve.

Two Other Possible Improvements

The two issues I've just mentioned—symmetry of the inflation objective and the role of financial stability—have been noted as under discussion in previous FOMC minutes. In my view, there are two other possible improvements to the FOMC's statement of its long-run goals that have not yet been mentioned in the minutes but deserve further Committee study.

First, 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 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. 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.

The second possible change in the framework statement that deserves further study is to consider targeting the price level, as opposed to the inflation rate. I've discussed the benefits of price level targeting, relative to inflation targeting, at some length in prior speeches. The relevant issues are somewhat technical, and so I don't plan to talk about them today. However, I'm certainly happy to talk about the two kinds of targeting during the Q&A period if anyone is interested.

Conclusions

The Federal Reserve has existed for over a hundred years. No organization lasts for so long without an ability to evolve in response to changes in conditions. The Federal Reserve is no exception. The changes in our public communications about monetary policy are especially notable.

The release of our framework statement for monetary policymaking in January 2012 was a key milestone in the evolution of our communications. But I am glad that, as we indicated in January 2014, we are willing to consider amending the statement in possibly substantial ways. We are always learning how to communicate about policy in better ways.

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