A Look at the Economy through the Federal Reserve's Dual Mandate

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Key points:

- Federal Reserve Bank of Atlanta President Dennis Lockhart says that the Fed is tasked with promoting stable prices and maximum employment in its monetary policy responsibilities.
- Recent readings on retail prices are a little elevated due to a run-up in gasoline prices earlier in the year. Lockhart says that higher energy costs appear to have caused a modest acceleration in other prices. Most forecasts of inflation, including Lockhart's, project the annual trend in prices to move back toward the Fed's 2 percent target over the course of the year.
- Lockhart says that while the headline measure of the unemployment rate was 8.2 percent in March, down by almost a full percentage point since last summer, the unemployment rate is still well above its prerecession level of around 5 percent. All things considered, he thinks the relatively modest economic expansion that has followed the recession—an extremely deep recession—is the primary factor restraining job growth.
- According to Lockhart, whether additional monetary policy actions should be used to try to speed the recovery must be balanced against the risks to the Fed's price stability objective, risks that could accompany an overestimation of the amount of economic slack, particularly labor market slack.

I'm pleased to be here today, to be part of the University of California Santa Barbara Economic Forecast Project. This is an opportunity to assess where the U.S. economy is now, and where it could be heading.

I'm first up among my Federal Reserve colleagues in this panel discussion, and I'd like to center my brief remarks on what's called the Fed's dual mandate. These are my views and may not be shared by my colleagues on the Federal Open Market Committee (FOMC) or in the Federal Reserve System.

In its monetary policy responsibilities, the Fed is tasked with promoting stable prices and maximum employment. Controlling inflation and promoting maximum employment are generally complementary. There may be short-term tradeoffs between the two goals, but not long-term ones. When circumstances arise where these goals are in conflict, the FOMC follows a balanced approach in promoting the two.

A two-objective mandate is not standard among central banks around the world. In Canada, for example, the sole focus of the central bank is on inflation. The same holds true for the European Central Bank. But even central banks with a single mandate still talk about a well-balanced approach to policy. Virtually all central banks have the broad goal of supporting healthy economic growth in the context of price stability.

A view of inflation

The FOMC judges that inflation at an annual rate of 2 percent is consistent over the longer run with the price stability part of our statutory mandate. This has been formal policy since January. The 2 percent target is important in that it is now an explicit objective to be achieved over the long term. In my interpretation of the objective, the committee should be expected to navigate close to 2 percent over time while pursuing that objective within an approach described as flexible inflation targeting. Some flexibility around the 2 percent target recognizes that it's the continuing trend that's important. Monthly price data can be noisy, and because monetary policy acts with a considerable lag, there is little we can do about the present or near term.

With that background, I'll now characterize the current situation as regards the inflation aspect of the FOMC's mandate.

Recent readings on retail prices are a little elevated due to a run-up in gasoline prices earlier in the year. Higher energy costs appear to have caused a modest acceleration in other prices. Various core inflation measures have been trending just a shade above 2 percent over the past three months, but these trends are not expected to persist. Most forecasts of inflation—my own included—project the annual trend in prices to move back toward the 2 percent inflation rate over the course of the year.

Retail prices are the end product of a large number of influences, so the state of inflation is best determined by synthesizing a number of indicators. The research staff at the Federal Reserve Bank of Atlanta regularly monitors 30 key indicators of price behavior. The Atlanta Fed makes this information readily available to the public with what we call our Inflation Dashboard, which can be found on our website.

We also track inflation expectations of the public. Inflation expectations are both a major influence on the medium-term inflation outlook and an active force in the achievement of price stability.

Most measures show that the current inflation expectations of households, investors, and businesses remain reasonably well-anchored and aligned with that 2 percent objective. The Atlanta Fed's Survey of Business Inflation Expectations is one data point confirming this claim. Last month our survey indicated that a broad cross section of 165 Southeast businesses anticipated costs to rise 2.1 percent over the next 12 months.

There are risks, of course, but I believe the threats to price stability are reasonably contained at present. Though not expected, a further rise in oil prices could provoke sustained upward pressure on prices more generally. But balanced against this risk is the persistence of considerable slack in the economy, especially labor market slack evidenced by the level of unemployment.

A look at the employment situation

So let me now turn to the state of employment, the FOMC's second statutory objective.

Since the end of the recession, employment has grown at a pace similar to that seen in the last recovery, but from a deeper bottom. That growth seems now to be broadly distributed across industries, with a few exceptions, the government sector and residential construction being obvious examples. The headline measure of the unemployment rate was 8.2 percent in March, down by almost a full percentage point since last summer. But the unemployment rate is still well above its prerecession level of around 5 percent. Tomorrow we'll get a reading on the labor market for April.

Employment market dynamics are complicated, but I'll try to break down the employment situation into demand and supply side influences and effects.

On the demand side, many businesses that existed five years ago are gone, and with their disappearance many jobs were permanently lost. Some amount of job destruction from business failures is a normal occurrence, but many new businesses that would have been established in less stressed times and that would have replaced the lost jobs were not born. Start-ups have been fewer because of a weak economy and difficulty getting financing. Also, many businesses that weathered the recession made deep and apparently permanent cuts in their workforce, at least in the ratio of workers to a given level of output. In the short run, the productivity gains by individual firms mean that increasing sales don't result in the same increase in hiring as in the past. In many instances, businesses have invested in technology that eliminated the need for certain types of jobs, and the skills these firms now demand may be quite different than in the past.

I hear a lot of anecdotal accounts of businesses having difficulty finding qualified workers. It is hard to assess how much of that difficulty reflects a change over the last few years in the mix of skills required, or how much employer frustration can be tied just to temporary frictions that normally occur when matching workers with job openings. The seemingly relentless drive on the part of firms for productivity gains has been motivating labor-substituting capital investment, but it is not clear to what extent this will hold back demand for additional workers as the economy continues to expand.

On the supply side, the recent decline in the unemployment rate is partly attributable to a decline in the share of the working age population actively engaged in the labor market. To be sure, natural demographic forces are at work here as a larger share of the workforce reaches normal retirement age. It's also argued that some of the decline may reflect discouragement of job seekers about wage and employment prospects. Participation is at its lowest level since the 1980s.

All things considered, I think the relatively modest economic expansion that has followed the recession—an extremely deep recession—is the primary factor restraining job growth. The Fed's already done a lot to support the recovery. Whether additional monetary policy actions should be used at this time to try to speed things up has to be balanced against the risks to the Fed's price stability objective that could accompany an overestimating of the amount of economic slack—particularly labor market slack.

One of my Atlanta Fed colleagues describes the employment situation as "messy" because the data do not speak loudly and clearly about what the reality is. Even getting good data is challenging. And, further, full

employment is not a fixed number. It moves over time and can be affected by many demographic and social factors as well as the impact of human capital policies in the areas of education and training.

Questions for policymakers

As policymakers, my colleagues on the panel and I have to grapple with the messiness of labor market reality while balancing the two objectives of the committee's dual mandate. Speaking for myself, as I have prepared for recent FOMC deliberations, I've had to engage these questions:

- How much of an employment gap is there?
- Can additional monetary policy actions close it?
- Is the pace of closure under current policy acceptable?
- If not, what more can and should be done?

I'll stop here and leave these questions in the air as a teaser. These are critical questions, and I hope we can address these and other issues in the panel discussion that follows.

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