Should Full Employment Be a Mandate for Central Banks?

Eric S. Rosengren
President & CEO
Federal Reserve Bank of Boston

Federal Reserve Bank of Boston
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The data in this speech have been updated to reflect revisions to the data series that occurred after it was delivered. These updates were made because the speech was being prepared for publication in an issue of the Journal of Money, Credit, and Banking.
Role of Unemployment in Monetary Policy

- Most advanced economies have very elevated unemployment rates
- How should central banks respond to weak labor markets?
- What should be the mandate of the central bank? Should other central banks adopt a dual mandate?
- My answer is an emphatic yes!
Dual Mandate Aids Communication with the Public

- FOMC statements make clear the importance of the dual mandate
  - Continue purchases, “until the outlook for the labor market has improved substantially in a context of price stability”
  - Maintaining interest rates at exceptionally low levels will be appropriate, “at least as long as the unemployment rate remains above 6.5 percent.....and longer-term inflation expectations continue to be well anchored”
The SEP and the Dual Mandate

- Tying the trajectory of policy to data and published forecasts for economic outcomes clarifies things for the public.
- During period where inflation is low and unemployment is high, including in our SEP forecasts, the need for accommodation is clear.
- Single mandate makes announcements less straightforward and understandable.
Do Different Mandates Improve Economic Outcomes?

- Examine price level path over past 20 years – inflation experience of single mandate versus dual mandate countries
  - Surprisingly, most countries fit a pattern of price level targeting surprisingly well – large increases or decreases in inflation offset in future periods to maintain an average of 2 percent
  - United States performs quite well relative to other countries
Figure 1
Price Level Path in Europe, the United States and Japan

January 1993 - February 2013

Index Level January 1993 = 100

- Euro Area Harmonized Index of Consumer Prices
- U.S. Personal Consumption Expenditure (PCE) Price Index
- Japan's Consumer Price Index
- 2% Annual Inflation

Source: Eurostat, BEA, Japan's Ministry of Internal Affairs and Communications / Haver Analytics
Figure 2
Price Level Path in Sweden, the United Kingdom and the United States

January 1993 - February 2013

Index Level January 1993 = 100

- U.K. Harmonized Index of Consumer Prices
- U.S. Personal Consumption Expenditure (PCE) Price Index
- Sweden's CPIX
- 2% Annual Inflation

Note: Sweden's CPIX is the National CPI excluding mortgage interest and adjusted for taxes and subsidies.
Source: Sweden's Statistiska Centralbyran, U.K. Office for National Statistics, BEA / Haver Analytics
Compare Simple Loss Functions

- Examine cumulative squared deviation of the annual year over year inflation rate from a 2 percent target
- Large misses get large weight
- Symmetric above and below 2 percent
Figure 3
Deviations from Inflation Target in Sweden, the United Kingdom, the United States and the Euro Area

February 1997 - February 2013

Cumulative Squared Deviations from Inflation Target of 2%

- Sweden
- United Kingdom
- United States
- Euro Area

Uses year-over-year change in the CPIX (Sweden), HICP (U.K., E.A.) and the PCE price index (U.S.) to measure inflation.

Source: Sweden’s Statistiska Centralbyran, U.K. Office for National Statistics, BEA, Eurostat / Haver Analytics
Figure 4
Deviations from Core Inflation Target in Sweden, the United Kingdom, the United States and the Euro Area

February 1997 - February 2013

Cumulative Squared Deviations from Core Inflation Target of 2%

- Sweden
- United Kingdom
- United States
- Euro Area

Uses year-over-year change in Core HICP (Sweden, U.K., E.A.) and Core PCE price index (U.S.) to measure inflation.

Source: BEA, Eurostat / Haver Analytics
Figure 5
Unemployment Rate versus Core Inflation Rate
Quarterly, 1997:Q1 - 2012:Q4

Source: Eurostat, BEA, BLS / Haver Analytics
Note: Most recent observation in red
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Unemployment Rate versus Core Inflation Rate
Quarterly, 1997:Q1 - 2012:Q4

Source: Eurostat, BEA, BLS / Haver Analytics
Note: Most recent observation in red
Central Bank Actions When Inflation Exceeds Target

- Easing in a single mandate country when unemployment is high and inflation is above target relies on a forecast that inflation is expected to fall (possibly because of slack resources)

- Dual mandate central banks can directly appeal to elevated unemployment rate
Figure 6
Central Bank Assets and Inflation: United States

January 2008 - February 2013

Source: BEA, Federal Reserve Board / Haver Analytics
Figure 7
Central Bank Assets and Inflation: United Kingdom

January 2008 - February 2013

Percent Change from Year Earlier

Harmonized Index of Core Consumer Prices (Left Scale)
Bank of England Assets (Right Scale)

Billions of GBP

Source: Eurostat, Bank of England / Haver Analytics
Figure 8
Central Bank Assets and Inflation: Euro Area

January 2008 - February 2013

Source: Eurostat, European Central Bank / Haver Analytics
Figure 9
Central Bank Assets and Inflation: Sweden
January 2008 - February 2013

Source: Eurostat, Riksbank / Haver Analytics
Figure 10
Deviations from Full Employment and Core Inflation Targets in the United States
1960:Q1 - 2012:Q4

Note: Full employment is the CBO estimate of the natural rate of unemployment. Inflation target is 2% in recent periods but ranges from 2% to 5% prior to mid 2005 based on a filter employed to provide smoothed estimates.
Source: BEA, BLS, CBO / Haver Analytics
Figure 11
Stacked Deviations from Full Employment and Core Inflation Targets in the United States
1960:Q1 - 2012:Q4

Sum of Squared Deviations from Full Employment and Core Inflation Targets

Unemployment
Core Inflation

Note: Full employment is the CBO estimate of the natural rate of unemployment. Inflation target is 2% in recent periods but ranges from 2% to 5% prior to mid 2005 based on a filter employed to provide smoothed estimates.
Source: BEA, BLS, CBO / Haver Analytics
Policy Implications

- Large misses in the 1970s and early 1980s: too little weight on inflation misses
- Large misses recently: too little weight on unemployment rate misses
- With unemployment at 7.5 percent and the PCE inflation at 1.5 percent the dual mandate provides clear, transparent rationale for highly accommodative policy as appropriate and necessary
Concluding Observations

- U.S. inflation outcomes as good as, if not better than, single mandate countries
- Many single mandate countries have expanded monetary policy accommodation despite exceeding their inflation target
- Dual benefits to dual mandate
  - Clearer communication, especially when there is significant slack
  - When unemployment is major economic woe it gets the appropriate attention