Interview Transcript

Minneapolis Federal Reserve President Narayana Kocherlakota

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Dr. Narayana Kocherlakota has been president of the Federal Reserve Bank of Minneapolis since 2009. He will step down from his position at the end of this month.

What follows is a lightly-edited transcript of a recent interview conducted at his office in Minneapolis on December 2, before the central bank decided to raise interest rates for the first time in nearly a decade.

Q. Let's start at the beginning.

I was born in Baltimore.

Q. Maybe not that far back. How did you first become interested in the job of Fed bank president? What was the interview process like?

That does take me back. We had known for years, those of us who are in the Minneapolis community, that 2009 was going to be a big year, because that was the year that Gary Stern was going to retire as president. We didn't know, for most of that time, that that was going to coincide with one of the deepest economic crises to hit the United States and the world in 75 years.

That really shaped my interest in taking on this position, that latter event. I was on leave from the university to the research department here in 2008. So I was actually was in part briefing Gary Stern in the latter part of 2008 while he was going to FOMC meetings, when the economy was collapsing. That experience, watching what was happening, I really felt, I need to contribute.

I had spent my life studying issues of monetary policy and financial crises, and there should be some way for me to help. So when I was called by a headhunter I expressed interest in the job.

The process of the search -- I don't really know the full process, I only know what I saw of it -- I thought it was exactly what you would want it to be. A lot of questions about how you're going to approach the job of a policymaker and how you're going to approach being the leader of this organization -- from the [Minneapolis Fed's] board of directors. The board of governors focused more on the policymaker aspect, which you'd expect.

Q. Trying to suss you out to see what your [policy] views are?

The main point that I got throughout the interview process, from my board of directors and the board of governors, was they wanted somebody who was going to be open-minded. This has echoes later. I took that very seriously. I always thought of myself that way. But very few people presumably say 'actually, I'm a very closed-minded person.' But throughout the course of my academic career, I had at least switched what I was working on over time. So I'd had that kind of evolution during my academic life.

During the interview process, especially given what we were going through, the real need that was felt was, you can't come to this knowing the answers. You might feel like you can help to figure out the answer, but you can't feel like you're going to know the answers. So that was a message I got loud and clear from my board here in Minneapolis and from the board of governors.

I wouldn't say that people are trying to suss out policy views. They're worried that you're going to come in with fixed views, because that's not going to be helpful.

So the interview process is—I was interviewed three or four times by the search committee. Then I went to Washington, and I talked to every member of the board of governors. Those interviews were extremely tough, and probing and searching. You meet individually with each one.

You come in with a bunch of preconceptions about how policy is going to work and how the world is going to work. First of all, the committee is much more about being a collective than 'we're going to listen to Chairman Bernanke figure out the world for us.' And I liked that aspect of it. It was very much us trying to work together to figure things out.

The attitude in the Bernanke Fed and the Yellen Fed as well is—we're trying to figure this out as a collective.

I quickly found out, it's different being a policymaker than being an academic. The need

for flexibility as a policymaker is just much stronger I think than as an academic. As an academic, people do respond to the evolution of the data, etc. but it's really more—you're in the marketplace of ideas, and you've got your ideas, and you're selling your ideas. That's not what you're doing as a policymaker. You're trying to do what's best for the US economy on an ongoing basis.

Obviously my thinking evolved, and it evolved by listening to my colleagues. Chairman Bernanke in his book and in other places has said that he and I talked a lot by email about the evolution of economy. And I would say my thinking changed on two key dimensions over time. One is I came into it as someone who thought that inflation would respond, would move back upwards relatively rapidly, that the impact of slack or weak economic conditions on inflation was going to be very transitory.

That, first of all, turned out to be wrong in 2010. Definitely 2010 was evidence that, boy, these weak economic conditions are being a drag on inflation. Then in 2011 we had this little burst of inflation and that I have to say was a point of confusion for me. At that point I thought actually maybe some of my original ideas about inflation had been right.

The other piece that was very important to the change in my thinking was -- a lot of focus on academia is on what's the right kind of backward-looking rule to use in shaping monetary policy. So, the Taylor-rule kind of ideas. This is the idea that there's a relatively fixed relationship between interest rates and macroeconomic observables like unemployment and inflation. Nobody would say that you'll follow it religiously but it can be a very good guide to policymaking guide. And I came into the job with the idea that, ok, that's a useful start.

As we go into 2011 and 2012, the Taylor rule is telling me one thing -- and I took very seriously the idea that asset purchases were providing this extra accommodation. That meant you should start to raise rates relatively rapidly as inflation goes up and core especially goes up in 2011. But it became clear this wasn't going to work.

At the same time I was talking to Chairman Bernanke about this. He has a very nice speech which influenced my thinking a lot called "The Logic of Monetary Policy" from 2004 where he lays out the two the kinds of thinking about monetary policy that he viewed as dominant. One is this backward-looking approach associated with [Stanford's John] Taylor. The other is a more forward-looking, goal-oriented approach, where you're saying 'here's what we're trying to achieve in the medium term with our policy instruments.' It's much less about the instruments themselves and more about, we're going to do what it takes to achieve the goals. And yet that's the communication that guides--that's your lodestar.

Q. It's about engendering the confidence in the recovery, is that it?

But you have to walk the walk too, and the way you're engendering the confidence is by saying—as we ended up doing in September 2012—that we've got the recovery's back. We didn't say it quite sharply as that but that was my read on what we were trying to do. We're not going to start removing accommodation unless we feel the recovery is in a very sustainable pace.

The other aspect was on the structural nature of unemployment. Professor Edward Lazaer, I've known him a long time. To see him stand up [at Jackson Hole in 2012] and say 'this is cyclical,' that was a big deal. There was a lot of other work that he was building on. And then at the aggregate level you just weren't seeing inflation or wage inflation. There are two sides to this, one was the switch in my thinking to becoming more goal-oriented and then at the same time realizing, we're not seeing the inflationary pressures from [lower] unemployment.

Now another person who influenced me, although this is after my public announcement about having more threshold based policy. Former Chairman Volcker gave a great interview with [former Fed vice chair] Don Kohn, this is in early 2013 in honor of the Fed centennial. Listening to hear him talk about his thinking in a speech of how he had brought inflation down—he clearly followed a goal-oriented approach. He would say that interest rates moved in a way that he was surprised by. But that wasn't the deal. The deal was, we're going to do what it takes.

I think the tenor of the way we interact in the committee, which is about learning from each other building from each other's ideas—I wouldn't have gotten to the point I got to. I've emphasized chairman Bernanke, he's obviously an intellectual giant. But there were many other folks I was listening to. Charlie Evans, the current chair, I learned a lot from her as well.

Q. Do you leave office now that you've had this transition with some frustration that you have not achieved your policy goals?

From that point of view, I came originally to be of support and help during a time of crisis. As my public remarks make clear I think there's room for us to make further improvement. But we're not in a time of crisis anymore and I think that the Federal Reserve's actions have been really helpful in ensuring that's happened. It's taken longer than I would have expected. I feel like this is a good time for me to go back to a job where I'm going to have more time to think about--if we were going to do it again, how

would we do it better. My speech in Philadelphia is trying to get at some of those issues.

There's a lot of talk in Washington, among my colleagues about how would we ever prevent a financial crisis from happening. That's valuable work and we should be thinking about it. I'm a little more pessimistic. If you read 'This Time It's Different,' actually I don't think 'This Time It's Different' goes far enough back. If you read Tacitus, 33 A.D., they had a financial crisis. It's all built into the system that there are going to be waves of confidence, we're all going to be sitting around thinking something about housing or some other asset, who knows what it will be.

My own takeaway was monetary policy was much better at cleaning up during the Great Recession than during the Great Depression. Let's make it even better next time. The lesson that some others have taken away has been that we don't want to be cleaning up. My own take is different. You're going to face these episodes. Hopefully they're not as bad but you're going to face these episode And you're going to be in a position as a monetary policy maker to have to 'clean up' after that. We did a better job in 2010 than we did in 1930. Let's do an even better job in 2050, 2080 or whatever the timeframe.

Q. So how do you go into the policymaking with that philosophy, how to you at the same time mitigate the moral hazard that might come from the market's feeling that the Fed is always going to come in and get us if things go awry

I think the answer to that is being goal-oriented. It's not about the markets. It's about bolstering unemployment and inflation against adverse shocks. So if you're reading of a particular downturn in asset prices is that it's not going to flow through that much to unemployment and inflation, then, hey, you're on your own.

Q. If the Fed could make public statements to that effect more often, I think it would go a great way toward ameliorating the public perception that the Fed is just there to cover Wall Street's holes. People talk about the Fed having a target for the S&P.

A lot of the coverage of the Fed is, as is very natural, from media that cover the financial markets. So it ends up about being, how are you thinking about what's happening in financial markets and how does that influence your thinking? The Taylor-rule and rule-based formulations drive you to what's going to happen to interest rates kind of thoughts and what's being plugged into that. As opposed to, ok, here's our outlook for unemployment and inflation, it's falling short relative to where we'd like to be relative to the medium term. Or it's inflation is running [too high]. To be clear this is about both sides. Being goal oriented, it happens that over the last seven or eight years it has been about doing more. But it's also about not being super gradualist if you see an

inflationary threat, being able to move rapidly in that context. On the monetary policy front, the right way for us to think about financial crises or movements in financial markets is always through the lens of our dual mandate objectives.

Q. You said earlier that we're not in a time of crisis anymore. A lot of folks who say the Fed is behind the curve say just that—we're not in emergency times and yet the rate is set at an emergency level. What do you make of that?

That's very Taylor-rulish, that thinking. It's the idea that the historical relationship between interest rates, inflation and unemployment is stable over time. When really we should be doing whatever is needed to get unemployment and inflation back to target.

My own forecast is that the 'neutral' rate [of interest]. But again it's about--I don't really care where interest rates are, ultimately. I care about the outlook for unemployment and inflation, the risks to that.

Now if you're telling me that, and certainly there are commentators who will suggest this, that our selection of policy is creating risks to unemployment or inflation by creating a bubble or some other [problem], that's material, I have to take that into account. A lot of our analysis post crisis has been along those lines. I just don't see that at this point. But everything has to come back to that, that is, to the outlook for unemployment and inflation, and the potential risks to that. It's not about we've got to get interest rates back to where they were historically. That doesn't make any sense.

Q. As far as the potency of monetary policy, there are people who argue that in the absence of more active fiscal policy, monetary policy is just pushing on a string. So how do you walk the walk, as you put it earlier. How do you make sure that you set a goal and then achieve it. For instance, let's if the Fed as some people suggest were to set a higher inflation target. Would it be able to meet it or would it just look like it was falling further short of its target?

The key for us when I think what we could have done more of is we could have talked less about exit. The strongest statement we made I thought was in September 2012 in terms of just saying, we're there for the recovery and we're going to do what it takes to make sure the recovery is sustainable before we exit. When I first joined the committee, I think the first testimony that Chairman Bernanke gave in February 2010 was about how we're going to unwind everything. So there was immediately a feeling that, ok, we're getting out. And to be fair to the Fed, this was being driven by a lot outside observers.

Q. Sure, and as I recall, a lot of the pressure was, you're not even going to be able to do this stuff unless you talk about the exit because you're not going to get the political buy-in.

Our wording was such that, there was a lot of conversation about -- is the Fed going to start raising rates in six months? Let me put it this way. The Fed committed to these thresholds in late 2012 of 6.5% [on unemployment], at the time I argued we could have gone to 5.5% and that was a lost opportunity. But suppose we had committed to 5.5% or 5%, to be even more aggressive, in November 2009. Boy, that's a lot of accommodation. There's a lot of things that could be done if we hadn't been thinking about monetary policy as being at an unusual, emergency setting, as opposed to doing whatever we need to do to achieve our objectives.

Q. I've actually brought this point up to Charlie Evans, especially when you use the term 'normalization.' When you use the term normalization it's like you've been in Alice-in-Wonderland for like 10 years, so you really hurt yourself.

I agree with your comment. We should always be doing whatever it takes to get ourselves back. Normal should be judged in terms of our dual mandate objectives.

Q. I often turn to your jacket analogy, I've found it useful. It was clearly inspired by your location.

Good. You tell that kind of story around here and people get it right away. If you start wearing shorts, you're not suddenly going to create summer in Minneapolis. It's not going to happen–even though shorts are highly correlated with good weather in Minneapolis. Following the Taylor rule, it worked well because conditions were such that it worked well. Following it is not going to make those conditions reappear.

One piece of unconventional policy the Fed has not gone to yet is negative interest rate. Given the inflation picture right now, it's certainly something we should be thinking about, going lower with interest rates than we currently are.

There are those who have suggested raising the inflation target, and the reason you'd want to do that as that you want to have more capacity. I don't know how low we can go and European countries are apparently doing some real-time research on this. Suppose we were able to, and that's all hypothetical at this points, suppose we were able to go to negative 50 basis points. When you go down to negative 50 basis points, that would be 75 basis points lower in terms of interest on reserves then we were at throughout [the recovery]. That's like having an inflation target that's 75 basis points

higher, because you've basically got that much more accommodation to play with when you need it.

But it's not going to be helpful if you keep talking about it as an emergency measure. Because then people are thinking you're going to pull it away as soon as you can. You want people to be thinking this is going to be in place as long as it's needed, as opposed to, you're just waiting for the first excuse to pull away.

Q. What about using wages as a target rather than inflation? It would seem like an easier sell to the public that you are trying to raise their wages rather than pushing inflation higher.

Congress has given us these goals of price stability and maximum employment. And we've measured them and communicated about them over time. It's absolutely worthwhile thinking about nominal income targeting, price level targeting, wage level targeting. I think we could do a better job given the goals we have.

Q. If I could get a little bit into your outlook, we've had these repeated disappointments, almost a yearly experience where the Fed starts off thinking, hey, maybe this is the year we'll get 3% growth, and by the end of the year it's happy it even got to 2%? What do you make of these arguments about this is secular stagnation or not, have we just gone through a bad recession or is there some other force at work that we don't understand?

Monetary policy is constrained around the world. I look at Japan, I look at the ECB. In terms of outcomes, that's been huge challenge and strain on monetary policy. But obviously conditions are different from what they were seven or eight years ago. I put a lot of weight on something which I hope will be transitory, which is simply the fear factor of 2007-2008 really being a huge scarring effect on businesses and households

You're getting at questions about productivity growth. The working-age population in the U.S. is going to grow more slowly. How those forces play themselves out is hard to know. The only thing I know about productivity growth is really hard to forecast.

But I do believe, if you look at employment to population is, it remains very low relative to 2007. If you talk to firms about why aren't you investing more, it's because they think I'm not going to have enough demand for my product. More demand, the prospect of more demand -- the prospects of monetary policy and maybe the word that won't be mentioned, fiscal policy that could provide support for demand conditions, would lead firms to invest more, could possibly lead them to invest more in R&D which would lead to more productivity growth and it would lead to more hiring.

This isn't just cheap talk. If you look at the way the U.S. responded to the Rooseveltian reforms in the 30s, productivity growth had been collapsing from '29 to '32, and it just turns around in the latter part of the decade, and it's as fast as it is at any time in peace time. He was arguably doing a lot of things which seem on their face as being very anti-supply-side, it was being driven by the demand side. I think doing better on the demand side could spill over in very helpful ways for the supply side.

Q. So overall you do think the low inflation rate is a sign that we still a lot of slack, that the 5% unemployment rate doesn't really tell a full story?

I don't think the 5% unemployment rate is telling us the full story. We were back here in this district to very low unemployment rates, and yet -- this is starting to improving thankfully-- but you still saw other measures of slack at very elevated levels. And that was showing up in low wage growth.

So no, I think we have to take a broader vision of what full employment means. Frankly if you talk to Americans who are out there in the labor market looking for work, you know, that's one way to get a vision, and it doesn't sound like we're back to full employment when you have those conversations.

2014 was such a great year for the labor market 2015 has not been that kind of year. What's going on in the labor market does not strike me as a very strong argument for tightening.

I have stressed in my discussions about policy what's going on in the inflation front. The employment mandate is always controversial among economists, how much progress you can make, etc. But everyone I believe agrees that we're responsible for what's going on with inflation. And the slow nominal wage growth, the slow growth rate of prices, the low break-evens that we see in financial market data, they all point in the same direction – that here's a significant risk that our inflation anchor has slipped downwards.

We have responsibilities in terms of full employment and we take those on, we welcome them, but the only way we can make progress and be successful on that is if our nominal anchor stays in place. I really am concerned that it's slipped downwards. You see it now in survey based measures too.

Q. Do you fear that if we head into an interest rate hike this month or next month, will it be a major policy mistake or is it a close enough call at this point?

It’s a risky move I think. It might turn out well and I hope it does. But it’s a risky move. But I’m not sure to use an old expression the game is worth the candle. I don’t see the benefits as being there. I look at it from the lens of this goal-oriented approach – I don’t see inflation coming back to target for years to come. And it’s not just my view. That’s the staff’s forecast. We have some of the best people in the world forecasting inflation for the Federal Reserve. That’s their forecast. And if you look at the financial markets we start to see erosion of credibility I would say at the end of last year and that’s only continued apace in 2015.