On the Limits to Monetary Policy
Executive Summary

Narayana Kocherlakota
President of the Federal Reserve Bank of Minneapolis

2nd Annual Hyman P. Minsky Lecture
Washington University, St. Louis, Missouri
March 20, 2012

Since the start of the Great Recession, employment has fallen considerably, while average inflation has been near the Federal Reserve's target of 2 percent. Given the Federal Reserve's dual mandate to promote price stability and maximum employment, an obvious question is "Why does the Federal Reserve appear to be doing so much better on one mandate than the other?"

In this speech, I present a simple model that suggests an answer to this question. A key feature of the model is that there are two distinct types of demand shocks: *labor demand shocks* and *product demand shocks*. The labor demand shocks reflect factors such as adverse credit conditions and increased uncertainty that lead firms to demand fewer workers at a given real wage. The product demand shocks reflect factors such as a loss of wealth and a higher risk of job loss that lead households to demand fewer goods at a given real interest rate. Each of these shocks leads to a fall in employment, with the decline in employment magnified by slow adjustments in the real wage.

When considering these shocks, it is important to distinguish how monetary and non-monetary policies influence the level of output and employment. In the model I employ, the Federal Reserve controls the real interest rate; lowering the real interest rate increases the demand for goods and services, and thereby influences national output and employment.

The first implication of the model is that monetary policy *can* offset the impact of the product demand shocks on employment, but it *cannot* offset the employment loss due to the fall in labor demand and any associated slow real wage adjustment. As a result, the level of "maximum employment" achievable through monetary policy is less than the "full employment" of labor resources.

A second implication is that non-monetary policies specifically designed to stimulate the demand for workers (such as government subsidies for hiring) can offset some of the employment loss due to the labor demand shocks, *but only if accompanied by monetary easing.* That is, monetary and non-monetary policy must work in concert to reduce the impact of a decline in labor demand; neither can do it alone.

Returning to the question posed at the beginning, this model suggests that the Federal Reserve is performing about as well as it can on both mandates. The Federal Reserve's accommodative policy has offset much of the impact of product demand shocks and so has kept inflation near target. However, this policy has been unable to offset the large adverse shocks to labor demand. The model implies that, in terms of employment, there are limits to what monetary policy can achieve on its own.