An overview of the Federal Reserve System

Additional Information

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Introduction

Today, I would like to give you some background on the Federal Reserve and the role we play in the economy. I will start by discussing our structure and some of our functions. Then I will share my perspective on being a national monetary policymaker on the Federal Open Market Committee. Finally, I will share a few thoughts on the economy here in Northeast Ohio and some of the challenges we are facing.

I. A Brief Overview of the Federal Reserve System

Let me begin, then, with a little "Fed 101." As you know, the Federal Reserve is our nation's central bank. It plays a unique role in our economy, and it has a unique structure that draws from both the public and private sectors.

The Federal Reserve was created by an act of Congress in 1913 and charged with creating a safe, stable, and more flexible monetary and financial system. These responsibilities are carried out by 12 regional Reserve banks and the Board of Governors in Washington, D.C.

One of the Federal Reserve's great strengths is this decentralized structure. The public aspect of the System is represented by the seven governors on the Federal Reserve Board, who are appointed by the President of the United States to 14-year terms.

The private aspect of the System is represented by the 12 regional Reserve Banks. Each of these Banks has its own charter and is governed by an independent board of directors, under the general oversight of the Board of Governors.

I lead the Federal Reserve Bank of Cleveland. My district-the Fourth District-includes all of Ohio, western Pennsylvania, eastern Kentucky, and the northern panhandle of West Virginia. Cleveland is our headquarters, and we also have branch offices in Pittsburgh and Cincinnati.

Like the other 11 Reserve Banks, the Federal Reserve Bank of Cleveland cooperates with the Board of Governors in supervising

banks in our respective regions. We also conduct research on national and regional economic conditions; we provide financial services to banks and the U.S. Treasury; and we are a resource for people and organizations that are involved in community economic development.

Each Reserve Bank works to understand the unique characteristics of its District. By better understanding the forces that shape our regional economies, we can better develop sound monetary policy for the nation.

The Federal Open Market Committee, or FOMC, is the group that is responsible for setting monetary policy. As president of the Federal Reserve Bank of Cleveland, I serve on this Committee, along with the eleven other Reserve Bank presidents and the seven members of the Federal Reserve Board of Governors.

The FOMC has a dual mandate from Congress: first, to maintain price stability over the long term-that is, to keep inflation under control-and second, to promote maximum sustainable economic growth. We seek to achieve these objectives by influencing interest rates and the money supply.

The main monetary policy tool we use is targeting the federal funds rate-that is, the interest rate that banks charge each other for overnight loans. Changes in this rate, in turn, affect a host of other short-term interest rates and economic variables.

II. My Role as a Federal Reserve Policymaker

Now I would like to give you more of an insider's perspective on my role as a Federal Reserve policymaker. It is a fascinating process, and one that I find challenging and energizing.

The FOMC meets in Washington, D.C., generally eight times a year. Most of our meetings last for a single day, although the Committee has been scheduling some two-day meetings to discuss special topics.

I happen to be a voting member on the FOMC this year. I rotate that responsibility with the president of the Chicago Reserve Bank every other year. But whether or not I vote during a particular year, I participate fully in the policy discussions at every meeting.

As you can imagine, I put a lot of work into my role as a Federal Reserve policymaker. I constantly review the latest national and international economic statistics. Economists throughout the Federal Reserve System pore over the data, conduct research, and create models to project economic activity. A big part of my preparation for the FOMC meetings essentially involves sifting through the different explanations that might lie behind the national statistics.

Very often, the official data that are available are just not current enough for a forward-looking enterprise like monetary policy. So to prepare for FOMC meetings, I must rely not only on my team of

economists-as talented as they are-but also on people in the community. Input from businesspeople and consumers provides me with reliable information on the economy far ahead of when the official statistics are released.

You might think of the statistical data that we gather on the economy as being like the readout on your car's dashboard: All of the information is meant to tell you what is happening to your car, but it typically does not tell you why it is happening. When the oil light on your car's dashboard comes on, you know that the oil level is probably low, but you don't know why. Maybe there's a leak, or maybe your mechanic left the cap off the reservoir. To find out, you have to look under the hood.

Meeting with people is my way of looking under the economy's hood. The conversations enable me to understand the why behind the what. They help me judge which of the various explanations being offered for the condition of the national economy is most reasonable.

I take these stories and lessons I learn from them to Washington. They allow me to attach reality-not to mention human faces and voices-to what would otherwise be seemingly sterile statistics. This information plays a key role in shaping our national policy decisions.

A typical FOMC meeting begins with the Board of Governors' staff presenting their projections for the domestic and international economy. Each participant at the table can ask the staff questions about the projections. Then we have what is known as a "go-round," where each FOMC participant provides comments on the economy and the economic outlook. As part of their commentary, the 12 Federal Reserve Bank presidents present their views on economic developments in their respective regions.

After the discussion about the current economic situation and outlook, the Committee members turn their attention to policy. To frame that conversation, the Board of Governors' staff suggests a few policy alternatives, and then the Committee members offer their view. We vote on our decision, which is formally called a "policy directive," and then discuss how best to explain it to the public. We release our decision to the public at about 2:15 in the afternoon.

A more complete summary of the meeting is provided in the meeting minutes, which are released three weeks following each meeting. Full meeting transcripts are made available after five years.

After hearing my short description, it may sound as if the FOMC meetings are very rigid and formal affairs, but I want to emphasize that there is always a great deal of interaction and collegiality around the table. I think of the meetings not so much as discreet events, but rather as part of an ongoing dialogue and debate. Over the course of time, we have some complex and fascinating discussions that help to inform all of our thinking.

Although the process itself is fairly straightforward, the judgments associated with monetary policy are not always as obvious as they might appear. Economic conditions can be unpredictable, and we are under no illusion that we are perfect forecasters. To paraphrase former Federal Reserve Chairman Alan Greenspan, we are essentially risk managers. We need to make policy choices that stand the best chance of moving us toward our objectives, given our imperfect understanding of the changing environment around us.

I mentioned earlier that the FOMC's objectives are price stability and maximum sustainable economic growth. As a practical measure, we look at the growth rate of a number of "core" inflation measures to assess price stability in the short- to medium run. As you may know, core measures of inflation strip out some of the more volatile components of the price indexes, such as food and energy.

For maximum sustainable economic growth, we try to support the expansion of gross domestic product, or GDP, near its "potential." The tricky part is that the economy's potential growth rate can change over time. Some changes are temporary ones-such as when we have energy price shocks. But some changes are more permanent-for instance, when new technological advances lead to major upward shifts in productivity, or when changes in the trend of labor force participation affect the labor supply. These changes make it difficult to measure potential GDP reliably.

Although we have more than one objective, I believe that in the long run, maintaining price stability is the unique contribution that the Federal Reserve can make to promoting maximum sustainable economic growth. In many, if not most, cases this is true in the short run as well. The bottom line is that you cannot achieve long-run growth without price stability.

Those are the basics of the Federal Reserve and monetary policy. I want to emphasize that although monetary policy is national in scope-meaning that the FOMC makes decisions based on what is best for the country as a whole-we are well aware that different regions of the country face their own special circumstances and challenges.

As we saw last year, some regions, like the Gulf Coast, can face sudden and catastrophic changes, while others, like our region, are in the process of responding to longer-term structural changes.

III. Economic Transition in Northeast Ohio

I would now like to take a few minutes to discuss the economic challenges that we are currently facing in Northeast Ohio. More than four million people live in the 15 counties that make up Northeast Ohio. After a century of relying on the heaviest types of traditional industry-coal, steel, autos, rubber, and electrical equipment-we have been deeply affected by global trends, including rapidly changing technology and increased international trade.

Deep currents of change have swept over our industrial landscape. Economists call this process "creative destruction." Creative destruction is a natural, and indeed a necessary, part of our economic development. As familiar industries of the past are replaced by the innovative technologies that will shape our future, resources are redirected to wherever they are most productive. Capital and creative energy will flow toward the new goods, services, and processes that will deliver the greatest value, and jobs will eventually follow.

Of course, creative destruction can be an uncomfortable process, but in reality it is the absence of this ebb and flow that should concern us. There is some evidence to suggest that a weak level of creative destruction can help explain why employment and economic growth have been less robust in our region than in other parts of the country. Here in Ohio, we have had a lower rate of job creation than the nation over the past few decades, as you might guess. But you might also be surprised to hear that we have also had a lower rate of job destruction.

During the past few years, Ohio's rate of job destruction has been moving up, closer to the national average. This may be a promising sign that Ohio's labor market is moving toward a more dynamic state. However, we still need to see rates of job creation move higher before our state's economy becomes dynamic enough to sustain healthy growth.

What can be done to encourage a more dynamic economy? One critical thing we need to do is to improve the levels of educational achievement in Ohio. A growing body of research suggests that education is a key component of an area's economic growth prospects. This is not hard to understand, especially in a global economy which seems to put an increasing premium on highly skilled workers.

What is perhaps surprising, however, is that this is not a recent phenomenon or an outgrowth of the computer age. As a matter of fact, in a recent research project, economists at the Federal Reserve Bank of Cleveland considered a number of factors that might explain differences in the relative income levels among the states in our country. They found that the best predictor of a state's relative income position is its so-called "stock of productive knowledge," as measured by levels of educational attainment and patents, and that this has been the best predictor since the 1940s.

Back then, differences in high-school graduation rates were a key driver of differences in income levels across the states, and Ohio ranked 19th in the country in high school completion. We also tended to produce significantly more patents per person than the national average-about one and a half times more. Since the 1960s, however, Ohio's patents per person have declined to about the national average.

Ohio also does not fare very well in the measure of educational attainment that matters most today-college graduation rates. In this

category, Ohio ranks 39th out of the 50 states in the share of its residents who have earned baccalaureate degrees. Not surprisingly, just as Ohio's patent production and educational attainment have failed to keep pace with most of the country, Ohio's per capita income-which was once above the national average-has also not kept pace with the national average for more than two decades now.

It is very interesting to know that some of the challenges we are facing in Ohio are very similar to those facing policymakers in Italy. Even today, in 2006, only about 11 percent of Italians hold college degrees. Italian officials I have met with said that they were envious of the education attainment in our country, where about 28 percent of the adult population has a college degree.

All of us want to build a sound foundation for future economic prosperity. I believe that one of the most promising ways to do that is to create a civic culture that supports education. I am proud to be a part of a statewide group -- the Ohio Business Alliance for Higher Education and the Economy - that is working to increase the strategic role of our colleges and universities in contributing to Ohio's economic growth.

As we look ahead, our prospects for building a stronger regional economy will depend on our commitment to invest in intellectual capital. The knowledge base of our students and the technological skills of our workers will be critical for our future prosperity. I am convinced that the investments we make in education today-if other conditions are right-will serve as a springboard for economic growth tomorrow.

I am confident that our region has a solid foundation for future growth for several reasons:

We have a wealth of established companies and a promising array of emerging technology firms.

We have a large concentration of financial expertise and legal talent.

We have fine public and private universities, such as John Carroll, and an outstanding health-care sector.

We have outstanding natural and cultural resources.

Most important, we have talented, committed people who enjoy living and working here.

Conclusion

I hope that I have offered you a bit more insight on the Federal Reserve System, the Federal Open Market Committee and the Northeast Ohio economy.