



## A Policymaker's Perspective on Monetary Policy and the Economy

### Introduction

I am delighted to have this opportunity to share my thoughts on monetary policy and the economy. As a Federal Reserve Bank president and a member of the Federal Open Market Committee, I spend a lot of time speaking to various audiences, both in my home district and across the nation.

But no matter where I go, I find that most people want to know more about the Federal Reserve and what we do. Our organization seems to be somewhat of a mystery. So today, I hope to dispel some of that mystery for you. I will begin with some background on the basic structure and operations of the Federal Reserve. Then I will offer some perspective on economic growth. Finally, I will say a few words about the inflation outlook.

Of course, my remarks today are my own and do not necessarily reflect the views of any of my colleagues in the Federal Reserve System.

### The Federal Reserve System: Structure and Operations

Let me begin, then, with a brief overview of the Federal Reserve System, our nation's central bank. Congress created the Federal Reserve System in 1913 and charged it with maintaining a safe, stable, and flexible monetary and financial system. To accomplish this, we perform many functions, such as regulating and supervising banks and providing financial services to commercial banks and the U.S. Treasury. The function that gets the most public attention, however, is monetary policy.

For a central bank, we have a decentralized structure. It consists of a seven-member Board of Governors, who are appointed by the President and located in Washington, D.C., and the 12 Federal Reserve Banks located across the country. We often like to say that the 12 Reserve Banks are private entities with a public purpose. Each bank is relatively autonomous, with its own charter and board of directors. In contrast with the members of the Board of Governors, the Reserve Bank presidents are not political appointees.

I lead the Federal Reserve Bank of Cleveland. My district includes all of Ohio, western Pennsylvania, eastern Kentucky, and the northern panhandle of West Virginia. Bonita Springs is part of the Federal Reserve Bank of Atlanta's district, which encompasses our nation's southeastern region. Our districts seem to have at least one

#### Additional Information

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important thing in common - thousands of residents from my region spend the winter months in your region!

Reserve Bank presidents spend a lot of time learning about and understanding economic developments in our districts. This knowledge supplements national economic data and sometimes even alerts us to economic developments before they appear in the national data. In that sense, we bring a regional voice to national monetary-policy deliberations.

Consistent with our decentralized structure, the Federal Reserve arrives at its monetary policy decisions through the consensus of a committee. That committee is the Federal Open Market Committee, or FOMC. I serve on the FOMC, along with the seven Federal Reserve governors and the 11 other Reserve Bank presidents. Ben Bernanke is our chairman, and we meet in Washington, generally eight times a year.

The Federal Reserve's decentralized structure also reflects and reinforces our independence. Monetary policy decisions are made without the direct input or the immediate approval of the other branches of government. This helps keep monetary policy independent of political pressures and influence. Nevertheless, we are independent within the government - not of the government. Ultimately, we are accountable to Congress for achieving two objectives: price stability and maximum sustainable economic growth.

You might wonder how monetary policy can attain these two objectives at the same time. To be sure, these objectives can sometimes conflict, but over the long term, they are complementary. Ultimately, the Federal Reserve promotes economic growth at its maximum sustainable rate by maintaining a low and stable rate of inflation.

The FOMC sets a federal funds rate target as a guide for implementing monetary policy. The federal funds rate is the interest rate that commercial banks charge each other for overnight loans of reserves. The FOMC essentially sets this rate, and by raising or lowering it, we contract and expand money and credit conditions in the economy. If we do this job well, we affect economic activity and inflation in a way that achieves our two objectives.

I make monetary policy sound like a fairly straightforward, mechanical exercise: Just set the federal funds rate target to maximum sustainable economic growth and low inflation, and stand back. But, as you may well imagine, it's not quite that simple. Around the FOMC table, we literally spend hours discussing the latest economic statistics and sharing our views on business and financial conditions, both here and abroad. Monetary policy decisions benefit from this kind of give-and-take, because economic growth is a complex and dynamic process.

## The Long and Short of Economic Growth

Let me take a few moments, then, to offer some perspective on economic growth and the role that monetary policy plays. As a monetary policymaker, it is helpful for me to try to distinguish between the long-term factors that affect our potential growth and the short-term factors that create business-cycle fluctuations.

Let's consider the long-term growth factors first. Generally speaking, two main factors - labor force growth and productivity - determine our nation's long-term potential for economic growth. When the workforce grows, so too does our economic output. Likewise, when

our workforce is more productive, we can generate more goods and services.

During the second half of the 1990s, for example, labor force participation—that is, the share of the working-age population who choose to be in the labor force - reached a record high. This trend helped to elevate our nation's rate of economic growth. Over the next few decades, though, I expect the labor force to grow more slowly, lowering our economic growth rate somewhat. Our population is aging, the baby boom generation is beginning to head into retirement, and the youngest adults are waiting longer to join the workforce, primarily because they are spending more time continuing their education.

The second factor that influences our long-term potential for economic growth is productivity. Many things, including scientific discovery, technological innovation, educational attainment, and investment patterns, affect productivity

During the second half of the 1990s, an investment boom in information technology nearly doubled our rate of productivity growth. Combined with the rapid pace of growth in the labor force, productivity gains helped the economy expand at nearly a 4 percent pace during those years - well above average.

Monetary policy was not divorced from this process. Obviously, the Federal Reserve cannot directly affect factors such as population growth and scientific discovery. But the investment boom that contributed to our productivity growth benefited from confidence that the Federal Reserve would keep inflation low and stable for years to come. Low and stable inflation helps to foster low interest rates, which in turn encourage investment.

My opinion is more than just theoretical. We have seen that countries with persistently high and variable rates of inflation eventually suffer a decline in long-term economic growth. When inflation persists, people become uncertain about future prices and costs. Instead of making investments in activities that encourage economic growth and employment, they put their funds into things like land or commodities to protect the value of their existing wealth. Over the long run, we have seen that high and variable inflation distorts people's economic decisions, lowers productivity, and typically reduces economic growth.

So we know that labor force and productivity growth determine our long-term economic growth trend. But we also know that unexpected events can temporarily push the economy off its longer-term path. One recent example is the terrible tornadoes that your neighbors to the north experienced last week. This natural disaster devastated human lives and the economic health of the communities that were hit.

On a larger scale, disasters like Hurricane Katrina can affect the economic growth of the entire country for months afterward. I vividly recall the FOMC meeting that occurred right after Katrina hit. All of us sat spellbound as we listened to Jack Guynn, who was president of the Atlanta Reserve Bank at the time, give us a firsthand account of the devastation on the Gulf Coast. At that time, nobody could really predict the extent of either the human toll or the damage to our energy infrastructure. I can assure you that we all were very concerned.

Of course, it is not only natural disasters that can cause business-cycle fluctuations. Many other short-term factors - such as oil price hikes and financial market disruptions - can also cause economic shocks

By far, the most pronounced economic shock of the past year was a contraction in the nation's housing market. The downturn in this sector has clearly pulled economic growth below its long-term potential.

Of course, here in Lee County, you are well aware that the housing market has fizzled. Home prices here rose about 30 percent in 2005, meeting or even exceeding the pace of price appreciation in other hot markets like Phoenix, Washington, D.C., and San Francisco. Nationally, rates of home appreciation have fallen since then. This is true in Lee County as well, where home prices have generally experienced lower rates of appreciation rather than outright declines. And even though home building slowed significantly last year, it was still the second strongest on record in Lee County.

Some observers think that the worst of the national housing contraction is behind us. That view may be premature, but the recent data are encouraging. Home sales no longer seem to be falling, and inventories of unsold homes have dropped a bit. And even though new homes under construction fell sharply last year following several years of strong growth, most economists expect further declines to become less steep. Some industries, such as construction and home building supplies, have clearly felt the brunt of the housing market contraction, but by and large, we have seen little spillover to other sectors of the economy.

Unfortunately, the FOMC can do very little to directly soften the housing contraction. The supply and demand for housing must eventually come into balance on its own. In fact, monetary policy has never been successful at completely smoothing out short-term, business-cycle fluctuations. We simply cannot fine-tune the economy. One reason is that our economic data are always incomplete and do not paint a full picture of current conditions. For example, we did not receive an estimate of the economy's growth in the fourth quarter of 2006 until last week. And that number still remains an estimate, because it is based on preliminary and incomplete data.

Another reason we cannot fine-tune the economy is that, in the words of the late economist Milton Friedman, monetary policy affects the economy only with "long and variable lags." This means that a change in policy today can take many months before it begins to affect spending and prices, and perhaps years before its full impact is felt. As a result, the FOMC must always be looking well ahead when formulating monetary policy. And, although we are pretty good forecasters as forecasting goes, economic forecasting is not an exact science.

I don't mean to imply that monetary policymakers ignore short-term economic fluctuations. We don't. Indeed, we calibrate our policy actions to have the best possible overall effect on short-term and long-term economic conditions. But supply and demand factors in the economy must ultimately adjust on their own. Our role is to provide a stable environment that enables these short-term imbalances to work themselves out in the least disruptive manner. We do that by keeping inflation low and stable.

## **A Word about Inflation**

Now let me say a few words about the inflation outlook. During the past few years, inflation has been high and quite volatile, largely due to fluctuating energy prices. Headline inflation rates rose to over 4 percent in the third quarter of 2005.

Generally speaking, brief periods of elevated inflation do not pose immediate threats to economic growth. However, if inflation rates remain high for a prolonged period of time, people might reasonably believe that inflation has permanently shifted higher, and adjust their behavior accordingly. If that happens, the whole inflation environment could change for the worse - distorting investment decisions, reducing productivity, and affecting economic growth.

We have not seen evidence of this. Measures of inflation expectations have remained fairly stable even as actual inflation rates have moved higher and become more volatile. Financial market participants appear to be confident that the Federal Reserve's monetary policy will keep inflation contained.

Since June 2004, the FOMC has moved the federal funds rate target up from 1 percent to 5-1/4 percent, where it stands today. We did that in a steady sequence of 17 consecutive, quarter-point adjustments. At our past five meetings, we have decided not to change the federal funds rate target. Holding the rate steady is giving us time to assess the full impact of our previous rate increases on economic conditions and inflation.

The most recent inflation statistics have improved. The core Consumer Price Index - which excludes food and energy items - rose by about 2-1/2 percent last year. However, during the last three months of the year, this index increased at an annual rate of only about 1-1/2 percent. I regard this movement as an encouraging sign, but I am not yet convinced that the inflation trend is shifting down.

The national inflation picture has been clouded in the past few years by large swings in energy, commodity, and housing prices. As these markets normalize, and as we gain a clearer picture of the underlying inflation trend, we may see that some inflation risks remain. In that case, some additional policy firming may be needed - depending, of course, on the outlook for both inflation and economic growth.

## Conclusion

I remain convinced that low and stable inflation rates will help us prosper as a nation. I hope that my remarks today have helped to dispel some of the mystery surrounding the Federal Reserve and that I have helped you to better understand our commitment to price stability and maximum sustainable growth.