Keys to Growth for the Nation and the Region

When Jim Foster called with the invitation for me to launch this new City Club speaker series -- the Business Leaders Series -- I was honored and eager to get on board. The City Club is celebrating its 100th anniversary this October for a reason - it is one of the gems of this city. I congratulate you on your 100th anniversary and your legacy of speakers that is unprecedented in the United States. It is my privilege to be asked to return to this platform in any capacity.

The underlying theme of this series is about driving growth in the region and the global economy. These are topics that I think a lot about in my role as president of the Federal Reserve Bank of Cleveland. Here in Northeast Ohio, we must constantly upgrade our businesses and communities to energize and sustain economic growth. With that in mind, this morning I would like to cover three topics:

- First, I'll describe economic conditions in the region.
- Second, I'll explain that the keys to our region's long-term growth are education and innovation.
- And finally, I'll close with some comments about the steps the Federal Reserve is taking to support the nation's economic recovery.

As always, the views I express are mine alone and do not necessarily reflect those of my colleagues in the Federal Reserve System.

Let me start with economic conditions in our region. Here in Northeast Ohio, we have weathered the Great Recession better than many other parts of the country. The unemployment rate in Northeast Ohio stood at 7.4 percent as of the most recent reading, which was December 2011. This is more than a full percentage point lower than the national rate of 8.5 percent that prevailed at that time.

This is in striking contrast to our recoveries from prior recessions. For example, during the harsh recession of the early 1980s, unemployment in Ohio peaked near 14 percent, which was 3 percentage points above the national rate, and it remained high for several years. Conditions in Northeast Ohio were even worse. Ohio lost almost a half million jobs, more than 10 percent of its total employment. And Ohio alone accounted for about 20 percent of the entire country's job losses in this difficult period. This high unemployment rate was due, in part, to our region's greater share of employment in manufacturing at that time.

Today the impact of manufacturing on our local economy is very
Manufacturing has not been the lead weight pulling down our economy. In fact, I have been hearing stories of strength and resurgence in manufacturing. In 2011, manufacturing employment increased more than 3.5 percent in Northeast Ohio and about 2 percent nationally. These statistics demonstrate greater diversification in our region's economy. This is good news.

We are also seeing relatively better news in Northeast Ohio in terms of incomes. Income measures include salaries, investment earnings, business profits, and transfer payments. A region's income reflects what households have available for spending. The level of a region's per capita income also tells us about the standard of living in the region, and the growth rate of per capita income gives us a sense about how economic conditions are changing over time. In 2010, average per capita income in Northeast Ohio rose about 3 percent, slightly outpacing the nation, after falling in both 2008 and 2009. To put this in context, a 3 percent increase in income translates to about $3 billion in local spending or saving.

Although the recent good performance is encouraging, income growth in our region has been persistently lower than the national average over the past few decades. This pattern is evident at the state level, as well. Fifty years ago, Ohio's per capita income was much higher than the national average, but today, it has fallen to just average among the states. So what can we do to improve income growth in our region?

Economists at my Bank researched the factors that have made states more prosperous over a 75-year period, from 1929 to 2004. The results of their research are clear - the two main drivers of income growth are education and innovation. Their research shows that regions with a more educated workforce and higher rates of innovation saw their incomes grow significantly faster over long periods of time.

Simply put, states that have more "knowledge capital" perform better than states with less. They have a larger pool of highly skilled workers to generate new ideas and find new ways of doing business. These workers may also be more flexible in adopting new technologies.

If education and innovation are the key drivers of growth, then how does our region stack up? The percentage of the population with a college degree serves as a good measure for education since so many of today's jobs require post-secondary education. Based on this metric, Ohio doesn't do very well. We rank 38th out of the 50 states, and we have been in the lower part of the distribution for many decades.

However, this statistic might be somewhat misleading. Ohio has a relatively older population, and people who are 55 and older are less likely to have college or graduate degrees in almost any part of the country. So our researchers dug deeper and focused on a younger age group -- ages 25 to 34. Here, Ohio does substantially better. We are in the middle of the pack for younger residents with college degrees - we rank 25th out of the 50 states. And if we look at post-graduate education of 25- to 34-year olds, Ohio does even better -- ranking 17th out of the 50 states. This is not ideal, but it is clearly movement in the right direction.

While these statistics are for Ohio as a whole, we find that Northeast Ohio statistics are consistent with these trends. Our overall educational attainment lags the nation considerably, but our younger residents seem to be doing better.

In addition, we need to remember that these comparisons are all
within the United States, but our workers and companies increasingly compete globally. Back in 1995, the United States had the second-highest college graduation rate in the world, but by 2008, we had slipped to thirteenth. In a recent comparison of 34 developed countries in tests of high school students, the United States ranked 14th in reading, 17th in science, and 25th in math. It is not so much that the United States is falling back, but that other countries, like Finland and South Korea, are improving their educational outcomes. In order to remain competitive, the U.S. labor force must become even better educated.

Beyond education, our research also shows that innovative regions experience higher growth. Innovation begins with new ideas, but for those ideas to have an economic impact, they need to be commercialized. In our Bank’s research, the economists used U.S. patent data to measure innovation because patents are a critical step in moving ideas, in this case inventions, into a profitable business venture. Without moving the idea all the way to commercialization, no extra income gets generated in our community.

Historically, Ohio has been a relatively innovative state, but over time our advantage has diminished. At one time, Ohio ranked sixth in the nation in the number of patents per capita. But today, Ohio is in the middle of the pack. How did this happen? Ohio has increased its patent activity; we are just not keeping pace with the rest of the nation. For example, the number of newly issued patents in Ohio in 2010 was up just 1 percent from 2000. In contrast, over that same period of time, the number of new patents issued nationally was up 27 percent.

So what can a region do to foster innovation? Unfortunately, the research on how to generate innovation as a region is not as well developed as it is for educational attainment. What we do know, first and foremost, is that a region needs to be able to produce new ideas, and research institutions play an important role in this process. Nonetheless, innovations that result in patents are primarily generated by companies. In fact, in the Cleveland area between 2006 and 2010, almost 90 percent of newly issued patents were connected with companies, rather than research institutions.

Government initiatives can also play key supporting roles in fostering innovation. The State of Ohio has made significant investments to support research and commercialization through the Third Frontier program. Here in Northeast Ohio, JumpStart is the regional partner for the Third Frontier’s entrepreneurial investment program. This organization has a growing portfolio of new businesses in Northeast Ohio that are developing new products and ideas. These endeavors, along with other local initiatives such as BioEnterprise and NorTech, have brought a renewed focus on supporting innovation, with the aim of benefiting economic growth throughout the region.

So, as we pursue efforts to improve the prosperity of our region, I am encouraged that we are coalescing around an agenda focused on educational attainment and innovation. These drivers of economic growth are closely linked. Innovative environments typically have strong educational institutions and research organizations, and attract a large concentration of people with high human capital. Ultimately, our efforts in these areas can’t be slogans or advertising, or short-term fixes. We need to work together and we need to understand that we are involved in a marathon, not a sprint.

Let me now turn to some comments on how the Federal Reserve is working to support economic growth across the country.

Monetary policy has an important role to play as our economy recovers from the deepest recession in more than 70 years. The
Federal Reserve's monetary policymaking group is the Federal Open Market Committee, or FOMC. This year, I am a voting member on the FOMC. The Committee generally meets eight times a year in Washington to review economic and financial developments and then to determine the appropriate stance for monetary policy. The FOMC is focused on achieving the dual mandate given to us by Congress: to maintain stable prices and promote maximum employment.

Needless to say, the last few years have been very challenging for monetary policymakers. As you are painfully aware, the economy has been through its worst recession since the Great Depression in the 1930s and the Federal Reserve has responded aggressively and creatively to the financial and economic crisis. In September of 2007, the Federal Reserve began to ease monetary conditions by lowering our target for the interest rate that banks charge each other for short-term loans, known as the federal funds rate. You and I can't borrow at the federal funds rate, but the rates we pay for consumer and business loans do respond to changes in the federal funds rate. By the end of 2008, we reduced the federal funds rate to nearly zero, and it has remained there ever since. Once the rate fell that low, we had to employ some different techniques to ease monetary conditions further. Think of it as taking the back roads when the freeway is shut down; it may not be as efficient, but the new route can still get you to your original destination.

The new techniques that we used included purchasing large quantities of U.S. Treasury securities and federally guaranteed mortgage-backed securities. Our balance sheet grew from $900 billion prior to the crisis to close to $3 trillion. Our objective in taking these alternative routes is to push down medium- and longer-term interest rates for consumers and businesses, and we have been successful in doing that.

Even though we have introduced some new techniques, we are still operating to achieve our dual mandate of stable prices and maximum employment.

Mindful of the unusual steps we have been taking to keep the recovery on track, we have dramatically stepped up our communications and looked for new ways to be transparent about what we are doing and why. In that spirit, we took an important and historic step following our FOMC meeting four weeks ago and released a document titled "The FOMC's Longer-Run Goals and Policy Strategy." In that statement, we announced for the first time a numerical objective for inflation. Specifically, we stated that an inflation rate of 2 percent is the rate most consistent over the longer run with the Committee's congressional mandate for stable prices.

Since inflation over the longer term is primarily determined by monetary policy, the Committee has the ability to set a longer-term goal for inflation, and can be held accountable for achieving it.

Our historic document also addresses how we plan to achieve our congressionally mandated goal for maximum employment. The maximum level of employment for our economy may change over time, and it will shift along with a host of non-monetary factors including changes in demographics and technology. Unlike an inflation goal, central banks cannot just pick any level of maximum employment they desire and achieve it. However, central banks can estimate maximum employment for the economic circumstances we live in, and set policy to achieve - over time - an unemployment rate consistent with it. In our statement, the majority of FOMC members currently estimate that the U.S. economy can attain an unemployment rate between 5.2 and 6 percent over the longer term.

Now that I've explained our dual objectives, let me talk about how I
see the economy performing in the next few years. My outlook for the national economy is for growth to continue to gradually improve. I am expecting the economic recovery to remain moderate and for the economy to grow around 2-1/2 percent this year and about 3 percent next year.

Our national unemployment rate of 8.3 percent still lies well above the levels that the Committee judges to be consistent with maximum employment. Recent labor market information has been promising. Employment gains have picked up, and new claims for unemployment insurance have trended down, over the past few months. If the economy grows at the moderate pace that I am anticipating, it could take as long as 4 or 5 years to achieve maximum employment.

Those of you who follow economic data know that inflation was about 3 percent last year, but has actually averaged only 1-1/2 percent over the past three years. My forecast for inflation is that it will run close to 2 percent for the next few years. Moreover, my staff's estimate of inflation expectations indicates that financial market participants expect inflation to remain below 2 percent for quite a while. Still, the recent spike in oil prices and housing rents could complicate the inflation picture if they persist.

My economic outlook, of course, is fundamental to my vote on monetary policy. At our last meeting in January, the FOMC decided that economic conditions are likely to warrant that we keep short-term interest rates at exceptionally low levels at least through late 2014. I want to be clear, however, that this statement is by no means a commitment that we will not raise interest rates until late 2014. Rather, it is an expression of what the Committee judges to be the earliest time that we would likely raise interest rates based on our current economic outlook. Changes to the outlook could result in interest rates rising either sooner or later than late 2014. And believe me, I would prefer nothing more than to support an increase in interest rates before late 2014 on the basis of a brighter outlook for economic growth—but I'm not there yet.

I am comfortable with the current stance of monetary policy. Policy is, in fact, already quite accommodative, both in terms of interest rates and the size of our balance sheet. With my current outlook, I think this path of interest rates is the one best suited to foster steady gains in output and employment and to maintain stable prices. In my assessment, doing more at this time could create too much inflation risk and doing less could risk weakening an already slow expansion and causing an unwelcome disinflation. Of course, I will continue to update my economic outlook as circumstances warrant, and my position on future policy actions will evolve accordingly.

We are, as I'm sure all of you in this room understand, in a challenging environment both nationally and here in Northeast Ohio. Whether you run a business, or manage a family, or work for a not-for-profit organization, we are all working through some of the most extraordinary challenges we have faced in our lifetimes.

Fortunately, while uncertainty remains, the national economy is improving. Locally, we can take some comfort in the knowledge that we are performing better in this recovery than we typically have done. But we cannot sit back and relax. We still have much work to do. Specifically, we need to boost educational outcomes and innovation in order to make our region more prosperous.¹

¹. The Federal Reserve Bank of Cleveland regularly calculates and publishes estimates of 10-year expected inflation. Information can be found at:

http://www.clevelandfed.org/For_the_Public/News_and_Media/Speeches/2012/Pianalto_20120301.cfm