The Fed and the Economy: Lessons from Milton Friedman

Additional Information

Sandra Pianalto

President and CEO,
Federal Reserve Bank of Cleveland

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My visit to Marietta has also included some time last evening with a great group of economics and business students and faculty members at Marietta College, and time with a number of area bankers this morning. I enjoy very much spending time with businesspeople, bankers, community leaders and academic organizations across my district. It is through your insights and these types of conversations that I gather valuable information on our region's economy.

Before I begin, I want to applaud the "town and gown" relationship between the college's Friedman Lecture Series and today's Economic Roundtable event. Linking these two programs is a very good example of forging strong connections among the academic community and area business and civic leaders. More generally, relationships formed among business, economic development and educational institutions are critical elements to improving our region's economic prosperity.

I feel privileged and honored to be among the impressive list of speakers for these programs that over the years have included my colleagues Al Broaddus, Jeff Lacker, and my predecessors at the Cleveland Fed - Karen Horn, Lee Hoskins and Jerry Jordan, just to name a few. Thank you for the invitation to be among the speakers for the Economic Roundtable, and to contribute to your legacy of discussing current and important economic, social and governmental issues facing this area and the nation.

As I did last evening on campus, I will refer often to Dr. Milton Friedman in my remarks, as he has had an enormous and lasting impact on how we approach our work at the Federal Reserve today. About the time he provided the inaugural lecture for Marietta's series which carries his name in the early 1980s, central bankers had begun to embrace some of his views about the economy and monetary policy. Dr. Friedman was perhaps the most prominent member of the "monetarist" school -- economists who taught that inflation was a monetary phenomenon. Moreover, his view was that the Fed -- if it would pay close attention to inflation -- might better succeed in its job of stabilizing the U.S. economy using the tools at its disposal.

Today I intend to cover three broad areas: I will start with some background on the Federal Reserve. Second, I will discuss how we have responded to the extraordinary economic conditions of the last few years. And I will conclude with some comments on my economic outlook and monetary policy.

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

To lay some foundation, let's rewind for a moment and talk about the creation of the Federal Reserve System. The Fed was created nearly a century ago, in 1913 to be exact, as the nation's central bank. We were charged with maintaining a safe, stable, and flexible monetary and financial system.

The formation of the Federal Reserve began with much debate in Congress. I guess some things never change in a democracy! While it was generally agreed there should be a central bank, one group wanted a central bank that would be part of the government. Another group wanted a central bank that would be owned and operated by the commercial banks. Our forefathers settled on a compromise: The Federal Reserve System consists of the Board of Governors in Washington, DC -- comprised of seven members who are appointed by the President and approved by the Senate. In addition, there are 12 Federal Reserve Bank presidents representing districts around the country. The presidents bring the voices and views of people in our districts across the United States to our decision making on monetary policy. I lead the Fourth District, which includes all of Ohio, western Pennsylvania, eastern Kentucky, and the panhandle of West Virginia.

You are probably aware of the Federal Reserve's monetary policymaking group, which is called the Federal Open Market Committee, or FOMC. The Committee is currently chaired by Ben Bernanke, and consists of the Fed governors and Reserve Bank presidents. We generally meet eight times a year in Washington to review economic and financial developments and then take actions to adjust monetary policy as necessary in light of our goals for economic activity and inflation. This year, I am a voting member of the FOMC, and will attend my next meeting in about three weeks.

At each meeting of the FOMC, we share insights and data about regional, national, and international economic conditions, and our outlooks for future conditions. We then make policy decisions based on the mandates given to us by Congress, which are to maintain stable prices and promote maximum employment. We do that primarily by influencing interest rates -- the federal funds rate to be precise -- which is the rate at which banks lend to one another. When the Federal Reserve initiates changes in the federal funds rate, our actions affect the growth of money and credit in the economy, and directly influence lending rates for businesses and consumers. By lowering interest rates and easing monetary conditions, we can encourage borrowing and spur economic growth. On the other hand, when we raise interest rates and tighten monetary conditions, we can throttle the economy back.

The level of interest rates and the amount of money and bank loans in the nation's economy, as Dr. Friedman persistently reminded us, also influences inflation and inflation expectations. Many of us recall Dr. Friedman's now-famous definition of inflation: "Too much money chasing too few goods." He forcefully argued that central banks can control the long-term trend of inflation in their countries because they can control the supply of money. The lesson he taught us -- and a lesson that has become very much a part of Federal Reserve decision-making today -- is that controlling inflation is a critical element in promoting the nation's overall economic health. Dr. Friedman reasoned that since the Federal Reserve has the power to control inflation, then the Federal Reserve has the power to prevent swings in inflation from being a destabilizing factor for the economy. Put another way, by maintaining low and stable inflation, the Federal Reserve helps to minimize economic distortions that could adversely affect employment, production, and the incomes of American families.

Dr. Friedman's recommendations gained more attention at the Federal

Reserve as inflation escalated throughout the 1970s. The Federal Reserve most fully embraced Dr. Friedman's perspective during Chairman Paul Volcker's term. In the early 1980s, the FOMC let the federal funds rate rise dramatically in order to restrict the growth of the money supply and get inflation under control. Over the years, the Federal Reserve gradually lowered inflation from a high of nearly 15 percent to about 2 percent. Today, importantly, the public expects inflation to remain low and stable well into the future. Thus, Federal Reserve policymakers accepted responsibility for controlling inflation, just as Dr. Friedman taught that we should. The period from about 1985 through 2007 became known as "the Great Moderation." The economy grew, unemployment was relatively low, and recessions were mild and short. Structural changes in the economy, and perhaps some good fortune as well, likely contributed to better economic performance. However, sound monetary policy surely also played an important role. I don't think Dr. Friedman would have been surprised.

Unfortunately, as we all know, the Great Moderation came to an end in 2008, when our country faced extraordinary financial market conditions prompting the worst recession since the Great Depression. While most people associate Dr. Friedman with his quest to prevent high and rising inflation, there is more to be drawn from his body of work that is relevant to our responses to the extraordinary conditions we have faced in the last few years. Dr. Friedman was just as concerned with the perils of falling prices, that is, deflation. In his monetary history of the Great Depression, which he co-authored with Anna Schwartz, Dr. Friedman faults the early Federal Reserve for not doing enough to prevent deflation and economic collapse. In particular, he emphasizes that the Fed's restrictive monetary policy during the 1930s contributed to making what might have been a severe recession into the prolonged, 10-year downturn that we now know as the Great Depression.

In a speech given at Dr. Friedman's 90th birthday celebration in 2002, then-Governor Ben Bernanke acknowledged the impact of Dr. Friedman's studies, and I quote from the Chairman's remarks that day:

“I would like to say to Milton and Anna: Regarding the Great Depression. You're right, we did it. We're very sorry. But thanks to you, we won't do it again.”

Although Chairman Bernanke spoke those words before the financial crisis in 2008, his words were prophetic. This time, the Federal Reserve, under Chairman Bernanke, has responded aggressively and creatively to extraordinary market conditions in our efforts to stabilize the economy and reduce the impact of the recession.

What did we do? The FOMC began to ease monetary conditions in September of 2007 by lowering the federal funds rate, and by the end of 2008, we reduced the federal funds rate to nearly zero, where it has remained ever since.

Once the federal funds rate fell that low, to ease monetary conditions further, we had to employ some different techniques. 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.

In our case, the new techniques included purchasing large quantities of federally guaranteed mortgage-backed securities and U.S. Treasury and government agency debt. Our balance sheet grew from $900 billion prior to the crisis to close to $3 trillion today. The intent of all of this buying of securities was to push long-term interest rates down further and to keep them low. And we have succeeded.

Although the actions that we took were unprecedented and sparked a great deal of debate, I think the FOMC's strategy has been consistent with Dr. Friedman's teachings about monetary policy in response to severe recessions induced by systemic financial failure. As Chairman Bernanke promised, the Federal Reserve would not allow another Great Depression. Through our actions, we demonstrated that, indeed, the Federal Reserve can mitigate the worst ravages of a financial crisis that could bring lending to a virtual standstill. The Federal Reserve does have the ability to blunt the impacts of a systemic financial collapse on production, employment, and incomes. And the Federal Reserve can prevent deflation.

There's one more lesson from Milton Friedman that is worth mentioning, and that is the value of clarity and proactive communications. Dr. Friedman strongly urged policymakers to be clear about their objectives and to be as transparent as possible. Following our January meeting, the FOMC took an historic step 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. In our statement, we acknowledged that the FOMC can set a numerical inflation objective because we believe that the Fed can control the average inflation rate over time. Not only will this 2 percent objective enhance economic performance, but now the public and all market participants have an explicitly stated benchmark to judge the FOMC's performance and anticipate our actions.

We also indicated in our strategy document that the maximum level of employment over the longer term is largely determined by factors outside the Federal Reserve's control, such as demographics, technology, and regulations. As a result, it would be inappropriate for the Federal Reserve to specify a numerical target for the maximum level of employment. However, the FOMC can make estimates of maximum employment for the longer term and set policy to achieve over time an unemployment rate consistent with it. FOMC participants currently estimate that rate to be somewhere between 5 and 6 percent.

This framework provides a clear statement about our longer-term objectives, and should enable the public to more accurately form expectations for monetary policy going forward. I think that it is fair to say that the approach we have taken in setting these objectives is very consistent with Milton Friedman's teachings. In particular, Dr. Friedman endorsed the concept of having the Federal Reserve be accountable for achieving an inflation objective. The FOMC's enhanced communications about our objectives for both maximum employment and stable prices are especially valuable in today's unusual economic and policy environment. Our communications should help the public make better economic decisions and improve the effectiveness of monetary policy.

Before I turn to your questions, let me close by briefly sharing my outlook for the economy and inflation, because my outlook is central to my views on monetary policy and ultimately how I vote at FOMC meetings. Our economy is gradually improving, and while some uncertainty remains, I am seeing more evidence that our economic expansion is becoming self-sustaining. Labor market information has been promising over the past few months. Employment gains have picked up, and new claims for unemployment insurance have trended down. Households have made notable progress in reducing their debt burdens, freeing up additional dollars for both spending and saving. Banks have raised capital, improved their asset quality, and increased lending to businesses and consumers. In addition, industrial production has been quite strong during the past year.

Despite these signs of progress, the economy still faces a number of headwinds. Housing markets are still in distress throughout much of the country; state and local governments are still in the process of adjusting to budget pressures; and rising gasoline prices are likely to restrain household spending. Furthermore, strains in European financial markets continue to pose downside risks. For all these reasons, businesses and households remain cautious about the future.

Obviously, there are a lot of forces shaping the economic landscape, and many factors to consider in constructing an economic forecast. My outlook calls for the national economy to continue improving at a gradual pace, growing about 2-1/2 percent this year and around 3 percent next year. At this moderate pace of growth, it could take as long as four or five years for the unemployment rate to fall to the 6 percent rate that I judge to be consistent with maximum employment.

Let me turn to my inflation outlook. Inflation as measured by the Federal Reserve's chosen yardstick, the personal consumption expenditure (PCE) price index, has averaged 2 percent over the past three years. On a monthly basis, of course, inflation can be volatile because some prices can rise or fall quite a bit in any given month or quarter. Sharp movements in the prices of items such as gasoline and food products can either temporarily boost or depress the overall inflation rate. While sharp movements in particular components can help or hurt consumers' budgets in the short term, these temporary movements can be misleading signals of where inflation is heading over an extended period of time.

At the Cleveland Fed, researchers have developed a measure of the underlying inflation rate, called the median CPI, which is a better predictor of inflation. This measure looks at the price change that's right in the middle of the long list of individual price changes. I also pay close attention to other factors that could affect my inflation outlook, such as labor costs. They too, are subdued. Finally, my staff's estimate of inflation expectations indicates that financial market participants expect inflation to remain below 2 percent for quite a while. Based on all the information I consider, my outlook is for inflation to remain close to 2 percent on average for the next few years. Still, the recent spike in gasoline prices could complicate the inflation picture if it persists.

That brings me to monetary policy. At our last meeting in March, the FOMC stated that economic conditions are likely to warrant that we keep short-term interest rates at exceptionally low levels at least through late 2014. This statement is not a commitment to keep the federal funds rate at its current level 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.

I believe that our accommodative monetary policy has put the economy on a path, albeit gradual, that will achieve our maximum employment objective while maintaining price stability. Trying to accelerate the pace of economic growth by easing monetary conditions further could put the Committee's price stability objective at risk. Alternatively, removing policy accommodation prematurely could risk breaking the momentum of the expansion and causing disinflation. With my current outlook, I think our policy stance is still the one best suited to foster steady gains in output and employment and to maintain stable prices. I am, of course, always adjusting my projections as new information becomes available, and my view of appropriate monetary policy may need to be adjusted if there are substantial changes to my outlook.

I hope this brief presentation has provided you with a better understanding of the role and activities of the Federal Reserve; our current stance on the economy and monetary policy; and the steps we've taken to help our nation recover.

When I look back on the darkest days of 2008, I realize how far we have come, and yet we know there is still work to do. Whether we are bankers, business or community leaders, or heads of households, we faced the most extraordinary economic period of our lifetimes. Through it all, the Federal Reserve demonstrated that a central bank can control inflation, can and should respond creatively and aggressively to a severe economic downturn, and finally, that there are benefits to having clear objectives and policy transparency.