



The Federal Reserve and Monetary Policy

I genuinely enjoy traveling throughout my District - which includes all of Ohio, western Pennsylvania, and portions of West Virginia and Kentucky - to meet with business and civic leaders, bankers, and the academic community. I view participating in events like this one as an important part of my job.

The actions of the Federal Reserve have been closely watched as we have navigated economic conditions that have been unlike any we have faced before in our lifetimes. Many of the actions that the Federal Reserve has taken have been without precedent. I'll speak more on those in a few minutes.

Dan asked if I would provide an "insider's view" of the role of the Federal Reserve, and how the Federal Open Market Committee -- or the FOMC -- makes U.S. monetary policy decisions, which, of course, affect every one of us.

So, today I will discuss three topics, beginning with some background on the Federal Reserve. Next, I will describe the FOMC and how we make monetary policy for the United States. And I will wrap up with my economic outlook and my thoughts on our current 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.

The Federal Reserve was founded nearly 100 years ago, in 1913, with the purpose of maintaining a safe, stable and flexible monetary and financial system in the United States.

It may sound like a contradiction, but the Federal Reserve is a decentralized central bank, as it operates from 12 geographic districts around the country, and a seven-member Board of Governors in Washington, DC. Each District has a president -- the post that I hold -- who participates in formulating monetary policy at FOMC meetings. Each District also has a board of directors that represents businesses, nonprofits, banks, labor unions, and agriculture from across the District. As I mentioned, Dan is a member of our board for the Fourth District.

This decentralized structure brings a range of input to our monetary policy discussions that take into account conditions across the country, and across economic sectors. I'll speak more about monetary policy shortly. First, I'd like to tell you briefly about the other important functions of the Federal Reserve.

Speaking very broadly, the Federal Reserve has three principal functions: Supervising banks, providing financial services, and setting the nation's monetary policy.

Additional Information

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In the Fourth District, and throughout the Federal Reserve System, bank examiners in our bank supervision function help to ensure the safety and soundness of financial institutions, a responsibility we share with other Federal and state regulatory agencies. In my District, we supervise the activities of more than 300 banks and other financial institutions. The institutions our examiners supervise range from small community banks to some of the nation's largest financial institutions that operate nationwide.

The Federal Reserve also provides financial services to banks, thrifts, and credit unions. You may be familiar with our role in ensuring banks have an ample supply of currency and coins to meet your needs, as well as access to an efficient electronic payments system. We also serve as the U.S. government's bank. In this capacity, we work closely with the U.S. Treasury to help to streamline their payments through the check and electronic banking system. We also provide the internet infrastructure for processing government payments and transactions.

Finally, the third and most high-profile function of the Federal Reserve is setting U.S. monetary policy, which is made by the Federal Open Market Committee or FOMC. The seven governors in Washington and the 12 district presidents participate in meetings of the Committee, which is chaired by Ben Bernanke. The Committee meets eight times a year in Washington, DC to review financial and economic conditions and determine appropriate monetary policy responses. Our next meeting is September 12th and 13th.

At each FOMC meeting, we convene around a large mahogany table, with Ben Bernanke at the center and District presidents and governors arranged in assigned seats. Our meetings begin with reports from the staff on U.S. and worldwide economic developments and outlooks. Then each District president and each governor provides comments on business conditions and their economic outlook. This is called the economic "go-round." Next, we turn to a discussion of possible monetary policy actions. Each participant gives his or her view, and the meeting ends with a vote on the policy statement.

With that general background, let me now turn to how we actually arrive at monetary policy decisions. To guide us, Congress passed laws requiring the Federal Reserve to promote stable prices and maximum employment over time. We refer to these two objectives as our "dual mandate." Put another way, we undertake monetary policy actions that promote full employment, and that are designed to keep inflation low and stable.

It takes time for our monetary policy actions to affect the economy, so our policy decisions have to be forward-looking. And that is exactly why participants around the FOMC table bring their economic projections to the discussions.

In conducting monetary policy, the Federal Reserve can influence the cost and availability of credit to keep the economy on a path that is consistent with our goals of stable prices and maximum employment. The FOMC typically conducts monetary policy by targeting the federal funds rate, which is the interest rate that banks pay one another for borrowing money overnight. In normal times, if we want to ease monetary conditions, we would act to lower the federal funds rate. To do this, we would purchase a relatively small amount of Treasury securities. Changes in the federal funds rate then filter through financial markets, affecting other interest rates and asset prices. When the Federal Reserve pursues an accommodative monetary policy, interest rates tend to decline and economic activity strengthens.

The remarkably unusual economic environment we are in today calls for a highly accommodative monetary policy, but it requires us to conduct monetary policy somewhat differently. So let me turn to the steps we have taken in response to the financial crisis.

Economic historians have criticized the Federal Reserve for not acting decisively and aggressively to reduce the severity of the Great Depression back in the 1930s. We learned from that experience, and I believe that we have responded creatively and aggressively to the financial crisis and the very deep recession. Indeed, this time, the Federal Reserve took unprecedented steps to avoid another Great Depression, and we have continued to aggressively pursue policy actions designed to promote economic growth while maintaining stable prices.

The Federal Reserve began to ease monetary conditions in August of 2007 by lowering the discount rate. In September, the FOMC reduced 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 federal funds rate fell that low and could fall no lower, we needed to use different tools to spur economic growth. We began to purchase federally guaranteed mortgage securities and U.S. Treasury debt in large quantities to push down longer-term interest rates. These nontraditional techniques served our purpose of further easing monetary conditions to support the economic recovery.

The initial large-scale asset purchase program, which is commonly called quantitative easing, or QE, was announced in the midst of the financial crisis in 2008 and has been extended and expanded several times since then. As a result of these programs, the Federal Reserve's balance sheet has grown from about \$900 billion before the financial crisis to nearly \$3 trillion today.

In addition, we have been adjusting the composition of our balance sheet by selling short-term Treasury securities and purchasing an equivalent amount of longer-term Treasury securities. We have also stepped up communications to the public about the future path of interest rates. The FOMC's most recent statement indicates that economic conditions are likely to warrant exceptionally low levels for the federal funds rate at least through 2014.

And yet, even with the aggressive and extraordinary actions that the FOMC has taken, we remain in a frustratingly slow economic recovery. Our economy is still struggling to build momentum almost five years after the Federal Reserve first began to ease monetary conditions. To understand why our recovery has been so sluggish, one of my Bank's economists has examined economic recoveries in the United States going back to the 1890s. His work concluded that the deeper the recession, the faster the snap-back, even when the recession was sparked by a financial crisis.¹ However, he found two exceptions to this pattern: the Great Depression and this current period. His analysis strongly suggests that the collapse of the housing market, which wiped out more than \$7 trillion of household net worth, has been a key barrier to a stronger expansion.

Many households had increased their net wealth during the boom period by taking on a lot of debt to finance the purchase of their homes, which increased in value. When the housing bubble burst, the value of their homes fell, but their debt obligations remained. Hence, these households were quite suddenly worse off -- literally less wealthy -- than they previously had been on paper. In response, households have stepped up their saving to rebuild the net worth they lost during the housing market collapse, and in the process, they have scaled back on their spending.

As consumers have adjusted to becoming less wealthy, their attitude toward debt in general has changed. My Bank's analysis shows that at the beginning of 2011, the average consumer had fewer open credit accounts than at any time in the past dozen years². This trend appears to be driving an overall reduction in the number of bank cards held by the public. Consumers are using fewer credit cards, and they have been paying down the balances on their credit. More than half of all U.S. consumers now have just one credit card or none at all, and most of that decline reflected consumers closing their bank credit card accounts. In just four years, between 2007 and 2011, the percentage of people with no bank cards increased from about 18 percent to 24 percent. Moreover, even though lenders have denied credit to some consumers, my Bank's study indicates that most of the reduction in credit card usage has come as a result of choices made by consumers - not lenders.

While consumers have been cutting back on credit card debt, they have shown a willingness to borrow money to buy cars. Cars in the U.S. are getting relatively old; indeed, the average age of the auto fleet in our country is at a record high. In addition, lenders increasingly have been willing to extend credit to purchase cars on favorable financing terms. As a result, the automotive sector is a bright spot in the economic picture.

While it cannot yet be called a bright spot, the housing sector is showing signs of improvement. Home sales are still anemic compared with historical norms, but an uptrend appears to have emerged this year. Most significantly, prices seem to have bottomed out in many housing markets around the country, and if this trend holds, it should stabilize household net worth and provide homeowners some greater confidence. This, in turn, would be a plus for economic growth.

That said, a stronger economic expansion is going to require significantly more support from consumers and businesses. In the business sector, many companies have very solid profits, but those profits reflect businesses closely controlling their costs and limiting their investments and hiring. Businesses, like consumers, are leery of taking on new debt to finance new projects. Companies have built large cash positions as a precaution in uncertain times.

Indeed, uncertainty seems to be the watchword of the day, specifically uncertainty about Europe and uncertainty about U.S. fiscal policy. Europe is a large export market for the United States, and its economic challenges present uncertainty for U.S. exporters - and consequently a risk to U.S. growth prospects. Many countries in Europe are unfortunately experiencing a recession right now, which is reducing the demand in those countries for U.S. exports. European governments have taken significant steps on political and economic reforms, but more work remains to be done, and financial conditions in Europe remain fragile and volatile.

Then, we need to consider the near-term issues with U.S. fiscal policy. Unless the Administration and the Congress can come to an agreement, major tax changes and spending cuts are scheduled to take effect in January. And, at nearly the same time, we are going to once again reach the federal debt ceiling, which could cause volatility in financial markets. There are reasons to think that these potential fiscal challenges are already taking their toll on our economy. Some business leaders I hear from have reported that they are preparing for lost revenue from their government contracts, and they are taking proactive steps today to reduce their spending and hiring.

So, in sum, I am expecting the U.S. economy to continue to grow, but at a moderate pace. I expect economic growth of about 2

percent this year. And with this moderate GDP growth forecast, my outlook is for very slow improvement in the jobless rate. I expect the pace of GDP growth to pick up gradually through 2014, and for the unemployment rate to remain above 7 percent through 2014. Given my outlook for slow economic growth, I also expect slow wage growth, and I anticipate that core inflation will remain near the FOMC's 2 percent long-term objective over the next few years. While inflation remains close to our objective, unemployment is still well above the FOMC's estimate of the longer-term normal rate. The monetary policy debate is whether the FOMC should take further actions to stimulate today's slow-growth economy to bring down unemployment.

Monetary policy should do what it can to support the recovery, but there are limits to what monetary policy can accomplish. Monetary policy cannot directly control the unemployment rate. It can only foster conditions in financial markets that are conducive to growth and a lower unemployment rate. At times, significant obstacles can get in the way. U.S. monetary policy cannot solve Europe's fiscal and banking problems; nor can it put U.S. fiscal policy on a sustainable trajectory. As such, monetary policy cannot solve all of the economy's problems, especially in today's highly uncertain environment.

There are benefits to further monetary policy actions, but we have to be realistic about what those benefits will be, how large those benefits will be, and how other factors will help or hinder the effectiveness of those benefits. We also have to consider the costs and risks of further actions. Such cost/benefit analyses are especially critical given the unique nature of both the current economic environment and the tools we are using to achieve our objectives. At the same time, such analyses are complicated by the fact that we have less experience assessing the costs and benefits associated with nontraditional policy tools.

Let me be more specific about the benefits and costs. By benefits, I mean the ability of our policy actions to move the economy closer to our goals of stable prices and maximum employment. By costs, I mean the potentially adverse effects that our policy actions might impose on financial markets and the economy. These benefits and costs are not always easy to identify and estimate. We use economic theory to guide our thinking about the many ways in which our policy actions could affect the economy and financial markets. We then try to estimate the magnitude of these effects, relying on models based on historical experience. We are fortunate that we have not experienced many economic hardships as severe as this last recession, but the lack of experience means that we can only generate very rough estimates of the likely costs and benefits of our actions.

With that caveat, let's consider the benefits, using the example of our large-scale asset purchases. When the Federal Reserve initiated the first large-scale asset purchase program in 2008, financial markets were in disarray and credit conditions were extremely tight, especially for mortgage loans. As you know, mortgage and corporate borrowing rates have fallen significantly during the past few years. Research studies support the conclusion that our large-scale asset purchase programs have contributed to the decline in interest rates. Lower interest rates have helped businesses to restructure their balance sheets and free up cash for new investments. It took some time, but business borrowing has begun to increase again. Households have also restructured their balance sheets. Note that \$4.1 trillion of home mortgages have been refinanced in the past four years. Such refinancing activity provides consumers more money to spend on other products and to pay down other debts. In 2010, our large-scale

asset purchases were also effective in pushing back against deflationary pressures, demonstrating that quantitative easing programs can help keep inflation from falling persistently below our inflation objective.

So, large-scale asset purchases can be effective. But our experience with these programs is limited, and as a result, they justify more analysis. For example, as the structure of interest rates has moved lower over time, it is possible that future large-scale asset purchase programs will yield somewhat smaller interest-rate declines than past programs. A related issue to evaluate is whether further reductions in longer-term interest rates would stimulate economic activity to the same degree as they have in the past.

Let me now turn to some of the potential costs. It is conceivable that, at some point, policies designed to promote further declines in rates could interfere with financial stability. Some financial institutions find themselves challenged today by the low-interest-rate environment, and they might take actions to remain profitable that could affect risk in the financial system. One possible response to these conditions is that financial institutions could take on excessive credit risk by "reaching for yield." At the same time, financial companies could keep prudent credit standards but still suffer significant losses if they were holding too many fixed-rate, low-yield assets when market rates began to rise.

Finally, it is also conceivable that, at some point, the Federal Reserve's presence in certain securities markets would become so large that it would distort market functioning. It is important to have good estimates of how large the Federal Reserve's participation would have to be to cause a meaningful deterioration in securities market functioning, and to better understand the potential costs of such deterioration for the economy as a whole.

The bottom line is this: I am supportive of actions that provide economic benefits with manageable risks. The FOMC's policy actions to date have been important economic stabilizers and have acted to support the expansion. Yet today, we still find ourselves in a challenging economic environment - one in which we continue to rely on nontraditional policy tools. These new tools come with benefits and with risks...and we must constantly weigh both in our efforts to meet our dual mandate of maximum employment and stable prices.

1. "[Deep Recessions, Fast Recoveries, and Financial Crises: Evidence from the American Record](#)," Michael D. Bordo and Joseph G. Haubrich. Federal Reserve Bank of Cleveland Working Paper. June 2012
2. "[Americans Cut Their Debt](#)," Yuliya Demyanyk and Matthew Koepke. Federal Reserve Bank of Cleveland. August 2012