



Providing Balance While Managing Uncertainty

This month, I celebrate my 10th anniversary as president and CEO of the Federal Reserve Bank of Cleveland and as a participant on the Federal Open Market Committee, which is the Federal Reserve's policymaking arm. Congress has set two goals for the Federal Open Market Committee--maximum employment and price stability--which we refer to as our "dual mandate." Generally speaking, these goals mean that we would like to see as many Americans who want jobs to have jobs, and we aim to keep the rate of increase in consumer prices--also known as inflation--low and stable.

When I was here three years ago, the economy was struggling to recover. In my 2010 speech at the Market Pulse conference, I said that the economy would grow gradually, and I discussed the headwinds of prolonged unemployment and excess caution that I believed would present some challenges to the recovery.

I looked back at that speech in preparation for today's speech--I thought some of you might do the same, to check on my track record--and, while I wish the recovery had progressed faster than I projected, the reality is that my expectations from 2010 have generally come to pass. We have seen real improvement in the economy--and yet, we still face uncertainty around when the economy will be able to stand on its own two feet, without extraordinary help from the Federal Reserve.

Whether I look back over the last few years, or forward to the next few years, the recurring theme, for me, is "providing balance while managing uncertainty." When I say "providing balance," I am referring to the Federal Reserve, the nation's central bank, using its policy tools to restore balance to the U.S. economy through the crisis, when financial markets nearly collapsed, and when many businesses saw sales fall off a cliff. Unless you lived through the Great Depression, the economic recession we faced was unlike any most Americans had ever seen before, and unlike any policymakers ever had to respond to before. And, when you're dealing with a new situation, uncertainty is usually part of the equation.

Today, I will talk about some of the dire circumstances we had to deal with. I will also explain how the Federal Reserve has been working to get our economy back to the point where it can sustain a healthy level of economic growth without extraordinary policy accommodation. I'll close with my thoughts on the approach I think we should take to ensure that we continue to provide the economy with the right balance in the weeks, months and years ahead. Please note that the views expressed here are my own and do not necessarily reflect the views of my colleagues in the Federal Reserve System.

Additional Information

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As I look back over the past few years, uncertainty seemed to be around every corner. The housing sector, which is an important part of our economy, began to slide downward in 2006. There was a lot of uncertainty about how much the housing collapse would affect financial markets and the overall economy.

Home building and home purchases nearly ground to a halt. Housing prices fell, causing the number of mortgage foreclosures to rise sharply. Many financial institutions were holding hundreds of billions of dollars' worth of complex securities tied to home mortgages, and the decline in housing prices called into question whether those financial firms could survive. This loss of confidence led to the worst financial crisis and the worst recession since the Great Depression. We saw consumers pull back on their spending because they lost some of their wealth as the housing market and the stock market fell, or their mortgages were underwater, or they were too deep in debt, or they lost their jobs--or some combination of these factors. Many businesses failed, and many of those that survived laid off workers and were reluctant to spend money or make investments as demand for their products fell to record lows. We saw unemployment rise to 10 percent. We saw the U.S. auto industry on the verge of collapse. And we experienced a breakdown in confidence among consumers and business owners, which made the situation worse.

Against this backdrop, the Federal Reserve intervened to help counterbalance these negative forces. Faced with a financial crisis and a deep recession, lessons learned from the Great Depression strongly indicated that the Federal Reserve needed to be aggressive and creative in our response. It is the role of a central bank to step in and provide liquidity to financial markets during a panic and to cushion economic downturns.

To address the financial crisis, the Federal Reserve implemented a number of lending programs designed to provide liquidity to financial institutions and help improve conditions in financial markets. We lowered the short term interest rate that we control, called the Federal funds rate, to nearly zero between 2007 and 2008. Once we pushed the Federal funds rate close to zero and it could go no lower, we had to use other, less-familiar tools, in an effort to support economic growth and maintain price stability. We turned our focus to helping the housing market, because the housing industry was at the root of the problem. The Federal Reserve purchased more than one trillion dollars of mortgage-backed securities in order to reduce mortgage rates.

We also purchased \$300 billion of U.S. Treasury securities to help lower other long-term rates. In the media, these actions were called quantitative easing, or QE1. Between November 2010 and June 2011, as the economy was still struggling to recover, and it looked like disinflation might take hold, we bought even more long-term Treasury securities, and this has been referred to as QE2. Starting in September 2011, we also sold short-term Treasury securities that were in our portfolio and used the proceeds of other sales to buy even more long-term Treasury securities in a program known as Operation Twist. Operation Twist was intended to lower longer-term interest rates without increasing the overall size of our balance sheet.

Our actions worked to stabilize financial markets and to bring down both short-term and long-term interest rates even further. But despite some progress, the strong, self-sustaining economic recovery that we hoped for still had not yet materialized by the fall of last year. Consequently, in September 2012, the FOMC decided to take further steps to nudge the economy forward. We started a program to purchase \$40 billion per month of mortgage-backed securities. In

December we also decided to purchase longer-term Treasury securities, starting at a rate of \$45 billion per month. Together, these two asset purchase programs are known as QE3, and they are expanding the Federal Reserve's balance sheet, which currently stands at \$3 trillion, at a rate of \$85 billion each month. The goal of these asset purchases is to maintain downward pressure on long-term interest rates and ease financial conditions. We indicated that we would continue to purchase these securities until the outlook for labor market conditions significantly improves, taking into account the costs and efficacy of these purchases as our balance sheet grows. In addition to the asset purchases, we reaffirmed that we would keep short-term interest rates low for a considerable time after the recovery strengthens.

Our actions have helped the economy go from a point where it was shrinking in 2008 and 2009, to the point where it is growing today, albeit at a moderate rate. When the Federal Reserve first announced our purchases of mortgage-backed securities in late 2008, 30-year mortgage interest rates averaged a little over 6 percent; today, they average around 3.4 percent. Lower mortgage rates have contributed to the improvement we have recently been seeing in the housing market. Other important interest rates, such as rates on car loans and corporate bonds, also have come down. Lower interest rates contributed to \$3.3 trillion in home mortgage refinancings and \$2.3 trillion in auto sales since 2009. Additionally, at the end of 2012, \$158 billion in commercial paper was outstanding, more than double the \$71 billion in commercial paper that was outstanding at the end of 2009. This indicates that many companies are taking advantage of this low-cost alternative to bank loans to finance their operations. Lower interest rates also have helped to restore some of the wealth lost during the recession by raising the values of homes, stocks, and other assets. This wealth effect should make households and businesses more likely to spend.

My outlook is that the economy will grow a little more than 2-1/2 percent this year and about 3 percent in 2014. And while, in normal times, 2-1/2 percent growth is typically strong enough to keep working people employed and absorb new entrants into the workforce, it's not strong enough to dig us out of the deep unemployment hole we're in—at least, not for the next several years. With economic growth around 2-1/2 to 3 percent, I expect the unemployment rate to fall to about 7-1/2 percent this year and close to 7 percent at the end of 2014—which means we will still fall short of full employment for several years to come. Faster economic growth is necessary for our economy to return to full employment more quickly.

So, why isn't the economy growing faster?

One way for the economy to grow faster would be for consumer spending to pick up. But consumers, who account for two-thirds of all spending in our economy, have become more cautious. They have been paying down debt and saving more. Many households were deep in debt when the recession hit, and today they are still climbing out of debt. In the late 1990s, household debt was equal to about 90 percent of disposable income. In other words, the average household's mortgage, credit card bills and other debt was roughly 90 percent of its income after taxes. To explain it even more simply, if a household's income after taxes was \$100,000, it had \$90,000 in debt outstanding on its mortgage and other debts. This ratio of debt-to-income accelerated, and by 2007, the average household's debt went from 90 percent to 130 percent of its income after taxes, so if a household's income after taxes was \$100,000, it would have \$130,000 in debt. Most likely, with that much debt, many households found it harder just to pay the interest on this debt, let alone make a dent in

paying down the principal. Since then, the debt-to-income ratio has declined somewhat; but on average, household debt is still 110 percent of income. So, while this trend of overly indebted consumers paying down debt is positive for the economy over the long term, it also means that consumers are being more frugal today.

To further complicate the situation, incomes earned by workers have been growing pretty slowly. This, too, has limited the amount of money consumers are pumping into the economy—and, therefore, affects how much the economy grows. Not surprisingly, consumers have been reluctant to spend money because they feel uncertain about the future. The University of Michigan's Index of Consumer Sentiment—which is a monthly measurement of consumer confidence based on a scale of 1-to-100—averaged 71.6 during this recovery period, which is well below the average of 91.3 for the index between 1990 and the beginning of the financial crisis.

A second way for the economy to grow faster would be for businesses to spend more. Businesses, which account for about 15 percent of spending in the economy, have been reluctant to add workers and make investments because of uncertainties over consumer spending, federal fiscal policy, regulations, and the health of the economies of foreign countries where they do business. Research from my Bank shows that uncertainty related to economic conditions dramatically lowered businesses' plans to hire and make capital expenditures¹.

A third factor in this slow-growth picture is that many lenders have also become more cautious, and they have established higher lending standards. As a result, some of the individuals and businesses that would have qualified for credit before the recession find themselves unable to qualify for loans today. Also, many consumers and businesses have become less creditworthy due to foreclosures, bankruptcies, and high ratios of debt to income. Ultimately, this translates into less purchasing power.

And finally, the government sector also has cut back on spending. Cities, states, municipalities and other government entities have faced falling incomes from taxes and other revenue sources as the economy has slowed and, as a result, they are spending less.

In this environment of cautious consumers, businesses, and lenders, and a government sector that has pulled back, how can the Federal Reserve best position itself to continue to provide balance to the economy?

As I mentioned earlier, the Federal Reserve has been aggressive and creative in its response to a very challenging economic environment, and our actions have been beneficial for the economy. In the wake of our actions, some of yesterday's uncertainties have turned into today's hopeful signs. Housing prices have stabilized and actually started to rise in 2012 for the first time since 2007. More people are buying and building homes. In fact, sales of existing homes have risen to an annual rate of 4.3 million homes sold, up from 3.9 million sold in 2009. Housing starts for single family units have nearly doubled since 2009, increasing from an annual rate of 350,000 units to 616,000 units. And starts on multi-family units are nearly seven times what they were three years ago, rising from 50,000 starts in 2009 to an annual rate of 338,000 starts in 2012. Mortgage foreclosures have slowed down—three percent of mortgage payments in 2012 were 90 days or more past due, down from nearly five percent in 2009. And last year, the auto industry had its strongest year since 2007 in terms of auto sales, with 15 million cars sold last year, compared to only 9 million sold at the height of the recession in 2009.

While our policies have been effective, our experience with our asset purchase programs is limited, and, as a result, we must analyze their

benefits and costs carefully. Over time, the benefits of our asset purchases may be diminishing. For example, given how low interest rates currently are, it is possible that future asset purchases will not ease financial conditions by as much as they have in the past. And it is also possible that easier financial conditions, to the extent they do occur, may not provide the same boost to the economy as they have in the past.

In addition to the possibility that our policies may have diminishing benefits, they also may have some risks associated with them. I will mention four: credit risk, interest rate risk, the risk of adverse market functioning, and inflation risk. These and other risks are not easy to see or measure, but they need to be taken into account when setting monetary policy.

First, financial stability could be harmed if financial institutions take on excessive credit risk by “reaching for yield” —that is, buying riskier assets, or taking on too much leverage—in order to boost their profitability in this low-interest rate environment. Second, interest rate risk could arise if financial companies are not prepared to manage the losses they might suffer by holding too many long-term, fixed-rate, low-yield assets when interest rates rise. Third, financial market functioning could, at some point, become distorted as a result of the Federal Reserve’s large and growing presence in mortgage-backed securities and Treasury securities markets. And last, but certainly not least, there is the risk that the Federal Reserve’s ability to respond to future inflationary pressures could be complicated by the size and composition of our balance sheet. We have developed tools to use for removing monetary policy accommodation when the time comes to do so, and we have even tested them on a small scale, so that we will be ready to use them. We have planned carefully. However, the bigger our balance sheet becomes, the more heavily we will have to rely on these new tools to work as intended.

It is critical that we take these risks into consideration as we make our asset purchase decisions. To minimize some of these risks, we could aim for a smaller sized balance sheet than would otherwise occur if we were to maintain the current pace of asset purchases through the end of this year, as some financial market participants are expecting. This course of action would be all the more attractive if the economic outlook continues to improve, as I expect it will.

To explain this more clearly, if you could picture two lines, one sloping downward, representing the diminishing benefits of our policy actions, and one line sloping upward, representing the rising costs of those actions, we need to think carefully about where those lines will intersect. Those lines will cross at the point where the costs and benefits are equal, and where further policy actions might cause more harm than good. Reasonable people will differ on where that point of intersection may lie, especially given that many of the policy tools we are using are unconventional. This cost-benefit analysis requires not only focusing on the benefits of our policies and how they contribute to improvement in the labor market; it also requires accounting for the risk considerations I spoke about previously—credit risk, interest rate risk, the risk of adverse market functioning, and inflation risk.

At each step along the path we’ve traveled in the past several years, the FOMC has assessed data and taken into account all the information we had on hand at the time, in order to guide our decision-making. At some point, we will have to stop buying assets, and ultimately we will have to unwind our now large holdings of Treasury and mortgage backed securities. We should be sure that when the time comes, we can exit without adversely impacting markets, without allowing an undesirable increase in inflation, and

without risking the progress that has already occurred in our economic recovery.

I will conclude by saying that the FOMC's actions in the current economic cycle have been needed, understood, and generally supported. Going forward, we must take care to balance the costs and benefits of our monetary policy actions, so that we don't introduce more uncertainty and create problems that hamper our ability to provide a balancing weight to our economy if needed down the road.

Clearly, monetary policy alone cannot address all of the economy's challenges. Further improvement in the economy will depend on improved confidence on the part of consumers and businesses. Today, consumers and businesses are concerned with our country's fiscal policy—which involves the U.S. government's handling of our country's debt, budget issues, and tax issues—and these concerns are weighing down consumer and business confidence and holding back economic growth. In addition, our ability to export depends significantly on developments abroad, especially in Europe. These are just a couple of examples of economic variables that are outside of the direct influence of the Federal Reserve.

The role of the central bank is to provide balance to the economy without destabilizing it, and without causing undue risks for the future. As a participant on the Federal Open Market Committee, it is my privilege to continue to work to "provide balance while managing uncertainty," with the ultimate objective of fostering a stronger economic recovery in the context of price stability.

1. See Mark Schweitzer and Scott Shane, 2011, "[Economic Policy Uncertainty and Small Business Expansion](#)," Federal Reserve Bank of Cleveland, Economic Commentary, 2011-24.