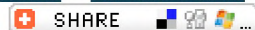


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Supporting the U.S....



## The Federal Reserve's Role in Supporting the U.S. Economy



### Additional Information

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**The International Economic Forum of  
the Americas, Palm Beach Strategic  
Forum**

West Palm Beach, Florida

*April 8, 2013*

The title of this conference, "The Path to Economic Growth," strikes a chord with me as a monetary policymaker on the Federal Reserve's Federal Open Market Committee, or FOMC. The global economy has indeed wandered off course in some ways, and choosing the right path back is critical. The FOMC works to point the U.S. economy in the right direction, by conducting monetary policy to promote maximum employment and price stability, which are the goals given to the Federal Reserve by the U.S. Congress. That means we want as many Americans as possible who want jobs to have jobs, and we want to restrain increases in the inflation rate. We refer to these goals as our "dual mandate," and we pursue these goals primarily by influencing the level of interest rates and other financial conditions.

Today, I will share my view of current U.S. economic conditions; I will describe how the Federal Reserve supported the U.S. economy through the financial crisis and recovery; and I'll share my observations on some of the challenges facing monetary and fiscal policymakers as we work to promote a sustainable global recovery. 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.

Let me start with some comments on the U.S. economy, within the context of the world economy. According to the International Monetary Fund, or IMF, the world economy will grow by about 4 percent both this year and next. However, advanced economies, including the U.S., are expected to grow more slowly than emerging and developing economies. The IMF forecasts economic growth this

year of about 2 percent for advanced economies, and about 6 percent for emerging and developing economies. The IMF predicts slow economic growth in the euro area of about half a percent this year and 1 percent next year, and much faster growth for the Latin American and Caribbean region of 4.2 percent in 2013 and 3.6 percent in 2014. The U.S. economy is in the middle, with growth expected at about 2.5 percent this year and 3.2 percent next year.

The U.S. economy is recovering from the deepest recession since the Great Depression in the 1930s, and is on better footing now than it was several years ago. Some measures of U.S. economic and financial health are now surpassing their pre-recession levels. Real gross domestic product returned to pre-recession levels in the



summer of 2011. Growth has continued since then, albeit slowly. U.S. banks have rebuilt their capital buffers and strengthened their balance sheets considerably. U.S. banks generally now have capital-to-asset ratios that well surpass their pre-recession levels. The housing market, which precipitated the U.S. financial crisis and recession, appears to have stabilized. Home prices are up, and homebuilding has resumed in most parts of the country. Consumers, which represent roughly two-thirds of final spending in the U.S. economy, have made considerable progress in paying down their debts, putting them in a better position to contribute to growth. The outlook for labor conditions has been improving over the last six months, adding an average of 188,000 jobs per month. Friday's employment numbers, however, were disappointing. I will need to see some more data before I can make any conclusions about the underlying strength of the labor market. Overall, recent developments point to continued, moderate growth for the U.S. economy.

My outlook is that the U.S. economy will grow a little more than 2-1/2 percent this year and about 3 percent in 2014. In normal times, 2-1/2 percent growth is strong enough to keep working people employed and to absorb new entrants into the labor force. But 2-1/2 percent growth is not fast enough to quickly pull the U.S. economy out of the deep unemployment hole caused by the recession. There are still three million fewer people on U.S. payrolls today than there were before the onset of the recession. With economic growth around 2-1/2 to 3 percent, I expect the unemployment rate to decline to about 7-1/2 percent this year and about 7 percent at the end of 2014—still well above pre-recession levels.

The U.S. recovery has been moderate and the economy has grown more slowly than many thought it would. There are several factors that have restrained U.S. economic growth, including the severity of the housing market downturn, household and business deleveraging, and uncertainty. I and other economists understand that housing wealth matters; however, it took time and analysis to fully appreciate the many different ways in which declining housing wealth would restrain the economic recovery.

Debt reduction, which we often refer to as deleveraging, has also restrained the recovery. The net worth of many households and businesses declined during the financial crisis as various asset prices, from real estate to stocks, fell. Feeling poorer, consumers and businesses curtailed spending and borrowing, paid down debt, and rebuilt their balance sheets, which also caused economic growth to slow.

Uncertainty has also been restraining the economy. Businesses have been hesitant to hire workers and make investments because of uncertainties over consumer spending, federal fiscal policy, regulations, and global economic conditions. Research from my Bank shows that uncertainty related to economic conditions dramatically lowered businesses' plans to hire and make capital expenditures.<sup>1</sup> Many lenders have also become more cautious and have imposed tighter lending standards on borrowers, making more consumers and businesses ineligible for loans. In this environment, the Federal Reserve has taken aggressive and unconventional actions to nudge the U.S. economy back to self-sustaining health.

Let me explain some of those actions, beginning with those in the fall of 2008. Back then, financial markets were in turmoil, the U.S. economy was contracting severely, and no one was certain when the pressures on the economy would ease. The outlook for the U.S. economy was extremely poor, and it was clear that significant monetary policy stimulus was needed. The Federal Reserve had to look back to the Great Depression for signs of how to respond to such a steep economic downturn. Between 2007 and 2008, the Federal Reserve lowered the short-term interest rate that we control, which is called the federal funds rate, to nearly zero. Once we pushed the federal funds rate close to zero and it could go no lower, we had to use other, unconventional tools, including large-scale asset purchases and communications, to spur economic growth and maintain price stability.

The Federal Reserve announced asset purchase programs in response to worsening outlooks for the U.S. economy. Our asset purchases have been successful in lowering longer-term interest rates and creating conditions that are more conducive to supporting economic growth. The first large-scale asset purchase program, which is popularly known as quantitative easing, or QE1, was announced in November 2008. Subsequently, we initiated several other asset purchase programs. Currently, the FOMC is conducting a third round of asset purchases, often referred to as QE3, which began in September 2012. QE3 is an open-ended program to purchase mortgage-backed securities and longer-term Treasury securities until the FOMC sees a substantial improvement in the outlook for labor market conditions. This open-ended approach to asset purchases allows the program to better respond to economic conditions. If conditions rapidly improve, then the program can be scaled down or stopped; if conditions worsen, the program can be scaled up or extended. The open-ended approach also enables the FOMC to respond more flexibly to changes in its assessment of the program's benefits and risks.

The Federal Reserve has also used communications as a policy tool. This is commonly referred to as "forward guidance" and serves the purpose of informing the public regarding the FOMC's anticipated path for the federal funds rate. The FOMC has stated that the current low range for the federal funds rate "will be appropriate at least as long as the unemployment rate remains above 6-1/2 percent, inflation between one and two years ahead is projected to be no more than a half percentage point above the 2 percent longer-run goal, and longer-term inflation expectations continue to be well anchored." These types of communications should both make policy more effective and reduce the risk that market misperceptions of the FOMC's intentions would lead to unnecessary interest rate volatility.

Clearly, the FOMC's policies have been beneficial in increasing economic growth, lowering unemployment, and promoting price stability. If the outlook for labor market conditions were to improve sufficiently, the FOMC could begin to slow the pace of asset purchases and limit the size of the overall program. But other

considerations could lead to the same result. The unusual size and nature of the FOMC's asset purchases also require us to consider risk factors that do not figure so prominently during ordinary times. Since the onset of the financial crisis, the Federal Reserve's balance sheet has grown from \$900 billion to more than \$3 trillion, and it continues to grow at a rate of \$85 billion each month. Our balance sheet could reach \$4 trillion by the end of the year if it continues to expand at the current pace. This large balance sheet could present its own uncertainties and risks. The Federal Reserve has never before had a balance sheet anywhere close to the size we have today, nor has the Federal Reserve ever before taken such large positions in the Treasury and mortgage-backed securities markets.

One way to mitigate potential risks is through a smaller-sized balance sheet than many market participants currently envision. Given our limited experience with our asset purchase programs, slowing the pace of purchases could help minimize the potential risks associated with our large and growing balance sheet. Even continuing asset purchases at a reduced pace, and limiting the size of the overall program, would enable the Federal Reserve to continue adding accommodation and providing meaningful support to economic growth and job creation.

Finally, I would like to share a few observations about the challenges facing monetary and fiscal policymakers as we work to promote a sustainable global recovery. In the realm of monetary policy, I have explained why and how the FOMC has been creative and aggressive in responding to the risks to the U.S. economy. Similarly, some other central banks also have been aggressive and creative in addressing their countries' economic challenges by using unconventional tools. The Bank of England, like the Federal Reserve, has relied on purchases of medium- and long-term government bonds with the goal of pushing interest rates down. In contrast, the European Central Bank has relied primarily on providing liquidity to banks in order to spur bank lending, because banks are such an important intermediation channel in Europe. The Bank of Japan has been buying government bonds and using communications for many years to combat its country's slow growth and deflation. Recently, the Bank of Japan has become more aggressive in pursuit of its objectives, significantly increasing both the amount and maturity of government bonds it would purchase. As you can see, many central banks are coping with the challenges associated with using unconventional tools to support economic growth.

However, monetary policy cannot offset large-scale fiscal restraint. The threat of fiscal austerity in the U.S. and in other countries around the world represents a near-term risk to the global economic recovery. Large debt obligations in many countries present risks to long-term economic growth.

In the U.S., our economy's performance near-term and longer-term will depend considerably on fiscal policy. Fiscal issues have led to across-the-board spending cuts, which are slowing U.S. economic growth in the near term. The challenge is for fiscal policymakers to enact a credible plan that will put the U.S. federal budget on a sustainable long-run path without adversely affecting the recovery. The United States is not alone in dealing with fiscal issues that threaten growth and stability. Political environments in various countries result in vastly different outlooks for fiscal action and economic and monetary policies. In Europe, the picture is mixed, with some euro zone countries advocating for fiscal austerity while others resist. In Japan, the central bank is ramping up monetary stimulus, while other parts of its government have pledged to establish a sustainable fiscal structure. Some countries may lean toward becoming more restrictive on trade, which would endanger

global growth. Around the world, countries are facing fiscal problems, and how they address those problems could have real economic consequences.

Today, the U.S. economy continues to recover at a moderate pace, but unemployment remains unacceptably high. Monetary policy is supporting economic growth, but monetary policy has limits. In current circumstances, it would be particularly helpful if fiscal and regulatory policies were among the forces supporting economic growth. Central banks worldwide are facing economic circumstances that are similar to those in the U.S., and are taking innovative monetary policy actions that may influence the theory and practice of monetary policy in years to come. I believe that our accommodative monetary policy stance is keeping the U.S. economy on the path of economic recovery, and is contributing to both U.S. and worldwide economic growth. But we are in uncharted waters. So, it is important that we continue to evaluate the risks associated with our policy actions.

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1. Schweitzer and Shane: "[Economic Policy Uncertainty and Small Business Expansion](#)," Economic Commentary 2011-24.