Reflections on What Works in Supporting the Economy

The financial crisis and recession delivered the most severe hit to America's economy since the Great Depression. My colleagues and I on the Federal Open Market Committee responded swiftly and creatively to the building threats, and our actions helped stave off a wider crisis and put the national economy on the road to recovery. I am extremely proud of my involvement in those efforts, and honored to have worked with so many dedicated professionals and public servants.

Monetary policy is still getting a lot of attention. Today, I will discuss the FOMC's decision last month to stay the course on our asset purchase program. Then I will discuss why very supportive monetary policy remains essential to support the economy. I will finish with a look at the principal drivers of regional economic growth, with an eye toward Pittsburgh's remarkable economic resurgence. As always, my comments represent my own views and not necessarily those of my colleagues in the Federal Reserve System.

Let me provide some context for the most recent meeting of the FOMC, which was held on September 17 and 18.

The Federal Reserve has a dual mandate given to us by Congress to promote maximum employment and price stability. The financial crisis and recession meant we had to supply a very accommodative monetary policy to get the economy back on a path to achieving those mandates. Our main and traditional tool to stimulate the economy in the face of a cyclical downturn is an interest rate for overnight loans between banks: the federal funds rate. As the recession that accompanied the financial crisis deepened, the FOMC drove short-term rates as low as they could go, right down to nearly zero.

But the recovery struggled to gain momentum, and it became clear that the economy would benefit from further monetary policy stimulus. So we turned to some unconventional tools to push down longer-term rates.

One of them is asset purchases, often referred to as quantitative easing, or QE. The FOMC is now on a third round of buying Treasury securities and mortgage-backed securities. That program was initiated in September 2012, a time when the pace of payroll gains was 96,000 jobs per month[1] and when most FOMC participants were projecting hardly any improvement in labor markets until late 2013. The FOMC said it would continue its asset purchases until there was a substantial improvement in the outlook for the labor market.

Although labor markets are not yet where we want them to be, I

Additional Information

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have seen encouraging developments since last September. Employers over the past year have been creating about 180,000 jobs per month. Meanwhile, since the start of the current purchase program last September, the unemployment rate has moved down 0.8 percentage points to 7.3 percent, reflecting, in part, 2.3 million more private sector jobs.

Some people have questioned whether the decrease in the unemployment rate is meaningful. They cite ongoing declines in the labor force participation rate—the fraction of the population that is either working or looking for work. The recession and the slow recovery have contributed to those declines, since some workers have become so discouraged about their prospects of finding work that they have stopped looking. However, research by my staff shows that much of the decline is related to demographics, with the baby boom generation moving into retirement, for example. Overall, I believe we are seeing meaningful progress on employment levels. My forecast is that the unemployment rate will continue to drop as labor market conditions slowly heal.

I know that my FOMC colleagues and I share the same goals—to ensure that as many Americans as possible who want to have jobs, have jobs. For me the improvement in labor markets seemed substantial enough to support a scaling back of the asset purchase program at last month's FOMC meeting. The statement that followed the September meeting, in fact, acknowledged improvement in economic activity and labor market conditions. However, the Committee had some concerns that the tightening of financial conditions that had occurred over the summer could slow growth. In addition, the Committee noted that the extent of the effects of restrictive fiscal policies remained unclear, and that the fiscal debate could add additional risk to financial markets and to the broader economy.

In the end, as you know, the FOMC decided to await more evidence that the recovery's progress will be sustained before scaling back the pace of asset purchases. I hope that the additional evidence that the Committee is looking for arrives soon. As I have said in the past,[2] we have limited experience with asset purchases so it pays to be cautious, especially in this uncertain economic environment. While to date the risks have mostly remained theoretical, I remain convinced that we need to be cautious in our expansion of asset purchases. The FOMC is constantly weighing the known benefits of asset purchases with their potential costs.

I have just told you that I have seen improvements in the labor market, but I also know that the economy still has some way to go to regain its full health.

Let me elaborate on why I think that is the case. It is true that bank lending is gradually strengthening and the housing market appears to be stabilizing. Home prices are up and home building has resumed in most parts of the country. And consumers have made considerable progress in paying down their debts, putting them in better position to contribute to growth. That is all certainly good news. But in order for growth to pick up, consumer spending must increase further. That in turn will give businesses more confidence to increase their investment and hiring. Unfortunately, confidence is being shaken these days by the fiscal situation. Uncertainty about the course of fiscal policy over the coming months and the strains related to the debt ceiling debate pose downside risks to the outlook.

Assuming the fiscal situation is resolved fairly soon, my forecast is for steady but slow improvement in the economy. This outlook is relatively consistent with that of my colleagues on the FOMC. GDP

growth this year has been around 2 percent. For the next few years, FOMC participants expect GDP growth to pick up a bit, but remain fairly modest, in the range of about 2.5 to 3.5 percent. Modest growth in all likelihood will bring about only a gradual reduction in the unemployment rate. It is not until 2016 that most FOMC participants predict the unemployment rate will fall below 6 percent, which is what I would consider close to full employment.

Turning to inflation, over the last 12 months, inflation as measured by the personal consumption expenditures price index, or PCE, has been just 1.2 percent. Based on analysis at my Bank, I view the current low levels of PCE inflation as temporary and I expect PCE inflation to gradually rise toward the FOMC's longer-term objective of 2 percent.

In this environment, it should be clear that monetary policy still has a big job to do, and we are committed to pursuing our long-run objectives of maximum employment and stable prices by holding interest rates low until we are closer to these objectives. Meanwhile, the Federal Reserve's substantial holdings of securities will continue to apply downward pressure to longer-term interest rates. These lower interest rates should add support to the economy until we are closer to the FOMC's dual mandate objectives. Even when we ease up on the rate of new asset purchases, we will still be some distance from beginning to increase short-term rates.

Indeed, the FOMC expects that the federal funds target rate will remain near zero for at least the next two years. Most FOMC participants don't anticipate the first rate increase until sometime in 2015. Even by 2016, when unemployment is projected to be much improved and inflation approaches our 2 percent objective, most FOMC participants expect the federal funds rate to be at or below 2 percent—still far below historical norms, still very supportive of the economy.

Monetary policy can be powerful, but it has limits. To accomplish long-lasting prosperity, other kinds of policies are necessary. And that allows me to pivot to my other focus: how we can build stronger regional economies.

Pittsburgh 30 years ago was a blue collar town panicked by the severe loss of jobs in the steel industry. Back then, my colleagues and I at the Federal Reserve Bank of Cleveland were monitoring the mass layoff notices in our region and we were concerned about the Iron City's future. Steel mills were closing and the unemployment rate in Pittsburgh topped 16 percent.

But the city has pulled off a remarkable rebound. The unemployment rate here today is below the national average. Pittsburghers earn more income than the national average and more than the workers in any other metro area in my District. Just walking here today I saw a bustle and vibrancy that would be the envy of other cities within my District.

How have you done it? Pittsburgh certainly looks different than it did 30 years ago, with your new convention center, office buildings, sports venues, and your attractive waterfront. However, in my view, the most meaningful transformation has not been in the physical capital, but rather it has been in the human capital. Pittsburgh has reinvented itself into a brain hub—a place with a high concentration of jobs that rely on human capital, innovation, and ideas.

Back when I started at the Cleveland Federal Reserve Bank in 1983, this country had a little less than one knowledge job for every one manufacturing job. A manufacturing job is one that produces physical goods in a plant. Today, there are 2.5 knowledge jobs for every one

manufacturing job in this country. That is just an extraordinary shift over the past 30 years.

Pittsburgh has trumped that shift, with almost 3 knowledge jobs per manufacturing job.[3] And Pittsburgh has added knowledge jobs at a faster pace than most other major cities in the country. As a result, Pittsburgh's economic performance has been better than most other major cities. Like other brain hubs, it is seeing the largest increases in jobs and income.

The saying goes that luck favors the well prepared, and Pittsburgh is very well prepared indeed when it comes to having education levels necessary to prosper in today's economy. Pittsburgh stands out for its high numbers of well-educated young people. The metro area ranks near the top nationally for young workers with bachelor's degrees. About 42 percent of young Pittsburgh residents have a bachelor's degree, which puts you at 12th out of the top 100 metropolitan statistical areas. The investments made by this state and this region in human capital are paying off.

I should add that Pittsburgh's experience tracks closely to the findings of research by economists at my Bank. We looked at 50 states over a 75-year period, and throughout that entire period two factors stood out as the most important for driving income growth: educational attainment and innovation.[4] And since innovation rarely happens without education, those two factors really go hand in hand. So what our research basically says is that if we want to improve our region's economy, if we want people to have higher incomes, we need highly educated workers. That has been true for 75 years. And Pittsburgh has proved it is still true today.

Granted, there is no shortage of stories in the media about the struggles of recent college graduates to find jobs matching their skills. But it is important to realize that even with mounting student debt, the value of a college education endures. The unemployment rate for fresh college graduates was 7.8 percent at the end of 2012, almost half that of people of the same age with less than a college degree. My point is that education matters. Your experience here in Pittsburgh is testament to that.

A lot has happened during my 30 years at the Federal Reserve Bank of Cleveland. I have seen this fading rust belt town transform into an up-and-coming technology center. And I have worked through a financial crisis that pushed our national economy to the brink. It took courageous and creative efforts to achieve Pittsburgh's transformation. And it has taken courageous and creative monetary policies to get our national economy back on firmer ground. I am hopeful that the ground will soon be solid enough that the Federal Reserve can begin to move away from one of our most innovative tools—long-term asset purchases—and return to supporting growth with our traditional tool of influencing short-term interest rates.

As I am completing my service as president and CEO of the Federal Reserve Bank of Cleveland, I find myself in a reflective mood. Many people have asked me what I have learned during my time as the leader of the Bank and a participant on the FOMC. I believe that my key takeaway has been that most challenges can be overcome through collaboration. From making monetary policy decisions, to meeting the challenges of the US payments system, to working out our country's fiscal difficulties, I believe that collaboration is central to resolving our differences and moving forward. Pittsburgh has learned this lesson and used collaboration to transform itself and rewrite its future. More could learn from your example.

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1. According to real time data in September 2012, monthly job gains had average roughly 96,000 over the previous six months.
2. Speech: "The Federal Reserve and Monetary Policy", August 27, 2012.
3. "Brain Hubs and Manufacturing Centers in the Fourth district," Joel Elvery, Federal Reserve Bank of Cleveland Economic Trends, August 7, 2013.
4. "Altered States: A Perspective on 75 Years of State Income Growth," Federal Reserve Bank of Cleveland 2005 Annual Report.