



The Federal Reserve: Policy Approaches Then and Now



This year the Federal Reserve is commemorating its 100th anniversary. Today, I want to highlight some of the changes that have occurred over our first century of existence. I will begin with the Federal Reserve's origins and then touch on some gradual

changes it has made in the way it conducts monetary policy. Then I will focus on some of the more recent changes in monetary policy that were brought on by the financial crisis and deep recession. I will conclude by discussing the monetary policy actions taken just last week. Before I begin, I have to note that these are my views alone and not necessarily those of others in the Federal Reserve System.

Since we are on a college campus, I think it is appropriate to begin with a brief history lesson. In October 1907, the US economy was seized by panic. It began with the ominous failure of New York City's Knickerbocker Trust Company. The collapse of that institution was made all the more sensational because the president of Knickerbocker committed suicide a month later. Knickerbocker's demise set the table for a series of bank failures that spread across many American cities. Depositors lined up for blocks to withdraw their funds from troubled banks. The stock market crashed and the unemployment rate rose sharply. The prevailing emotion of the time was fear. As it was later said, "The nation had lost its confidence. It would take leadership and courage to bring it back."^[1]

Leadership and courage found their form six years later. On December 23, 1913, President Woodrow Wilson signed the Federal Reserve Act, which created the Federal Reserve System. To this day, there is no organization in America structured quite like the Federal Reserve. The structure of the Federal Reserve reflects the debate that led to its formation. Commercial bankers wanted the Federal Reserve to be owned and operated by the banks. Businesses and banks outside of New York City wanted to make sure the Federal Reserve wasn't controlled by Wall Street. Meanwhile, many in Congress wanted the central bank to be a part of the government. The resulting legislation struck a compromise. It may sound contradictory, but the Federal Reserve is a decentralized-central bank with public and private components.

Additional Information

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To be more concrete, the Federal Reserve Act established the Federal Reserve Board in Washington, DC, with seven governors appointed by the president and confirmed by the Senate. And it divided the country into regional districts with Federal Reserve Banks headquartered in each. The president of each of the 12 Reserve Banks is appointed by a board of directors consisting of private citizens from the district.

The Federal Reserve has a number of responsibilities, many of which you may not be familiar with. For example, the Federal Reserve serves as the lender of last resort. Federal Reserve Banks can make loans to address financial panics, and we certainly made use of that power during the financial crisis in 2008. We supervise the banking system. We work to ensure an accessible, efficient, and secure US payments system, and we serve as the federal government's bank. Our community development efforts support the economic growth of low- and moderate-income neighborhoods across the country.

But a lot has changed over the past 100 years. Clearly, as a woman, I wouldn't have been leading a Federal Reserve Bank in 1913, nor would a woman have been the Federal Reserve Board's chair, as is now the case with Janet Yellen. As an employer, the Federal Reserve has definitely adapted to reflect the times and our nation's diversity. In addition, there are plenty of examples of how the Federal Reserve's responsibilities have evolved over the years to fit the nation's changing needs and ambitions. Monetary policy is a prime example.

To begin with, monetary policy as we know it today didn't exist in 1913. At that time, the US economy operated under the gold standard. There was no such thing as buying and selling financial assets to influence interest rates. But the gold standard proved too inflexible in times of stress like the Great Depression, and it was gradually abandoned. Ultimately, the country transitioned from a system of money backed by gold to a system of money backed by public confidence in the US economy.

It wasn't really until the 1930s that the Federal Reserve began conducting "monetary policy." During that decade, Congress established the Federal Open Market Committee, or FOMC, as the nation's monetary policy body. The Committee consists of the seven Federal Reserve governors and five of the 12 Reserve Bank presidents who vote on a rotating basis.

The Federal Reserve's objectives have been refined and updated over the decades as well. After World War II, lawmakers were concerned about millions of soldiers returning home with no job prospects. In response, Congress passed the Employment Act of 1946, which called for all parts of the government—including the Federal Reserve—to promote maximum employment, production, and purchasing power.

Then in 1978, Congress gave the FOMC an official mandate. The economy was reeling from energy price shocks, rising unemployment, and rapidly increasing inflation. In response, Congress approved the Full Employment and Balanced Growth Act, often called the Humphrey-Hawkins Act after its sponsors. It directed the Federal Reserve to "promote full employment" and "reasonable price stability." Today we call those objectives the Federal Reserve's dual mandate.

So you can see that the Federal Reserve has continued to adapt over the past 100 years. However, some of the most significant changes in the way we conduct monetary policy have occurred very recently in the aftermath of the financial crisis, severe economic recession, and ensuing slow recovery.

Before the crisis, the Federal Reserve's main monetary policy tool was to target the federal funds rate. By way of background, the federal funds rate is a very short-term rate that influences a whole host of other interest rates. So when the federal funds rate goes down, car loans get cheaper, home mortgage rates decline, and even credit card rates may get less expensive, to name just a few. Low interest rates have a positive impact on the broader economy. When consumers can borrow at lower interest rates, they can afford to buy more goods and services, and the businesses that supply those goods and services can hire more people. And when more people are working, they have more money to spend. More spending creates more jobs, and more jobs create more spending. The reverse happens when we raise the target federal funds rate. So that is why targeting the federal funds rate for many, many years was an effective way for the Federal Reserve to fulfill its objectives.

But that ended in late 2008. When the economy teetered on the brink of another depression, we lowered the federal funds rate to essentially zero. It couldn't go any lower than that, but the economy was still in a recession. So we had to turn to unconventional tools. The most well-known of these tools is what we call large-scale asset purchases, or what you may know as Quantitative Easing, or QE.

The purpose of the asset purchase program is to put downward pressure on longer-term interest rates. And we accomplish this goal by purchasing longer-term securities. This is in contrast to the way we lower the target federal funds rate, which we do by buying very-short-term securities. In turn, the purchase of longer-term securities pushes down the interest rates that consumers and businesses borrow at. Mortgage interest rates are a good example of the kind of interest rates that get pushed down by our asset purchase program.

The other major unconventional monetary policy tool we have turned to is what we call forward guidance. I know the term may sound strange, but really all it means is that we are giving the public more information on how monetary policy is likely to evolve.

Increasingly, the effectiveness of monetary policy depends on how the public reacts to the policy action. This is especially true with our forward-guidance tool. Banks are quick to understand that our forward guidance means that their cost of funds will remain low. But the policy effects are strongest when not only lenders but borrowers have confidence that short-term interest rates will *stay* low. Studies have shown that both of our unconventional tools—forward guidance and asset purchases—have helped to significantly lower long-term interest rates, just as we intended. [2]



So the way we conduct monetary policy has changed significantly, and the way that we *communicate* about policy has also changed. It was only 20 years ago that we first communicated our policy decision to the public immediately following an FOMC meeting by releasing a statement at the conclusion of the meeting. And on that first occasion, the statement was only a few sentences long, and we weren't sure whether we would be making similar announcements on a regular basis. Compare that to today, when we release a statement following every meeting, and the average policy statement is now up to 900 words.

Our enhanced communications go beyond issuing regular policy statements. Here are some other recent enhancements to our communications: We have told the public that our objective for inflation is 2 percent over the longer-term. We have started releasing projections for inflation, unemployment, economic growth, and our expectations for the federal funds rate on a quarterly basis. And now the chair of the Federal Reserve holds press conferences following four of the FOMC's eight meetings each year. Janet Yellen held her first press conference as Federal Reserve chair just last week.

In a time when the use of unconventional tools has made monetary policy more complex, uncertainty about monetary policy could have gone up. But in my view, our enhanced communications have delivered greater clarity to the public and financial markets. We have come a long way from when former Federal Reserve Chairman Alan Greenspan proudly said, "If I turn out to be particularly clear, you have probably misunderstood what I said."

So that is some background on how monetary policy works and why communications are so important. Now, let me tie everything up by discussing the rationale for the FOMC's recent policy decisions. To put it simply, even though we are making some progress, we are still falling short of achieving our objectives for maximum employment and 2 percent inflation.

On the employment front, the economy has generated 180,000 net jobs per month over the past year. That is a respectable number and it is helping to reduce the unemployment rate. In fact, the unemployment rate has fallen from around 8 percent at the start of the current QE program in September 2012 to 6.7 percent today. Our latest QE program is aimed at supporting ongoing improvement in labor market conditions. So in light of the improving labor market, the Committee decided last week to make another modest reduction in the pace of its asset purchases. This was our third consecutive reduction since December of last year. We have now trimmed our purchases to \$55 billion of Treasury and mortgage-backed securities each month.^[3]

But at 6.7 percent, the unemployment rate remains elevated. In addition, there are too many people who can find only part-time work even though they would rather work full-time, while others have simply given up looking for work. And the still-very-large numbers of people that have been unemployed for long durations remains a significant concern.^[4]

Turning to inflation, we are falling short of our 2 percent objective. The main inflation gauge we watch at the FOMC—the PCE price index—has hovered around only 1.1 percent over the past year. Low inflation might sound like good news, but today it is also a sign of an economy that is not firing on all cylinders. The big risk is that persistently low inflation could tip into deflation, which is when the level of prices actually falls. When deflation happens, businesses and consumers put off spending and investment because they are waiting for even lower prices, which is bad for the economy.

Given elevated unemployment and persistently low inflation, monetary policy remains very accommodative. Even though we are scaling back our asset purchases, we are still buying a sizable amount. At this point, we have accumulated about \$4 trillion worth of securities—which is four times the size of the Federal Reserve’s balance sheet six years ago before the financial crisis and recession. These sizable asset holdings should continue to maintain downward pressure on interest rates.

The FOMC has also indicated its intent to keep the target federal funds rate exceptionally low in order to continue to make progress on both maximum employment and inflation. The Committee will take into account a wide range of information in determining how long to keep the target federal funds rate low. We will be watching labor market conditions, indicators of inflation pressures and inflation expectations, and readings on financial developments. It is a complicated world out there, and no single data point will determine our next move.

With appropriate monetary policy, I see the economy expanding at a slightly stronger rate this year than last. I expect GDP growth this year to be around 3 percent. I expect the unemployment rate to fall to 6.2 percent by the end of the year. And I project that accommodative monetary policy, a strengthening economy, and stable inflation expectations will bring inflation back to our 2 percent objective over time, but I expect that progress to be slow.

That is my outlook and the current stance of monetary policy in a nutshell. To sum up my talk this morning, I have discussed some notable changes in the way the Federal Reserve conducts monetary policy. I hope that you have a better understanding of the Federal Reserve’s actions, and can see that we are working to build an economy where soon-to-be young professionals like many of you can follow your dreams.

[1] “The Panic of 1907: Lessons Learned from the Market’s Perfect Storm,” by Robert F. Bruner and Sean. D. Carr. 2008. Wiley.

[2] [Macroeconomic Effects of FOMC Forward Guidance](#) and [Measuring the Effect of the Zero Lower Bound on Medium- and Longer-Term Interest Rates \(PDF\)](#)

[3] [FOMC Statement, March 19, 2014.](#)

[4] According to the Bureau of Labor Statistics, 3.8 million people have been unemployed more than 27 weeks as of February 2014.