Demystifying the Federal Reserve

"Demystifying the Economy"

Lafayette College Policy Studies Program

Farinon College Center, Lafayette College

Easton, PA

September 29, 2009

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FEDERAL RESERVE BANK
OF PHILADELPHIA

The views expressed today are my own and not necessarily those of the Federal Reserve System or the FOMC.

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I want to thank Lafayette College, the Greater Lehigh Valley Chamber of Commerce, the Lehigh Valley Economic Development Corporation, and the Lehigh Valley Workforce Investment Board for sponsoring tonight's program.

When Mark Crain first wrote to propose this event, I noted with more than a passing interest that he is the William E. Simon Professor here at Lafayette. Having spent so much of my career as a professor and then as dean of the William E. Simon Graduate School of Business Administration at the University of Rochester, and having worked with Bill Simon over the years, I felt confident that this would bode well for a successful event.

Moreover, my ties to Lafayette extend somewhat beyond the fact that it is an outstanding educational institution within the Philadelphia Fed's District. Two of your current trustees are old friends. One of them, of course, is Peter Simon, Class of '75, who served on the Simon School's advisory council the entire time I was dean, and the other is my former colleague Michael Moskow, Class of '59, who was president of the Federal Reserve Bank of Chicago until he retired from that post in 2007.

For over three decades, my academic research and teaching centered on the subjects of macroeconomics, monetary theory, and finance. And for the past three years, I have had the rare opportunity to serve as a monetary policymaker on the Federal Open Market Committee, or FOMC. I am delighted, therefore, to have the opportunity to discuss my perspective on monetary policy and the economy, in what has been an extraordinary episode in this nation's economic history.

To put the current episode in some perspective, incoming freshmen at Lafayette College were born around the time of the 1990-1991 recession. As recessions go, that was a mild one, only eight months long, with real GDP falling about 1.3 percent from its peak in 1990 to the recession's trough in early 1991. That period was also a time of a severe financial crisis when hundreds of banks and savings and loan institutions failed. At the

peak of this crisis in 1989, 534 institutions failed. In 1990, we saw 382 failures and another 271 in 1991.

Now, as Lafayette freshmen enter college, the economy is again in recession — in fact, the deepest recession since the Great Depression; so far real GDP has fallen 3.7 percent since its peak at the end of 2007. Residential and nonresidential real estate problems abound, and we again see a financial crisis and a rising number of bank failures. By way of comparison, last year 30 banks failed around the country, and so far this year, we have 95 failures. Thus, despite the recent talk about massive bank failures, we are a long way from the magnitude of failures we experienced during the so-called S&L crisis of the late 1980s and early 90s, and I doubt we will come anywhere close to that level.

Such periods of economic turmoil — whether the early 1990s or now — inevitably have a way of raising the visibility of the Federal Reserve. While many Americans hear about the Fed in the news every day, not everyone knows how we work or how we are structured. So, I thought I would begin with some background to help demystify the Federal Reserve.

Then, I want to share some thoughts on current economic conditions at the national level, in our region, and here in the Lehigh Valley, as well as my outlook for the recovery. In doing so I will offer my perspective about some of the challenges facing the Fed as it seeks to ensure price stability and sustainable economic growth.

The Historical Basis for a Decentralized Fed

First, a little history about central banking in the U.S. Just a few blocks from the Philadelphia Fed stand the vestiges of our country's two earlier attempts at a central bank. The intellectual father of central banking in the United States was, of course, Alexander Hamilton. He spoke out fervently for the creation of the first Bank of the United States, which became our nation's first central bank. It received a 20-year charter from Congress and operated from 1791 to 1811. Although its charter was not renewed, the War of 1812 and the ensuing inflation and economic turmoil convinced Congress to establish the second Bank of the United States, which operated under its own congressional charter from 1816 to 1836. However, as with its predecessor, Congress did not renew its charter. Public distrust of centralized power was an important factor that led to the demise of both banks. Both became entangled in politics and failed to find the balance and independence necessary to serve our vast and diverse country.[1]

[1] For more information, see *History of Central Banking,* Federal Reserve Bank of Philadelphia, 2009, and *The First Bank of the United States: A Chapter in the History of Central Banking*, Federal Reserve Bank of Philadelphia, 2009.

It was almost 80 years before the nation was ready to try again. When President Woodrow Wilson signed the Federal Reserve Act into law in 1913, it included an ingenious compromise — a decentralized central banking system. This unique structure helped overcome political and public opposition that stemmed from fears that this new central bank would be dominated either by political interests in Washington or by financial interests in New York.

To balance political, economic, and geographic interests, Congress created the Federal Reserve System with 12 regional Reserve Banks throughout the country, overseen by a Board of Governors in Washington, D.C. The Philadelphia Federal Reserve Bank is the Third District, which includes Delaware, the southern half of New Jersey, and the eastern two-thirds of Pennsylvania. The Reserve Banks distribute currency, act as bankers' banks, and generally perform the functions of a central bank, including serving as the federal government's fiscal agent.

The Reserve Banks have many features of private-sector corporations, including stockholders, in the form of private banks in each District that pay in capital. Each Reserve Bank has its own board of directors drawn from its District's banks, businesses, and the public in a nonpolitical process. One very important responsibility of these directors is to select the Reserve Bank's president, subject to the Federal Reserve Board of Governors' approval. Because of this structure, Reserve Bank presidents have direct links to the public — the men and women on Main Street and the business communities within their Districts. Through this interaction, each Reserve Bank seeks to keep informed about its region's economic and financial developments.

The Fed Governors, on the other hand, are political appointees, nominated by the President and confirmed by the Senate. In order to insulate the central bank and the Fed Governors from short-term political pressures and to encourage them to take a long-term perspective on the economy, Congress limits each Fed Governor to one full 14-year term.[2] Congress also made the Board of Governors independent from the Treasury and the administration.

Reserve Bank presidents and the Governors come together every six to eight weeks for meetings of the FOMC to make monetary policy decisions. As I prepare for these meetings, I receive a lot of information about business and financial conditions from contacts throughout the mid-Atlantic region, as well as from contacts in the national and international business communities. At the FOMC meetings, my fellow Fed presidents and I share the information we have gathered with each other and with the Fed Governors. As you might imagine, a variety of views are expressed during these meetings. The diversity of views regarding both the state of the economy and appropriate policy results in a vital and healthy discussion that shapes the FOMC's monetary policy decisions and, I believe, leads to better policies.

[2] Governors can finish out a previous appointee's term prior to serving their own full term.

This mix of private and public governance makes the Federal Reserve System uniquely American. It provides a valuable form of checks and balances — between centralization and decentralization, between the public and private sectors, and between Wall Street, Washington, and Main Street — all to ensure that policy decisions are balanced and independent. I might add that the Fed receives no government appropriations from Congress. In fact, the System turns over any excess earnings on its portfolio of securities and loans above the cost of its operations to the U.S. Treasury, which in 2008 amounted to nearly $35 billion.

The independence of the Fed is critical to its ability to achieve the monetary policy objectives that Congress has established: maximum employment, stable prices, and moderate long-term interest rates. Research has shown that countries with more independent central banks have lower rates of inflation on average, without sacrificing real economic growth.

Why is independence so important for monetary policy and the central bank's ability to achieve its objectives? The easiest way to see this is to recognize that monetary policy decisions affect the economy with a long and variable lag. Actions that policymakers take today will likely not have much impact on the economy or inflation for many quarters. Consequently, monetary policy must be forward-looking. Policymakers must anticipate what the economy will look like over the next one to three years.

Despite the best of intentions, the political environment tends to be focused much more on the short-term and has great difficulty looking beyond the next news cycle, let alone beyond the next election. Thus, political interests are likely to encourage policy decisions that place undue weight on the very short-term consequences of those choices relative to the long-run interests of the economy. The Fed's independence is correctly intended to provide the opportunity for central bankers to take that long-term perspective, unencumbered by short-term political pressures. It also helps prevent the government from using the central bank to fund off-budget spending plans or to more directly fund budget deficits. And, as I mentioned, evidence from around the world and through history demonstrates that monetary policies set by central banks with less political interference or influence yield better economic outcomes.

Fed independence, however, does not mean the Fed is unaccountable. Ultimately, the Fed is accountable to the American people as it seeks to ensure price stability and promote sustainable economic growth. The Fed reports regularly to Congress about its monetary policy goals and its efforts to achieve them. It also regularly produces a wealth of data on its balance sheet and financial positions. In a democracy, our independence requires that we be as transparent as possible, consistent with fulfilling our mandate. We have made great strides at becoming more transparent in the last two decades, and we will continue to seek ways to do so.

With that as background, let me turn to the economy and its prospects.

The Economy in the Nation and Region

After more than 20 months of the deepest recession since the 1930s, signs are finally indicating that the economy is turning a corner and prospects for a return to growth are increasing. It is certainly a different picture from a year ago. Then, in the face of the steadily deteriorating economy and severe financial crisis, the Fed was aggressively easing monetary policy by reducing the target federal funds rate to near zero. We also put in place many special lending facilities and more than doubled the Fed's balance sheet, to over $2 trillion. This year, we are seeing a decline in the use of a number of these special lending facilities as financial markets have begun to function more smoothly again.

The economy is now in a transition from the sharp contraction we experienced in late 2008 and early 2009 to expansion. Real GDP decreased at an annual rate of only 1 percent in the second quarter, a vast improvement from the previous two quarters in which we saw declines of 6.4 percent in the first quarter of 2009 and 5.4 percent in the fourth quarter of 2008.

As usual in such transitions, I expect some ups and downs in the incoming economic data, but over the balance of this year and into 2010, I expect that the good news will increasingly outweigh the bad news. For some time, I have anticipated that the second half of this year would exhibit positive growth, and my confidence in this outlook is growing. In the last couple of months, many private forecasters have substantially increased their own outlooks for the second half of the year. In the second quarter, our Bank's Survey of Professional Forecasters, the oldest quarterly survey of macroeconomic forecasts in the country, predicted real GDP growth of about 1 percent in the second half. In our third quarter survey, however, the forecasters raised their second-half forecast to 2.3 percent — a significant improvement in their outlook in just three months.[3] My own forecast for the rest of the year is similar. Next year, though, I expect growth to pick up to about 3 percent and then settle down to a long-term trend rate of about 2.7 percent in 2011.

Although many forecasters now expect growth to improve, they also expect the unemployment rate to rise to near 10 percent at the end of this year or the beginning of 2010. Actual numbers are trending in that direction. The unemployment rate climbed to 9.7 percent in August, even though nonfarm payroll jobs had the smallest decline so far this year.

[3] See the Third Quarter 2009 Survey of Professional Forecasters, published by the Federal Reserve Bank of Philadelphia.

I too anticipate that the unemployment rate will continue to creep up for a little while longer. We will continue to hear about this as a concern in news reports in coming months. Yet, we know that the unemployment rate is a lagging indicator. We will see the unemployment rate come down only well after the economy begins to recover.

A key element of the improving outlook is the better news from the housing market. Housing sales and starts have generally shown improvement over the past six months, and even house prices appear to have bottomed out this summer.

The outlook for consumer spending is a mixed bag. The good news is that while the "cash for clunkers" effect on auto sales appeared to be significant, measures of consumer spending that exclude automobiles and gasoline have stabilized and the prospects have improved somewhat. Nonetheless, there are reasons to remain cautious in one's outlook: employment remains weak and housing values, while showing some signs of life, remain well below their pre-crisis levels. On the other hand, increases in equity values have helped restore some strength to household balance sheets.

Looking at our region, the Philadelphia Fed's Third District was once known for its manufacturing sector, but its economy has become more diverse over the past 30 years. In many ways, conditions here have been a good barometer for the national economy. For example, one closely followed indicator for the region is our monthly Business Outlook Survey of current manufacturing activity. The encouraging news is that the survey's general activity index has improved sharply in recent months. In September, the index reported its second consecutive positive reading and, in fact, reached its highest level since June 2007.[4]

In addition, the manufacturers in our survey have become more optimistic about activity over the next six months. The index of future activity has been near its five-year peak for the last three months. That doesn't mean manufacturing activity will take off rapidly, but it does reflect a more positive outlook than we saw earlier in the year.

Since our region often foreshadows national trends, it is not surprising that manufacturing activity in the August report of the Institute for Supply Management improved for the first time since January 2008. Its non-manufacturing activity index also improved recently. In addition, industrial production for the nation increased in July for the first time this year and then rose further in August. Our latest survey offers some optimism for continued improvement in the national numbers.

The Lehigh Valley has fared slightly better than the nation in some ways and worse in others. For instance, the Lehigh Valley's unemployment rate has not risen as sharply as the nation's and has remained below the national level in recent months. Since the

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[4] See the September Business Outlook Survey, published by the Philadelphia Fed.

peak of the business cycle in December 2007, employment in the Lehigh Valley has declined 4.2 percent, compared to the national decline of 5 percent. The area has benefited from a concentration of more stable education and health-care sector jobs and has lost a smaller percentage of construction jobs locally compared to the very large decline nationally.

The housing sector, on the other hand, has fared somewhat worse here than in the nation. In the second quarter, for instance, house prices in the Lehigh Valley had fallen 5.4 percent year-over-year, compared to a 4 percent decline nationally. The level of house prices is now back to the level we saw in 2005. As for housing permits, the decline in the Lehigh Valley's level of permits simply reversed the unusually rapid rise in permits in 2004. The current level of permits is now close to the pre-boom levels that prevailed at the beginning of this decade, whereas the national level of permits has fallen to the lowest levels recorded since the data began to be collected in 1960.

Looking beyond the current recession, it seems likely that, in coming years, the Lehigh Valley will once again see more in-migration of people from the neighboring states of New Jersey and New York. Such in-migration has slowed substantially during the current recession, as it did in the 2001 recession. Yet, the long-term demographic trends seem to point to the region as an attractive area for people to locate.

Outlook for Inflation

The outlook for inflation in the near term remains subdued, which is in line with the latest Survey of Professional Forecasters. The survey's forecasters were expecting that the CPI would increase less than 1 percent over the four quarters of 2009. Long term, the forecasters expect the average CPI inflation rate over the next 10 years to be 2.5 percent — which is essentially the level they have been predicting for a number of years.

While I see little risk of inflation in the near term, I do see greater risk of higher inflation in the intermediate to long term for several reasons. First, monetary policy is extremely accommodative. We have expanded the Fed's balance sheet to an unprecedented degree since last fall and have kept interest rates at historically low levels. Second, I put less weight than many other economists do on the idea that economic slack or low resource utilization is a reliable predictor of inflation.[5]

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[5] For research on this subject, see Stephanie Schmitt-Grohe and Martin Uribe, "Optimal Simple and Implementable Monetary and Fiscal Rules," *Journal of Monetary Economics*, 54, September 2007, pp. 1702-25; Andrew Atkeson and Lee I. Ohanian, "Are Phillips Curves Useful for Forecasting Inflation?" Federal Reserve Bank of Minneapolis *Quarterly Review*, 25 (Winter 2001), pp. 2-11; Michael Dotsey and Thomas Stark, "The Relationship Between Capacity Utilization and Inflation," Federal Reserve Bank of Philadelphia *Business Review*, Second Quarter 2005, pp. 8-17; and Stephen G. Cecchetti, "Inflation Indicators and Inflation Policy," *NBER Macroeconomics Annual 1995*, pp. 189-219.

Today, I often hear some forecasters argue that inflation will remain low in the coming years because the slack in the economy is not likely to disappear for some time. Yet, several empirical studies have shown that economic slack is difficult to measure with any accuracy.[6] It is particularly hard to measure slack near the turning points in business cycles, so making policy decisions based on measures of such slack becomes problematic.

Lafayette's students did not experience the Great Inflation of the 1970s. But I did. Our current circumstances pose an eerily similar set of conditions to those in the mid-1970s. The nation had experienced a severe recession, in part due to a large oil-price shock. Many economists and Fed policymakers believed that a large amount of slack existed and it would help slow inflation and keep it low, even as the Fed undertook a rapid monetary expansion to spur economic growth and lower the unemployment rate. Unfortunately, slack was poorly measured and turned out to be not as significant as first estimated. Thus, the Fed's monetary expansion led to rising inflation for the balance of the 1970s. One lesson learned during this episode is that inflation expectations can matter a great deal, and if they become unanchored — that is, if the public comes to believe that the Fed will not do what is necessary to preserve price stability — then inflation can rise quickly regardless of the amount of so-called slack in the economy. The price we paid to regain control of inflation and the Fed's credibility to do so came in the form of the 1981-82 recession and was a steep one.

Consequently, just as the Fed has taken aggressive steps in flooding the financial markets with liquidity during this crisis to reduce the possibility of a second Great Depression, it will also have to take the necessary steps to prevent a second Great Inflation. Our credibility depends on it. As the economy and financial markets improve, the Fed will need to exit from this period of extraordinarily low interest rates and large amounts of liquidity. We recognize the costs that significantly higher inflation and the ensuing loss of credibility will impose on the economy if we fail to act promptly, and perhaps aggressively, when the time comes to do so. The Fed will need courage because I believe we will need to act well before unemployment rates and other measures of resource utilization have returned to acceptable levels. The issues of when and the pace at which we unwind the extraordinary measures taken during the financial crisis and recession are ones that are high on my list of priorities and are the subject of ongoing discussions within the Fed.

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[6] See Athanasios Orphanides and Simon van Norden, "The Unreliability of Output Gap Estimates in Real Time," *Review of Economics and Statistics*, 84, November 2002, pp. 569-83. See also Susanto Basu and John Fernald, "What Do We Know and Not Know About Potential Output?" Federal Reserve Bank of San Francisco, Working Paper Series 2009-05, March 2009.

Conclusion

In sum, the nation and the Federal Reserve have been facing some serious challenges. Even so, the economy and financial system have been showing signs of improvement in recent months, and I expect the economy to be in much better shape a year from now.

Lafayette's graduating Class of 2010 will not face as weak a job market as the Class of 2009. When this year's freshmen graduate in 2013 — the year that will mark the 100th anniversary of the Federal Reserve System — I expect the economy will be expanding at a more normal pace and the unemployment rate will be substantially lower. Although this year's college freshmen were born during a recession and have entered college during an even worse recession, let's not forget that they also grew up during the longest economic expansion in U.S. history — the 10-year expansion of the 1990s. What's more, inflation over the first two decades of their lives has generally been far less volatile.

It is important that, even in times of recession, we continue to remind ourselves of the importance of price stability. Since these freshmen are likely to have longer life spans than those of us in the baby boom generation, keeping inflation low will be even more important to them as they move into the workforce and begin to earn a livelihood and save for their own retirement years. For people who live 30 years after retiring and reach an age in the mid-90s, even an average inflation rate of 2.5 percent — which many people might consider low today — will cut the purchasing power of their retirement dollar in half.

To keep inflation low, the central bank must have a strong commitment to the goal of price stability. As I mentioned, research and history have shown that central banks that **do not** have independence from short-term political influences in the conduct of monetary policy tend to produce higher inflation rates and lower economic performance. That is why I believe that, regardless of what types of financial reforms are adopted in the coming months, we must preserve the decentralized structure and independence of the Federal Reserve System as an essential means of ensuring the institution's credibility and commitment to its long-term objectives.