

Presentation to business and community leaders at a breakfast meeting co-sponsored by the
Federal Reserve Bank of San Francisco and the Greater Arizona Chamber of Commerce
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By Robert T. Parry, President and CEO of the Federal Reserve Bank of San Francisco
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The Role of the Federal Reserve in the Economy

- I. Good morning. It's a pleasure to be with you today.
 - A. I'd like to try to answer some of the questions that I often hear people ask:
 - 1. What's the Fed's role in the economy?
 - 2. How does it function?
 - 3. What can it do for the economy?
- II. I'll begin by describing the Fed's role in a nutshell:
 - A. As the nation's central bank, the Fed basically does three things:
 - 1. It works to keep the banking, financial, and payments systems safe, sound, and stable.
 - 2. It also provides financial services to the government and the public.
 - 3. Finally--and very importantly--the Fed's conduct of monetary policy contributes to the long-run health of the economy by promoting maximum sustainable employment and stable prices.
 - B. Since its founding in 1913, it has evolved with some special characteristics:
 - 1. public and private
 - 2. national and regional
 - 3. subject to congressional oversight, but "independent" and insulated from day to day political pressures.

4. These characteristics create important checks and balances for conduct of policy and operations.
- C. Structure embodies public/private, national/regional, independent characteristics
1. BOG in Washington: 7 members with staggered 14-year terms; appointed by President with consent of Senate; Chairman preeminent.
 2. 12 Reserve Banks cover all 50 states
 - a. Reserve Banks are each incorporated
 - b. and have own boards of directors,
 - (1) made up of bankers, businesspeople, and the general public.
 3. SF Fed--Twelfth District
 - a. Headquarters plus four branches cover largest geographic territory—nine westernmost states
 - b. nearly one-fifth total US population and employment
 - c. and almost one-sixth of total U.S. banking assets.
- D. Reserve banks provide banking services, bank supervision and regulation, and discount window.
1. Banking services
 - a. check processing and collection
 - (1) System handles over sixty-nine million checks a day
 - b. electronic wire payments system (Fedwire)
 - (1) System handles \$2 trillion per day
 - c. other electronic payments services (ACH)
 - d. banker for U.S. Treasury
 - (1) handles payments for Treasury through account at Fed

(2) sells Treasury securities and keeps track of ownership through book entry system

(3) provides fit coin and currency

2. Supervision and Regulation

- a. State-chartered member banks
- b. All bank holding companies
- c. Foreign banks operating in U.S.
- d. Large financial conglomerates that own banks, such as Charles Schwab and Countrywide Mortgage
- e. Consumer protection regulations

3. Discount Window

- a. provides credit to help depository institutions meet temporary liquidity needs.

III. Monetary policymaking also reflects national/regional, public/private, independent characteristics.

A. Conducted by FOMC

- 1. 12 members: 7 Governors plus 5 Reserve Bank presidents on a rotating basis.
- 2. All Reserve Bank presidents attend FOMC meetings and participate fully in discussions,
 - a. providing independent perspective on national policy and regional information.

B. The tools the Fed uses to conduct policy are

- 1. open market operations--federal funds rate
- 2. discount rate.
- 3. With these tools,

- a. the Fed can affect credit conditions in the economy,
- b. which affect people's demand for goods and services,
- c. and ultimately economic performance.

C. The Fed uses these tools to achieve both short-run and long-run goals.

- 1. For example, a short-run goal would be to deal with weakness in the economy—which is exactly the situation we're in now.
 - a. That's why at our recent meeting, we agreed to ease up on interest rates.
 - b. It will help stimulate the economy and promote a return to maximum sustainable growth.
- 2. For the long-run, however, the goal remains low inflation—because monetary policy is the main determinant of inflation in the long run.
 - a. This is true not only for the Fed, but also for central banks around the world.
 - b. Keeping inflation low is the best way a central bank can promote maximum sustainable growth and employment, which are keys to the nation's economic health.
 - c. And, in fact, in the U.S. and many other countries, inflation *has* been low in recent years.

IV. This difference between the short-run and long-run goals of monetary policy is at the heart of the difference between what the Fed can and cannot do.

A. For example,

- 1. although the Fed *can* provide stimulus to help lower unemployment in the short run,
- 2. it *doesn't* have an effect on unemployment *in the long run*.
- 3. The reason is that, in the long run, unemployment depends on things that are *beyond* the reach of monetary policy.

- a. That is, it depends on things like
 - (1) technological change,
 - (2) and people's preferences for saving, risk, and work effort.
 - 4. In fact, both experience and research have shown that, in the long run, too much sustained stimulus only leads to inflation in the economy.
 - a. Of course, we're not confronting this problem at the present time.
- B. Monetary policy also can't be used to boost specific regions of the country—or even specific industries.
 - 1. For example, right now, you could make the case that Arizona is struggling harder than most states to recover from last year's recession,
 - a. as employment in the state has continued to decline this year.
 - b. There are two main reasons for this:
 - (1) Arizona relies more heavily on high-tech than does the typical state,
 - (a) making it especially vulnerable to continued sluggishness in tech demand nationwide.
 - (2) Tourist activity also is important here.
 - (a) Although that sector has recovered somewhat from the post-9/11 shock,
 - (b) measurable performance has not returned to normal levels.
 - 2. Understanding what's going on in the District is a very important part of the policy process. It's one of the main reasons for the national and regional structure of the Fed I mentioned before.
 - 3. That structure is critical in the conduct of policy, because it helps the Fed get a good picture of what's going on in *all* the regions of the country.
 - a. For example, one of the most important things we ask of our directors is a good *grassroots* perspective on economic conditions.

4. In addition, the Research staff at each Bank uses the Directors' input—as well as survey responses from local people and regional data—to provide an analysis of regional conditions for the meetings of the FOMC.
 5. And at each meeting, we spend a good deal of time going around the table talking about each District's economy.
 6. That's how we put together a picture of how the whole economy is doing.
- C. And the *whole* economy *has* to be our focus, because policy works through national credit markets.
- V. So far, I've tried to give you a broad overview of how the Fed tries to strike a balance in conducting monetary policy—
- A. —a balance between concern over the short-term measures of economic performance, and attention to the long-term goals of sustainable growth and employment and low inflation.
1. Recently, as I've already indicated, we've been addressing the short-term concerns about the sluggish recovery.
 2. I'd like to say a few words about our recent move to cut short-term interest rates before I turn to your questions.
- B. The recovery has been pretty uneven.
1. We started the year with real GDP growth coming in really strong in the first quarter and much softer in the second.
 - a. That gave us a respectable average growth rate of around three percent for the first half of the year.
 2. I must admit, I expected the economy to do at least that well in the second half.
 - a. And, indeed, the preliminary data on real GDP for the third quarter did come in at a touch over three percent.
 3. The trouble is,
 - a. a lot of that growth had to do with a surge in spending on autos early in the quarter that tapered off in August and September.

- b. The other problem, of course, is that labor demand has been stubbornly soft,
 - (1) with payrolls and hours worked edging down in October.
 - c. So the current quarter's growth is likely to be noticeably slower than last quarter's.
 - 4. Underlying this soft spot is the current elevated level of uncertainty and risk,
 - a. which appears to be depressing business and consumer sentiment and restraining spending.
- C. In light of all this, and in light of our low-inflation environment,
- 1. it seemed wise to take out a little insurance to keep the expansion going,
 - a. so we lowered the target interest rate by half a percentage point.
 - 2. I believe that, with this policy action,
 - a. the prospects for achieving our long-term goals of price stability and sustainable economic growth appear to be balanced.
 - 3. Going forward, there are other positive forces at work in the economy.
 - a. The very strong productivity growth we've been recording will help create business opportunities that stimulate economic growth.
 - b. And the economy also is getting stimulus from fiscal policy.
 - c. These sources of stimulus—combined with the recent further easing of monetary policy—should help set the stage for a moderate expansion next year.

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