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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

III. Most of you are probably familiar with the Fed's responsibility for monetary policy. And I'll turn to that in a moment.

A. But first I want to focus on two other important Fed responsibilities, both mandated by the Congress.

B. The first is the payments system, which is at the heart of our financial system.

1. The payments system is a complex, interdependent network,

a. and trillions of dollars flow through it every day.

b. In fact, the Fed's electronic wire payments system handles some two trillion dollars a day.

2. The Fed's primary function here is essentially to ensure the system's stability.

a. That is, when some participants are in bad financial health and can't complete their payments, the Fed's role is to guard against the possibility that the system will "unravel."

3. We're also involved in another part of the payments system—check processing and collection.

   a. This function has certainly been changing in recent years, as Americans write fewer and fewer checks and turn more to other forms of payment.

4. In addition, the Fed is the banker for U.S. Treasury

   a. handles payments for Treasury through account at Fed

   b. sells Treasury securities and keeps track of ownership through book entry system

   c. provides fit coin and currency

C. Supervision and Regulation function helps ensure safety and soundness of the nation's banking system and ensures fair access to credit. We supervise

1. State-chartered member banks

2. All bank holding companies

3. Foreign banks operating in U.S.

4. Large financial conglomerates that own banks, such as Charles Schwab and Countrywide Mortgage

D. Discount Window

1. provides credit to help depository institutions meet temporary liquidity needs.

IV. Now let me turn to monetary policy, which is a good example of the Fed's national/regional, public/private, 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 main tool the Fed uses to conduct policy open market operations--federal funds rate.

1. By adjusting the fund rate,

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 strives to achieve both short-run and long-run goals.

1. For example, a short-run goal would be to stimulate the economy when it's weak.

2. In 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.

V. 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.

B. Monetary policy also can't be used to boost specific regions of the country—or specific industries.

1. For example, right now, you could make the case that Arizona's manufacturing sector could use a boost.

2. But if the Fed stimulated every time a sector or region of the country were weak,

a. we'd be stimulating all the time.

3. Moreover, the *whole* economy is more appropriately our focus, because policy works through national credit markets.

C. This, of course, doesn't mean that the Fed doesn't pay close attention to developments close to home.

1. On the contrary, understanding what's going on in the District is a very important part of the policy process.

a. It's one of the main reasons for the national and regional structure of the Fed I mentioned before.

2. 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.

3. 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.

4. And at each meeting, we spend a good deal of time going around the table talking about each District's economy.

5. That's how we put together a picture of how the whole economy is doing.

VI. 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.

B. So let me say a few words about current conditions in the economy before I turn to your questions.

VII. It looks as if—after a couple of years of sluggish performance—the economy may have finally found its legs.

A. We've been expecting this because there are some very positive fundamentals at work.

1. One is the stimulus in the pipeline from fiscal policy. This includes

a. the pickup in defense spending to support the action in Iraq

b. and a series of tax packages.

2. Another is the stimulus from monetary policy.

a. Since 2001, the Fed has cut short-term interest rates from six and a half percent to one percent at present.

b. So short-term rates are now at their lowest levels in more than forty years.

3. A third important fundamental is the economy's phenomenal productivity performance.

a. It began with the economic boom in the mid-1990s

b. and it has continued—

c. —even through the 2001 recession and the modest expansion.

d. This suggests that the process of technological innovation that drives productivity in the long run is still alive and well.

e. And that bodes well for the future, because faster productivity growth creates business opportunities that stimulate economic growth.

B. The most recent data clearly have been positive.

1. GDP grew by a superb 7.2 percent in the third quarter.

2. Business investment in equipment and software—and especially the information processing equipment component—showed strong overall gains.

3. The beleaguered manufacturing sector has begun to grow,

4. And consumers are still spending.

a. Although auto sales have moderated in recent months, this is probably a payback for the extraordinary strength in the third quarter, so it's likely to be temporary.

b. Outside of autos, consumer spending has been robust, especially in housing.

5. Finally, and very importantly, we're seeing some progress on the jobs front.

a. This is good news, after several months earlier in the year when payrolls were shrinking by an average 85,000 a month.

b. The data show that employment started to grow three months ago, and it grew by about 125,000 over each of the last two months.

VIII. Now, what about the outlook for inflation?

A. Well, even though we're seeing some job growth, there's still a lot of slack in labor markets—

1. —the unemployment rate is still at six percent, and it has been at or above that rate for the last six months.

B. Product markets have slack, too—

   1. —that is, there's excess capacity out there.

C. Given that slack, as well as the low level of inflation, I think there's still room for some pretty strong growth before the risk of inflationary pressures becomes a primary concern.

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