Challenges to Economic Growth

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It's a pleasure to be with you today. I seem to have lucked out with my timing. Not only am I able to join you in celebrating the five-year anniversary of the Frank Batten School of Leadership and Public Policy, but I get to kick off homecoming weekend. I know some of you will be eager to get started, so I'll try not to keep you too long.

Today, I plan to share my perspectives on some of the economic challenges facing our country, and in doing so provide background on the Federal Reserve's role on behalf of the nation's economy. We, too, will be observing an important milestone soon, our centennial. But first, I should share our standard disclaimer — that the views expressed in this talk are my own and are not necessarily shared by anyone else in the Federal Reserve System.[1]

To start, I'd like to say that I feel an affinity for the Batten School, although this is my first visit here. This is due in part to Gerry Warburg, your assistant dean. He spoke at a gathering at the Federal Reserve Bank of Richmond last year and then again to our Board of Directors last month. Warburg was quite enlightening regarding the overall political landscape and the political opportunities and pitfalls that may await the Fed in the years ahead. I was delighted to learn that he is related to Paul Warburg, the famous financier who 100 years ago championed the creation of our nation's central bank. He helped author the first draft of the bill that would ultimately become the Federal Reserve Act, which was signed into law on December 23, 1913.

Not only did Paul Warburg campaign for a central bank, he served on the Board of Governors in the Fed's early years and wrote a detailed book explaining the operation of the Fed for the general public.[2] Anyone who has taken a good look at the Fed's structure can appreciate why someone would see the need for a book explaining who the Fed is and what it does. I plan to say a bit more about our complicated structure in a moment.

Another link to the Batten School is that I feel a bit of an indirect connection to Frank Batten Sr. himself. A man named Lemuel Lewis served as the chairman of the Richmond Fed board of directors a few years back, and he worked for Frank Batten at Landmark Media Enterprises for many years. (The company was formerly known as Landmark Communications.) Lem was quite generous with his praise for Frank Batten and spoke warmly of the tremendous difference he made in his professional and personal life. I can well understand why your school's report uses the word "revered" regarding your school's namesake.

Frank Batten's vision for this school was to bring together teaching and research concerning the practice of leadership in the public policy realm. As a Reserve Bank president, it has been a unique privilege to be able to participate in such a unique American policy-making institution. I've had a ringside seat for, and at times have participated in, some of the most significant economic policy challenges of recent years. I've seen firsthand the enormous demands placed on the leaders of such policy institutions. So I heartily endorse the creation of educational institutions founded on this compelling vision.

The notion that economic policy requires highly collaborative leadership skills will resonate with anyone with a good working knowledge of the Fed. Our nation's monetary policy is entrusted to a relatively large deliberative body called the Federal Open Market Committee, or FOMC, which consists of 12 voting members. Seven are the members of the Fed's Board of Governors, and five voting members are drawn on a rotating basis from the ranks of the 12 regional Reserve Bank presidents.[3] All 19 of us — the seven governors and all 12 Reserve Bank presidents — participate fully in each meeting.

A word about the Reserve Banks. While the Board of Governors is a federal agency, the regional Reserve Banks are independently chartered banks empowered under the Federal Reserve Act to provide clearing and settlement services for our nation's banking system and for the U.S. Treasury. In addition, Reserve Bank staff members supervise financial system entities on behalf of the Board of Governors and conduct economic research in support of the Fed's monetary and financial policy mission. In all, the expenses associated with Reserve Bank operations total more than $3 billion. So you can see that leadership challenges within the Fed come in many varieties.

The design of this collaborative structure was quite deliberate and reflected the vision of, among others, Carter Glass of Lynchburg, Va. Like Frank Batten Sr., Glass was a newspaper editor by trade. He also served in the U.S. House of Representatives and later in the U.S. Senate. While in the House in 1913, Glass led the effort to pass the Federal Reserve Act, and while in the Senate in the 1930s, he played a crucial role in Depression-era banking legislation, including the Banking Act of 1935, which established the FOMC. Glass insisted on a federated structure of geographically dispersed reserve banks so they would understand and remain connected to the diverse regional economies that make up our huge country. He strongly opposed the proposals of some — including, I have to add, Paul Warburg — that would have concentrated power in a single centralized financial institution.

This federated structure ensures that a wide range of perspectives are brought to bear on policy questions. Moreover, the Fed's structure blends public and private governance. Each Reserve Bank is overseen by its own Board of Directors consisting of private citizens, drawn from various walks of life. Each Reserve Bank president is appointed by his Board of Directors, subject to the approval of the Board of Governors. This provides a measure of insulation for monetary policy decision-making from the short-run pressures associated with electoral politics, and thereby allows a longer-term focus, which is essential for good monetary policy.

Much that is distinctive about the Federal Reserve's leadership culture derives, I believe, from our federated structure. It's often observed that the Fed is an exceptionally collegial institution, and that is quite consistent with my experience. You can see this in the transcripts of FOMC meetings, which are released to the public with a five-year lag. (They are posted on the Board's website, federalreserve.org.) You'll notice there is a certain gentile formality about the proceedings, so participants are referred to as, for example, "President Plosser," "Governor Duke," and so on. Ben Bernanke is addressed as "Mr. Chairman."

More substantively, reading the transcripts reveals the lengths to which the Committee goes to reach a workable consensus. Policy alternatives are circulated a week in advance, and participants are polled as to whether they span the range of plausible alternatives — that is, could you support one of them? At the meeting, after a set of staff briefings, each participant provides an extensive statement on their views about the economy. Presidents usually include their views on economic conditions in their District. Another go-round follows in which participants express their views on policy alternatives. By the time the Chairman puts a proposal on the table, a workable consensus is generally clear. At times, this is followed by some surprisingly efficient collective wordsmithing, in which the language of the statement is tweaked here and there to better express the Committee's intent. A final roll call concludes, and only then would an observer realize which participants were voters and which ones were not.

This deliberative process is laborious and time-consuming and is supported by large staffs dedicated to research and analysis, both at the Board and the Reserve Banks. This makes sense in light of the potentially serious consequences of FOMC decisions for millions of Americans. But I also believe that our federated structure contributes to the strong sense of collegiality that pervades the Fed. The fact that the regional Reserve Bank presidents derive their authority from distinct independent governance bodies has a leveling effect on deliberations, I believe. As a result, FOMC participants expect their colleagues to bring their best independent judgments on the policy problems at hand and to listen thoughtfully to alternative perspectives. In my view, this results in a high-quality deliberative process.

As a voting member of the FOMC this year, I have found myself at times within — and at times outside — the workable consensus and sometimes both at the same meeting! For example, I have agreed with the Committee's decision to keep interest rates near zero, since our economy is growing at only a relatively modest pace. In such an environment, low interest rates and the corresponding monetary stimulus are needed to keep inflation from falling below the Committee's 2 percent objective.

On certain key points, however, I've disagreed with the Committee's other voting members and as a result, I have dissented at all six FOMC meetings this year. Let me explain. At each meeting this year, the Committee has issued "forward guidance," that is, language stating that economic conditions are likely to warrant a federal funds rate near zero for at least several years. I have objected to that language because it's a highly imperfect way to communicate about future policy. Such language could be misinterpreted as suggesting a diminished commitment to keeping inflation at 2 percent. I would oppose adopting such a stance, and I do not believe my colleagues on the FOMC intended that interpretation.

In addition, at its September meeting, the FOMC decided to begin increasing the size of its balance sheet by purchasing mortgage-backed securities. I believe that the benefits of that action are likely to be small, because it's unlikely to improve growth without also causing an unwelcome increase in inflation. At the same time, adding to our balance sheet increases the risks we'll have to move quickly when the time comes to normalize monetary policy and begin raising rates.

Finally, if we were to purchase more assets, I would've preferred to purchase Treasury securities rather than agency mortgage-backed securities. Buying mortgage backed securities rather than Treasuries may reduce borrowing rates for conforming home mortgages, but if so, it will raise interest rates for other borrowers and thus distort credit flows. This is an inappropriate role for the Fed, a principle that was recognized in the Joint Statement of the Department of Treasury and the Federal Reserve on March 23, 2009: "Government decisions to influence the allocation of credit are the province of the fiscal authorities," that is, Congress and the administration.

As I said, our economy is on a relatively sluggish path of recovery from the sharp contraction in activity that occurred in the Great Recession of 2008–09. We lost over 8 million jobs in the recession and its immediate aftermath. Since then, we've added about 4 1/4 million net new jobs, which leaves us far from a full recovery. Similarly, the unemployment rate rose from 5 percent at the end of 2007 to over 10 percent near the end of 2009. While the unemployment rate has fallen to 7.8 percent in the most recent report, the decline has been disappointingly slow.

There are several factors that appear to be impeding a more rapid recovery in labor market conditions right now. First, the housing market is still coping with the large inventory overhang that remains from the prerecession boom. This sector has begun to show some encouraging signs, with home prices and construction improving this year. But housing investment is still quite low relative to historical norms, and it will continue to underperform until the demand for housing makes more progress catching up to the existing housing stock.

Second, and related, was the significant shift in economic activity away from residential construction and related supply industries. The rapid loss of jobs in these industries, layered on top of ongoing longer-run sectoral shifts, resulted in large inflows into the ranks of the unemployed. The resulting shift in the skill profile of available workers has meant that the reallocation and skill mismatch frictions affecting labor markets are at a relatively high level.

Third, the Great Recession appears to have made many consumers more cautious and less willing to spend, relative to their income and wealth. The declines in income and wealth during the recent recession were far greater than in other recent recessions. As a result, consumers have become more apprehensive about their future income prospects, which have tempered the growth in consumer spending.

Finally, the political gridlock that has delayed remedies to our unsustainable federal fiscal path has meant paralyzing uncertainty across the vast range of fiscal policy touch points in the economy. This appears to have seriously dampened investments and hiring for the new business ventures that typically would take up the economic slack caused by one sector's decline. Should they all take effect, the spending cuts and tax increases that will automatically occur next year if Congress fails to act — the so-called "fiscal cliff" — will likely cause the economy to contract and move back into a recession. On the other hand, the longer-run federal fiscal outlook is a significant imbalance between taxes and spending. I'm sure you are familiar with projections by the nonpartisan Congressional Budget Office, showing that the outstanding stock of federal debt is likely to increase without bound as a ratio to gross domestic product. This is not a feasible scenario and cannot persist indefinitely. At some point Congress will have to align taxes and spending. The set of policy changes that could conceivably be adopted affect almost every American consumer or business in a meaningful way.

So where do we go from here? My best guess is that growth will begin to firm later next year and continue to improve beyond that. While the recession in Europe poses risks for this outlook, I think those risks will likely dissipate next year as leaders work through the adjustments necessary for creating a new fiscal regime. As U.S. labor markets continue to heal, I expect household confidence to slowly firm and bolster consumer spending.

The fundamental prospects for longer-term U.S. growth remain quite promising, in my view, and are likely to reassert themselves in the years ahead. We have a proven ability to generate advances in scientific knowledge and commercial innovation. The flexibility and resilience of our markets, along with a relatively well-educated populace, make this an excellent market in which to implement innovations. Our major challenge over the long haul is to deepen the knowledge and skills of our people, because growing our human capital is fundamental to improving our standards of living.

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[1] I am grateful to Roy Webb and John Weinberg for assistance in preparing these remarks.
[2] Paul M. Warburg, "The Federal Reserve System." New York: The Macmillan Company, 1930.
[3] Under current law, the president of the New York Fed is a permanent voting member of the FOMC. The presidents of the Cleveland and Chicago Feds alternate yearly as voting members. The other presidents vote every three years.