

A Brief History of the Fed Universe

Greater Vineland Chamber of Commerce
Vineland, NJ

April 17, 2019

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President and Chief Executive Officer
Federal Reserve Bank of Philadelphia



FEDERAL RESERVE BANK
OF PHILADELPHIA

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Before I begin, I'd like to do two things.

First, I want to congratulate the Chamber on its centennial year — happy anniversary.

Second, I want to address the elephant in the room. It might be better to avoid such a divisive subject in these polarized times, but I think it's better to face controversy head-on. So I venture in, bravely posing the question: Is Vineland the dandelion capital of the country or the egg capital?

This has been a subject of internal debate at the Philadelphia Fed for weeks now, and Wikipedia supports both camps.

So please, by a show of hands, help us start the healing: dandelion or egg?

Now that that's settled, I'll turn to something almost as important: the economy.

At an event like this, I'd normally give an economic update and discuss what that means for my policy outlook, and I intend to do that. But I've also been asked to give a Fed primer for anyone who's not 100 percent familiar with the history and functions of the Federal Reserve. If you count yourself among them, you're in very good company. It can be a byzantine and complicated system, and I remember being surprised, as a newly minted member of the board of directors, at the scope of the Fed's work — it's more than just interest rates.

With that in mind, I'll give a quick intro to how the Federal Reserve came to be and what it is we do, then give the requisite outlook with some added context.

And I will start with the most important aspect of Fed history and tradition, which is the standard disclaimer: The views I express today are mine alone and do not necessarily reflect those of anyone else in the Federal Reserve System.

The Federal Reserve System

With that done, a brief history. It's probably safe to say that a central bank like the Federal Reserve could only happen in America. That's because its structure reflects a deep and long-standing battle of ideological wills that are foundational to our national existence.

The Fed has only existed for a little over a century. Compare that with the Bank of England, which has been around since 1694, or the Riksbank, Sweden's national bank, which was established a few decades before that. Of course, those were sovereign nations much earlier than we were, but the Federal Reserve Act was passed in 1913 — not exactly the dawn of the republic. So why is that?

Without going too far down the historical rabbit hole, there were, in fact, attempts — and successes — at central banking in the United States before the Fed. But their rise and fall reflected those competing ideological forces: On one side were those who wanted the stability and economic advantage wrought by a central bank, while the other housed those who fundamentally distrusted centralized power. This was at the heart of our founding: Federalism and Republicanism. Hamilton and Jefferson. Dandelion and egg.

Before the 20th century, we had two real central banking successes — both in Philadelphia, by the way — which we imaginatively refer to as the First and Second Banks of the United States. Both had 20-year charters when they were established, and both faced political climates that were hostile to their renewal when the time came — which meant both were left to expire.

That philosophical tension never went away. But in the late 1800s, a series of booms and busts culminated in the Panic of 1907, and the need for a central bank became clear. The Federal Reserve was born.

Again, I will spare you the extensive details, but the important part is the result: a decentralized central bank. A compromise between those two underpinning viewpoints.

At its center is the Board of Governors in Washington D.C., which is where the Chair sits and is what most people think of when they hear “The Fed.” But there are also 12 District Banks around the country, each an independent entity with its own president and board of directors. People often ask what it’s like to work for Jay Powell, or Janet Yellen before him. But the thing is, I don’t. I work for our board and our District.

That unique Fed structure gives us a better view of the realities on the ground — the United States is a vast and complicated economic machine, but it is fundamentally made up of a collection of micro-economies across the cities, towns, and communities that blanket the country.

The regional Banks bring the viewpoints of our Districts when we meet in D.C. to formulate monetary policy, which we do roughly every six weeks at the Federal Open Market Committee, or FOMC. Again, that local perspective is crucial, because we’re making policy at a national level, and the size and scope of the U.S. economy can flatten the peaks and valleys we see in different areas.

In those meetings, we discuss monetary policy and, at the end, we vote. The governors are permanently in a voting position, as is the president of the New York Fed. The rest of us rotate in — I’m up in 2020, and despite the fact that you’d never know who’s in rotation until the last 30 seconds of a two-day meeting, people will be a lot more interested in what I have to say come January ...

Congress outlined a “dual mandate” of price stability and maximum employment for the Federal Reserve, which is again unusual for central banks, most of which focus solely on inflation. The Fed also regulates banks, processes payments, and conducts economic research.

And — the part that never gets enough attention, in my opinion — we do research and work to help strengthen our local economies. As I said, each of the Banks are independent entities, which means we have the freedom to tailor our work to our own area’s needs. While all Feds

have a community development function, each of us executes it in a different way. At the Philadelphia Fed, we've created the Economic Growth & Mobility Project (EGMP), which focuses on what we think are the three foundational aspects of economic mobility: job creation — that is, stable, well-paid jobs that lead to financial security; workforce development — that is, education and training for people to get those jobs; and infrastructure, which includes everything from housing to transportation to broadband.

The Fed can't make grants or finance projects; it's not in our congressional remit. What we can do is bring people together and offer sound research. So with the EGMP, we're forming partnerships around our District to help address systemic issues in what we call Research in Action Labs.

The first of those was in northeastern Pennsylvania, where they did have one of those three pillars — a lot of jobs at fulfillment centers — but were struggling with another: infrastructure. Those centers are located outside of town, and the region was built like most of America in the latter half of the 20th century: constructed to bring commuters from the suburbs and outskirts into the city, not the other way around. So we worked with local partners, and they came up with a collective set of solutions that worked for them — launching pilot programs, establishing a council on equitable transit, and making transportation a priority in the area.

That part is crucial: The Fed can offer research, data, and support, but communities are the ones that understand their own unique needs. Our job is to offer our research and convening power, and to share projects' data and results with anyone who might benefit. We've already heard from communities that have issues similar to northeastern Pennsylvania, asking how they can do something similar. Now that we've helped with the program, we can share a blueprint.

Different Banks also sometimes specialize in particular research areas. Obviously, Dallas does a lot on energy markets. New York has a special focus on international financial markets. In Philadelphia, our area of expertise is consumer credit: cards, household debt, student loans, etc.

So that's the Fed overview. We do a lot of things other than monetary policy.

For instance, we use our research to share our economic outlooks.

The Outlook

Turning to the first part of our mandate, “maximum employment” means, more or less, that if you’re looking for a job, you can find one relatively easily. That comes with some caveats, including that it doesn’t necessarily mean you’ll find the job you *want*, and, obviously, this is nowhere near a technical term. In fact, somewhere, a cold shiver just ran down an economist’s spine ... But by a colloquial measure, that’s what we mean.

The unemployment rate will never be zero. People naturally leave jobs and come in and out of the labor force, and we expect some level of unemployment to reflect that. We think about a sort of happy medium, where jobs are available but not so abundant that it starts to put upward pressure on inflation; we refer to this as the “natural rate” of unemployment. It’s important to note that the natural rate is elusive – it’s more easily evaluated in the rearview mirror, and even then it’s not concrete enough for consensus, but we do have estimates. Most economists currently put that measure somewhere around 4½ percent. So by contrast, the current unemployment rate of 3.8 percent is relatively low. I actually see that rate moving further down this year — somewhere around the 3½ percent range — before edging back up a few tenths of a percentage point.

Job creation is another metric that garners a lot of attention, and the last two months’ data definitely made a few headlines. February’s initial number made headlines at 20,000 — though it’s now been revised up to 33,000 — because it was much lower than expected, and much, much lower than other months. March, on the other hand, was a robust 190,000 — which has been more or less the average number over the last half-year or so.

These numbers illustrate the persistent Fed mantra of data dependency. First, it’s important to take a medium-term view, and not let one report or data series derail an outlook. Second, the dismal science is not exact. If you look at economic predictions from a year or two ago, a lot of them had job creation slowing significantly by now — my own included. But the labor market has shown remarkable strength, and its continued tightening has surprised a lot of experts. So

it's important to be patient as the data roll in, and not jump to conclusions on the basis of one round — or even a generally agreed-upon prediction. We want the data to confirm it.

Turning to price stability, the Fed has a goal of 2 percent inflation. That's enough for the economy to grow at a healthy pace without price changes causing discernable friction in the economy.

After several years of running persistently below our preferred 2 percent target, inflation finally started running about that rate. In recent months, it's edged back down somewhat.

I see inflation averaging slightly higher than 2 percent this year and next. Again, my focus is on the medium-term average, and what I'm watching in particular is inflation's trajectory — that is, not just its direction, but the speed at which it travels.

As with all things policy related, I'll be driven by the data. In particular, I'm giving weight to core inflation for a better view of the fundamentals, as fluctuations in energy prices are likely to affect the headline metric.

Turning finally to GDP, I see growth a bit above 2 percent for 2019, and around 2 percent next year, which I see as trend.

That number is disappointing to a lot of people. But it's important to remember that we're on track for the longest economic expansion on record, and it's coming in the context of very low unemployment and low and stable inflation. In that setting, continued steady growth is not what I'd call "disappointing."

There are, of course, some risks to watch for, and I'm keeping an eye on global developments, growth abroad, and trade.

Another risk that's been discussed is the yield curve, a part of which inverted last month. Again, a primer for the uninitiated. The yield curve shows the difference between the return on bonds with various lifespans — in general, shorter-term bonds tend to have lower returns while the longer terms yield more. Economists refer to the premium on short-maturity Treasuries as "the money premium," reflecting the idea that they have many of the features of money. The

normal shorthand would be to say that they're more liquid than long-term securities, but that money-like quality is something that investors are willing to pay for in the form of lower returns.

So normally, there is an upward tilt to the yield curve. Long-term rates reflect expectations of *future* short-term rates; so if long-term rates fall below *current* short-term rates, it signals a market expectation that future rates will likely be lower than they are now — which happens when the economy gets weak and policymakers respond.

Try saying that last sentence five times fast.

With the yield curve discussion laid out, there are some mitigating factors to consider, because we're looking at a very different economic playing field than we have in the past. The Fed's balance sheet is still historically large, which may be affecting long-term yields. And while inversions in the yield curve do appear to have a relationship with downturns, correlation does not equal causation, and that inversion is not an absolute predictor.

Ultimately, my views are shaped by multiple indicators, and there are certainly aspects of the economy — the strength of the labor market, for instance — that point to a fundamentally sound U.S. economy.

Accounting for all those factors — a strong labor market, muted inflation, sustained moderate growth, and the penumbra of uncertainty — I continue to be in wait-and-see mode, and my outlook for rates remains, at most, one hike for 2019 and one for 2020.

The Fed's Balance Sheet

I just mentioned the Fed's balance sheet, which is yet another aspect of Fed policy and action that has captured attention lately, and the last issue I'll touch on before we head into Q&A.

I want to start by saying that while the balance sheet is an important part of the policy discussion, it's not indicative of our monetary policy *stance*.

A final primer, this one on the balance sheet: In the wake of the global financial crisis and the Great Recession, the Fed turned to what we call "unconventional" monetary policy.

Our conventional means of conducting monetary policy is the federal funds rate. Lower rates can encourage economic activity while higher rates can help prevent overheating. But in 2008, the economy was severely damaged, and when the Fed lowered rates to essentially zero, it still needed help. We had to go beyond our usual toolkit and turned to large-scale asset purchases, which was a program better known as quantitative easing, or QE. QE involved buying assets on a larger scale and venturing into longer-term Treasuries along with mortgage-backed securities, or MBS. After three rounds of QE, the balance sheet — which was roughly \$900 billion before the crisis — had swelled to \$4.5 trillion.

In late 2014, we stopped the purchases, and kept the balance sheet constant by reinvesting the proceeds as they came to maturity. A year later, the FOMC voted for the first modest rate hike, signaling the first baby steps toward normalization. After three more increases to the federal funds rate, the FOMC was ready to start looking at bringing the balance sheet into the normalization process, voting in September of 2017 to start the unwinding process the following month.

At that point, the size of the balance sheet was larger than we'd ever seen, and the MBS in particular rendered its makeup different than it was before the crisis: Assets were made up primarily of those Treasuries and MBS, while the liability side overwhelmingly consisted of paper currency and bank reserves and balances.

The means of unwinding the balance sheet were straightforward: We could either stop reinvesting the securities as they come to maturity or sell them on the open market. We opted for the former, with gradually increasing caps on the amounts that were not redeemed. This helped us attain the gradual, predictable, and thoroughly boring process that we're aiming for.

Which brings us to 2019. At the March FOMC meeting, we said that we intend to end the balance sheet runoff in September. Once we do so, we'll reinvest paydowns from MBS — subject to a cap of \$20 billion per month — into Treasuries, which reflects our long-standing plans to hold primarily Treasuries in our portfolio.

That won't quite be the end of normalization, however. In September, when the runoff ends, reserves will likely still be slightly higher than what we need to "efficiently and effectively" implement monetary policy, and our ultimate goal for reserves is "no more than necessary."

Our plan is to keep the size of our aggregate securities holdings constant for some time after September. During this period, we will see a very — and I do stress "very" — gradual decrease in average reserves, as currency and other non-reserve liabilities grow over time.

For me, a key issue is that we only have estimates of the demand for reserves, which means we should approach the "efficient and effective" level with caution.

This slow and steady approach, which is based on work by the Philadelphia Fed staff,¹ is not only the safer option, it has the additional advantage of reducing uncertainty about the evolution of asset redemptions, and proceeds in the FOMC's preferred "gradual and predictable manner."

Finally, I want to note that balance sheet normalization has received a lot of attention both in our meetings and communications, and will continue to do so. Again, while that does reflect its importance, it does not reflect our current monetary policy stance. We often refer to the FOMC's "toolkit" when discussing policy options. Balance sheet policy certainly remains an option, but we've put it back in the toolbox, and stored it in the basement — within arm's reach, but out of sight for now.

Conclusion

That, in the smallest nutshell possible, is the combination overview of the Fed's purposes and functions and my economic outlook as it stands today. Instead of going on any further, I'm going to stop there to turn it over to you for questions, and again, wish the Chamber a happy 100th birthday — you don't look a day over 85.

¹ I would like to thank Roc Armenter for his research and insight.