Remarks by Governor Mark W. Olson

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The Federal Open Market Committee and the Formation of Monetary Policy

Thank you very much for inviting me here this evening. When my longtime friend Lance Jacobson extended this invitation more than a year ago, I readily accepted. Several months later, the 2004 calendar of Federal Open Market Committee (FOMC) meetings was released, and I discovered that this meeting would occur on the day following the Committee's May meeting. Because FOMC members observe a blackout on discussions of the economy for the week before and the week of the FOMC meetings, I prefer not to talk about current economic conditions. However, I can provide you with some insight into the way the FOMC functions and the impact of monetary policy on the U.S. and global economies. My former Federal Reserve colleague Laurence Meyer provided the blueprint for this presentation in a 1998 speech entitled *"Come with Me to the FOMC*."[1] That title, in turn, was borrowed from remarks given back in 1951. While my remarks are not identical in either style or substance, I have borrowed heavily from Larry's presentation, and you have the assurance that they have a long history.

First, a comment or two on who we are. Nineteen policymakers participate in FOMC meetings, although at most only twelve vote at any one time. At times vacancies on the Board mean that the FOMC has fewer than twelve voting members. The Board has now operated at full strength for almost two years, after several years with two vacancies. Each of the Board members is appointed by the President of the United States and confirmed by the Senate. Our Chairman, Alan Greenspan, has two designations: The President has appointed him both as a Board member and as Chairman. A Board member's term is fourteen years, and the Chairman has a term of four years. Though Alan Greenspan's chairmanship expires this June, his term as a Board member extends through January 2006. As you may know, President Bush announced last year that he intended to reappoint Mr. Greenspan as Chairman. The Board Vice Chairman is also appointed by the President for a four-year term. The current Vice Chairman, Roger Ferguson, was reappointed last fall.

In addition to the Board of Governors, five of the twelve Reserve Bank presidents vote in any given year. The President of the New York Fed is a permanent voting member whereas the other Bank presidents vote every other or every third year. If you find this construct confusing, or unduly complex, perhaps a bit of background is in order.

The Federal Reserve System is generically described as the central bank of the United States. In the late eighteenth and early nineteenth centuries there were two attempts to establish a central bank of the United States, and neither endured for more than twenty years--in contrast to most European nations, where central banks were well established by the nineteenth century. Though you may not be familiar with the history of our central bank, you may well remember learning about the debates on the concept of federalism by our

nation's founders, when the forces favoring decentralization, led by Thomas Jefferson, fought the proponents of a more centralized government, led by Alexander Hamilton. The Jeffersonian forces largely prevailed. As a result, the United States lacked a strong central bank presence but had no authority even to grant national charters to commercial banks until the Abraham Lincoln Administration. All bank charters were originally granted by the states and, as a consequence, the United States at one time had more than 25,000 bank charters. Today, we have about 8,000 separate bank charters. By contrast, most other developed nations have fewer than 100 separately chartered banks.

In the early part of the last century, a monetary panic stimulated the legislation leading to the Federal Reserve Act of 1913. And consistent with our tradition of dispersed economic power, the new central bank of the United States was created with a significant grass roots component. As a result, twelve Federal Reserve Banks were created, owned by member banks in each District, headed by a Reserve Bank president, and supervised by the Federal Reserve Board in Washington. To give you a sense of the dispersal of resources within the Federal Reserve, more than 22,000 employees work in the System, meaning both the Banks and the Board. Of that number, about 1,700 work for the Board in Washington, and the remaining 20,000-plus work in the twelve Banks. Of the 1,700 Washington employees, roughly 250 are Ph.D. economists, the majority of whom support the Board's monetary policy responsibilities.

The FOMC has eight scheduled meetings each year, roughly every six weeks. Financial markets follow the FOMC's actions very carefully and examine each word in the statement released after each meeting. Today I would like to share with you my perspectives gleaned from thirty months on the Board and twenty FOMC meetings.

I was most impressed at my first FOMC meeting in December 2001 by the extraordinary level of preparation by and for the FOMC members. Let me begin by describing the contributions of the twelve Bank presidents. Each of the twelve Banks is staffed with economists who monitor the economic conditions in their respective Districts. A summary of the regional analysis is compiled in what we call the Beige Book (because it has a beige cover) and released to the public about two weeks before the FOMC meeting. Today we are in Florida, which is part of the Atlanta Fed's District, so let me speculate on how developments in this area's economy may enter our deliberations. Jack Guynn, president of the Atlanta Fed, comes to the meeting prepared to discuss the outlook for the entire Sixth Federal Reserve District. With respect to this particular part of the District, Jack may discuss Florida's citrus crop, the relative health of the tourism industry, and trends in Florida real estate prices. Because Florida is also a gateway to Latin America, he may also discuss factors affecting trade with that part of the world.

Similar preparations take place at each of the other eleven Banks. Though only five presidents vote at each meeting, all twelve prepare reports and participate fully in FOMC discussions. The president of the New York Federal Reserve Bank is accorded a special role on the FOMC. That person--currently Timothy Geithner--is always a voting member and is traditionally elected as Vice Chairman of the FOMC. This role is largely a reflection of the New York Fed's responsibility for implementing monetary policy decisions through its open market desk operations.

Typically, after the approval of the minutes of the previous FOMC meeting, the first order of business is a report from the System Open Market Account (SOMA) Manager at the New York Fed. The Manager discusses market activity since the most recent FOMC meeting and

may also report on any other domestic or international market activity that may reflect trends in the U.S. and world economies.

The SOMA Manager's report is followed by reports by senior Board economists, including the directors of the Division of Research and Statistics and the Division of International Finance. Each report summarizes what we refer to as the Greenbook, which is prepared by a team of economists. The time between receipt of the Greenbook and the reports by the directors is a time of intense study and preparation by the FOMC members. Governors often schedule briefings from Fed economists besides conducting their own individual reviews. The materials typically arrive on our desks late Thursday or early Friday and our Board review of economic conditions occurs the following Monday morning. In our household, my family has learned that my time during the weekend before an FOMC meeting is often largely consumed in preparation for it.

While the preparation for FOMC members is very intense, I would be remiss if I did not give full credit to the effort of the economists preparing the reports. Fed staff economists hold off their Greenbook preparation until the last possible minute and supplement it just before the meeting with the most up-to-date economic data releases and developments.

The Federal Reserve Board has, over time, developed powerful econometric modeling tools to assist our understanding of the many interrelated economic forces. In large part because human behavior cannot be modeled, we cannot fully anticipate all the factors that can affect our economic policy, and no econometric model can predict perfectly. Therefore we often review alternative scenarios that may reflect different ways in which the economy may respond in a variety of situations.

After the economists' reports, we turn to the presidents and governors. Typically the presidents report first on regional economic developments as well as on their independent views on the national economy. Not surprisingly, economists from the Banks and the Board largely agree, but occasionally discernable differences exist, particularly with respect to economic forecasts. The presidents' reports often include anecdotal updates from businesses or other sources to provide real-time information on regional economic activity.

Following the presidents' presentations, the Fed governors provide their individual analyses. Our presentations focus largely on analysis of the current condition of the economy and, for the most part, do not contain monetary policy recommendations.

After each of the FOMC members has spoken, the director of the Division of Monetary Affairs presents the Bluebook, with prospective policy options for the Committee's consideration. In my time on the FOMC, generally two or three options have been presented, each accompanied by a list of pros and cons. After the presentation of policy alternatives, FOMC members resume their discussion, focusing now on their policy preferences. In the twenty FOMC meetings in which I have participated, Chairman Greenspan's participation in the discussion until this point has been limited. I suspect that this fact might surprise most FOMC observers as Chairman Greenspan, like virtually all of his predecessors, is considered almost the personification of monetary policy. Yet before the Chairman offers his first substantive comments at these meetings, eighteen other participants, representing literally hundreds of hours of study and analysis, have provided their input.

Considering the complexity of the U.S. economy and the implications of monetary policy on the world economy, the issue facing each FOMC member is deceptively simple. We establish

a target interest rate for what is known as federal funds--or, more commonly, fed funds. Fed funds constitute an interbank arrangement that allows banks with surplus balances at their Federal Reserve Bank to loan those funds overnight to banks that temporarily need to borrow to meet their balance requirements. An individual bank's balances on their Federal Reserve accounts can vary significantly depending on the dollar amount of the checks cleared that day, the volume and sequence of wire transfers in and out of the bank's account, and changes in investment or lending at the bank. In the aggregate, fed funds are an important indicator of liquidity in the banking system and, by implication, the money supply. All fed funds loans are for a single day, and the interest rate is reestablished daily. Fed funds rates thus are an excellent barometer of both the price of money and the changes in the money supply.

The Federal Reserve Act requires that monetary policy promote maximum employment, stable prices and moderate long-term interest rates. Happily, in this instance, congressional intent is also sound monetary policy. Former Federal Reserve Chairman Paul Volcker once said, "No central bank can--or should, in my judgment--conduct policies for long that are out of keeping with basic, continuing objectives of the political system."[2] When I was a young banker in the 1960s, many of my loan customer's decisions were affected at least in part by memories of the Great Depression. While depression fears were widespread, the ravages of high inflation elsewhere, such as post-World War I Europe, had not been experienced here. In fact, many people had a positive view of inflation as leading rising property values and were not convinced that inflation was inherently bad. Public policy decisions with inflationary implications--often expressed as funding both "guns and butter"--were broadly supported. Only after the high-inflation years of the late 1970s and early1980s, after the spending power of incomes had been seriously eroded, were the consequences of inflation fully understood. Part of the success in achieving consistent economic growth in the United States is due in significant part to broad public support for our mandated monetary policy objectives.

FOMC monetary policy affects the money supply through the Open Market Desk at the New York Federal Reserve Bank. A team of young (I mean young--half my age or less), whip-smart men and women begin each workday by analyzing all the factors affecting the money supply. They then gauge the appropriate amount of buying or selling for the Fed's portfolio of government securities required to maintain our target rate. When more liquidity is required, the Domestic Trading Desk purchases securities. If tightening is in order, the Desk sells into the market, replacing idle balances with investment securities and thereby marginally reducing the liquidity in the banking system. Though these professionals are young, money market activity conducted by the New York Fed is an established discipline more than eighty years old. As a result, the team knows from experience how best to maintain the target rate. The daily determination to buy or sell is communicated to a group of pre-selected securities dealers known as primary dealers, which ensures a consistent and reliable group of market participants and a competitive bid process for these transactions. The buy or sell orders are communicated electronically to the primary dealers early each day, and when the bidding is opened shortly after 9:30 a.m., the day's transactions are completed within seconds.

However, the FOMC members know that our decisions affect more than the money supply. Many other interest rates are indexed directly or indirectly to the fed funds rate. Further, FOMC decisions are viewed as an indication of the economy's underlying strength or weakness. In part, because of these broad implications, efforts have been made in recent years to improve our communication practices. The FOMC's current practice is to issue a

news release after our regular meetings, about 2:15 p.m. (ET). The release currently has three parts. The first part states the fed funds target rate of interest; the second briefly explains and updates our analysis of current economic conditions. The third provides our assessment of the balance of risks with respect to the prospects for price stability and economic growth.

The FOMC decision is communicated to the Domestic Trading Desk at the New York Fed, and the revised policy is then initiated and becomes the policy guideline for the next six or seven weeks. However, the FOMC can reconvene and reconsider its monetary policy stance at any time, at the call of the Chairman, as changes in the economy warrant.

I said earlier that one of my first impressions of FOMC meetings related to the extraordinary level of preparation by both economists and members. Let me share two other impressions as well.

At most FOMC meetings, the vote on the final FOMC target and the accompanying statement has been unanimous. This pattern raises an obvious question as to the extent to which votes contrary to the will of the Chairman--or the majority--are tolerated. Having spent several years on Capitol Hill where unanimous votes on major issues rarely occur, I am particularly conscious of the contrast. One reason many votes are unanimous is that there is no "loyal opposition" bloc within the Committee. The FOMC contains neither caucuses nor coalitions representing either political or philosophic differences. Second, and in stark contrast to other environments, there is a notable absence of posturing, which I define as an isolated or "throw away" vote to make a statement or to call attention to an individual cause.

Yet there are clearly discernable differences in economic philosophy among FOMC members. Over the years, FOMC watchers have labeled some of the Committee members as either inflation-fighting hawks or growth-promoting doves based on previous voting patterns and public statements. In recent months, news articles have pointed out the different approaches to policy represented by Governors Ben Bernanke and Donald Kohn, the Board's two newest members. Governor Bernanke, a widely respected researcher and monetary policy textbook author, has advocated inflation targeting--that is, publicly identifying an acceptable range for inflation. Several other monetary authorities, including the Bank of England, have adopted this approach. Governor Kohn, a career Federal Reserve System economist with an equally stellar reputation in his field, disagrees, preferring that FOMC members establish monetary policy not with a predetermined range of acceptable inflation rates but by considering a broader range of economic factors. I find this relatively public debate to be both instructive and healthy. It provides evidence of the depth of understanding and analysis by FOMC members and supports the integrity of FOMC voting patterns when observers note that Ben and Don have recorded identical votes during their tenures.

One other thought on the FOMC tendency for unanimous votes concerns the nature of Chairman Greenspan's leadership. The Chairman encourages forthright and thorough discussion. He seeks consensus among FOMC members, and the personal views he interjects into the discussion serve more as a beacon than a command. As a result, he achieves consensus through the quality of his leadership and the depth of his analysis.

A final observation concerns the limitations of monetary policy. During the months between my nomination and swearing-in to the Board, I read numerous articles and talked with many monetary policy authorities. A common theme during that time of preparation concerned

monetary policy's limitations. In his *Come with Me to the FOMC* article, Larry Meyer wrote eloquently on this very point. I will try to make the same point.

The primary role of monetary policy is to achieve price stability. Inflation, as Milton Friedman famously said, is always a monetary phenomenon. To control the supply of money is also, in the long run, to control the rate of inflation. By contrast, monetary policy does not as directly influence employment or output. Therefore, much of the historic strength and resilience of the U.S. economy is only tangentially influenced by monetary policy. Obviously, output and employment benefit from the environment of price stability that monetary policy works to achieve.

Monetary policy is also a blunt instrument. It does not, and cannot, target a particular segment of society or of the economy. FOMC members become very conscious of this fact as every part of the economic cycle seems to benefit some and penalize others. Overwhelmingly, however, monetary policy aimed at achieving price stability and maximum sustainable employment over time provides the best environment for job creation and improving living standards.

It has been my privilege to associate with the men and women who constitute the Federal Open Market Committee. Without exception, it is a dedicated, committed, and talented group that fully understands both the responsibilities and the limitations of making monetary policy for the United States. I hope this presentation has provided some insight into how we carry out our responsibilities.

Footnotes

1. *Come with Me to the FOMC*, Laurence H. Meyer, the Gillis Lecture, Williamette University, Salem Oregon, April 2, 1998. Return to text

2. The Human Factor and the Fed, Paul C. Volcker, in David C. Colander and Dewey Daane, eds., The Art of Monetary Policy, (Armonk, N.Y.: 1994), pp. 21-33. Return to text