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Behind the Scenes at the FOMC: How the Federal Reserve Determines Monetary Policy

Good evening. I'm certainly pleased to be back in Tennessee with a chance to visit with some old friends. I am often asked what it is like to be a Federal Reserve Governor and what I actually do. So I thought I would give you an overview of the Federal Reserve System, to assure my friends that, yes, it is a full-time job, and, yes, I did have to move to Washington to accept the appointment.

Before I start, let me offer the customary caution that the views I'll express are my own and don't necessarily reflect those of other policymakers or staff members of the Federal Reserve. First, I want to spend some time offering you a broader perspective on the Federal Reserve's purposes and functions. Then I want to talk in more detail about how monetary policy is determined. At the Board, we sometimes nickname this topic "Fed 101." In fact, the Fed has a wonderful website with just that name. You can find it by going to www.federalreserveeducation.org and clicking on the "Fed101" tab at the top of the page.¹

The Federal Reserve System

The Federal Reserve System is generically described as the central bank of the United States. It represents our nation's third, and I trust final, attempt to establish a central bank. You may well recall learning in school that, in the late eighteenth and early nineteenth centuries, the Congress chartered the First Bank of the United States and the Second Bank of the United States, but neither institution lasted more than twenty years. The Banks' very existence was controversial and went to the heart of the great national debate, which continues to this day, over which responsibilities and powers should be handled at the federal level and which should be left to the states. Suffice it to say that, after the charter of the Second Bank of the United States expired in 1836, we went without a central bank for nearly eighty years.

A series of financial panics in the late nineteenth and early twentieth centuries, most notably the Panic of 1907, revived the idea of creating a central bank to provide the nation with a safer, more flexible, and more stable monetary and financial system. But suspicion of centralized power remained at the core of the American psyche, and so the institution that the Federal Reserve Act established in 1913 was a central bank that assigned significant responsibilities for monetary-policy-making to regional Federal Reserve Banks. The System that resulted consists of a governmental agency--the Board of Governors--in Washington and, in twelve major cities, the regional Federal Reserve Banks, which combine public and private elements. The role of the Board vis-à-vis the regional Banks was elevated in the aftermath of the stock market crash of 1929 and in the early years of the Great Depression, but the combination of centralized and regional responsibilities remains an important

strength of the Federal Reserve System, as I'll explain shortly when I discuss the formulation of monetary policy.

The role that the Fed's founders envisioned for the central bank was narrower, and more passive, than the role that the Fed plays today. The emphasis was on providing currency and reserves to meet seasonal demands and on assisting banks in accommodating the credit needs of commerce and business. Indeed, until the 1920s, it wasn't clearly understood that the Reserve Banks' purchases and sales of government securities influenced the supply of money and credit in the economy.

Today, the Federal Reserve's duties fall into four general areas--some that would have been familiar to the central bankers in the Fed's early years and some that would have been unfamiliar:

- maintaining the stability of the financial system and containing systemic risk that may arise in financial markets
- supervising and regulating banking organizations to ensure the safety and soundness of the nation's banking and financial system and to protect consumers from harm in their use of credit and banking services
- playing a major role in operating and overseeing the nation's payment system, including providing certain financial services to financial institutions, the U.S. government, and foreign official institutions
- conducting monetary policy in pursuit of stable prices and maximum sustainable employment

We have an all-too-recent example of the Fed as a source of financial stability in its response to the financial aftermath of the terrorist attacks of September 11, 2001, which occurred just before I joined the Board in December 2001. As a commercial bank executive, I was impressed with the speed at which the Fed responded when the normal settlement and information systems in check and securities markets were interrupted. The Fed worked immediately through discount window lending, open market operations, and other means to provide the financial and banking systems with sufficient liquidity.

It worked with public- and private-sector participants to keep markets open or, if circumstances forced markets to close, to return them quickly to normal operations. As the operator and overseer of key payment systems, it had to ensure that its own systems, as well as those of the private sector, were operational. And on the Monday after September 11, it lowered the target federal funds rate to help cushion the economic fallout of the blow to consumers' and businesses' confidence. Because the Fed worked so effectively, bankers throughout the country could serve their consumer and business customers and thereby help to minimize the economic effects of the terrorist attacks.

The Fed's role as the supervisor of banking organizations--both as the federal supervisor of the roughly 900 state-chartered banks that have joined the Federal Reserve System and as the umbrella overseer of more than 5,000 financial and bank holding companies--gives the Fed's staff and policymakers the kind of hands-on experience and knowledge that is essential for a central bank during a financial crisis.

The Fed's examiners and supervisors seek to ensure not only the safety and soundness of the banking system but also the financial strength of individual banking organizations and the effectiveness of their systems for complying with anti-money-laundering, consumer-protection, and other laws. In fact, the Congress charged the Federal Reserve Board with

writing the rules that implement consumer protection laws such as the Truth in Savings Act and the Truth in Lending Act, though each of the various federal banking agencies enforces the regulations for the institutions within its purview.

Given all the attention paid to the Board and its Chairman, you may be surprised to learn that more than 21,000 of the Federal Reserve System's roughly 23,000 employees work not in Washington but at the twelve regional Federal Reserve Banks. A substantial portion of these employees work in vital, but often unsung jobs, keeping the payment system operating smoothly. The System's employees handle the distribution of U.S. currency and coin throughout the nation and the world. They also clear and process checks and electronic payments, such as the direct deposit of paychecks, and they facilitate the electronic transfer of huge sums between large financial institutions.

Monetary Policy

But it is monetary policy--and the Fed's principal monetary lever, the federal funds rate, which is the interest rate on overnight loans of reserves between depository institutions--that earns the Federal Reserve all that ink and airtime. Deciding on the appropriate policy from among the various options keeps nineteen policymakers and a staff of more than four hundred Ph.D. economists at the Board and the Reserve Banks quite busy.

The chief monetary-policy-making body within the Federal Reserve is the Federal Open Market Committee, or FOMC. It meets eight times a year but can confer by telephone more often if necessary, as it did in 2001 as it responded to incoming economic information as well as economic shocks from terrorism, and as it did again in 2003 as policymakers sought to understand the economic effect of the war in Iraq. The FOMC has nineteen participants--the seven Governors of the Federal Reserve Board and the twelve presidents of the Reserve Banks. Although all actively participate in discussions at the meetings, only twelve have votes at any one time on the Committee. Each of the seven members of the Board wields a vote, as does the president of the Federal Reserve Bank of New York by virtue of that Bank's unique responsibility for implementing monetary policy decisions through the open market operations of its Domestic Trading Desk. The responsibility for casting the remaining four votes alternates among the remaining eleven Reserve Bank presidents: Two vote every other year, and the other nine vote every third year.

But the important point to remember is that, in a consensus-driven body such as the FOMC, the identity of a member who casts a vote in any given year is less significant than the fact that each member of the FOMC participates fully in the deliberations. The presidents, in particular, bring to the table analyses of economic and business conditions in their districts. The boards of the Reserve Banks also contribute a wealth of anecdotal information to supplement the torrent of hard economic data the Fed analyzes. Moreover, they make recommendations to the Board on the discount rate, the rate the Fed charges on its own loans to financial institutions. The information from the Reserve Bank boards, along with other economic intelligence, is summarized in a report known as the Beige Book, which is publicly released about two weeks before each FOMC meeting. The FOMC also consults other books of other colors. But I'm getting ahead of myself.

Let me describe the routine at a typical FOMC meeting. After seating ourselves around the twenty-seven-foot-long, polished mahogany-and-black-granite Board table, we begin punctually at nine o'clock. After approving the minutes of the previous meeting, our first order of business is a report from the Manager of the System Open Market Account at the New York Fed, who focuses on conditions in domestic and international financial markets.

That report is followed by a presentation from the directors of the Board's Divisions of Research and Statistics and International Finance, who deliver the Board staffs' economic forecast as represented in the Greenbook, which FOMC members have usually had the weekend to study. The Greenbook contains the staffs' summary of recent economic information, a baseline economic forecast, which is the staff's best estimate, and scenarios based on possible alternative future events. Then comes the first "go-round," in which every member of the Committee offers his or her assessment of current economic conditions.

We may usefully digress here to consider how the Board staff arrives at its forecast and to describe what role the forecast plays in policymakers' deliberations. An important, perhaps obvious, point to make is that it is not--I repeat, not--the FOMC's forecast. The economic staff of each Reserve Bank independently advises its president. And the economic staffs of the Reserve Banks and the individual members of the FOMC may or may not agree with elements of the Board staff's forecast. Indeed, FOMC members sometimes couch the presentation of their economic views in terms of where those views coincide with and diverge from the Greenbook's forecast. That description, in and of itself, gives you some sense of the staff's influence of the forecast. It sets the parameters of the discussion.

So what kind of forecast is it? It is a forecast based on human judgment. But this judgmental forecast is informed by sophisticated econometric models. The staff's core, large-scale structural model has been dubbed FRB/US--pronounced "ferbus." But that model is not the only one the staff uses. Indeed, the staff uses its suite of smaller-scale models to probe the vulnerabilities of the core model. But as seductive as modeling is to us economists, we must remember that no model can fully capture a dynamic, ever-evolving economy such as ours. Thus, the staff's forecast, and I'm sure the individual forecasts of each FOMC member, are in the end judgmental assessments.

After the Greenbook session, the director of the Board's Division of Monetary Affairs briefs the committee on the Bluebook, a document that presents policy options, usually two or three, for the Committee's consideration and that offers arguments for and against each course of action. Not a recommendation from the staff, the briefing is instead a vehicle against which FOMC members can test their own thinking.

Finally, after hours of discussion and analysis, the Chairman speaks on the policy choice for the first time. Until this point, his participation in the meeting has usually been limited to questions and to comments aimed at keeping the meeting moving. After the Chairman makes his recommendation, FOMC members react in the second go-round. Then we vote, and by then it is usually about one o'clock and time for lunch. About an hour later, at around quarter after two, a statement publicly announces our decision. As currently formulated, the announcement has four parts: the first states the target for the federal funds rate; the second briefly explains the Committee's analysis of current economic conditions; the third provides the Committee's assessment of the risks to price stability and economic growth; and the last provides Committee members' votes.

The statement is a relatively recent innovation; it is about a decade old and, over that period, it has evolved from a quite terse missive to the almost loquacious form it takes today. Before the advent of FOMC statements, market observers had to infer shifts in monetary policy by watching the New York Fed's open market operations, and trying to guess whether the Fed was easing or tightening monetary policy.

As you may know, the Federal Open Market Committee decided this past December to

begin releasing the minutes of its meetings on an accelerated basis. Previously, our practice had been to release the minutes on the Thursday following the next regularly scheduled meeting--that is, with a typical lag of a bit more than six weeks. Under the new schedule, that time has been cut in half: Minutes will now be released with a lag of just three weeks. This move is the latest in a long sequence of changes that the Federal Reserve has implemented over the past decade to enhance the openness and transparency of monetary policymaking.

Before reaching our decision to accelerate the minutes, we discussed the pros and cons of doing so at some length at our December meeting. For a number of months, we had been experimenting internally with accelerating the preparation of the minutes, and we agreed that the trial had been a success. The minutes contain a more complete and nuanced explanation of the reasons for the Committee's policy decisions and our view of the risks to the outlook than we can possibly include in a brief post-meeting announcement. For that reason, speeding up the release of the minutes was seen as helping markets interpret our policy actions in the context of evolving economic developments and so better anticipate the course of interest rates.

Another advantage is that the minutes now will provide the public a more up-to-date context for individual policymakers' public remarks. That is, when members of the FOMC give speeches, you will know how their views compare with the range of other members at the last FOMC meeting. We recognized, however, that there are risks to accelerated release: In particular, there is a possibility that, at times, the markets could misinterpret the minutes. In the end, our clear consensus was that the likely benefits outweigh the risks, and we decided to proceed with releasing the minutes on an expedited schedule.

We went "live" with accelerated release beginning with the minutes of the December meeting, which were published on January 4. The document was intensively covered in the press and received considerable attention in financial markets. My impression is that most investors agree that the change is an improvement in openness and transparency of monetary policy. However, it is important to note that, when interpreting the minutes, readers should keep in mind that they are not simply a longer and more-detailed version of the statement that the FOMC issues after each meeting. The statements are intended to concisely convey the Committee's broad consensus. The minutes, however, are intended to reflect the broad range of views held by members of the Committee, including views expressed by just a few members. Thus, it is perfectly possible and appropriate that a statement in one part of the minutes does not accord with another passage in the minutes.

If you want further details of how the discussion goes at FOMC meetings, transcripts are released after five years. These are verbatim transcripts, but the names of companies who provide confidential information are redacted, to encourage the sharing of forward-looking information with FOMC members, who in turn share that information with others as we have our discussions.

Members of the FOMC also communicate to the public through speeches, which we all make at various times during the year. As I noted in the disclaimer I gave at the start of this speech, when we give speeches, we are speaking for ourselves, and not necessarily for the FOMC or in my case the Board of Governors. The Chairman also delivers twice-a-year reports to the Congress on monetary policy, where he speaks for the FOMC. The Chairman also testifies before Congress, giving his views on economic policy.

These methods of communication are all important elements of the transparency necessary for an independent central bank to function within a democracy. As I mentioned, our goals--price stability and maximum sustainable employment--are set by law, but we are afforded the political independence to make the sometimes unpopular decisions required to achieve those goals. Appropriate transparency and accountability offer a necessary counterbalance to that independence.

Conclusion

I hope this gives you an overview of the broad range of purposes and functions of the Federal Reserve System, as well as an insiders view of what happens behind the scenes at the FOMC. Next time you hear or read a news account of the Fed's actions to change the fed funds rate, I hope you appreciate all of the activities that go behind our decisions.

Footnotes

1. These remarks draw from the following sources: Laurence H. Meyer (1998), "[Come with Me to the FOMC](#)," speech delivered at Willamette University, April 2; Mark W. Olson (2004), "[The Federal Open Market Committee and the Formation of Monetary Policy](#)," speech delivered at the Twenty-sixth Conference of the American Council on Gift Annuities, May 5; and David J. Stockton (2002), "What Makes a Good Model for the Central Bank to Use?" speech delivered at the Federal Reserve Bank of San Francisco, March 2. [Return to text](#)

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