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THE MONETARY POLICYMAKING PROCESS

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Thank you for inviting me to speak to you tonight. It is a pleasure to address an audience as interested and well-informed about monetary policy as this one. In keeping with your interests, the subject of my talk is the making of monetary policy at the Federal Reserve. However, rather than focus--as one often does--on the actual policies and strategies that emerge from the decisionmaking process, I will devote my remarks this evening to the process itself.

Since the Federal Open Market Committee is the principal policymaking body within the Federal Reserve System, my topic requires me to give you an inside look at what goes on in a typical FOMC meeting. I plan to do this by reviewing the structure of the meetings, as well as discussing how the Committee reaches decisions. Although my remarks necessarily represent my own interpretation of the meetings, I suspect that other participants would be in general agreement with me. In addition to the meetings, I will touch on intermeeting policy changes, which also can be important.

At the outset, I must admit to my own longstanding fascination with FOMC meetings and the policymaking process of the Federal Reserve. Prior to my appointment to the Board of Governors, I had always been curious about what went on in the meetings and would have welcomed the opportunity to have those involved share their knowledge and insights with me. This in my intention tonight. When the evening is over, I hope you will come away with a sense of what it is like to be in the meetings, as well an enhanced understanding of the policy process.

Setting of the Meetings

As you know, FOMC holds eight regularly scheduled meetings each year at the Board of Governors in Washington, D.C. By law, there are 12 members on the committee, consisting of the seven Governors and five of the 12 district Bank presidents. The remaining seven presidents attend the meetings and participate actively, although they do not vote. Typically, the Chairman of the Board of Governors is elected Chairman of the FOMC and he presides over the meetings. Similarly, the Vice-Chairman of the committee is the President of the Federal Reserve Bank of New York. The president of the New York Fed is the only Bank president to serve as a permanent member of the FOMC. The four other positions held by Bank presidents rotate on an annual basis. Through this year, the changes occurred on March 1 of each year. But beginning in 1990, the membership of the Committee will change on a calendar year basis to enable those serving on the Committee to have an opportunity to vote in February on the long-run monetary targets for the year in which they serve.

In addition to the FOMC participants, Board staff members who are responsible for economic, international, and monetary policy analysis make presentations at the meetings. The managers for domestic and foreign operations, both from the Federal Reserve Bank of New York, also make oral reports to the Committee on the domestic and foreign operations. Finally, another 20 or so senior staff members from the Board and the Federal Reserve Banks attend the meetings to provide analysis and information as needed.

Overview of the Structure of the Meetings

The meetings are organized in a manner that is broadly consistent with the sequential nature of the decisionmaking. That is, the meetings begin with an analysis of the current state of the economy and financial markets, the economic and financial outlook, and finally, the policy adjustments that may be needed to move the economy closer to the FOMC's objectives.

The meetings themselves are divided into three parts. The first part consists of a summary of developments in foreign exchange and domestic financial markets, along with a review of System actions over the period since the last meeting. This part of the meeting is followed by briefings on and discussion of the economic outlook for the next one to two years. Finally, the participants are briefed on long-term and near-term policy approaches. This is then followed by a discussion that culminates in a directive setting the guidelines for open market operations until the next meeting.

In addition to these three main parts of the meetings, occasional special reports and briefings are included. For example, at the December meeting, the Committee considered an analysis of the recent instability in the relationship between the federal funds rate and borrowed reserves and its implications for the System's operating procedures.

Let me now elaborate a bit on each of the three segments of the meetings.

Reports from the Managers of Domestic and Foreign Operations

The meetings begin with presentations from the Manager for Foreign Operations, Sam Cross, and the Manager for Domestic Operations, Peter Sternlight. Both of them are based at the New York Fed. Their reports cover the foreign exchange and domestic open market operations since the last FOMC meeting, as they relate to the directives set out at that time. Analyses of developments in financial and foreign exchange markets also are included in their reports.

For the most part, these presentations tend to be factual, although they are supplemented by the managers' interpretations of recent developments and their impressions of the evolving attitudes of market participants. Since the

FOMC establishes only broad directives under which day-to-day operations are undertaken, these reports enable the Committee to assure itself that its instructions have been properly carried out. They also help to assess whether the FOMC's policies are having the intended effects on financial markets and, thus, are consistent with attaining the FOMC's long-term economic goals. This information also provides a reference later in the meeting when the Committee considers alternatives for future policy moves.

Economic Forecast

The FOMC then turns its attention to the economic environment. A detailed review of recent economic developments, the current state of the economy, and the outlook for the next one to two years has been circulated in advance to participants in a document known by the color of its cover: the Green Book. Although use is made of econometric models, the staff's forecast is essentially judgmental.

This part of the meeting begins with a staff review of the current economic situation and a presentation of its forecast. Alternative forecasts using different assumptions about monetary policy or developments in other key sectors are sometimes included, especially at the February and July meetings, at which time the longer-run ranges for the monetary aggregates are selected and reported in the

Humphrey-Hawkins report to Congress. At these two meetings, the presentation on the outlook and its implications are much more thorough and detailed than usual, resulting in the meetings stretching over two days, rather than one day for the other meetings. Mike Prell, Director of the Research and Statistics Division, and Ted Truman, Staff Director of the Board's International Finance Division, give these formal briefings, which are followed by a question-and-answer period. A general discussion then ensues during which all the participants--Committee members and nonvoting Bank presidents--have an opportunity to comment and to express their views on the economic outlook. Reserve Bank staff analyses and regional business conditions, as they bear upon the outlook, are always an important element of the discussion. A considerable amount of the regional information is contained in the Beige Book, which is released to the public at about the same time it becomes available to the FOMC participants, roughly two weeks prior to the meeting.

In this phase of the meeting, participants' views on the outlook are generally expressed relative to the greenbook forecast, as, for example, stronger or weaker than the Board staff's projection. Such differences might reflect alternative assessments of the time it takes the economy to adjust to monetary policy and other factors.

They also may result from different views about developments in various sectors of the economy or from concerns about regional or industrial developments that may be lost in the aggregate analysis. Moreover, participants use different analytical frameworks, as well as different indicators as reference points to measure the current stance and the forecasted effects of monetary policy, which likewise can cause departures from the greenbook forecast.

Monetary Policy Decisions

After the airing of the views on the outlook for economic growth and inflation, the third and final portion of the meeting is devoted explicitly to the setting of monetary policy. The direction of this discussion is often foreshadowed by participants' views of the economic outlook. In particular, changes in monetary policy are considered in the context of altering the likely path of the economy to bring it in line with the FOMC's long-term goals.

The bulk of the discussion focuses on the near-term stance that monetary policy should take over the next few months. The major exceptions occur at the February and July meetings, when the annual growth targets for the monetary aggregates are set as part of the Humphrey-Hawkins report. These annual targets also may be reviewed at other meetings, but not in the same depth.

This portion of the meeting starts with a staff presentation given by Don Kohn, Director of the the Board's Division of Monetary Affairs, on near-term policy alternatives. These alternatives also are contained in a document with the very logical title "Monetary Policy Alternatives", but is better known to all of us as the Blue Book. Usually the staff presents three alternatives, keyed to unchanged, firmer, and easier reserve conditions, although at times when the risks to the economy or inflation seem relatively unbalanced, only two alternatives may be included. For each alternative, there is a borrowed reserve operating target, an associated federal funds range, projected monetary growth paths, and an analysis of financial conditions likely under each alternative. In the briefing, these issues may be amplified or new perspectives may be brought out that had not been included in the bluebook.

The discussion that follows the staff presentation can be marked by considerable differences of opinion over the appropriate specific near-term course for monetary policy, even though there may be general agreement on the overall direction that policy should take. These differences often stem from the same considerations that arise regarding the economic outlook. In addition, they may reflect differing weights that participants place upon long-term economic goals and the time frame within which they should be achieved. These disagreements may be reflected in alternative proposals for the wording of the directive, which is the set of instructions guiding open market operations until the next FOMC meeting. The directive is carefully crafted and language is selected with a view toward communicating the stance of policy. To be sure, policy nuances also can be gleaned from the surrounding discussion, which is reported in the formal policy record. The directive also includes criteria that could lead to changes in the operating targets during the intermeeting period.

During the discussion, each participant states his or her policy preference, which then enables the Chairman to formalize what appears to be a consensus. The suggested policy specification might be one of the three alternatives presented by the staff or it might be an intermediate variant. In principle, the Chairman's proposal could be outside the range of Blue Book alternatives, but I cannot recall that ever having happened. Following further discussion and possible modification of the Chairman's proposal, it is put to a vote, which brings the meeting to an end.

The Process of Consensus-Building

As often noted by outside observers, the FOMC policy directive is typically approved by the vast majority of the FOMC members. I believe that the very structure of the meetings, which moves from general economic considerations to a discussion of monetary policy and then forges a policy consensus is an important element in achieving this near-unanimity in favor of the directive. As the discussion proceeds through the various stages, the rough edges of the different perspectives are worn off, a consensus is molded, and finally the polished product in the form of the directive emerges.

Another factor that tends to produce this widespread agreement is the flexibility of the directive for changes in policy over time, given the criteria relating to the intermeeting developments. The wording thus permits those with differing views on the outlook to recognize that if incoming data subsequently confirm their views, policy can be adjusted accordingly. Thus, these committee members can find the consensus acceptable.

The formation of a consensus on policy also is facilitated by each meeting being a part of an ongoing dialogue among participants. Participants' views on the economy and monetary policy have generally been developed and discussed over a series of meetings and in other settings. As a result, an individual does not have to explain fully his or her position on these matters in order to communicate with other participants. In other words, the ongoing nature of the meetings results in an efficient and effective means of transmitting viewpoints. Under the Chairman's guidance, the Committee can therefore often move quickly and easily to ascertain points of agreement and reconcile differences. This observation underscores the importance of including nonvoting presidents in the discussion.

And finally, Committee members recognize the importance of producing a policy that has broad support. From the outset of the meeting, members are thus aware that compromises are required. This spirit of compromise and cooperation, I might add, is certainly part of "the Federal Reserve tradition," which lurks in the background of each meeting. Consequently, even marked differences among members do not become divisive and do not impede the decisionmaking process.

The diversity of perspectives held by the participants is, in fact, beneficial to the extent that it acts to assure the reasonableness of the consensus and helps to avoid major policy mistakes. The danger of striving for consensus is that the resulting policy action could be inappropriate. Although there is no guarantee that the consensus will always be the optimal choice, giving full consideration to points of view arising from different analytical frameworks and policy indicators, relying on different sources of information, and having all the regional perspectives considered reduces the risk of error. Indeed, I find it an impressive testimonial to the efficacy of the process that monetary policy decisions emerge that generally have stood the test of time.

Intermeeting Policy Changes

As noted above, the directive often contains references to specific developments that could lead to intermeeting changes in the operating targets. For example, the directive from the February 1989 meeting listed, in order of importance, "indications of inflationary pressures, the strength of the business expansion, the behavior of the monetary aggregates, and developments in foreign exchange and domestic financial markets" as factors that were to be taken into account in implementing monetary policy. Depending on the circumstances, "somewhat greater reserve restraint would, or slightly lesser reserve restraint might, be acceptable during the intermeeting period."

Intermeeting adjustments to the operating targets are normally initiated by the account manager, after consultation with the Chairman, although FOMC participants sometimes discuss proposed changes in a conference call. In recent years, a significant number of intermeeting policy changes have been implemented. Indeed, this process seems to be well-understood by market participants, who appear adept at detecting when policy adjustments have occurred. In many cases, the markets have anticipated these adjustments, based upon publicly available information.

Changes in the discount rate are made by the Board of Governors, not the FOMC. The desirability of an adjustment in the rate occasionally is discussed at the FOMC meetings, but, of course, no action of this type may be taken by the Committee. Nonetheless, the Board does attempt to coordinate discount rate changes with FOMC policy decisions and operations. At the same time, the Committee on occasion has conditioned its intended provision of reserves on changes in the discount rate that might occur during the intermeeting period. Under these circumstances, changes in the discount rate have tended to be been passed through completely to the federal funds rate, because no offsetting change was made in the operating target for borrowed reserves. At times, the pass-through has appeared to be partial under conditions when financial market participants have anticipated the discount rate change and adjusted the funds rate toward its new trading area prior to the actual discount rate announcement.

Conclusion

In conclusion, let me return once again to the subject of consensus-building, which plays such an important role in the formulation of monetary policy. Overall, I am very impressed by the consensus-building qualities of the FOMC's decisionmaking. Our decisionmaking process is not adversarial, but rather is designed to uncover information, discuss the available options, and to form a consensus. All this tends to reduce differences. If a vote were taken at the beginning of each meeting, I doubt that it would result in an almost unanimous vote regarding the stance monetary policy should take. However, successive rounds of discussions allow for subtle shifts in the views of FOMC members to occur. In the end, this results in the vote basically being on the question: Am I in broad agreement with the proposed policy, or are my views so sufficiently different that I cannot support the proposed policy directive? Most members find that they can live with the directive--at least for the next six or seven weeks.