THE FORMULATION OF MONETARY POLICY
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May 31, 1994
(No charts, one handout of directive)

I. A Federal Reserve Bank like the one in Atlanta is involved in three main functions:

A. Fosters an efficient and safe payments system by providing financial services for depository institutions and the federal government

B. Promotes safety and soundness in the nation's financial system by supervising and regulating the activities of bank holding companies and certain commercial banks

C. And the item Dean Hogan would like me to speak with you about today: contributes to economic growth with stable prices through the formulation and implementation of monetary policy

1. One of the two tools of macroeconomic policy, the other being the government's fiscal policy.

2. Will discuss mechanics of monetary policy process in more detail in a moment.

II. Overview of System's Structure

A. Fed has dual nature that makes it at once public and private in its operations.

B. Partially reflected in the differences between the Board of Governors in Washington and the District Banks.

1. Board members are appointed by the President with the advice and consent of Congress.

2. District Banks are organized like private corporations: governed by their own boards of directors, sell services to banks through our financial services business. Presidents are elected by boards, but must be approved by Board of Governors.

C. Public service type activities--supervision and regulation of banks and monetary policy formulation--jointly carried out by the Board and the District Banks.

III. Monetary Policy Formulation and Implementation

A. Fed seeks to influence anticipated economic activity by affecting the demand for and supply of money and credit.

1. Decisions are made as to how much, if at all, pressure on bank reserve positions should be increased or decreased.

2. Three tools for implementing strategy:

a. Adjust reserve requirements

b. Adjust the discount rate, the tool over which directors of the District Banks have the most influence

c. Open market operations

(1) Operations consist of buying and/or selling large quantities of government securities, thereby adding and subtracting, respectively, from banks' reserves.

(2) Most open market activity is aimed at making short-term adjustments in the reserves of depository institutions.

3. Banks become more willing to supply credit, and interest rates fall when pressure on their reserve positions is eased through any of these three tools.

4. When we provide fewer reserves for a given period, we push them toward borrowing at the discount window.

B. Over time, Fed policy affects economic activity, but it is not the only factor influencing the economy at any given time.

1. The government's fiscal policy--budget and taxation--carries its own consequences.

2. In global economy, the policies of foreign governments have an impact on the U.S. economy.

3. Other factors whose effect is largely beyond social policy measures--oil supply shocks and demographic shifts --also add to the mix.

4. Thus two major points about the process of devising this strategy bear emphasizing at the outset:

a. The environment of the policymaker is dominated by uncertainty.

b. Fed policy has its effects with a lag; thus, successful policy entails maintaining a vision of the economy in terms of optimal performance under the conditions we project 6 months to 18 months down the road.

5. Long-term objectives represent desired values for real income--usually expressed in terms of real GDP--and for employment and prices.

a. In general, we work on the assumption that the more ease there is in the amount of available money and credit, the more stimulus is provided for GDP growth; growth in turn reduces unemployment.

b. Excess ease in money tends to be associated with inflation.

IV. The Federal Open Market Committee (FOMC)

A. Members are the Board of Governors and the presidents of the 12 District Banks.

1. Describe voting president rotation. (I am a voting member this year. Last time was 1991.)

2. Note that all presidents participate, along with their research directors, and provide regional information supplied in part by members of the Banks' boards of directors.

3. Also, presidents bring their own perspective on national and international economic conditions, based on:

a. Analysis done by their research staffs. (For example, the Atlanta Fed has more than 15 economists and nearly as many analysts on staff in the research department, covering macroeconomics, finance, and regional economics.)

b. Meetings and discussions with bankers, business leaders, consumer and labor leaders, and other representatives in their districts.

B. FOMC assesses an elaborate forecast of the economy prepared by the Board's staff based on a large-scale model of the economy.

1. Also need to consider exogenous factors that are not predictable--for instance, what Congress might do.

2. A full-scale simulation that projects for a period of 4 to 8 quarters is done about four times a year; estimates are updated prior to each FOMC meeting in response to new data.

3. The forecast indicates the income, employment, and inflation that are expected to be consistent with a particular policy and assumptions about exogenous factors.

C. District Bank research staffs conduct their own discussions of the economy prior to the FOMC meeting.

1. We debate the exogenous variables and also have a small mathematical forecasting model that projects GDP, employment, and prices.

2. Directors report monthly on very recent developments in their industries and localities.

D. At FOMC meetings, there is an extensive discussion of the District Banks' forecasts along with discussion of the Board's staff forecast. Presidents of the District Banks may then compare their own staffs' forecasts with that of the Board's staff or with other forecasts.

1. At every meeting, the committee assesses the objectives for the monetary aggregates.

2. Starting in the late 1970s, except for a few periods, the FOMC has steadily reduced the ranges for the monetary aggregates to signal its desire to reduce inflation.

3. The FOMC continues to have some faith in the information provided by the monetary aggregates. Nevertheless, it has been clear over the last few years that the influence of other depository and market instruments has changed the behavior of the monetary aggregates.

a. Consequently, the FOMC has broadened the array of variables that it uses to assess economic conditions and the impacts of monetary policy.

b. FOMC also uses forecasts of financial and non-financial variables, such as GDP, inflation, and unemployment.

V. How an FOMC meeting works

A. Open Market Committee meetings have been held in some form since the 1920s, but the FOMC as we know it today was established by the Banking Act of 1935.

B. Meetings are held eight times a year. The last one was held May 17, 1994, and the next one will be on July 5 and 6.

   1. Description of meeting: Chairman enters; report of foreign desk; domestic operations; summary of staff outlook; discussion; coffee; policy alternatives (note blue book, green book, beige book, gold book); go-round; vote.

C. Each voting president in turn is charged with monitoring the Fed's open market operations.

   1. Daily conference call

   2. New York desk manager typically discusses current financial market conditions and his proposed action for the day.

VI. FOMC's short-term response functions as a guide to the manager of the System Open Market Account, at the Trading Desk of the Federal Reserve Bank of New York.

A. In the short run, FOMC may tolerate more rapid or slower growth in monetary aggregates than specified.

B. For example, if we expect income growth to accelerate to an unsustainable pace, we might want to make policy more restrictive to prevent a build-up in inflation.

   1. Several alternatives: could move to restrain bank reserve growth now; could restrain growth a little bit now, raising the possibility that more might need to be done later.

   2. Members then incorporate their own judgments of the economy, as well as their policy preferences, into their decision.

      a. Those FOMC members who are fairly certain the economy is accelerating would choose to tighten.

      b. Those less certain about the degree of change in the economy could opt for gradual adjustments.

      c. Those who disagree with the forecast could choose to make no change in policy or even to ease.

3. Each alternative contains short-run specifications for a reaction function for the New York Fed Trading Desk--one that is related to the policy thrust the committee has chosen.

4. They also condition the response to incoming information.

VII. The most recent directive

A. Reading the records of policy actions taken as printed in the Federal Reserve Bulletin can give you a picture of what data FOMC members considered to be the most relevant economic data during a given period.

1. The most recent meeting that is a matter of public record was held March 22.

2. If you will look at pages 17 and 18 [muscheck], I will highlight some of the key points. (Go to highlighted copy).

VIII. Issues in the Sixth District

A. Constant concern of all central bankers: wage and price pressures

B. International trade--e.g., weaknesses in G-7, instability in Russia, changes in Latin America, all of which are becoming a larger force in the Southeast and the U.S.

C. Financial markets; especially, foreign bank supervision (e.g., Banco Latino) and growth of derivatives

D. Long-term growth--We cannot take it for granted even in Southeast.

1. The ultimate concern is economic well-being.

2. Growth statistics based on output, such as GDP, do not capture the whole story.

a. For instance, following natural disasters, such as a hurricane, GDP usually expands because of the rebuilding needed.

b. However, this GDP growth hardly captures the devastation wrought on the lives of those affected by the hurricanes, floods, or earthquakes.

c. Another example of divergence between growth statistics and economic well-being: The good news about fast-growing states like Georgia is diminished by concerns about persistent poverty, high infant mortality rates, poor test scores, and higher-than-national-average of high school dropouts.

IX. Conclusion, Questions and Answers

A. Even with all the economic statistics that are available, monetary policymakers must make decisions in the face of great uncertainty.

B. But cannot keep putting off decisions until the perfect information becomes available; must act.