

**THE ROLE OF MONETARY POLICY**  
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**To the Seminar on Monetary and Fiscal Policy, Owens Graduate School of Management**  
**Vanderbilt University**  
**Nashville, Tennessee**  
**January 18, 1995**

- I. A Federal Reserve Bank like the one in Atlanta is involved in three main businesses.  
(Chart 1)
  - A. Fosters an efficient and safe payments system by providing financial services for depository institutions and the federal government
    1. Clears checks, supply and process cash, and transfer funds and securities electronically.
    2. Bank for banks: holds reserves, makes loans through "discount window."
    3. Serves as fiscal agent for the U.S.Treasury: auctions for securities, maintain Treasury Department checking account, clears checks drawn on that account.
  - 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
    1. Is primary regulator for state-chartered Federal Reserve member banks and all bank holding companies.
    2. Supervises U.S. activities of foreign banks, foreign activities of U.S. banks.
      - a. Following on the BCCI debacle, Congress has made stricter laws re foreign-banking activities via the Foreign Banking Supervision Enhancement Act with the main increase in responsibility assigned to the Fed.
    3. Shares oversight of commercial banks with the comptroller of the Currency and the FDIC.
      - a. Without the hands-on knowledge of banking that we obtain from regular examinations of large and small banks, the Fed's understanding of the nation's financial system would soon become abstract.

- b. We would quickly lose our insight into the pressures, demands, and changes taking place in the vitally important process of matching deposits and credit demands.
  - 4. Explain examination process.
    - a. Safety and soundness according to CAMEL.
    - b. Separate examinations for compliance with consumer regulations, such as CRA.
  - 5. Mandates capital requirements and processes applications for bank mergers and acquisitions.
  - 6. Note that Fed can't prevent individual banks from failing--our concern is the industry as a whole rather than single institutions.
  - 7. Acts of Congress become Fed regulations (e.g. Expedited Funds Activity is enforced as Reg CC).
- C. And it 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

- A. Fed has dual nature that makes it at once public and private in its operations. (Chart 2: Organization of the System)
- 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 Formation 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 very difficult to foresee--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 was a voting member last year.)
  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. (Chart 3, Definitions of 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. This past year, M2 ended up at the lower end of its specified range. (Chart 4, Money Supply-M2, 1990-1994)

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 next one will be held on January 31 and February 1, 1995.
  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 the desk's proposed action for the day.

#### VI. The FOMC's relationship with the Trading Desk of the Federal Reserve Bank of New York

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

- C. 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.
  5. These specifications define the conditions under which the System will supply reserves.
    - a. If, for example, market participants thought we were being "too easy," the yield curve would get steeper, reflecting expectations that interest rates would need to rise by more later on. This can be seen in the yield curve for October 16, 1987--the Friday before the dramatic stock market correction. (Chart 5: Yield Curve)
    - b. If they thought that we were being "too tight" and that the economy would weaken significantly, then long-term interest rates might decline relative to short term ones and the yield curve would flatten. (Broken line on Chart 6: Yield Curves for 8/3/90 and 1/11/95)
    - c. Note on this graph that on August 3, 1990 (broken line), the spread between the 3-month and 30-year instruments was only about 1/2 a point. The present yield curve is much steeper.

6. Procedures also allow flexibility to cope with unexpected events, as after the stock market crash in October of 1987.

#### 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 November 15, 1994.
  2. If you will look at pages 17 and 18 of the of the copy Dr. Daane provided for you, I will highlight some of the key points. (Go to highlighted copy).

#### VIII. Outlook for the economy in the year ahead

- A. In 1994, real GDP expanded by about 4 percent on an annual average basis.
  1. The average annual unemployment rate fell to 6.2 percent in 1994.
  2. The CPI increased on an annual average basis by 2.6 percent.
- B. Looking to 1995, the economy should grow at a moderate, and more appropriate, pace of about 3 percent on average.
  1. The jobless rate should drop to around 5-1/2 percent. [SLT thinks 5-1/2; MSR thinks 5-1/4.]
  2. Inflation may rise further to slightly more than 3 percent, since price pressures tend to increase as the economy operates at or near capacity.
- C. Strengths
  1. Continued expansion will be supported by those components of gross domestic product that have been growing in 1994--personal consumption, capital spending, and construction.
  2. However, they will be growing at a slower rate than they did in 1994.

- a. Personal consumption: Sales of automobiles and other durable goods will decelerate slightly due to higher interest rates and the fact that pent-up demand has been met.
- b. Capital spending: Businesses will continue to invest in productive capital, such as plants and equipment, but this investment will retreat from the unsustainably high double-digit growth of 1994.
- c. Construction: The boom in building activity, particularly single-family homes, has now peaked.

#### D. Weaknesses

- 1. Government spending likely to remain flat after shrinking last year. However, especially this year, it is difficult to make political forecasts.
- 2. The gap between exports and imports should begin to shrink after several years of growing larger.
  - a. But U.S. trade balance will still be in considerable deficit.
  - b. Due largely to the United States growing relatively faster than trading partners.
  - c. Also, demand in the U.S. for imports has grown faster than the demand abroad for U.S. exports.
  - d. Fortunately, with ratification of the General Agreement on Tariffs and Trade (GATT) and slowing down of U.S. expansion as economic growth picks up in Europe and Japan, the trade gap should begin to narrow.

#### IX. Conclusion, Questions and Answers

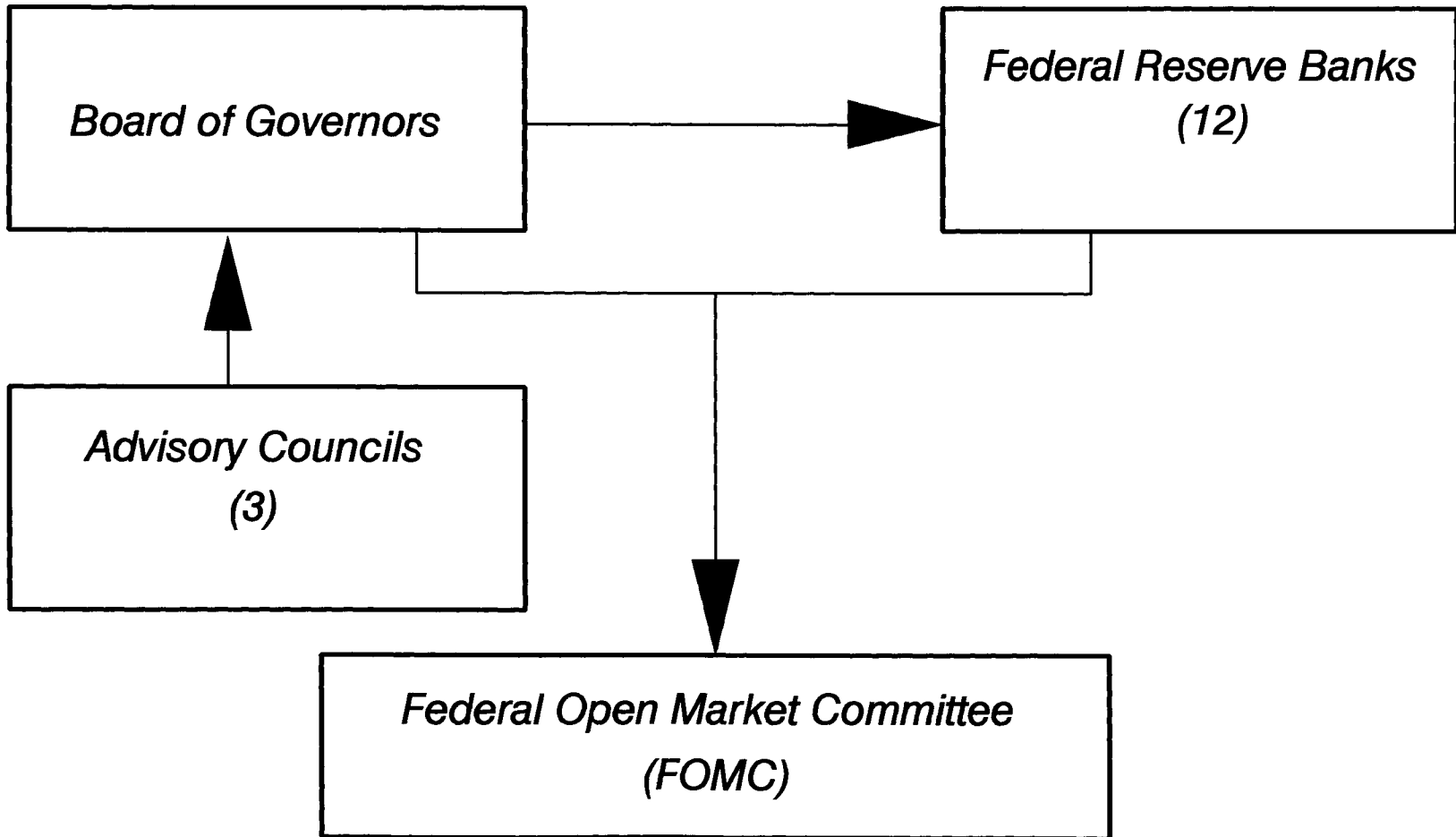
Chart 1

# **A FEDERAL RESERVE BANK: Its Three Main Businesses**

- *Providing financial services for depository institutions and the Federal Government*
- *Supervising and regulating the activities of bank holding companies and certain commercial banks*
- *Contributing to the formation of national monetary policy*

Chart 2

# ORGANIZATION OF THE FEDERAL RESERVE SYSTEM



### Chart 3

# DEFINITIONS OF THE MONETARY AGGREGATES

**M1 =**

- Currency (of the nonbank public)*
- + *Demand deposits at commercial banks*
- + *Other checkable deposits, including:*
  - NOW, Super NOW, and ATS accounts at banks and thrifts*
  - Credit union share drafts*
  - Demand deposits at mutual savings banks*
- + *Travelers checks of nonbank issuers*

**M2 =**

- M1*
- + *Savings and small-denomination time deposits at all depository institutions (including retail repurchase agreements)*
- + *Overnight repurchase agreements at commercial banks\**
- + *Overnight Eurodollar balances\**
- + *Money market deposit accounts\* (MMDAs)*
- + *General purpose and broker/dealer money market mutual fund shares\* (including tax-exempt MMMFs)*

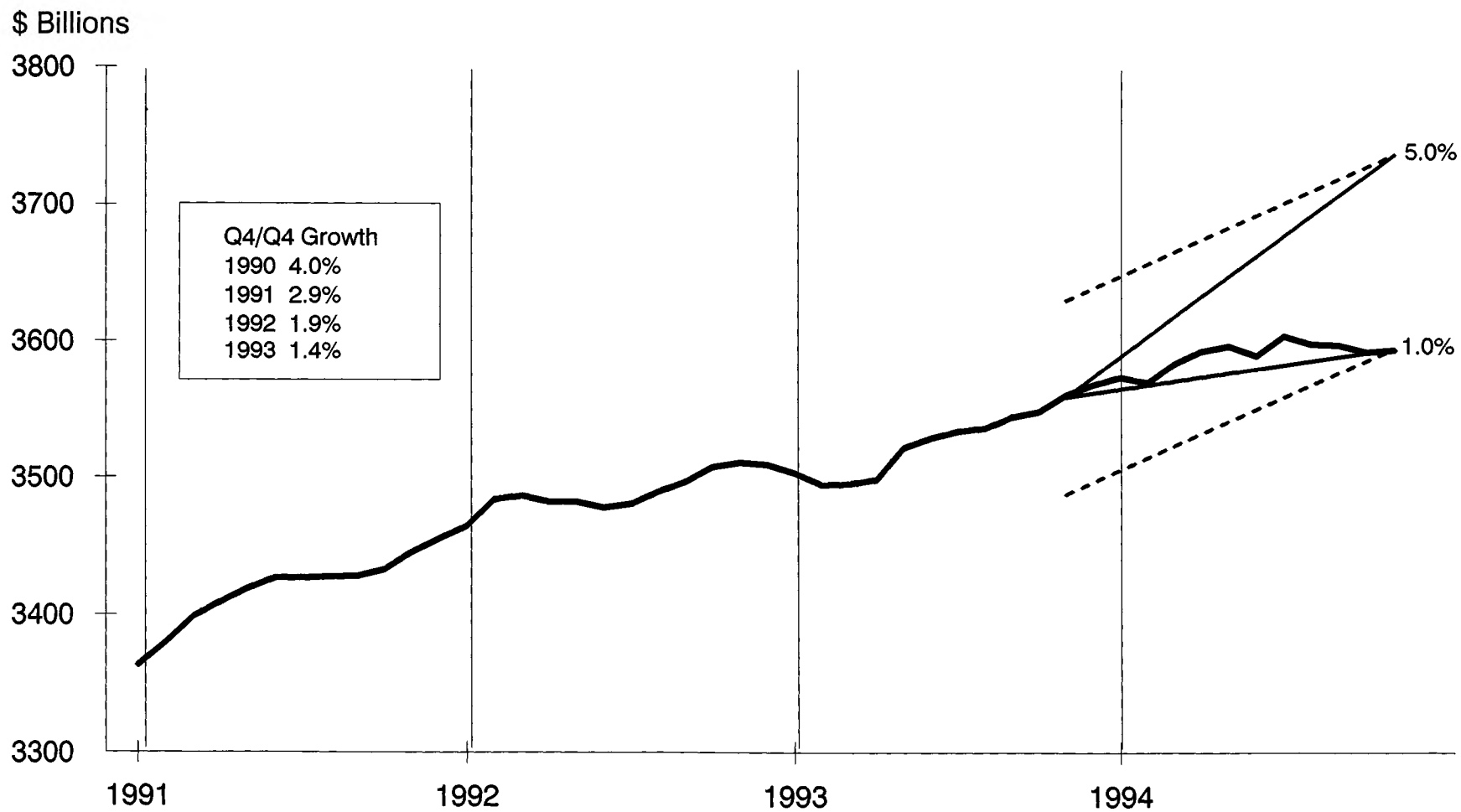
**M3 =**

- M2*
- + *Large-denomination time deposits at all depository institutions*
- + *Term repurchase agreements at commercial banks and S&Ls\**
- + *Institution-only money market mutual fund shares\* (including tax-exempt MMMFs)*
- + *Term Eurodollar balances at depository institutions and MMMFs*

*\*Not seasonally adjusted*

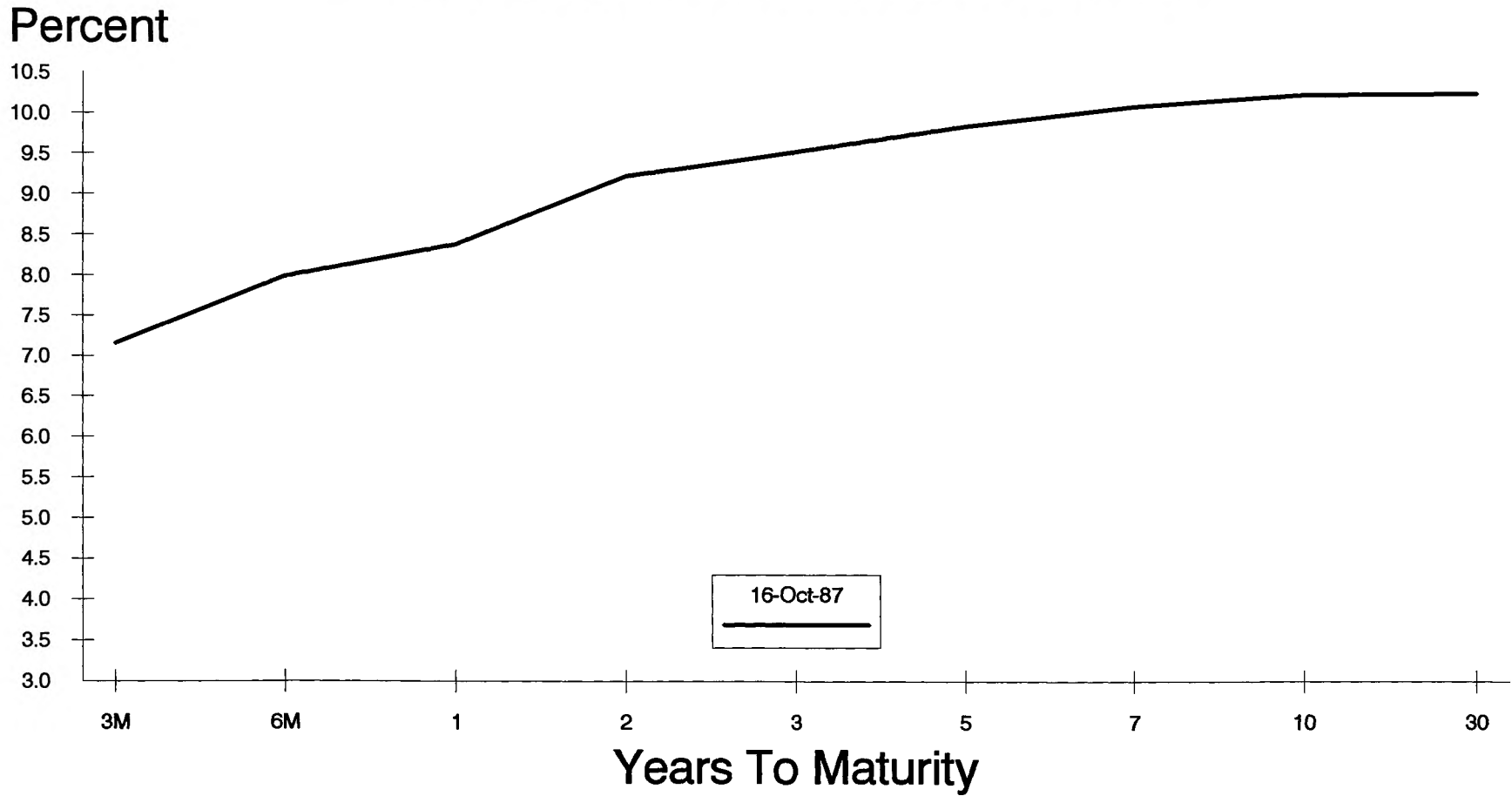
# Chart 4

## MONEY SUPPLY-M2



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Chart 5  
**YIELD CURVES**  
**TREASURY SECURITIES**

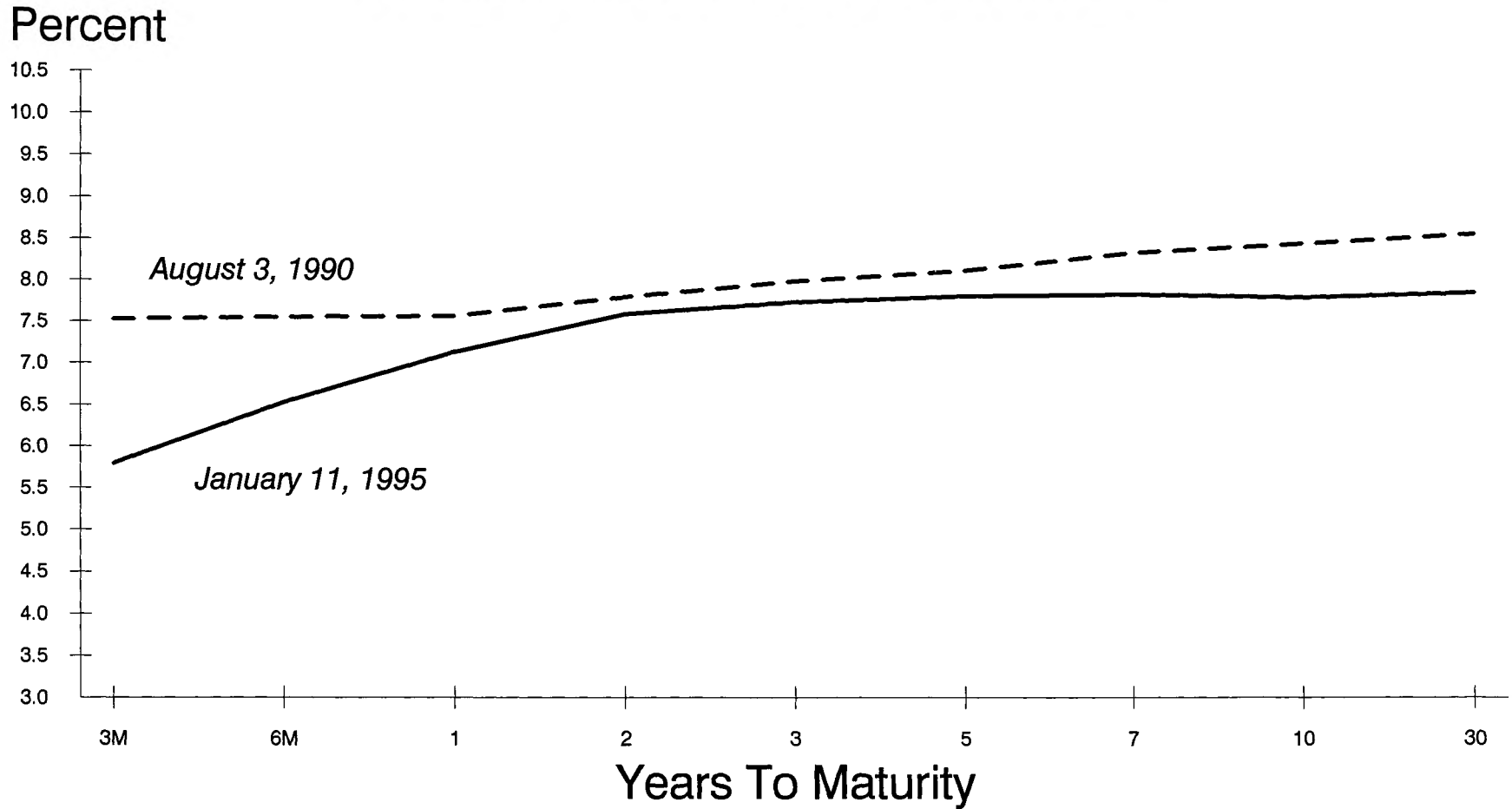


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# Chart 6

## YIELD CURVES

### TREASURY SECURITIES



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