INSIDE THE FEDERAL OPEN MARKET COMMITTEE*

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by

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*Prepared for Mr. Kimbrel's use by William N. Cox. This speech is loosely based on "Come With Me to the FOMC!", by Edward A. Wayne, former President of the Federal Reserve Bank of Richmond.

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One Tuesday morning each month, eighteen policymakers gather around a massive table in a large room overlooking Constitution Avenue in Washington. Staff aides and secretaries line the perimeter. On the stroke of 9:30 a nineteenth man--short-statured, smiling and determined--emerges from a side door and walks purposefully to a seat at the south side of the table. Conversation stops. Seats are taken. Heads raise in anticipation. The monthly Federal Open Market Committee meeting has begun.

The FOMC is the monetary policy forum of the Federal Reserve. Once each month, all the resources of the Fed come to bear on the deliberations and decisions about monetary policy. The FOMC exemplifies, in the finest kind of way, the orderly and flexible evolution of a public institution in response to

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changing needs: From its inception in the Twenties to coordinate the actions of twelve regional Federal Reserve Banks, to its formal establishment in the Banking Act of 1935, to the resumption of active postwar monetary policy in 1951, to the continuing small modifications of procedures and customs which persists today. The FOMC has changed a lot in fifty years, all right. But each of us, as we take our seats around that table, feels the unbroken chain of tradition.

"Now let's hear from the Foreign Desk," begins Chairman Miller. A senior official of the New York Fed, the Deputy Manager for Foreign Operations, describes foreign exchange market developments, supplementing a stack of written reports already furnished each member. The emphasis is on what it all means, and on subtle indications, based on the official's daily conversations with his counterparts, about financial attitudes--hopes and fears--around the world. It is an impressive four or five minutes. The policymakers regard the Manager's summary with attentive respect and then proceed, in a friendly and admiring way, to shred its conclusions. Several men with particular experience and responsibilities on the international side relate their own conversations with other central banks and with U. S. Treasury officials, with whom the Fed shares responsibility for exchange operations. Twenty minutes later, the Foreign Desk official sits back. His operations have been okayed, and a couple of special arrangements have been dealt with. The room is silent once again.

"As we turn to the question of domestic policy today, we need to recognize why this is a particularly important time...." Unlike some of his predecessors, who rarely voiced an opinion until all others had been heard, the Chairman now capsules his own concerns into two or three minutes of compelling philosophy and economics. The Governors and Presidents listen carefully, because the Chairman is first among equals, even if he does have only one vote. He must later convey the System's intentions to the Congress, administration, and general public. His job has been described as the government's most important, next to the President's. Each mind around the table weighs what the Chairman says, mulling it, figuring out what is wrong with it.

Attention shifts to the end of the table, where a staff economist offers a fifteen-minute summary of the U. S. economy and its prospects. The jargon of the economist creeps in--savings rate, velocity, multiplier effect--but the presentations are deceptively simple--the simplicity of painstaking preparation over thousands of man-hours. The emphasis is not just on what prospects are likely, but on what the risks are, on either side. As with the foreign report earlier, the brief presentation highlights and supplements a massive pile of written information the policymakers have already digested including, importantly, a thick compilation of economic intelligence coming in from Reserve Bank directors and other contacts around the country.

As the presentations come crisply to an end, several members nod unobtrusively at the secretary, who keeps a list so the Chairman knows who wants to speak. The process of gentle, tough questioning continues. Disagreements emerge, and are refined by cross-questioning. A President mentions detailed evidence from his District contradicting the staff's interpretation. Another tersely documents the similarity of the current situation to others in the past thirty years; still another provides reasons to show the situation really is not similar at all. Polite and calm, with humor here and there, the discussion is quick and crackling in its content. The nineteen men move in the next hour to probe and complete their own thinking about the economy, to qualify the staff's assessment, to provide a common base for the establishment of monetary policy.

The clock is now past 11. Tension subsides as the members move out in the hall for coffee, clustered in a dozen conversations with other members and staff assistants, usually talking about something else--administrative problems, personalities, the weather in Washington--as if to recharge their batteries before they dive back.

Then the group gathers around the table again, and heads turn toward the Deputy Manager for Domestic Operations, who describes domestic open market operations during the past month. Like its predecessors, his report is concise, focusing on exceptions and problems rather than the routine. As before, each member feels free to ask "Why?" It is a tough audience, and few people could handle it. He can. He and his associates have that special quality, come through it well, and are highly respected in their role on the front line of monetary policy. These actions, too, are ratified.

Next another staff economist presents the financial outlook: The relationship between money growth and interest rates, movements of funds in and out of financial institutions, why unusually sharp movements in this or that series may be ominous...or unimportant.

Now, two hours into the meeting, the FOMC has reached the critical part. It is time to make monetary policy. Each has been preparing for a month--with the preceding economic analysis and discussion, and with countless consultations with Reserve Bank directors and staff advisors, briefing notebooks, summaries, oral briefings, and draft statements, right down to the loose ends each member has discussed with his senior advisor over breakfast that morning.

By now each has sorted out the whole situation several times, each time differently. This is not one of those meetings where each participant listens to himself. All listen carefully, adding to some concerns about questions, crossing others off the list. As each policymaker sketches his preferences and conclusions about monetary growth and interest rates, the others are hearing not only what he says, but the context from which he is saying it. A lot of skills and experience are gathered around that table--economists, bankers, lawyers, businessmen--each with a different perspective. These are not nineteen strangers. They have spent many hours together, know each other well. Each understands the peculiar style with which the others shoulder similar responsibilities.

There is no order to the comments. Some like to get in early; others lay back to digest the context. Sometimes the discussion ends quickly; sometimes it lasts for several hours. Finally, after each has said his piece, the Chairman guides the Committee, through informal soundings, to a consensus: a combination of interest rates and monetary growth ranges which the Committee can support.

Out of this comes agreement, or substantially so, on instructions to the Open Market Manager for the ensuing month.

Then the seven Governors, and the particular five Presidents who (except for New York) cast votes for their twelve colleagues on a rotating basis, face another decision. Everyone is not completely happy with the consensus. Each of them must decide whether any disagreement he has is strong enough to vote "no," and why. This happens fairly often: Many meetings culminate in the registering of one or two dissents out of the twelve votes.

It is downhill from here. The secretary calls the roll of each voting member, and the votes are cast formally. The tension lifts, a housekeeping matter or two rolls by, and the meeting breaks up. Each member heads for an afternoon of committee meetings, taking advantage of the time when all the Presidents and Governors are together. The domestic and foreign managers head for the telephone to implement their instructions, which will be watched and discussed around the world each day in the coming month. Members drift out of the room, each thinking of the work that has to be done between now and that time next month, when those nineteen men will again gather around that massive table overlooking Constitution Avenue.

For one of the Presidents, however, the activity is just beginning. It is his turn to monitor the Fed's open market operations. Assisted by his own staff, he will participate each day in a conference call with the Board staff and the Open Market Account Management at the New York Fed, getting a full measure of the subtleties and details against which the Directive just approved by the FOMC will be executed. This experience adds a great deal to the perspective of each participant.

I hope I have been able to give you the flavor of how monetary policy gets made, of the care and energy we devote to it, and of the work and excitement which builds into a crescendo to that Tuesday morning each month. It is too early to tell yet all the modifications the new Chairman will bring. There have been few thus far. It will be interesting to see how our tradition continues in its newest chapter.

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That is what it's like to be sitting around the FOMC table. Now let me conclude by telling you what's on my mind right now, as I look forward to the next meeting.

What is on my mind, in a word, is inflation. As I look out over the rest of this year and into the next, I see many elements pushing up prices and wages; I see very few holding them down. First and foremost, the substantial progress we have made on unemployment and economic growth is bringing us closer to bottlenecks in skilled labor and plant and equipment--closer to the time when production costs will accelerate in response to those shortages. The disappointing rate of business capital investment will hasten that reckoning.

Second, the recent depreciation of the dollar internationally cannot help but add to inflation--by one-half to one percent, the experts tell us. We are just beginning to see these effects on our imports--the Toyotas--and their domestically-produced substitutes--the Fords.

Third, it is quite clear we have not adjusted yet to what energy will cost in the future. When we do, some prices will go up as our producers and consumers react by changing what they sell and what they buy. This kind of churning, history tells us, is inevitably inflationary.

Fourth, we have to reckon with the Federal budget stimulus, and with whatever additional tax cuts will emerge in this, an election year.

Finally, I am troubled by the "I'm gonna get mine first" way of thinking which, as always, accompanies widespread expectations of inflation. Next year brings a heavy collective bargaining calendar, with more pressure on labor costs in prospect. Businessmen are looking for ways to protect their profit margins. Farmers need help. Everyone, it seems, is looking for Federal money as an equalizer. This is the psychology inflation breeds, and I am troubled to see it building up again.

I hope I am wrong. Weak economic growth around the world is restraining international commodity prices, and that may offer a welcome, if temporary, respite. Maybe the Administration will pull a rabbit out of the hat and implement a workable and effective anti-inflation policy, but I cannot avoid being skeptical. I am pleased, however, to see that the Administration has joined our new Chairman, Mr. Miller, in declaring that inflation is our top-priority economic problem.

One final note. It is sometimes fashionable to say that wealthier people with jobs are always more concerned about inflation. That argument does not mean much to me, for two reasons. First, our recent inflation has clearly hit poorer people much harder than the general population, because our worst inflation has been right where lower-income people spend most of their money: health care, housing, transportation and food.

Secondly, our postwar experience tells us, equally clearly, that the only way to get unemployment down and keep it down is to avoid recessions. Accelerating inflation is the surest road I know back to a recession and rising unemployment. So we <u>all</u> should be concerned about inflation, and that is the primary concern I will carry with me next month as I take my seat around that table in Washington.

Thank you very much.