REFLECTIONS OF A FRESHMAN FOMC MEMBER

Remarks by Cathy E. Minehan
before the "Inside/Outside" Group
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Good evening. Thank you Sandra, and thank you for inviting me to speak to this group. I understand ISOS is a new organization, and I am flattered to be among your earliest speakers. It is very heartening to see how the number of professional women's groups has grown in Boston over the last few years. I am intimately aware of their growing number, because I think I've given talks to all of them. I've actually been giving quite a lot of talks to many different types of groups, as I find them a very important source of information, as will discuss a bit later.

In March of last year, I attended my first FOMC meeting. As you know, the FOMC is the Fed's monetary policymaking Committee, where those decisions regarding the level of interest rates are made. While I have certainly worked in the Reserve System for a long time, before March 1994 I had never attended a Committee meeting. My predecessor Dick Syron never had the good grace to be away at the time of a meeting, and I never was a "back bencher", so it was all new territory. Prior to the meeting I read two years worth of minutes

(honestly, I did) and then sought help-- both from old friends in New York and from my new staff. Where do I sit? What really happens? How do I know when to talk? What do I talk about? And mostly, I thought about two questions: First, how could I, with a background largely in making things in the Federal Reserve System work rather than in monetary policy formation, contribute to this most fundamental task of the central bank? And, second, especially after I became President, what particular role does the President of a regional Reserve Bank play in monetary policy making? I'd like to focus this talk on the answers to these two questions.

My formative years at the Federal Reserve Bank of New York were spent largely in the area of payment systems, and related supporting activities like doing budgets, running computers, accounting and the like. In the seventies, these areas were a good definition of the backwaters of a Reserve Bank, but by the eighties, given changes in technology, the volumes and values of payments being transferred, and the periodic crises involving payment system risk, knowing how things actually work, and being able to make them work in a problem situation became a powerful adjunct to policy-making. Thus, it was a great time to be in those areas. We lived through many crises,

including the stock market crash to Drexel Burnham shutting down--and with a few stops in between at power outages and computer failures--we in operations became the close allies of policy makers in a crisis, and important players on the team when it became time to figure out how to handle things better the next time. This was an extraordinary time to learn, and I've found the lessons of this period very powerful in establishing the framework within which I make my decisions regarding monetary policy. What are those lessons?

- That in addition to price stability the country's, if not the world's, financial stability is the overriding responsibility of the U.S. central bank;
- That a central bank's credibility is essential to its ability to step into a crisis as a trusted intermediary and promote stability; and
- That credibility comes in large measure from the expertise it develops over the years and, most importantly, the control the central bank exerts on inflation, since low and stable rates of inflation produce incentives throughout the economy that work in the direction of encouraging productive growth rather than excessive speculation.

So, to cut to the question reporters like to ask: does this make me a hawk or a dove? Neither, I think, since I believe the essence of monetary policy formation is much more subtle than the simplistic hawk/dove dichotomy. However, the lessons of the 80's have made me a staunch defender of the course monetary policy has been following. I believe the focus on containing inflation begun in the early part of that decade has resulted in longer periods of cyclical economic growth, lower interest rates at cycle peaks, and, at the same time, lower unemployment rates, at cycle troughs. It hasn't been perfect, but it has laid the groundwork for the United States regaining its position as one of, if not <u>the</u>, most productive and competitive world economies. That, I think, is the very definition of success for a central bank.

With this perspective, I have approached this first year at FOMC meetings, and now as a voting member, with the old physician's oath in mind "Do no harm." In 1994, the strength of the economy kept exceeding most forecasts while inflation remained well controlled. But now things are getting especially challenging as some indicators suggest the slowdown is well underway, while the labor markets, and other patterns of resource utilization seem fairly tight. On the one

hand, we don't want to increase interest rates to the point that the economy slows too much; on the other, we don't want to hold off if, in fact, inflation accelerates beyond what might be seen as a small cyclical blip. If a material acceleration does occur, correcting it will only require more tightening later, if our focus is on maintaining a stable rate of inflation, as I believe it should be. This is a delicate balancing act, and I must say each time I speak at an FOMC meeting, I am aware of how much is at stake.

Moving to the monetary policy formation process itself, let me focus on the role of the regional Reserve Bank and how we in Boston approach this task.

On paper, the monetary policy decision process looks unwieldy--some might even say messy. Nineteen participants, twelve members who vote, the others with votes rotating on some arcane system that seems inspired by astrologers--why does Cleveland vote every other year?--the cumbersome Committee sets open market monetary policy. As if that weren't bad enough, consider the other tool of monetary policy, the discount rate, which, although it is in some ways symbolic, has an influence on the primary tool. The discount rate evolves from the initiatives of the Boards of Directors of the regional Reserve Banks,

but is changed only after ratification by the seven-member Board of Governors. It's hard to believe that such an arrangement would work well, let alone produce a coherent monetary policy. Nonetheless, external appearances notwithstanding, I would argue that this arrangement, this awkward-appearing system of checks and balances, this blend of public and private inputs, has worked well for many years and, as I noted earlier, has worked particularly well recently.

Undoubtedly, much of our success has to do with the good fortune we have had in the men who have served as Chairman. Both Alan Greenspan and Paul Volcker deserve much of the credit for our success. But as great as their contributions have been, some of the credit also goes to this seemingly ungainly federal committee system in which not all of the input to decisions comes from Washington, D.C. (or even the combination of Washington, D.C. and New York City) but some portions come from provincial outposts like St. Louis, Richmond, and yes, even Boston. Specifically, I believe that the contribution from <u>outside</u> the Beltway has been a major factor in making the Federal Open Market Committee an effective institution.

Economics, as some of you are probably already aware, is NOT an exact science. This applies fully, if not doubly, to monetary policy,

which, as you know, works only with a lag. Like it or not, forecasts and reasoned, experienced judgements about future economic prospects, and about the variety of financial market reactions are an integral part of monetary policy because of this lag in its impact. Such judgements and forecasts form a place to start but they necessarily are surrounded by a cloud of uncertainty.

Recognizing this, it is also important to have a wide-ranging, active debate about the assumptions that underlie the starting point. Where are the risks to this "best guess?" Are these risks evenly balanced, or asymmetric to one side or the other? And what the prospects are for whatever policy is ultimately adopted? This debate means that more than one perspective, more than one school of thought, more than one econometric model can make a valuable contribution. And I also think it means that there's a lot of room for the contributions of those of us with less mathematical but more experienced-based senses of both the tenor of economic growth and the feel of the markets. Ultimately, monetary policy formation ends up being a process of exercising judgement, with very few clear-cut rights or wrongs. The Committee has to make a call, and to do so we all have to learn from each other, even from those with whom we

ultimately may disagree.

One example of this is the role the Federal Reserve Bank of St. Louis has played in representing the monetarist school of economic thought. The "salt-water" economists in Boston have never been slavish followers of every wiggle in the monetary aggregates, those measures of the money supply that you used to hear more about -- M1, M2, etc. That doesn't mean that we in Boston have not absorbed valuable lessons from the monetarist perspective on how the world works, however. To give a specific example, I have no doubt that the recognition of an apparent relationship at that time between monetary growth and inflation played a key role in the Federal Reserve's successful change of operating procedures in October 1979, which led ultimately to the dramatic decline in inflation in the early 1980s. In addition, I am told that the behavior of M2 in mid 1989 provided valuable information to the Committee on the potential for economic slowdown.

By the mid to late 1980s, however, the relationship between the monetary aggregates and inflation, nominal GDP, or really any variable of policy interest no longer seemed strong, though we continue to track aggregate behavior. Recognition of this breakdown was

probably enhanced by the fact that the Committee reflects several diverse viewpoints. The lesson of these episodes is the value of a federal system, one in which not all power resides under a single roof at a single location.

The current District-based Committee approach allows and encourages a variety of viewpoints to develop and thrive. The inclusion of the monetary aggregates as policy variables, and their subsequent downplay, illustrates that even when one approach appears to dominate all others, a dubious general proposition, we can never be sure when a new approach will be needed or where that approach must evolve.

In addition to providing a forum for different schools of economic thought to flourish and interact, the decentralized system also provides insight into economic conditions in each region. A region's economic experience can differ quite markedly from the national average and these differences can provide an "early warning" of developments that could affect the nation as a whole. A case in point is the New England experience during the 80's. I am told that Frank Morris, then President of the Boston Fed, was a voice in the wilderness regarding the problems inherent in the excess of real estate lending in the mid-80's.

This fueled a sizeable economic boom in New England, but the recession that followed was much deeper than the national downturn. The combination of a declining economy and a collapsing real estate market led to severe problems at the region's banks. As banks struggled to survive, they cut back their lending, which further exacerbated the regional recession.

New England's problems were later echoed elsewhere; but because of New England's earlier experience, the FOMC was already sensitized to the contractionary effect of disruptions to the availability of bank credit. This was one of the headwinds to which Chairman Greenspan referred frequently during the early stages of the national recovery and which contributed to the FOMC's reducing short term interest rates to their lowest levels in 30 years.

As you can probably tell from the foregoing, I take the role of a regional Reserve Bank like Boston seriously. My preparation for monetary policy includes almost constant grass-roots interaction with businesspeople. This exposure takes many forms--speeches such as thise one, where learn alot from hearing what's on your minds during the Q&A and informal chatting, telephone contacts for our Bank's Beige Book report, meetings with an informal group of local investment

managers, with a more formal advisory council of New England's smaller businesses and, of course, with the members of the Board of Directors of the Boston Bank. I don't think anyone could get this intensive exposure to New England's economy and intellectual resources without living here, "on the spot."

Contact with my Board of Directors is particularly intensive. We are required by the Federal Reserve Act to deliberate about the discount rate and hence about the state of the economy at least every two weeks. Our Board is now, and historically has been, made up of successful businesspeople, and academic economists as well as labor leaders and other representatives of the public interest. I learn a lot from our interactions. Even though the discount rate does not have the importance of the federal funds rate, the deliberative process we go through is extremely thorough and informative. It has been my experience that the Board of Governors takes the insights and the recommendations from our Board very seriously.

For more than twenty years, The Boston Fed has surveyed the views of leading economists from the New England district before each FOMC meeting and shared our findings with the other Committee members. In thinking through what I personally need for Committee

meetings, I quickly realized I would be foolish if I did not on an even more regular basis pick the brains of top minds at Harvard, MIT, and Yale. This has been one of the most fascinating parts of my new job. When I was named President of the Bank in July, I received many congratulatory letters, including some from those same illustrious economists whose textbooks and theories we all studied in college: Paul Samuelson, Bob Solow, Franco Modigliani, Jim Tobin. My initiation into this sphere was not without intimidation. I was reminded of an old adage: In New York, they ask "how much is a person worth?" In Boston they ask, "what does he know?" Despite this initial anxiety, however, I have found these academic stars extraordinarily kind and helpful even if our periodic dinners do seem at times to be debating sessions.

The final step I take in preparing for each FOMC is to get together with the economists in my research department. We compare the Board staff's economic outlook to our own models and to prominent, private sector forecasts and weigh the pros and cons of changing monetary policy. Because each Reserve Bank has relative autonomy, each Bank's research department has developed a distinctive character; such a rich variety would be most unusual if all of the System's

research and analysis were conducted under one roof.

One of the lessons that I have taken away from all these deliberations is that while controlling inflation is the key objective of monetary policy, inflation works through the product and factor markets of the economy. If you want to understand and predict what inflation will be, you have to look beyond just money growth or just interest rates or even Wall Street, to the nonfinancial parts of economic activity. The 1987 stock market crash was a dramatic event, but it hardly put a dent in the pace of economic activity and ultimately in the upward creep of inflation. After several false signals from gold and commodity prices, it has ultimately been the increased pressure of the "real economy" on our productive capacity that has provided me with the justification for the Federal Reserve's tighter policy since February 1994.

I have found that our approach has been working well in providing early, reliable signals of changes in inflation, and in economic growth. Other Districts use different approaches, and I can assure you that I learn from my FOMC colleagues, but I like to think that they benefit from exposure to Boston's perspective as well. The point is that the Federal Open Market Committee functions as a committee in

the best sense of the word, a glaring exception to the common observation that a committee decision is an oxymoron.

I believe the Federal Reserve System was designed in a particularly farsighted way in investing real authority and responsibility to its regional Banks. This not only facilitates contact with local business conditions, and different schools of economic thought, but allows each Bank to develop its own unique character that can persist over time, notwithstanding the most recent fad out of Washington, Wall Street, or academia. The existing set-up embodies a unique and effective form of independence from day-to-day politics that, through the Reserve Banks in particular, is deeply rooted in the public interest.

In closing, let me share with you two of the biggest surprises of my first year on the FOMC. First, I never cease to be amazed at the media attention I or any other Reserve Bank president attract at any gathering at which the press are present. Nothing in my former life prepared me for walking up to a podium, or out of a meeting, into the glare of TV lights and a host of microphones and wire service people ready to dash to the telephone. I have learned to be extremely careful in everything I say, and to be almost fanatically up-to-date on incoming data, but this is something I wonder whether I will ever be

comfortable with.

The other surprise is a more substantive. After attending FOMC meetings for about nine months, my rotation as a voting member came around. Blithely I thought that the change would make little difference since each FOMC member, voting or not, contributes equally to the discussion. Imagine my shock then when I found myself almost shaking when my name was called for my first vote. The enormity of the responsibility of being an FOMC member really hit me then. Exercise of that responsibility cannot be a rote or mechanical function; the very real human impact is too important. To me this position is the pinnacle of a career spent in public service and the intellectual challenge of it, as well as the ability to make a real impact on the country's economic welfare, make it an incredible opportunity as well. In that regard, I will greatly miss the reassuring presence of John LaWare, who has been sitting next to me in those meetings over the year. With his retirement, the System will have lost a tireless advocate for both a stable economy and a stable banking system.

I've really enjoyed sharing my thoughts about this past year with you this evening. Thank you for your attention, and I look forward to your questions and comments.