

**A Reserve Bank President Looks at the FOMC**

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I want to thank Dewey Daane for giving me this opportunity to speak to you today. As I'm sure you know, I've been scheduled to speak two other times and have been frustrated by bad weather, both in Boston and here in beautiful Nashville. Well, today we have sunshine in both places, and I'm certainly happy to be sharing this day with you.

This past couple of years have been an extraordinary period for me; one characterized by intellectual challenge and a defining sense of public service that, while not unexpected, has had a powerful impact on me. In large part this is because of my membership on the FOMC. I'd like to provide some insights for you about FOMC membership that might be an interesting way to begin what I know will be an engaging dialogue after my remarks.

When people ask me about the Fed, and more specifically the FOMC, they usually are interested in two things: what really goes on in a process sense, and what is the substance of the Committee discussion, that is, what are the key issues focused on at any meeting? I'd like to talk about both of these areas today, and add a third--what is

the role of a regional Reserve Bank President, and what effect do regional matters have on the formation of national monetary policy?

It may come as some surprise to you, but the inner workings of the FOMC were as much a mystery to me when I began attending in March, 1994 as they may be to you--despite the fact that I had been with the Federal Reserve System for almost 27 years by that time. 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" (that is, a senior economist or a director of research) so it was all new territory. And this territory didn't come with much of a map--Where do I sit? What really happens? And most importantly, how can I most effectively make the case for what I believe to be the right policy action? I've sought answers to all these questions over the past couple of years, so let me cover them for you, looking at process first and substance second.

FOMC meetings come along every six-eight weeks or so and seem at times to be scheduled for maximum personal inconvenience. Why must we always meet on the day before or after July 4, and the Tuesday before Christmas? The real answer to this question is a mystery, but tradition I suppose plays a role. While in many ways one

is always preparing for an FOMC meeting, formal preparation for each Tuesday meeting begins the prior Thursday or Friday when extensive information is distributed by the excellent staff of economists at the Board of Governors. This material is of three general types: an exhaustive compendium of current economic statistics and analysis, focused on what has already happened; a baseline forecast with alternative scenarios, and a discussion of monetary trends and policy options. As you can imagine, all this material is shared among only a few economists, Lynn Browne and myself here at the Bank. We, of course, have our own perspectives on current economic data, and our own forecasts, and we carefully review the Board material to determine both where we might differ, and where we might agree.

We at the Boston Fed are keen believers in controlling inflation, but we are also sensitive to the short-run effects of monetary policy. We look at the monetary aggregates for whatever information might be there, and we follow interest rate trends and data on financial market activity. But most of all we look at the product and factor markets of the economy as key predictors both of economic growth, and inflation. Our discussions of Board staff material tend to focus not so much on analytical differences, because we share a similar eclectic approach,

but on where the risks are and what policy action should be taken.

These discussions usually start on Friday and continue through Monday when Lynn or Eric Rosengren and I head off for Washington.

Once there, all FOMC participants receive another flood of paper in their hotel rooms. The Board members are briefed on Monday morning, and we receive this material as well as any last minute updates the staff has prepared. By the time the meeting comes around on Tuesday, I usually have such a full briefcase that I've often thought that weight training should be required for all Reserve Bank Presidents as an adjunct to FOMC preparation.

FOMC meetings themselves, at least in my experience, have a rather set process, in contrast to the very free exchange of views that takes place. One does sit in an assigned seat both as a member at the table, and on the couches and chairs behind the table for the back-benches. The meeting opens with a discussion by the Manager of the System Open Market Account--currently Peter Fisher of the New York Fed--of both domestic and international market conditions, and actions taken by the Desk since the last meeting. Then senior members of the Board staff present their baseline forecast and alternatives. Each Reserve Bank President then speaks about conditions in his or her

region and about their reaction to the staff forecast material. Board members also reflect on various aspects of the national economy and their perspectives on the forecast. After this is done, without exception we break for coffee, served with doughnuts and muffins in the hallways outside the Board Room.

After the break, policy actions are presented to the Committee and the Chairman adds his perspective. He usually covers current economic activity and may present a recommendation. Then, each President and Governor expresses his or her own policy perspective, and what action he or she would prefer. Divergent points of view are not unusual, and there is lots of room for different economic philosophies.

This, I think, is an important fact to keep in mind. While the formal process of the meeting follows a set pattern, the substance does not. There is no attempt prior to meetings to pull the Presidents together on a policy recommendation, and there would be strenuous resistance if that were attempted. Even in the coffee break prior to the policy discussion, there is little, if any, consensus building. Rather, the meeting itself is the place for honest, open discussion about both our economic philosophies and how they should be reflected in policy.

These past two years have been an extraordinarily interesting time to be on the Committee from a substance perspective. In general, setting monetary policy is easier when all the signs point in the same direction. For example, the combination of tight markets, low unemployment, and prospects for unsustainable rates of economic growth, all suggest a tighter policy is necessary. Conversely, high unemployment, prospects for slow or negative growth, and little price pressure suggest a more accommodative policy. But things aren't so easy when, as has happened over much of the last year to year and a half, there is no obvious direction for policy, only upside or downside future risks to be perceived, understood and avoided.

By any rational measures of economic policy, we seem to have achieved that economic equivalent of nirvana, the soft landing--relatively low unemployment, continued underlying sources of economic growth, though at slowing speeds, in consumer and business spending; interest rates at levels that support housing markets and business finance; very few price or wage pressures; ebullient though at times volatile stock and bond markets; and declining fiscal and trade deficits. The issue now is how to keep things on track without on one hand being so tight that growth is stifled, or so loose that inflation

takes control. And if you look over past history, our track record in smoothing out and extending the growth phases of economic cycles, while improving during the eighties and early nineties, is anything but perfect. Clearly this isn't easy to do, but to be at all successful we on the Committee need to listen to each other's perspectives.

Where are the risks in this economy? Are they on the upside as it seemed in February 1995, with growth strong and labor markets tightening? If so, should we take advantage of the seeming health of the economy and purchase insurance, as we did then against rising rates of inflation? Are the risks on the downside, as it seemed later in the year, when we moved to ease policy in the face of low rates of wage and price growth?

Have things really changed out there in the labor markets with globalization, technology, and ever increasing competition so that wage pressures are permanently lower at any given level of unemployment? It is tempting to believe this is true, but do we have enough confidence in the data so far to avoid the surge in inflation we experienced in late '89 when similar arguments were made? Has all the investment in computers and productive capacity changed our underlying ability to grow to the extent that more workers can be absorbed than we could

expect from historical relationships? And what, if anything, should be done about the possibility of fiscal drag when the ongoing budget talks finally conclude, with all that they could imply for lower federal budget deficits and lower long-term interest rates? These are issues that have absorbed each of us on the Committee over the last year whether implicitly or explicitly. And whether we come at them from the prospect of a "hawk" or a "dove," as they are rather simplistically characterized by the media, we all have a similar appreciation for the necessity over the long run to keep rates of inflation low.

To reiterate some economic verities, over time, the long-run growth rate of the economy can for all practical purposes only be increased through higher rates of productivity. In turn, higher rates of productivity growth can only be achieved through higher rates of domestic savings and investment. And, finally, higher rates of saving and investment will occur most readily in an environment in which the threat or reality of inflation does not distort the decisions of savers or investors. I think we have only to look at the progress this country has made since 1982, when the back of the high rates of 1970s inflation was essentially broken, to recognize the benefits that can be realized from a restrained inflationary environment in terms of increased

international competitiveness and renewed emphasis on productive investment.

Thus, I start from the maxim that whether at any moment in time the primary concern is inflation or economic growth, the best policy over the longer run is to remain vigilant against inflation. This is a variant of the old maxim--an ounce of prevention is worth far more than a pound of cure. Moreover, from the point of view of the central bank, the credibility that accrues from a recognized pursuit of inflation stability is invaluable when it comes to addressing the Bank's other preeminent task of maintaining the country's financial stability. Throughout the 80s when crises of many types hit the financial markets, I cannot help but believe that the Fed's demonstrated willingness to take firm steps to pursue the right economic ends was integral to its success in solving those crises.

I don't believe I am in any way unique in these beliefs. They are, I think, shared in one way or another by all my colleagues on the Committee. But the power of the Committee is that by including both the regional Reserve Bank Presidents, whether or not they are voting members at the time, and the Washington-based Board of Governors, it provides an umbrella for a wide range of thought and geographic

perspective. As you know, economics 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 regional and financial market reactions are an integral part of monetary policy formation because of this lag. Such judgements and forecasts form a place to start but they are necessarily surrounded by a cloud of uncertainty.

Recognizing this, it is also important to have a wide-ranging, debate about assumptions, and within this debate, more than one geographic perspective, more than one school of thought, more than one econometric model can make a valuable contribution. 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 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 perspective. As you may have inferred earlier, the "salt-water" economists in Boston have never been slavish followers of every wiggle in the monetary

aggregates. Nevertheless, this fact does not mean that we have not absorbed valuable lessons from the monetarist perspective on how the world works.

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 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. 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 there are some signs of stabilization in velocity rates recently. Recognition of this breakdown was probably enhanced by the fact that the Committee reflects several diverse viewpoints, as reflected most prominently by the regional Reserve Bank Presidents who are members.

The Committee approach allows and encourages a variety of viewpoints to develop and thrive. The inclusion of the aggregates as policy variables, and their subsequent downplay, illustrates that even when one approach appears to dominate all others, a dubious general

proposition in and of itself, we can never be sure when a new approach will be needed or how that approach might evolve.

In addition to providing a forum for different schools of economic thought to flourish and interact, the Committee discussion 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 80s and early 90s. 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 helped the Committee to understand and manage the dynamics of the national economic adjustment process taking place--an adjustment from a highly leveraged, over extended

economy to one that has performed well in the aggregate over the last several years.

As you can probably tell from the foregoing, I take the role of a regional Reserve Bank like Boston seriously. My informal preparation for monetary policy includes almost constant grass-roots interaction with businesspeople. This exposure takes many forms--speeches, telephone contacts for our Bank's Beige Book report, meetings with a group of local investment managers, with an advisory council of New England's smaller businesses, quarterly dinners with our academic luminaries and Nobel prize-winners and, of course, with the members of the Board of Directors of the Boston Bank.

Contact with my Board of Directors is particularly intensive--as you know. Reserve Banks are required by law to deliberate about the discount rate and hence about the state of the economy 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. I learn a lot from our interactions. Even though the discount rate does not have the impact 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 of our Board very seriously.

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 for the nation's Central Bank from day-to-day politics that, through the Reserve Banks in particular, I believe is deeply rooted in the public interest.

In closing, let me turn to near-term prospects for the economy as I see them. The usual process of assessing where we are is "murkier" than usual given Federal government shutdowns, blizzards, and strikes but, nonetheless, I remain relatively optimistic. Clearly, activity in the fourth quarter slowed from the third, and some of this slowness, along with blizzard effects, will hold back the first quarter. It is also true that historically speaking, this expansion is rather old. But one can take heart, I think, from the emerging picture of the 4th quarter as one in

which inventories were depleted, not accumulated, with all that could imply for less of an inventory hangover in first quarter than might have been expected. I do not believe that the consumer has died, given reasonable overall growth in personal income, recent upticks in confidence, and the resumption of rather strong job growth, if one averages the last two months together. Also, I do not think that growth in business fixed investment spending will come to a halt. Ebullient stock and bond markets have created both a stronger financial base for savers, investors and businesses, as well as levels of long-term interest rates that can only continue to help the housing markets. Internationally, the trade deficit has eased a bit, and the economic health of our major trading partners, even with the weaknesses in Germany and France, seems on balance reasonably good. Prices have been remarkably restrained given the seeming tightness in labor markets, but here I would stress the need for constant vigilance. Taken together, I think the prospects are decent for a resumption of trend-rate growth by second quarter--perhaps a softer economy than some would like, but certainly without serious threats of recession. Borrowing a bit from that old children's tale of the "Three Little Pigs," an economy that's not too hot, not too cold, but just about right.