

A Reserve Bank President Looks at the FOMC

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I want to thank Diane Crane for inviting me to speak with you here today. It's wonderful to see a whole room of U of R alumni and friends. These past few 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? Then I will conclude with a few remarks on the current economic scene.

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 was never 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 several 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, our Director of Research and myself 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 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-benchers. 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 speaks about conditions in his or her region and about their reactions 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 hallway 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 four 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 are at times no compelling need for policy change, only upside or downside risks to be understood and avoided.

By any rational measure of economic policy, we seem to have achieved the economic equivalent of nirvana, at least domestically--relatively low unemployment, continued underlying sources of economic growth in consumer and business spending; interest rates at levels that at least for the present don't seem to have significantly affected housing markets and business finance; very few price or wage pressures; ebullient though at times volatile stock and bond markets; and a fiscal deficit that is in the process of disappearing. And while challenges remain on the international front, the real 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 an easy job, and one that is just as difficult when "holding the line"---perhaps more so---as when making significant policy changes.

In the absence of a clear and compelling case for policy change, we naturally focus on the risks associated with continuing our current policy. Are the risks more pronounced on the upside, with strong growth and tight labor markets manifesting themselves in rising wage and price inflation? Or are they weighted toward the downside, as might be the case if the spillover from the Asian crises is more widespread than expected?

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 how does the prospect of

balanced federal budgets affect monetary policy, with the salutary effect that this development likely has had, and may continue to have, on long-term interest rates. These are issues that have absorbed each of us on the Committee over the past year. And whether we come at them from the perspective of "hawk" or "dove," as they are simplistically characterized by the media, ultimately we need to listen to each other's perspectives to arrive at balanced and informed decisions.

To reiterate some economic basics, 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, an umbrella is provided for a wide range of thought and geographic

perspective. 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. 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 listen and learn from each other.

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.

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.

Now, let me turn to near-term prospects for the economy as I see them. As I noted earlier, we are experiencing one of the longest periods of sustained growth, low inflation, and low unemployment of the entire post-war period. Indeed, one has to go back to the 60's to see periods of similar success. And, even more surprising, is the degree to which this success has been unexpected--in fact, most forecasters have been wrong about growth (on the low side) and about inflation (on the high side) for a year and a half or more.

Over the past four quarters, the economy has grown at a pace of 3.9 percent, well ahead of what most forecasters expected. Reflecting this, and the fact that about 3.2 million net new jobs were added during the past year, the unemployment rate has fallen about half a point to 4.7 percent, whereas most forecasters had expected the rate to stay flat.

These signals of capacity constraint in the face of growth that continues above the long-term trend could signal higher rates of inflationary growth. But, as yet, we see almost no signs of increasing

price pressures. Core inflation has declined almost four-tenths of a point to 2.2 percent at an annual rate over the past year. Here again, most forecasters were too pessimistic, expecting inflation to drift upwards.

Looking forward, the real fundamentals continue to look positive. Job growth and personal income are strong and these are the primary drivers of consumption. Consumer confidence is at all time highs and consumer spending on automobiles and other big-ticket durables advanced at a brisk pace in 1997. In fact, over the course of this expansion, spending on durables has grown about twice as fast as consumer income and GDP.

Even residential investment, which was expected to be a source of slowdown in 1998, continues to appear strong, supported by income growth, capital gains, and high levels of affordability. The most recent data on building permits support this analysis. To be sure, the rate of personal bankruptcies has risen sharply over the past decade, which is worrisome. But the consumer's overall balance sheet remains in relatively good shape.

Similarly, most businesses are in good shape as well. Investment spending by firms is one of the principal stars of this business cycle

expansion. Business purchases of plant and equipment also have grown almost three times as fast as GDP. Ordinarily, such aggressive spending might threaten the longevity of the expansion, as businesses' capital budgets outstrip their cash flow by an excessive margin, inducing companies to curtail their orders in the future. During this expansion, however, capital budgets have remained modest compared to companies' cash flow. As earnings and profits have grown much more rapidly than GDP, the ratio of capital spending to cash flow has remained well within its historical tolerances for business cycle recoveries.

These fundamentals suggest that investment in plant and equipment should continue to expand. Strong cash flows, and a relatively benign cost of capital, aided in part by the good news on the federal deficit, should continue to spur firms to invest at least in the near term. Moreover, industrial production in January -- looking through the fair-weather decline in utilities' output -- suggests that manufacturing continues to thrive into this year, which bodes well for continued economic growth.

There are a couple of areas where dark clouds, or at least worrisome trends are apparent. The first of these involves the Asian

crisis and its impact on net exports. Although gross exports gave a tremendous boost to the economy in the fourth quarter, that trend is unlikely to persist. Prospects for real economic growth in many of our major trading partners are still sound but less rosy than in 1997. But, the recent problems in Asia -- both the appreciation of the dollar versus these currencies and the lowered prospects for economic growth in this region -- will almost certainly bring a marked contraction in our net exports. Thus, net exports could exert a considerable drag on domestic GDP. Now I should add here that given resource constraints, especially in labor markets, such a drag may be just what the doctor ordered to keep the U.S. economy in a healthy, low inflationary state for without some restraint we could well see significant price pressures. However, risks also exist on the downside, and we need to be vigilant about that as well.

The second area of concern that I have involves the very sense of confidence, if not ebullience, that has propelled the U.S. economy to a near-record length recovery. This is a dangerous time for unwise investors and lenders. It's easy to believe that things will go up forever, and that loans and securities purchased now--no matter what the risk or price of these assets--will be as profitable as they were in

1997. But things don't go up forever, and, if we are not careful, we'll be left with the asset problems, empty office buildings, and excess debt that can follow a period of ebullience. As a bank regulator, I am especially concerned here.

Even accounting for these sources of concern, however, the real economy is strong and likely will remain so for at least the first half of next year. The risks of inflationary pressure remain, but with a great deal of care--and some luck--my hope is we will be able to extend this period of balanced, low inflationary growth.