

A Reserve Bank President Looks at the FOMC

**Cathy E. Minehan, President
Federal Reserve Bank of Boston**

**University of Rochester
Simon School of Management
October 9, 1998**

When I was invited to give this presentation, I was also given the choice of the topic. I thought I'd use this opportunity as a way of engaging you in one of my primary responsibilities as a Reserve Bank President--sitting on the Federal Open Market Committee. The past four 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?

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 week when we in Boston review what

our own internal forecasts say about the economy and the stance of policy. On Friday and Saturday, 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 carefully review the Board material against our own 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 afternoon when I and one of the staff 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 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 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.

Despite the infrequency of interest rate movements over the past couple of years, this has been an extraordinarily interesting--if not difficult--time to be on the Committee. In general, setting monetary policy is more straightforward 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 rarely ever are that clear. Crosscurrents abound, and the international and financial market turmoil of this summer and fall have turned an already complex situation into one that now seems to have more than its share of downside risk.

For much of the last couple of years, the U.S. economy has expanded at a pace well beyond most estimates of its long-run potential, driven by high rates of job growth; strong consumer and business spending; interest rates at levels that support housing markets

and business finance; ebullient, though at times volatile, stock and bond markets; and a declining fiscal deficit. One critical issue facing the Committee for much of this period was how long could this go on without igniting inflation, since unemployment rates had fallen over the period to a point well below most estimates of the rate likely to keep inflation from accelerating. Moreover, even in the absence of inflation, what were the extremely liquid markets, and observably easy credit conditions, doing to the level of risk-taking in the economy?

Late this summer, we began to see the answer to this question with the Russian devaluation and default. Up to that time it was possible to view the turmoil in emerging markets, and in Japan, as a reasonable offset to U.S. domestic economic strength--unfortunate if not tragic for the countries involved, but a helpful restraint in our own economy. Despite its relatively small size in economic terms, the unilateral Russian default created a panic among investors who had sought the outsized returns available in emerging and other markets, without, it appears, a healthy appreciation of the related risks. Over a short period of time, credit conditions tightened, yield spreads widened to record levels, and the Asian contagion began to threaten not just

emerging markets but major economies as well. Thus, at its last meeting the FOMC voted to ease monetary policy slightly, despite the fact that only two months before the strength of the domestic economy suggested that significant inflationary risks existed. Clearly, risks have shifted, but even as policy is eased the Committee must remain vigilant on the inflation front.

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 maintain low rates of inflationary growth. 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--that of maintaining the country's financial stability. Right now the country's financial markets are being buffeted by internationally generated turmoil. Without the success the central bank has had in maintaining low rates of inflation, I believe the capacity to react to cushion the economy against this turmoil would be compromised.

I am not in any way unique in my belief that inflation needs to be a primary concern of the central bank. This is, I know, the view of 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. 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-80s. 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 continues to perform well despite the risks presented by the international situation.

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.

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, I believe is deeply rooted in the public interest.