

A Reserve Bank President Looks at the FOMC

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

**A. R. Holmes Visiting Lecturer
Middlebury College
Middlebury, Vermont**

October 26, 2000

It is a pleasure to be here this afternoon at Middlebury College. I am especially glad to see my old friend and colleague Scott Pardee in such beautiful surroundings.

The Federal Reserve's monetary policy-making role, conducted through the Federal Open Market Committee, or FOMC as it is commonly known, is the principal subject of my address today. These past six years as President of the Boston Fed 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 reflects an evolving process as FOMC meetings have been held at different intervals over the years. In the late '60s, for example, meetings were held every three weeks. Later that changed to once a month, and by the '80s to the current schedule of eight times a year.

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 the week before the FOMC meeting and continue through the day before 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 poll the FOMC members 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 the questions facing the U.S. economy and the balance of risks that must be addressed in setting policy.

There are times when the appropriate course for policy is easier to see than others. When resource constraints are tight,

and inflation trends turn up, absent other concerns, policy probably needs to be tighter, as we saw last year and into this one. Alternatively, when concerns about the resiliency of the real economy are paramount, as during the period of the Asian, Russian and LTCM crises, easier policy may be the best course. But for most of my six years, the right course for policy represented a balancing act between upside and downside risks. In this balancing process, however, my paramount concern has been maintaining the hard won control achieved during the '80s over price growth.

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. Since the mid-1990s there has been a marked acceleration in productivity growth, which many analysts attribute to a pickup in the rate of investment, particularly in information technology. Such high rates of 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 a renewed emphasis on productive investment. Indeed, current rates of productivity growth – about 3.7 percent in the last two years – exceed anything seen since the '60s.

Thus, I start from the maxim that whether at any moment in time the primary concerns are inflation or slow economic growth, or whether we are in fact experiencing a “new economy” productivity miracle, 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 judgments about future economic prospects, and about the variety of regional and financial market reactions are an integral part of monetary policy formation. Such judgments and forecasts form a place to start but they are necessarily surrounded by a cloud of uncertainty.

Recognizing this, it is 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 judgment, 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.

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 has performed quite well over the last several years.

Now, let me turn to near-term prospects for the economy as I see them. As you all know, we have been experiencing the longest period of sustained growth in U.S. economic history. United States real GDP grew on average between 4 and 5 percent for the last four years, speeding up rather than slowing down as the expansion got older. Unemployment declined to a thirty-year low of 3.9 percent, and while that number has been bouncy, it hasn't varied much from 4 percent in over a year. Until the last year or so most any measure of overall price growth was benign as well, completing a combo of stellar economic readings not seen since the '60s. Business investment has been strong, particularly in the high tech goods so important to the really stunning productivity growth that has characterized this period as well. Asset markets, while volatile, have created significance

wealth and added to tax receipts, consumer confidence has soared, and the fiscal deficit has all but disappeared. Even the one black cloud on the horizon – the deepening trade and current account deficit – has, to a large degree, reflected the differential in growth rates between the U.S. and the rest of the world and has been funded by foreigners' clear willingness and desire to invest in the U.S.

But trees don't grow to the sky; history teaches that economic growth phases often overdo, inflation accelerates, and the Fed needs to step in. In June, 1999, as a building excess of demand over supply became evident, especially in labor markets, the FOMC began to take steps to rein in economic growth in the face of projected inflationary pressure. In total, the Committee raised the overnight funds rate by 175 basis points – a small amount of tightening by historical standards – and then this summer, decided to remain on hold to see how the economy would react.

Sure enough, the indications are reasonably clear that the economy has slowed. Final sales in second quarter grew at only

half the pace of first quarter, residential investment slowed as well in the wake of higher interest rates and these trends seem to be holding in third quarter as well. But things certainly haven't ground to a halt. Indeed, while employment growth has slowed from its 1999 pace, unemployment remains very low and most other measures of labor markets confirm that resource constraints remain. Moreover, business investment continues to be strong, and foreign growth has added to the demand for U.S. exports. Growth in inflation including the recent uptick in oil prices, has been significant. Core prices – without the volatile energy and food components – have been better behaved, though the days of declining inflation seem to be gone. Indeed, it is slow growth in goods prices – reflecting the intense international competition in the global economy and the major strides in productivity growth made by U.S. business – that has kept core inflation at its moderate 2.5+ pace of growth. Services prices, on the other hand, have escalated by a much greater amount.

So the economy is slowing – probably to something like 3 percent in third quarter, with perhaps a bit more growth in the

fourth quarter. The \$64 million question now is whether that will be enough to keep inflation in check. The key to the answer to that question lies in whether productivity continues to accelerate.

Increased productivity has been a buffer between strong demand and short supply in labor markets and has been responsible in large part for the relative success we have had in constraining inflation. But at least some portion of this productivity growth is a function simply of the strong economy. As demand slows, so will productivity, providing less and less insulation from inflation. Moreover, as the rest of the world continues to grow, pressure on other resources may well push price growth. Obviously, oil is a concern at present; many believe that as additional supply is added, and some of the panic in markets subsides, oil prices may well decline. They also cite the very real fact that our economy is much less dependent upon oil than it was in the '70s. This is true, but I believe there is room for caution here. It is hard to forget that most of the recessions in the last 30 years had oil price increases in the economic mix.

Along with these upside risks, downside risks have emerged as well. Financial markets are particularly tricky; credit spreads are as wide now as during the liquidity crunch after the Asian/Russian/LTCM crisis. Stock markets are volatile and, at best, sideways in movement. These financial trends could slow consumer and business spending even more than expected. And the current account deficit grows larger by the month, still reflecting U.S. growth and the attractiveness of its investment markets but certainly a risk to the value of the dollar.

So the big question for policy is how to weigh this balance. For now, in my view, the best guess is that we going forward will achieve the slowing of the economy that will take pressure off resources, and constrain rising prices, without bringing a halt to consumer or business activity. But these outcomes are by no means assured and policy remains a delicate balancing act.

That takes me back to the FOMC and its critical role in creating the means by which such balancing can take place. This may be a somewhat biased view I recognize, but I am a believer that the regional structure of the System and the participation of

the regional Banks in policy setting is vital to achieving that balance and to creating the public buy in and support so necessary in maintaining the credibility of the central bank. The Banks are the means by which regional views, and different economic philosophies play a role in policy formation. They also are a conduit for explaining policy and achieving grass roots understanding of the difficult issues involved.

In closing, let me share with you a defining moment for me even after 6 years in this position—the moment when they call my name for a vote on FOMC action. As you may know, regional Reserve Bank presidents, with the exception of New York, don't vote at FOMC meetings every year. They fully participate in each meeting but vote on only a rotational basis. Every three years it is my turn. Even now, after two turns at voting, and as I contemplate my third next year, I am struck both by the responsibility this brings and the opportunity it affords to contribute to this area of U.S. economic policy.

Thank you.