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## The Process of Policy

Thank you for that kind introduction, Ron. I'm proud to be a part of the Pilliod Lecture Series, and I'm glad to be here with all of you this evening.

As Ron mentioned, I am approaching the one-year anniversary of my appointment as president and CEO of the Federal Reserve Bank of Cleveland. Over the past year, I have spoken to thousands of people all across this region, and whether the audience has been business people, bankers, college students, or community leaders, a couple of topics seem to come up over and over again.

The first is that people—even people who think they already know about the Federal Reserve System—really want to know and understand more. Second, everybody wants to talk about the economy. So tonight, I'm going to talk about both of these topics.

I'll give you some background on the Federal Open Market Committee and its responsibilities for setting monetary policy. I'll share some information on our economy and explain why—when it comes to policymaking—it makes sense to consider a wide range of indicators and benchmarks. Finally, I'll conclude my comments by explaining how people just like many of you, in communities all over our region, are helping me with the process that leads to monetary policymaking.<sup>1</sup>

To start, I'll give you a very brief overview of the Federal Open Market Committee (FOMC), the Federal Reserve's policymaking arm. The FOMC's long-term objectives are price stability and sustainable economic growth.

The FOMC consists of nineteen members: the seven members of the Board of Governors and the twelve Reserve Bank presidents. Twelve of the nineteen are voting members of the Committee. The seven Governors and the president of the Federal Reserve Bank of New York always have a vote. Four of the remaining eleven Reserve Bank presidents vote on a rotating basis. The presidents of the Cleveland and Chicago Federal Reserve Banks rotate every year, and the other nine presidents get a vote every three years.

Last year, I participated in the FOMC meetings as a nonvoting member of the Committee. Each Reserve Bank president has an equally important voice in the national policy discussion, whether he or she is voting that year or not. The only difference is that voters get one more word at the end of the meeting—"yea" or "nay." This year, I become a voting member, which means I will have a voice and a vote.

I have outlined the structure of the Federal Open Market Committee; now I want to invite you to attend a meeting of the FOMC. I can't

### Additional Information

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literally do that, of course, because these sessions are not open to the public, but I can try to describe a meeting for you.

Here, I would like to acknowledge former Federal Reserve Board Governor Larry Meyer who, in 1998, delivered a lecture called "Come with Me to the FOMC." I will walk you through a typical FOMC meeting agenda in the way Dr. Meyer did.

The FOMC meets in Washington, generally eight times a year. Just before the 9:00 a.m. start, Committee members gather around an immense oval table. The first presentation comes from the manager of the System Open Market Account at the Federal Reserve Bank of New York, who covers developments in domestic and international financial markets, as well as open market operations, since the last FOMC meeting.

Next, we turn our attention to the domestic and international economic projections. These projections are developed by the economists at the Federal Reserve's Board of Governors and are contained in a document known as the Green Book. The projections are reviewed with the Committee, whose members use this time on the agenda to raise questions about the projections and discuss issues associated with them.

The meeting then shifts to what we call a "go-round," when Committee members give their views on the economic outlook. The Bank presidents usually go first. In addition to commenting on the national outlook, we present information from our regions. Later, I'll explain the nature of this information and how we collect it.

After each member has spoken, it is time to consider policy options, which are outlined for the Committee members in advance, in a document called the Blue Book. The director of the Monetary Affairs Division at the Board of Governors lays out the policy options for the Committee. Then it is time for a second go-round, with members stating their views on which policy option should be adopted. This time, Chairman Alan Greenspan goes first.

If it is obvious that members generally agree, this go-round is often fairly brief; otherwise, a more in-depth discussion takes place. When the go-round wraps up, it is time to vote. The Committee strives to reach consensus on the policy decision and, more often than not, a unanimous vote results.

Each meeting concludes with a decision—or policy directive—designed to achieve the objectives I mentioned earlier, price stability and sustainable economic growth. The primary tool to execute the policy directive is targeting the federal funds rate through open market operations. By this I mean that the Federal Reserve buys or sells government securities on the open market. These operations enable us to affect the liquidity of the banking system, thereby enabling us to achieve our target for the federal funds rate—the interest rate that banks charge each other for funds on an overnight basis.

The Committee's decision is publicly announced at around 2:15 that afternoon. By then, the meeting has ended and it is time for me to return to Cleveland and begin preparing for the next FOMC meeting.

That's the process in a nutshell. My brief description might sound quite cut and dried—but I'll tell you, even though I've been part of the Federal Reserve System for more than 20 years, my first year as president has left me with a deep appreciation for the complexity of the task of policymaking.

This brings me to the second area I'd like to cover this evening. The forces driving the economy at any point in time are complex—which

makes formulating the appropriate policy a real challenge. This is especially true in times like the present. We are in the third year of an economic recovery, but the lack of employment growth has made this a very unusual recovery. At this stage of recovery from the 2001 recession, many economists expected much stronger employment growth than we have seen to date.

Ordinarily, at this stage of a business cycle, the level of employment returns to—or exceeds—its level prior to the onset of the last recession. Unfortunately, employment growth in this phase of the current cycle is the slowest in 50 years, a situation that remains something of a puzzle.

Businesses are adjusting to rapid technological advances and rising global competition. Changing trade patterns are not only affecting the manufacturing sector, as has been the case for decades; they are also having an impact on the service sector. We've all read press accounts about companies moving their software development, call centers, and back-office operations offshore.

Productivity growth during this recovery has been high compared with other postwar recoveries—indeed, productivity growth has not stayed this strong this long into a recovery in over 30 years. I view this as a favorable development, since rapid productivity growth is usually followed by growth in wages and employment. However, the pick-up in wages and employment might lag the productivity spurt in the short run.

Businesses often require some time to restructure their operations to take advantage of new technologies. In the process, we may find that there is a mismatch between the skills required by sectors of the economy that are growing and the skills of our current labor force. The very slow growth in employment that we are seeing could be indicative of this type of restructuring, even while other indicators of economic activity appear satisfactory.

### ***How can we make sense of these developments as we formulate policy?***

Most economists rely on a concept known as the output gap. Output gaps represent a divergence between what we actually produce in our economy and what we estimate we could produce if all of our labor and capital resources were fully utilized. We call what we actually produce GDP, and the estimate of what we could produce potential GDP.

Many economists theorize that disinflationary, or even deflationary, pressures can arise if GDP is too far below its potential. Inflationary pressures can loom if GDP is too far above its potential.

Application of the output gap concept is complicated because the potential of the economy is not something we can directly observe. Weak labor markets might mean that there is deficient spending in the economy and the economy is performing below its potential. However, a weak labor market might also reflect a fundamental restructuring of the economy that, for a time, somewhat lowers potential output.

It is important to be mindful of the possibility that restructuring can alter the historical relationships among the variables policymakers typically look at. Uncertainty about whether—and how—the economy might be changing inevitably leads policymakers to look for supplemental indicators to help us understand how to best depict the economic environment.

Financial markets are another important source of information. Just

as economists have found the concept of potential output to be a useful guide to policy, they have found another concept, the natural rate of interest, to be a helpful policy guidepost. You can think of the natural rate of interest as the rate of return to capital that is consistent with an economy growing at its potential.

When the federal funds rate lies below the natural rate, policy is described variously as stimulative or accommodative. Conversely, when the funds rate lies above the natural rate, policy is commonly described as restrictive or tight.

As is the case with potential output, the natural rate of interest cannot be directly observed; what is just as problematic, the natural rate can fluctuate as part of the economic restructuring process.

When you hear people say that policymaking is both art and science, you can now see why: Policymakers must exercise considerable judgement when interpreting the information we receive.

A significant part of my preparation for FOMC meetings essentially involves sifting through the different explanations that might lie behind the data we observe. The research staff at the Bank and I review a wide variety of data and attempt to match it to a set of plausible underlying explanations. At the FOMC meeting itself, I share this information—and my interpretation of it—with my colleagues.

So how exactly do I go about getting the information that allows me to assess which models of the economy best fit the facts at a given time? That's my third area of focus tonight—the process that precedes and supports my preparations for policy meetings and the role that people all over the region are playing in this important work.

Obviously, I rely on my research staff to sift through the latest economic information and help me think through the issues that the upcoming Committee deliberations are likely to deal with. While this is an essential part of the process, it is insufficient by itself.

Very often, the official data that are available are just not current enough for a forward-looking enterprise like monetary policymaking. So I must rely not only on my team of economists—as talented as they are—to prepare for FOMC meetings, but also on people in the community. Input from people like you provides me with good information on the economy far ahead of when the official statistics are released. But there is a more subtle value as well.

You might think of the statistical data that we get on the economy as being a bit like the readout on your car's dashboard: All of the information is meant to tell you what is happening to your car, but typically does not tell you why it is happening. When the oil light on your car's dashboard begins to flash, you know that the oil is probably low, but you don't know why. Maybe there's a leak, or maybe your mechanic left the cap off. To find out, you have to look under the hood.

In a sense, meeting with people in the region is my way of looking under the economy's hood. The conversations help me understand the why behind the what. That's extremely important in helping me judge the reasonableness of the various explanations being offered for the condition of the national economy and in correctly calibrating policy.

There are a number of vehicles that I rely on to collect these anecdotal accounts from people across the region.

First, members of my Board of Directors brief me on business conditions in their industries and communities every two weeks. As a

matter of fact, providing information on the economy is an important role of Directors in the Federal Reserve System.

I also have two advisory councils made up of banking and business leaders from across the region. I meet with these councils a few times a year and I view them as another important source of information in preparing me for policy meetings.

Finally, I hear from individuals in the region through the Beige Book process. The Beige Book is a Federal Reserve System publication that assembles anecdotal accounts of current economic conditions. These accounts are usually collected through telephone interviews conducted by each of the Reserve Banks.

The aim is to survey a broad cross-section of contacts in the region to form as complete a picture of economic conditions as we are able to produce. These interviews, conducted in advance of all scheduled FOMC meetings, involve a mix of contacts who provide new insights and noteworthy patterns over time.

As you can see, as a Reserve Bank president, I have a lot of formal ways of gathering information. I also have a less formal, but equally important, way to find out what's going on. I talk with people—people just like you. I travel all over the region, meeting with bankers and business people. Every time I am invited to speak at an event like this one, I try to listen just as much as I talk. The comments and feedback I get help to sharpen the focus of the current policy debate.

This evening I have given you some background on the Federal Open Market Committee and its role in formulating monetary policy. I have explained why policymaking is such a challenge in today's economy, and I've given you a glimpse into the process of policymaking—and the vital role people all across our region play in that important work.

For me, being at the table to chart the most prudent and sensible economic course is both a rare experience and a humbling responsibility, and I am extremely proud to be a part of it.

Thank you..

<sup>1</sup>As always, the views expressed in this speech are those of the speaker and do not reflect official positions of the Federal Reserve System.