

HOW TO IMPROVE FED DECISIONS

OR

MUDDLING THROUGH WITH THE FOMC

Paul Volcker's reappointment as Chairman of the Federal Reserve has reassured the financial community, but it may yet cause him to wish he had quit while he was ahead. Having played a key role in bringing inflation down, he now faces the even more difficult job of guiding the economy along a smooth path to non-inflationary growth. The odds are against him.

In his remaining time - he has indicated he may not stay the full four years of his new term.-the most lasting contribution he can make is to improve the Fed's decision process. This, too, will not be easy. He will need to bring along the eleven (actually eighteen) other individuals - and individualists - who participate with him in the Fed's most important policy making body, the Federal Open Market Committee; he will have to work against entrenched habits and traditions; and he must take some risks. Given his performance up to now, the task is doable; its completion would leave a legacy for years to come.

Other Fed Chairmen have made changes as times have demanded and as their unique styles have required. Arthur Burns, in particular, is mostly responsible for the FOMC's current decision process, introducing an element of the seminar (with himself as professor) but also sharpening and quantifying the end product. As Volcker builds on this foundation, he will do well to take advantage of a body of theory and practice of decisionmaking that has now grown to substantial proportions. One may doubt that this accumulated wisdom qualifies for the term "science" sometimes claimed for it - there is too much art in decisionmaking for that - but it does have a reasonably firm basis in observed

behavior of individuals and groups and in empirical evidence from psychological experiments. Decision theorists analyze such phenomena as the risky shift (the idea that participants end with riskier positions after discussion than before), how bargaining works, the influence of peer on peer, deliberations in friendly and hostile environments, the role of preparation, procrastination, bolstering (i.e. rationalization of positions and denial of responsibility) and so on. All are relevant to the FOMC, but two concepts are particularly enlightening. One is muddling through, an idea developed by Charles Lindblom at Yale; the other is group-think, a theory expounded by Irving Janis, also at Yale.

Lindblom backs into muddling through, (his more dignified term is "disjointed incrementalism") by looking first at the ideal, rational-deductive decision process. This approach to decisions involves the common-sense, scientific, steps of defining the problem, canvassing alternatives, weighing benefits and costs, assimilating all possible information, planning implementation, establishing contingency plans, etc. etc. The difficulty with this approach, Lindblom says, is that it never works. The human mind, even with help of computers, can't grasp all contingencies, alternatives and outcomes, nor can it sort out and prioritize the unstable and fluid values underlying alternatives. The ideal process ignores shortness of time and resources and limitations (or a plethora) of information. So the best course is to nibble away - incrementalism, muddling through. Problems are never really "solved"; they don't stand still long enough for that. Small changes are made serially in the direction of improvement or, more frequently, away from disaster. Graham

T. Allison, of Harvard, in dissecting the decision process explaining the Cuban missile crisis in the 1960's, has described government action more precisely. "The best explanation of an organization's behavior at t", he writes, "is t - 1; the best prediction of what will happen at t + 1 is t".

In essence, muddling through is the democratic process, with all its strengths and weaknesses. The "intelligence of democracy," another Lindblom concept, flows from this imperfect, pragmatic, counter-balanced, zig-zagging approach to solving problems. No one charismatic genius with a bank of computers could do nearly as well.

If muddling through is the intelligence of democracy, group-think is the unintelligence of a cabal. Janis bases his concept on analyses of some major debacles in history, including Vietnam, Bay of Pigs, and Korea in the Johnson, Kennedy and Truman administrations. Group-think decisions were those made by a small, tightly-knit, insulated group dedicated to a common purpose. Within the group a strong sense of conformity and us-against-them psychology produced a calloused view of costs and a blindness to alternatives, risks and unfavorable outcomes.

FOMC decisions contain elements of both muddling through and group-think. Volcker would do well to bring in a decision theorist to help find ways to muddle through with greater purpose and precision and to break down the barriers of group-think. The effort should cover the entire scope of FOMC decision-making, but especially five component aspects: the FOMC group, tradition, independence, eclecticism, and secrecy. Because all are closely interrelated they must be treated together. In a very real sense, they are the FOMC.

The group

The dynamics of the FOMC center in the interaction between the Chairman and members. The Chairman clearly plays a leading role and is spokesman, but his power lies primarily in his persuasive talents; he has only one vote in twelve. William Mc Chesney Martin, Chairman in the 1950's and 1960's, led by force of personality. Participants read their prepared remarks in fixed order (clockwise around the table at one meeting, counter-clockwise at the next) before Martin would state the consensus. Observers recall occasions when individual positions varied widely only to have the Chairman remark with a benign smile that "we're not very far apart today" and proceed to state his own version of the "consensus." Arthur Burns, Chairman in the 1970's, encouraged freer discussion, but he also waited until the end to announce his position - usually; on important occasions, he stated the problem and his conclusions at the outset. During discussion he interjected comments freely on all kinds of issues, including, for example, the validity of the latest month's statistic on new orders for durable goods. Volcker more or less follows the Burns pattern.

In general, FOMC discussion has not been dominated, at least in objectionable and overt ways, by the Chairman. Group-think tendencies are not largely traceable to that source.

The composition of the group, however, raises substantial problems. Aside from the Chairman the other members of the FOMC are the six other Governors of the Federal Reserve Board and five Presidents of the regional Federal Reserve Banks. Since the Presidents (except for the President of the New York Bank who

is a permanent member of the FOMC) serve in rotation and since all twelve of them participate in all FOMC meetings, "the group" is really nineteen individuals.

A profile of a typical participant currently looks like this:

- o male
- o white
- o 55 years old
- o 14 years' experience in the Fed (including his experience before becoming Governor or President)
- o about two-fifths of total working life in the Fed
- o professional training in economics
- o holder of a Ph D degree
- o at one time or another a teacher of economics

Concealed by this quick sketch is some variation in characteristics. Ages range from 40 to 69, experience in the Fed from a few months to 30 years. There are two women and one black; a couple members with law or business degrees; some who have worked in banking or business; and a number who have served in Government. Yet characteristics of participants are remarkably uniform.

One distinguishing characteristic of participants is their geographic base. The seven Governors of the Federal Reserve Board, originally from many parts of the United States, have spent considerable years in Washington D.C. - fourteen on average. They have had long exposure to the political atmosphere dominating the capital. The twelve Presidents of Reserve Banks, on the other hand, come to the meeting with exposure to widely differing economies, from booming Texas to depressed Ohio. The influence of these varied environments is difficult to discern in any consistent pattern of voting, but is frequently apparent in discussion.

What changes might be made? Unfortunately, immediate opportunities for broadening the group are limited. Assuming the present Governors remain for their full terms and the Presidents serve until mandatory retirement, the typical member has about ten years to go. Yet five of the group - Governors Nancy Teeters, Charles Partee and Henry Wallich and Presidents Anthony Solomon of New York and John Balles of San Francisco either reach the end of their terms or retirement age within five years. In addition, William Ford has resigned as President of the Atlanta Bank. All are economists.* Variety in the FOMC would be served if the replacements of some of them were individuals with broad and practical experience in finance, business or government. A Ph D in economics is helpful but not necessary for useful service on the FOMC. Prior experience in the Fed is also an asset, but to offset tendencies toward inbreeding it would be refreshing to have the new members come in from the outside. Even within the present composition of the group, opportunities should be sought to increase the role of Presidents of the Reserve Banks, particularly those not currently voting. Differences in their view points emanating from varied geography and staff advice could inject an important element of variety.

A case in point is preparation for the meetings. The common denominator is a set of analyses of economic and financial conditions and prospects prepared and presented by the Washington

* This is somewhat of an oversimplification. They have also worked for various periods and in various capacities in business, banking, government and academia. But they all share a strong background in economics.

staff in the Greenbook. Quantity is voluminous and quality is impressive, but it would help to broaden discussion by having other material and viewpoints presented by Reserve Bank Presidents or outside economists.

One result might be more spirited controversy. As things are, discussion is restrained, lengthy, and technical. Because the FOMC meets so frequently there is often not much new to discuss, and because participants have met together so many times they seldom are surprised by what their colleagues say. A participant once was heard to observe: "Everybody's position is completely predictable, including mine."

One of the penalties of incrementalism, in short, is a certain sameness. But it needn't be so. It is entirely possible to vary the cast of characters by asking a member (again, perhaps, a non-voting President) to serve as devil's advocate. Invited guests could make special presentations. Meetings could be made less frequent, routine decisions handled with more dispatch, and special sessions held to debate broader and less immediate concerns.

More variety in discussion would, of course, make it more difficult for the Chairman to bring it all into focus for a policy decision. The vehicle for this now is the directive to the manager of the open market account, the person who supervises activities in supplying or reducing the volume of reserves in the open market. It is in specifying the directive that the Chairman's leadership comes into full play, for in corralling the largest possible majority he engages in a subtle bargaining game with respect to guidelines for money growth and

money-market interest rates.* Discussion can become drawn out and tedious, centering on fairly fine differences of a few basis points in money rates or a few percentage points in money growth. Chairman Burns with good reason sometimes deplored the "narcissistic" proclivities of some participants, implying that such fine differences were a matter of personal vanity and were more than swamped by margins of ignorance in the art of monetary policy.

In the end, votes focus on this directive, non-voting Presidents more or less retiring to the sidelines. The Chairman may find it impossible to avoid some dissents because a move in a direction to mollify one participant will alienate another. Dissents are not infrequent, but members of the FOMC place high value on consensus, in periods of pressure from the outside will band together to support the Chairman, and usually are restrained in public statements about their dissenting views.

Incrementalism means that changes usually are small and opportunities for correction come frequently. The large size of the group helps to assure that a point missed by one member is caught by another. Because policy is made by consensus it moves slowly. Rarely does it make sharp turns in direction, working like a moving average in statistics. A lone dissenting member gradually gains allies in succeeding meetings, a minority becomes a majority

* In one meeting a member, trying to help Chairman Burns bridge an impasse, offered: "Mr. Chairman, if you do so and so I believe you would buy a couple of votes." Burns bridled and replied, "I'm not in the business of 'buying' votes". He was, of course, doing just that in almost every meeting.

and policy changes. It is a gradual, smooth, careful, responsible, and often uninspired process - muddling through.

More attention to the longer run could provide direction to incrementalism. For a considerable time the Fed was urged to specify annual targets for money growth and finally complied only after Congressional legislation. Now the Fed is under pressure to target its objectives for major variables like economic growth, prices and unemployment. Although it's understandable that the FOMC would resist being pinned down, the exercise would help further to focus short-run policy actions. There seems little danger that the FOMC will be carried away by long-run goals at the expense of short-run flexibility.

As for group-think, tendencies in that direction can be offset by changing the composition of the group as opportunities arise and opening up possibilities for varied viewpoints to be expressed. Janis makes much of the intolerance of dissent in group-think situations. This element is not present in the extreme in FOMC deliberations, and Volcker, unlike Burns, who could wear the group down in pursuit of unanimity, seems content to live with a number of dissenting votes. Yet, among the group there is a certain feeling of fraternity, a certain esprit that comes from sharing a common purpose as well as long tradition, and this characteristic does have group-think implications.

Tradition

The FOMC can't do much very drastic about tradition even if it might want to, but it should be aware of the influence tradition exerts so that useful elements can be reinforced and harmful elements dampened. A key to FOMC tradition is that its members consider themselves central bankers, part of a centuries-old, honorable and elite profession. Writing over

a century ago, Walter Bagehot, the English student of central banking, concluded that "money will not manage itself." The idea that, left to its own devices the economy would deteriorate into inflationary chaos gives FOMC members not only a strong sense of public dedication but must, subconsciously at least, impart a feeling of power and superiority, perhaps mixed with a twinge of paranoia. Marriner Eccles, Chairman in the 1930's and 1940's, reflected some of this when he described the Fed's duty as "leaning against the wind." William McChesney Martin, Chairman in the 1950's and 1960's likened the task to that of the chaperone, forever removing the punch bowl just as the party's getting good.

One must have strength of character to lean against winds and remove punch bowls. One must know that the wind is blowing the wrong way and when more punch is bad for the health. Only a wise parent can do for us what is good for us. To take the unpopular action invites persecution and through persecution comes strength.

There is danger in being carried away by this kind of psychoanalysis, but it sheds some light on a number of things. It helps to explain, for example, the Fed's dogged insistence on independence, about which more in a moment. It illuminates the relationship of long and short run, already referred to. FOMC members believe their actions are a necessary balance wheel in an erratic and unstable environment pushed off center by politicians, unions and others driven by short-run expediency. Only an independent Fed, they believe, can look over and beyond the immediate. Actually, as we've seen, FOMC decisions are almost

completely incremental and short-run. This contrast provides further reason for the FOMC to focus policy more on the long-run; it needs to put its practice where its tradition is.

Most important, tradition strongly influences the value systems of FOMC members. It causes them to be essentially conservative, not necessarily in the usual sense, but in the sense that, like their brother central bankers in centuries past, they dedicate themselves to conserving the value of the currency; fighting inflation is in the blood. Some participants vote consistently for more expansive or less restrictive policies than others, but all share the basic tradition. It is taken for granted, to the extent that members never discuss in depth their underlying economic philosophy and values.

A case in point is a speech which Paul Volcker made not long ago at a human relations award dinner in Los Angeles. He joked at the outset that when he mentioned to an associate the challenge of talking about humanitarianism and central banking, the response was that it would be a pretty short speech. Not so, said the Chairman, launching into an argument why "discipline" is necessary for human welfare (mercifully forbearing reference to free lunches). It was a fine speech, made eminently good sense, and articulated effectively the views of all his colleagues. The point is not that these values are right or wrong, but that they are never exposed to debate.

The FOMC would do well to spend some time in introspection. Making policy incrementally does not require this. Lindblom argues, in fact, that settling on a value system is not only impossible but gets in the way. Values are more likely to

flow from action than the other way around. It may not be too much to ask of the people who have so much power over the rest of us, however, that they do some weighing, measuring and arguing, about, say, the human costs of inflation as opposed to unemployment, the pain of recessions in the short run against the benefits of growth in the longer run. Who knows, their values might even change. Certainly, the "discipline" the Fed is willing to impose today is a great deal less harsh than that it inflicted in the 1920's and 1930's. Values and tradition, it seems, can also move incrementally.

Independence

The Fed mounts the ramparts when any outside force threatens its independence, so it's hardly likely to take the initiative in tampering with it. Yet the independence issue has such a strong influence on policy making that it should be explored with some openness of mind. This is difficult for members of the FOMC to do for each of them has absorbed and expounded the gospel: independence is within government, not from government; the Fed is responsible to Congress, not the President; insulation from narrow partisan politics is essential for sound monetary policy. Each member takes umbrage whenever it is said policy is slanted to influence an election. Independence is a matter of personal integrity. This feeling of rectitude helps to explain such things as the indignation of Arthur Burns and his colleagues with a magazine article alleging that he interrupted an FOMC meeting to get instructions from the White House. It just isn't done.

In two decades of observing and participating in FOMC deliberations I never have witnessed a decision deliberately slanted for political purposes. On numerous occasions, timing of a decision has been influenced by a desire to avoid the impression of political motivation; during election campaigns, for example, Fed officials try to lie as low as possible. Occasionally a Reserve Bank President may feel that a rejection by the Governors of a recommended discount rate for his bank reflects undue sensitivity to political conditions in Washington; the Governors, in turn, may regard the Reserve Bank President as naive about prevailing realities. This is the stuff of which independence usually is made - small shadings of action rather than cataclysmic confrontations.

The psychological impact on policymakers of the independence issue is complex: a Caesar's-wife approach to political involvement; a suspicion of entrapment in cooperative governmental programs; stubbornness in safeguarding freedom of maneuver; soul-searching in distinguishing between fundamental desires of the electorate and short-run political gyrations; and satisfaction from the frequent exclamation, "With all those politicians in Washington, thank God for the Federal Reserve!"

Given the deep and complex feelings it arouses, therefore, independence is not something to tinker with; caution is advised. With respect to the Fed's relations with Congress no change is required. The Fed is responsible to Congress and the Chairman seems to be testifying before some committee or other almost daily. He frequently is staving off attempts to intervene directly in the Fed's business and rightly insists that the

FOMC be given sufficient leeway to do its job. Like any good boss, Congress should lay down the general guidelines, delegate responsibility to carry them out, and then assess performance.

With respect to the Executive Branch, it seems possible to explore closer relations between the FOMC and certain administration officials. The Chairman, of course, sees Treasury officials regularly, other officials frequently, and the President sometimes. It would be helpful to invite the Treasury Secretary or Under secretary to an FOMC meeting from time to time for an exchange of views. The same might be done with the Chairman of the Council of Economic Advisers. The FOMC is not likely to be tainted permanently.

Ultimately, independence rests on good performance and good performance is facilitated by good decision-making. The fact that the Fed has retained most of its independence and is supported in that posture by most of the nation's citizens speaks well for past decisionmaking. Preservation of independence can be helped by improving the decision process as time goes on.

Eclecticism

If independence is sacred, and untouchable, eclecticism is nearly so. An eclectic view of how monetary policy works makes for flexibility, and flexibility is an integral part of muddling through. Lindblom argues that theory is not necessary for incremental decisionmaking, and, like values, can actually get in the way. Members of the FOMC would be the last to say they have no theory of how policy works, but each of them has his own theory and the amalgam of these shifts over time.

Historically, the Fed always has resisted pressures to focus on a single objective or guide to policy. In the 1920's, long hearings in Congressional committee on ways to stabilize prices found the Fed arguing the need to look at many aspects of the economy. After the Great Depression, many efforts to have the Fed focus solely on full employment and, more recently, Congressional pressure to target desired real interest rates met the same response. Eclecticism has become part of tradition.

Eclecticism and independence go hand in hand. The Fed resists being tied down to a theory, goal or operating procedure partly because it can thereby act more independently. But eclecticism also bespeaks a good deal of humility in approaching the art of monetary policy. FOMC members see the economy as a most complex and ever-changing mechanism which, despite advances in economics over the years, is only dimly understood, let alone controlled. The Fed entered the age of econometrics long since, but probably no one on the FOMC has enough faith in models to rely on them heavily. A distrust of forecasting models is particularly critical given the fact that monetary policy exerts its effects with such long and uncertain lags. So members of the FOMC prefer to look at everything, sift it through their judgments, and then decide, but decide subject to the arrival of new information from all sources at any time.

Many critics are unhappy with this way of conducting monetary policy. Most of them have some particular thing they would like the Fed to concentrate on: unemployment, prices, interest rates, the money supply. More thoughtful observers fault eclecticism on grounds that the Fed can accomplish only one thing at a time;

if it concentrates on keeping interest rates stable, for example, it can't control the money supply. The Fed's response always has been that it will use its best judgment under prevailing circumstances in balancing multiple goals and guides and that lack of perfection in reaching all of them is preferable to tying itself down to any one of them.

This answer satisfies nobody, but it's the right one. Knowledge is so incomplete, conditions so changeable that this kind of eclecticism is the most practical and workable way to live in a muddling-through world. The FOMC can, however, take action on two fronts, one specific and the other general, to make the eclectic approach more effective. Specifically, the FOMC can exploit maximum possibilities of the Bluebook. The Bluebook is a vehicle of eclectic philosophy, an ingenious document that serves most effectively to focus decisions and shorten debate. FOMC staff developed it some years ago to bridge a gap between members who tended to concentrate on money growth as the important guide to policy and members who thought interest rates most important. The Bluebook presents combinations of money growth and money rates likely in the period immediately ahead assuming various conditions. Monetarist and Keynesian alike can choose from this smorgasbord without engaging in time-consuming theological argument. The Bluebook, has, however, tended at times to exclude possibilities that should be considered. Usually, it presents three alternative combinations of money growth and interest rates: those with no change from current policy, those with an easier policy, and those with a more restrictive policy. The Bluebook is a successful and handy

tool of eclecticism, but breaking out of the standard format from time to time and presenting a larger choice of possibilities could prevent it from becoming confining.

More generally, the FOMC should exercise self-discipline in using eclecticism as a copout. Persistent research into aspects of how monetary policy works - exploring such phenomena as relationships between money rates and money growth, between both of them and the economy, and the efficacy of various measures of money - is essential. "The answer" will never be forthcoming, and so the FOMC will continue an eclectic approach; but the more it knows, the better it can muddle-through less haphazardly and aimlessly. Self-discipline can help the FOMC remain accountable. Eclecticism offers too many temptations to get off the hook; if M1 is exceeding the targeted growth path, for example, M2 can then be made the significant target. In the nature of things, although the FOMC possesses great power, its power is ambiguous, and where there is ambiguous power there is ambiguous responsibility. It is always possible to say that monetary policy didn't work as intended because Government ran a big deficit or OPEC jacked up oil prices. Usually this is true, but there are enough external forces at work to excuse monetary policy without the FOMC adding internal fudging through its eclectic approach.

Secrecy

Possibilities for making immediate and substantial changes in the FOMC group, its tradition, independence and eclectic philosophy may be limited, but steps can be taken right away to reduce the secrecy surrounding the FOMC. This will not be easy for the FOMC to do partly because secrecy serves as a cement that helps bind "the group" together. One of the perks for serving

on the FOMC (what at salary-review time has been called "the public-service discount") is the psychic income derived from helping to formulate monetary policy. This satisfaction is enhanced by the secrecy enveloping FOMC deliberations; at least for a time we know something that all of you out there don't.*

Kenneth Boulding, the economist, wrote a paper in the late 1960's on "The Legitimacy of Central Banks." With that touch of whimsy that often rings so true, Boulding listed among the ingredients of legitimacy what he called an element of mystery. "Whether", he wrote, "the central banks should try to enlighten the public and to dispel the mystery is a nice point. It may well be that their own legitimacy is best fostered by preserving a certain air of charismatic obscurity about their operations. Their officers might even take to wearing gowns and robes and their public pronouncements might be couched in even more mysterious and impressive language than they now use."

It's all part of central banking tradition. Central banks by and large have preferred to let their actions speak for themselves rather than be explained. In recent years, sunshine legislation has opened up some Federal Reserve deliberations, but FOMC meetings are exempt. Secrecy enhances independence of action and makes it easier to pursue an eclectic course; fewer awkward questions are likely to be asked.

* In October 1979, I received a call from the Secretary of the FOMC who was arranging what turned out to be the meeting in which policy procedures were radically changed. I was not to tell my secretary or my policy advisor of the meeting and was to buy my own train ticket. Secrecy can add a touch of spice.

The official rationale for secrecy, of course, is none of the above. It is based mainly on the idea that secrecy makes for more effective policy. For one thing, participants feel freer in discussion. For another, it is more feasible to experiment; probing action can be taken in the market and reversed if necessary without it becoming a big deal. Both reasons make much sense, but a third is more controversial. It is that open information can disturb the market and give unfair advantage to some market participants. Critics counter with a general principle of markets: the better the information the better they work. They contend that by withholding information the FOMC hinders implementation of its policy. At any rate, although the issue is still open, FOMC meetings are still closed. Results of the deliberations are released much sooner (about a month afterward) than they used to be, but that has evolved only under a good deal of pressure and criticism.

It is time to lessen the degree of secrecy. As Janis points out, most errors in group-think situations come from lack of exposure of the group to ideas from the outside and exposure of the group's deliberations to the outside. Some of the suggestions made above such as bringing others occasionally into FOMC meetings would help to combat this. The time has also come to announce results of each FOMC meeting immediately. Steps in recent years to shorten the release time has not had ill effects, and market participants have become so sophisticated in monitoring open market activities that they are unlikely to be greatly upset by word from the horse's mouth. It is true that the FOMC may give up some element of flexibility, but the greater knowledge and certainty from immediate disclosure would be worth it. Further

inroads on secrecy are possible, but the time is not yet.

Conclusions

The way the FOMC makes its decisions is not bad, but it could be better. A better decision process is likely to (although not guaranteed to) produce better decisions. Those decisions would encompass a wider variety of viewpoints. They would look more toward the longer run, leaving shorter run problems to the market system to take care of. They would be more promptly and thoroughly explained to the public. And they would reflect a more thorough consideration of the human and philosophical values underlying them.

Paul Volcker understands the FOMC, its cast of characters, its tradition and philosophy, and its methods. He is accustomed to incremental change, although he also has made a few sharp zigs and zags during his tenure. The changes suggested here may strike the layman as mild and inoffensive, but together they constitute a departure from current practice that would be hard for some FOMC members to accept. Whether they are adopted in detail is not important; their major thrust is toward a more open and innovative attitude in decisionmaking. In various situations Volcker has indicated a capability of thinking the unthinkable and acting thereon. He has accomplished a great deal of what he set out to do in bringing down inflation, for which we are all grateful. Before he leaves the public scene for perhaps more lucrative pursuits, bringing new life to the FOMC could pay even bigger dividends for us all.