From Professor to Policymaker: Emerging from the Shadow

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Olin School of Business
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I appreciate comments provided by my colleagues, especially Robert Rasche, Director of Research, at the Federal Reserve Bank of St. Louis. I take full responsibility for errors. The views expressed are mine and do not necessarily reflect official positions of the Federal Reserve System.

Since coming to the St. Louis Fed four and a half years ago, a number of people have asked me about how that move happened and how my new career direction has worked out. In thinking about a speech topic for today, it struck me that reflecting on my transition from professor to policymaker might fit especially well in the context of the Executive MBA program of the Olin School. I'm certainly not the only one to have made a right-angle change in career direction, and some of you may already have had a similar experience.

Although I'll not have much to say in my prepared remarks about current monetary policy, I would not be surprised if you ask me about this subject when I finish speaking. So, I will offer the standard Federal Reserve disclaimer, that I'm speaking for myself and that my views do not necessarily represent official Federal Reserve positions.

What I want to do is talk a bit about how I got to St. Louis, how my years as a university professor are relevant to what I do now, and the intellectual connections between my life as professor and my life as policymaker. I particularly want to discuss one specific aspect of policymaking: the important role of clear communication with the markets and general public.

The Federal Reserve is an unusual organization in a number of respects. One peculiarity is that I can take positions that are not 100 percent aligned with those of the Fed Chairman. During the late 1960s and early 1970s, St. Louis Fed President Darryl Francis was in pretty open rebellion, actively and publicly opposing policy positions taken by the two Fed Chairman who served while Francis was president. More generally, members of the Federal Open Market Committee can, and on occasion do, publicly dissent from the majority position, which has always been defined by the position of the Fed Chairman. I hasten to add that I feel very fortunate that I am serving under a Fed Chairman I have known and respected since the early 1970s, and with whom any differences are the typical professional disagreements over details and not over fundamentals.

Still, can you imagine an officer of a private-sector company publicly dissenting from a decision taken by the Chairman of the board? Standard practice is to argue your case internally, but definitely not externally, and then to fall in line with whatever decision the CEO makes. In fact, the Federal Reserve is not fundamentally different in this respect. At the end of the day, there can be only one monetary policy; although I may dissent publicly, and believe I have an obligation to dissent if I feel strongly enough, I also have the responsibility to support the monetary policy decisions of the FOMC.

One lesson I draw from these observations is that I have been able to make this career transition successfully—at least from my perspective—

because I knew the Federal Reserve quite well before assuming my current position. That knowledge stemmed from my employment on the staff of the Board of Governors for four years in the early 1970s; a year on the staff of, and several years consulting for, the Boston Fed; and my research on monetary policy issues as a university professor. Moreover, and this is where the "shadow" reference in my title comes from, I was a member of the Shadow Open Market Committee from 1985 to the time I came to St. Louis in 1998. The SOMC is a group of academic and business economists that meets twice a year to discuss macroeconomic policy issues and to present their conclusions to the press. Consequently, through my years of research, teaching, and my involvement with the SOMC and a number of other professional activities, I was quite familiar with monetary policy issues and their history. If you are going to make a career change, you are well advised to know a lot about the organization you are about to join and about the issues you are about to face.

Even so, I had no experience as the CEO of an organization as large as the St. Louis Fed, which has about 1,300 employees. Two brief stints as economics department chairman at Brown University did little to prepare me to lead the Bank. So, I had a lot to learn when I arrived here.

Another peculiarity of a Federal Reserve Bank is that there is no real understudy position to prepare a candidate to be Bank president. As you know, there are 12 Reserve Banks; some of the presidents have extensive managerial experience, either in the Federal Reserve System or the private sector, and others have an extensive monetary policy background, as I did. But no one comes into the job with the full range of experience across all the different responsibilities of a Reserve Bank president. I was fortunate to inherit a strong senior staff to run the operating side of the Bank and that has permitted me to concentrate on my comparative advantage, which is monetary policy. Nevertheless, during my years in St. Louis, I've learned a lot about all the various responsibilities of the Bank and have become increasingly involved in all aspects of the Bank's operations. I've also taken a growing role in System-wide activities affecting all the Reserve Banks. These totally new areas for me have been challenging and very rewarding personally as I've learned the ropes and have been able to make some contributions beyond the subject matter I knew pretty well when I arrived.

When my predecessor informed the St. Louis board of directors of his intention to resign, the board began the search process for a new president. One consideration was that the board wanted, if possible, to find a monetary policy expert whose views were consistent with the policy tradition of the St. Louis Fed. That tradition began in the 1950s, when Homer Jones became research director. Jones brought the University of Chicago school of monetary economics to the Bank, and those views later became the focus of intense policy debate. Within the Federal Reserve, Darryl Francis led the Chicago school side of the argument.

MY PROFESSORIAL LIFE

My professional training in economics was at the University of Chicago in the early 1960s. At that time, after roughly 30 years of neglect, the subject areas of monetary economics and monetary policy became highly controversial. The dominant professional paradigm that emerged from the Great Depression of the 1930s was based on the work of John Maynard Keynes in his General Theory and the work of economists who followed Keynes and further developed his ideas.

One of those ideas was that the federal government could, and should, stabilize short-run fluctuations in economic activity through the active application of fiscal policy—timely changes in government spending and taxes. Government was expected to moderate, and if you were an optimist, eliminate the business cycle. In the United States, the federal government became committed to such a policy objective by the Employment Act of 1946.

A second central Keynesian idea was that monetary policy was irrelevant or nearly so.

Indeed, from 1942 until the Federal Reserve–Treasury Accord in 1951, the Fed was committed to a policy of pegging nominal interest rates at low levels to minimize the interest costs of the large Federal debt accumulated during World War II. In this regime, the Fed was nothing more than a price controller. After 1951, the Fed was relieved of its narrow mandate, but the principal objective of monetary policy—to keep nominal interest rates low and stable—remained. The Fed's role in, or responsibility for, inflation was not on the radar screen in most policy discussions of the late 1950s and early 1960s.

So, I came to graduate study at Chicago at a time when Chicago economists, especially Milton Friedman, were conducting a frontal assault on what was then mainstream macroeconomics—the received Keynesian wisdom. Friedman was involved in a number of research projects, but perhaps the most important was his work, with co-author Anna J. Schwartz, on *A Monetary History of the United States 1867-1960*.[1] This monumental study was published in 1963. The book covered a lot of ground, but perhaps the single most important topic concerned the proposition that monetary policy mistakes turned what might have been a minor recession into the Great Depression. Given the prevailing Keynesian wisdom, those were indeed fighting words.

As a graduate student, I studied papers just published and papers in prepublication form presented in research workshops, especially Friedman's Money Workshop. Along with other Chicago graduate students, I was an inside observer of the frontiers of the monetary economics debate. In 1976, Friedman was awarded the Nobel Prize in Economics, in part for his work in monetary history and theory. It is exciting to me even today to look back on my Chicago years and realize that I was there at such an important time.

Although I took lots of economics courses and was a member of the Money Workshop, my home base at Chicago was actually the graduate school of business and I received my Ph.D. from that school. Pathbreaking work at Chicago was not confined to the economics department. There was exciting research proceeding at the business school as well—what later came to be called the efficient markets theory of financial markets. This work fit in naturally with the broader Chicago school tradition of respect for competitive markets and distrust of government intervention. Such intervention was based on the incorrect view that markets are often, or even typically, inefficient and irrational. A growing body of empirical research, much of it from Chicago, demonstrated that markets were not the irrational casinos that so many thought they were. One of my thesis advisors was Merton Miller, who won the Nobel Prize in Economics in 1990 for his work in finance.

These themes from my graduate school days, of the importance of monetary policy and respect for the efficiency of markets, motivated much of my research and teaching during my years in academia.

MY POLICYMAKER LIFE

By the time I arrived at the St. Louis Fed in 1998, the policy environment was remarkably different from what it had been in the 1960s and 1970s. At least the way I see it, most of the issues monetary economists fought over in the 1960s had been resolved in favor of positions espoused by Milton Friedman and others who led the development of the Chicago approach to monetary economics.

As academic views changed, so also did the views of central banks. I know of no central banker today who does not subscribe to Friedman's dictum that "sustained inflation is everywhere and always a monetary phenomenon." Central banks today emphasize their responsibility for controlling inflation, and some have made that commitment clear by adopting an explicit inflation target. The Reserve Bank of New Zealand proved to be the pacesetter when, in 1991 in concert with a Labor government, it accepted a single policy

[1] Milton Friedman and Anna J. Schwartz, *A Monetary History of the United States 1867-1960*, (Princeton, N.J.: Princeton University Press, 1963).

responsibility, namely, to hit a prespecified quantitative inflation target. Since then, "inflation targeting" has been specified as the policy objective for a large number of central banks, including the Bank of Canada, the Bank of England, the Swedish RiksBank, and the Central Banks of Chile and Brazil and the Bank of Korea, to name a few.

There is another aspect of changing central bank practice that is much less complete and much less understood—the growth of central bank transparency. Around the world, central bankers have been abandoning their traditional preoccupation with secrecy in favor of a policy environment with transparent objectives and substantial disclosure of the rationale for policy actions. However, there are many unresolved issues in this area, and I'll now take up some of these issues.

TRANSPARENCY AND COMMUNICATION

During the 1970s, a key development was the construction of rational expectations macroeconomic models. Research on efficient markets at Chicago and elsewhere and theoretical insights from economists such as Robert Lucas, who won the Nobel Prize in 1995 for this work, made clear that it was impossible to model the behavior of the private sector without incorporating market expectations about all relevant information, including the course of monetary policy. That meant that a satisfactory outcome for the economy depended not only on the central bank following a sound policy but also on the central bank making clear what the policy was. Otherwise, the economy might suffer the equivalent of a broken play in football, where the line believes the quarterback is calling one play when the backfield is running a different play. If markets believe the central bank is pursuing a different policy than it intends, both the markets and the central bank will probably suffer nasty surprises.

Academic model builders solved this problem by assumption. To solve a rational expectations model, all that was necessary was to write down the equation describing monetary policy and assume that the markets knew what that equation was.

Before coming to St. Louis, I knew, as did other academics, that no such monetary equation, or monetary rule, existed. But I did not understand the full import of this observation. When I got to St. Louis, I immediately began to struggle to explain monetary policy to audiences that had invited me to speak. I had to field questions from the press. Moreover, I became increasingly interested in the fact that the federal funds futures market seemed to be able to predict FOMC policy decisions with great accuracy. Those observations encouraged me to think more systematically about communications issues and to begin to conduct research in this area. With an excellent research staff at the Bank, and finding some interest among our economists in what I was thinking about, we began to uncover some fascinating evidence on how the process works. We devoted the Bank's annual research conference to this subject in 2001. The title of the conference was, "Getting the Markets In Synch with Monetary Policy"; the Bank has published the conference proceedings, which are available in hard copy and on the St. Louis Fed web site.

Let me go beyond my simple analogy of the broken play in football to discuss just how important this topic is. The FOMC, at each meeting, sets a target for the federal funds rate, which is the overnight rate between banks that borrow or lend funds on a temporary basis. All other interest rates are linked to the federal funds rate through market expectations. The rate on a 1-month Treasury bill depends on the market's expectations of the federal funds rate over the next month; the long-term mortgage rate similarly depends on market expectations of the average one-day rate over the life of the mortgage. These expectations depend on the interaction of monetary policy and the economy—all the influences that combine to determine rates of interest. For just one example of why this matter is important, consider the mortgage rate, which is critically important for the strength of the housing industry. That rate does depend in part on expectations of future monetary

policy. Those expectations do not come out of thin air, but are dependent on how the Fed conducts monetary policy and communicates its strategy.

How can the Federal Reserve most effectively and accurately convey to the market its monetary policy expectations and plans? This is not an easy question, for many reasons. Policy interacts with what is going on in the economy, and we must talk about probabilities rather that certainties. Inputs to our thinking include highly abstract economic theory, statistical theory, gut feelings about what is going on, and views about how best to react to contingencies that may arise. How do we convey this knowledge, and our recognition of its incompleteness, to the markets and the general public?

My thinking on these issues is still evolving. To my mind, improving our understanding of how best to communicate with the markets is a pressing monetary policy problem, because increasing the stability of the economy probably depends on making progress on this front. Let me offer a few thoughts, with the understanding that these are reflections subject to development and certainly reflections that should not in any way be considered official Federal Reserve views.

I think it is very important to concentrate first on clear communication of policy decisions and their rationale, and not to attempt to convey the full range of debate in real time. For one thing, internal debate will be stifled if positions and the names of persons holding those positions are released promptly to the press or presented live on C-SPAN. Televising FOMC meetings will not disclose debate, but change it and interfere with the free exchange of ideas. Moreover, would it really help markets to better forecast policy direction if everyone knew all the details of a minority position held by only one FOMC member? If you are interested in this subject, I would urge you to read the published transcripts of past FOMC meetings, which the Fed releases with a five-year lag. These transcripts serve an important function in promoting accountability and providing a record for economic historians; however, even assuming that real-time TV did not change the debate I do not think that such detailed knowledge would help markets to price securities more efficiently.

The issue, I think, is how the FOMC can best explain its policy decisions. The explanation is important at any time, but even more important is the regularity of decisions over time. That regularity defines a predictable policy. Creating that regularity and the market's understanding of it is a crucial aspect of the explanation of each individual policy decision. Policy regularity in turn is what permits the market to predict decisions in advance, based on the fundamentals that drive the decisions. In fact, Robert Rasche, research director at the Bank, and I explored this issue fairly systematically in a paper we published in 2000.[2]

Consider the policy statement released by the FOMC at the conclusion of each meeting. Meeting minutes, speeches, and testimony contain the same principal elements, but obviously at much greater length. The policy statement contains the policy decision and several other elements. One element is information on the Fed's view of the current state of the economy, its likely future direction and risks. Obviously, this information is highly relevant to the justification for the policy decision determining the intended federal funds rate.

A second element is information on the likely or possible future direction of policy. How to deal with this element is a difficult issue. Ordinarily, it seems to me, if the FOMC is certain that it will want to adjust the funds rate at its next meeting, then it would be better advised to simply make the entire adjustment at the meeting in question. It makes no practical difference to the rate on a 10-year Treasury bond whether the federal funds rate is changed by, say, 25 basis points at a particular meeting or at the next meeting in six weeks.

Usually, though, the intended federal funds rate set at a particular meeting reflects the FOMC's best judgment as to the appropriate rate given the information available at the meeting, and judgments about future changes in the rate are

[2] "Perfecting the Market's Knowledge of Monetary Policy," *Journal of Financial Services Research*, *18* (December 2000), pp. 241-54.

probabilistic. We know that information that changes the picture may arise before the next meeting. How can I convey to the market that I think that the probability of a change at the next meeting is 0.5, or 0.2, or whatever? Can the FOMC as a committee, with members holding different assessments of the probabilities, come to a common view and convey a committee decision on this issue? Clearly, I am skeptical that this is a productive avenue of communication. Frankly, when I first came to the Fed in 1998 and the FOMC was using the policy "bias" or "tilt" language in its policy statement, I thought that the language could serve a useful purpose. The more I have reflected on the problem of clear communication of policy intention, the more skeptical I have become that such communication can be helpful.

What I think is quite clear, and more important to explaining the policy process to the markets, is that whatever may be our assessment of probabilities of future action, new information may drive a change in that assessment. The markets should not believe that we will fail to act on new information just because previous information had led us in a different direction.

The problem is to explain what sort of new information drives such reassessments. I wish I could say more than "I know it when I see it." That is not a satisfactory response, but to date I do not know how to formalize this process. If someone did, we could write down a policy rule linking policy actions to observable data. But that is exactly what we cannot do at present.

A third element in the policy statement may involve—and I emphasize "may"—an effort to shape public perceptions of the state of the economy, to encourage a sense of greater optimism, or suggest a need for greater caution.

I emphasize "may" with regard to an effort to shape public psychology because my view is that efforts in this direction that do not accord with the Fed's own view about the situation are unlikely to be successful. If a policy statement exudes optimism, and new data arriving over subsequent weeks then suggest that the optimism was unwarranted, any psychological effect will be short-lived. I followed events pretty closely in the 1970s, and believe that the Fed's efforts, and efforts by several national administrations, to defuse inflationary psychology were not only unsuccessful but also harmful to the government's credibility. We cannot fix an economic problem by talking people out of it; we must instead work to get the fundamentals right. In some cases, there is nothing the government, or the Fed, can do about a problem in the short run except wait patiently for the problem to be resolved by market processes.

If the policy fundamentals are right and we are right in our longer-run assessments of how the economy will perform, then in due time the data will support us and public views will change. It can be painful to go month after month with public psychology seemingly at odds with economic reality, and as I reflect on living through several such periods I know that the apparent disconnect between fundamentals and psychology makes me question my own assessments. My strategy in such situations is to keep searching to see how pieces of evidence fit together, and whether they continue to confirm my beliefs or lead me to change my beliefs. I do the best I can to explain my beliefs, but try not to change public psychology to be more optimistic than I myself feel. That is the point I'm emphasizing—that efforts to change psychology to manufacture a happy outcome are, I think, rarely successful.

One final point. Analysts read between the lines of what I write. I write knowing that analysts read between the lines. Analysts know that I know they are reading between the lines and write accordingly. Given this infinite regress, I actually try to write as plainly and simply and directly as I know how. I try not to write using code words, or words subject to misinterpretation because the usage of a word in economics discourse differs from ordinary English usage. I think the cause of clear communication is served by careful writing and by accumulation of trust over time between writers and readers. I've come to know a handful of journalists who follow my speeches; from my perspective, I believe that my communication through them is effective in the sense that they accurately report what I say and convey the intent of what I am saying in reports that are

necessarily much shorter than my speeches.

I have no doubt that my years of teaching and writing have helped me to communicate effectively in this sense. Thus, although I said at the outset of my remarks today that my career has taken a right-angle turn, in fact, there is far more continuity in what I do now with my professor years than might appear at first glance.

I'll finish by saying that I find my job nonstop fascinating, challenging, and never boring or tiresome. I've been successful in following the advice I always gave to my students—find a job where someone will pay you to do something you really love.