

External Review of the Research Department of the Federal Reserve Bank of Chicago

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We have been asked to review the Research Department of the Federal Reserve Bank of Chicago, in order to evaluate the extent to which the Research Department helps the Chicago Fed achieve its various missions. To conduct this review, we spent two days on site at the Chicago Fed interviewing members and team leaders of all research teams, as well as the President, the First Vice President and Chief Operating Officer, Senior Vice President and Director of Research, and the Vice President with responsibility for FOMC coordination. Prior to our visit, we studied various written materials, including the structure of the research teams, a brief description of the activities of each team, the CVs of all researchers, and samples of the various publications of the Research Department.

Based on the written materials and the information gathered during our site visit, we have concluded that the Research Department is thriving and contributing importantly to the mission of the Chicago Fed. The Research Department provides outstanding support to the President. The primary component of this support consists of briefing the President for FOMC meetings eight times each year. In addition to these regularly scheduled briefings, the Research Department produces special reports to address various questions posed by the President about regional and national economic issues, as well as payments and consumer issues. Though the President is the primary client of the Research Department, the Research Department provides effective support to other divisions, including banking regulation and community affairs.

The Chicago Fed is well served by a Research Department performing scholarly research that is published in leading refereed journals, and which extends the scientific frontier. Though some of the duties of the Research Department, such as FOMC briefings, occur on a regular schedule and may appear to be routine, they are not performed in a routine fashion and are most effective when performed by researchers at the frontier. The macroeconomy and financial markets are dynamically evolving entities. In order for the President to be well informed about developments in the macroeconomy and financial markets, and to formulate the best policy advice, it is crucial that briefings be prepared by economists whose deep knowledge of economics and commitment to research give them the capability to analyze new developments and to study newly evolving issues. At the same time, it is important that these frontier researchers are willing to engage the questions confronting current policy. The Research Department excels at combining the dual roles of conducting frontier research and applying this research to practical questions facing policy makers. It is evident that the quality and usefulness of policy advice is enhanced by having a strong group of researchers to support this function. It is also true that the willingness of researchers to devote serious thought and energy to policy questions can help motivate new and interesting areas of research. The Research Department at the Chicago Fed and the President have

recognized and fostered the mutually reinforcing benefits of frontier basic economic research and socially valuable policy advice. The Research Department, under the inspired leadership of the Research Director and the various team leaders, and with the backing of the President, has developed into one of the top Research Departments in the Federal Reserve System. This high standing of the Research Department is recognized both inside the Federal Reserve System, and in the academic community. It is an extremely valuable asset to the Chicago Fed, and it is important to continue to nurture this asset in the coming years.

To insure that the Research Department continues to perform at its current high level, it is imperative to recognize that the ability to maintain the high-caliber talent pool on the research staff and to deploy this talent pool effectively to advance the mission of the Chicago Fed depends on a very critical bargain with the research economists. To attract economists of the high caliber of the current staff, economists must be allowed to devote a large fraction of their time to self-directed research. In exchange for this freedom to spend much of their time researching questions of their own choosing, the researchers need to be prepared to devote serious thought, creativity, imagination, and hard work to address questions posed by their clients at the Chicago Fed. Currently, this bargain is working extremely well. But this is a delicate balance that can only be preserved if all parties continue to honor the bargain. We believe that the current constellation of players recognize this balance and will work to continue it. Over the longer term, the continued strength of the Research Department, and its ability to support its clients at the Chicago Fed, requires that all players—current and future—remain committed to this balance.

We will organize the remainder of our report by reviewing the six research teams, and then we will briefly discuss a few miscellaneous items.

1. Macro Team

One of the primary duties of the research department at any of the 12 regional Federal Reserve Banks is to brief the president for FOMC meetings. Because the issues confronting the FOMC most naturally fall in the area of macroeconomics, it is crucially important to have a strong macroeconomic research team. The Macro Team at the Chicago Fed has been extremely successful over the past several years in assembling an enviable group of well-known researchers who publish their work in the top journals in the economics profession. These economists form a high-energy group and a visitor to the group can easily sense the excitement generated here. We believe that the macro group at the Chicago Fed ranks among the top three macro groups in the Federal Reserve System, and is probably one of the two best. Its excellence is recognized by outsiders and this recognition makes it easy for this group to attract outside scholars to visit the Research Department, either to give seminars or to visit more regularly as consultants.

The Macro Team has successfully capitalized on the Chicago Fed's location midway between Northwestern University and the University of Chicago, which are home to two of the nation's top economics departments (broadly defined to include

economists in the business schools at each university). The Research Department has been very effective in attracting an energetic group of economists from these nearby institutions, as well as from other leading universities in the region, to serve as consultants. In the case of the Macro Team, these consultants visit the Chicago Fed frequently, often three or four times per month over periods of several years. These long-term relationships with the consultants have advanced the Macro Team in three distinct, but complementary, ways. First, the consultants interact productively with the research staff on a regular basis. Part of this interaction is informal, taking the form of discussing mutual interests and contributing to seminar discussions. Some of the interaction is formal, taking the form of co-authoring papers with members of the research staff. Second, because of this productive interaction, the consultant relationships make the Research Department a more attractive place for potential new hires. Third, the consultants have provided an abundant source of contacts for new hires. Many of the members of the Macro Team have had some prior affiliation with the consultants, either as colleagues or as students of the consultants.

The Macro Team now comprises a group of top scholars who have attractive alternative opportunities in academia or elsewhere in the Federal Reserve System. They seem quite happy with the bargain described above, in which they provide thoughtful, serious policy advice and are allowed to devote a large portion of their time to self-directed research. Retaining this group of scholars at the Chicago Fed will require continued attention to make sure that their own research is supported by the Chicago Fed.

2. Applied Micro Team

The Applied Micro Team at the Chicago Fed is larger than its counterparts at other regional Federal Reserve Banks. It is about the same size as the Macro Team, and both of these teams are much larger than the remaining four teams. The Applied Micro Team shares the strengths of the Macro Team that we have discussed. In fact, the boundary between the Macro and Applied Micro teams is rather fuzzy and ill-defined. The boundary seems to exist at least partly for administrative expediency, and importantly, the boundary does not impede productive interaction between the two teams. Indeed, at least two recently hired members of the Applied Micro Team might be primarily identified as macroeconomists (and two of the members of the Macro Team might feel equally at home in the Applied Micro Team). We regard it as a very positive sign that the two teams cooperate so strongly to the point of virtually sharing slots in an effort to bring the best people to the Research Department. The fact that top-notch macroeconomists with attractive alternatives recently accepted positions in the Applied Micro Team is testimony to the high regard in which the Applied Micro Team is held and to the cooperative, synergistic behavior of both teams and their team leaders.

As mentioned earlier, the Applied Micro Team is larger than at other regional Federal Reserve Banks. Part of this extra size, of course, reflects the fact that a couple of team members are essentially macroeconomists. But in addition, the Applied Micro Team has a cadre of specialists in labor economics, which gives the Research Department a valuable expertise in labor markets that is stronger than at other regional Federal

Reserve Banks. Like the Macro Team, the Applied Micro Team briefs the President for FOMC meetings. Members of the Applied Micro Team also succeed in publishing research in top-flight specialty and general economics journals.

One minor difference between the operation of the Macro and Applied Micro teams is in their use of consultants. We have described how the Macro Team has used long-term relationships with consultants to build its team. Consultants to the Micro Team tend to have short-term arrangements with the Chicago Fed, which provides the opportunity for greater rotation of consultants. In discussing the Macro Team, we described advantages of long-term relationships with consultants, but it is important to recognize that whether potential benefits of the long-term relationships are actually realized depends strongly on the personalities of the particular consultants. It is not only a matter of the quality or stature of the consultant that determines whether the long-term relationship pays off. Other intangible factors, many of which are idiosyncratic, often determine whether these potential benefits are realized. Thus, we point out that the Applied Micro and Macro teams have taken different approaches with their consultants, but we are not advising that Applied Micro switch from short-term to long-term relationships. Macro was particularly fortunate that the available consultants were inclined to bring their energy and ideas to the Chicago Fed on a sustained basis and to provide a set of contacts for their students. If consultants with these qualities and tendencies are identified by Applied Micro, then Applied Micro might want to cultivate long-term relationships with those particular consultants. And in the event that such an opportunity arises, we would urge the Chicago Fed to provide the funds to foster that relationship. Absent such opportunities, there seems to be no compelling reason for Applied Micro to change its approach to consultants.

3. Smaller Teams

The remaining four teams in the Research Department have much smaller staffs than the Macro and the Applied Micro teams.

3a. Regional and Payments Teams

The two smallest teams—the Regional Team and the Payments Team—each comprise a staff of three research economists in addition to the team leader. These teams both have well-defined missions, which they succeed in achieving. Because of the small size of the teams, there is less opportunity to spread client work among researchers in the group. Occasionally a researcher will spend much more time on client work than is consistent with the bargain described earlier in this report. Some researchers appear content to spend more time on client work. For those who wish to devote substantial time to self-directed research, one hopes that intertemporal smoothing will keep the bargain alive. Specifically, individuals who have devoted unusually large fractions of their time to client work might reasonably expect to enjoy generous allocations of time to pursue self-directed research in the not-too-distant future. This sort of intertemporal smoothing is perhaps well understood by the researchers and the clients, but it is important to keep in mind.

3b. Banking, Financial Markets and Regulation

The Chicago Fed's Banking Team is doing a good job of producing high-quality, policy-relevant research. The Banking Team also organizes the annual Bank Structure Conference. This conference is the pre-eminent one in its field, and has been an enormously successful endeavor for the Chicago Fed, generating both a high degree of external visibility as well as a wide range of useful policy insights.

Building on these accomplishments, we believe that the time is ripe for the Banking Team to broaden its research agenda, and to exploit several potentially attractive opportunities. Given that Chicago is a major center of financial activity, and given the local presence of two world-class business-school finance groups (at Chicago GSB and Northwestern's Kellogg School) it seems to us that the team should aspire to be at the top among regional Federal Reserve Banks not only in banking *per se*, but in financial economics more generally. Moreover, now is the perfect time to entertain such a strategic reorientation of the team, given that there are several unfilled positions.

The Banking Team has experienced a series of departures in recent years, and based on historical staffing levels, currently has three open slots. The team has thus far been unable to fill these slots, which has led to some frustration on the part of team members. It appears that the difficulty in hiring is at least in part due to salary constraints, and the generally higher outside options for researchers in banking and finance. Team members expressed to us the view that their offers have been significantly below market levels for the candidates they have tried to attract recently.

At the same time, some concerns have been expressed about whether the scope of policy advice that the team provides regarding financial-markets issues is as broad and useful as it could be. (Examples of topics of potential policy interest include: the relevance of banking developments for monetary policy transmission; the potential implications of the growth of the credit-default-swap market, etc.) These concerns strike us as being both valid and important.

One option that was suggested would be simply to leave the banking slots unfilled, and to redirect the resources to other areas where the Chicago Fed appears to have a more natural comparative advantage in hiring, such as macroeconomics. However, as described above, we believe that it would be better to take steps to strengthen the Banking Team by broadening its scope. Especially given its location in a major financial center, it is very natural for the Chicago Fed to be an important system player in finance-related issues.

Increased resources for market-competitive salaries are likely to be an essential part of any plan to attract new researchers to the team. But it is important to stress that such resources should not be committed unless there is a fundamental strategic rethinking of the role of the team—both in terms of its research portfolio, as well as what it aspires to contribute to policy analysis and advice. In particular, we believe that the Chicago Fed

should seek to hire outstanding financial economists with a broader research orientation, rather than focusing narrowly on banking experts. In the long run, the goal should be to have a stable of researchers who can address topics in corporate finance, financial markets, derivatives, and other topics, in addition to banking.

This broadening strategy offers a number of advantages. First, it should serve the policy function better, allowing the team to offer advice on a wider range of current and future issues. Second, the talent pool available for recruiting will be substantially deeper. Third, there is the potential for increased synergies with the very strong and dynamic Macro Team: for instance, a finance candidate with a broader research orientation may be attracted by the high quality of the Macro Team.

If outstanding candidates in the broader area of financial economics are identified, at this point we would urge the Chicago Fed to be as aggressive as possible with respect to salary, research time, etc., in order to land them. Again, however, one probably doesn't want to push the salary boundaries for a candidate who is less than stellar simply to fill open slots; this is likely to raise the potential for conflict and bad feeling across the teams.

We can envision various other potential elements of a strategic plan. For example, it might be helpful to invest more in developing long-run relationships with prominent outside researchers in finance; this has been of great value to the Macro Team. One possibility might be to commit to ongoing full or partial funding of a sabbatical for a year-long visitor. Another possibility might be to try to establish additional one-day-a-week consulting relationships with Chicago GSB or Kellogg finance faculty. To the extent that it is difficult to attract senior faculty in finance for such positions, it might make sense to target instead a couple of particularly interesting and energetic junior faculty.

3c. Consumer Issues Research

One innovative change that has had very positive consequences for the Chicago Fed and for the Research Department has been the move of Consumer and Community Affairs (CCA) into the domain of the Research Department. CCA is a broad department containing three groups; Community Affairs, Emerging Issues, and Consumer Issues Research (CIR). Only the latter, CIR, is a research group relying on PhD economists. The mission of CCA is to provide guidance to the community and to the President on topics of community development and fair access to capital and credit. Under the leadership of the long-time head of CCA, the Chicago Fed recognized that tapping into the research expertise of PhD economists would increase the quality of the analysis and thereby better serve the community and the President. We have heard examples at all levels that this objective has clearly been met by the move of CCA into the Research Department. Other regional Fed banks see the value of this organizational change and are moving in this direction as well.

In many ways, the move to incorporate PhD researchers into CCA has been very well implemented. We offer several examples of this. First, a range of issues fall under the domain of community development, and the economists' research has fit this domain well without being directed towards specific goals. Recognizing this breadth, we can see avenues for drawing upon additional researchers outside CCA. Second, the contacts arising from CCA community work can provide creative opportunities for new ideas for research. While the credit access project with Robert Townsend is larger than would be typical, it provides an example of the overlap between the interests of pure research and CCA opportunities. Other projects, on topics like micro credit, would be valuable as well. Third, CIR is developing new products that help provide clear ongoing output for researchers and ideal projects for CIR. An example of this is the inflation index for the working poor.

We think that the mission of the CCA group could be even better achieved and sustained in the long run if further organizational changes are considered. In moving CCA into the Research Department, the number of PhD economists in CCA has been expanded from one to three, who are located in the sub-department of CIR. We see several clear advantages to grouping the CIR economists more closely with other economists in the Research Department. Much as the FOMC preparation process taps into researchers from all teams as needed, CCA would benefit even further by having greater access to more members of the Research Department. One way of doing this is to move CIR into the Applied Micro Team, though there are other possibilities as well. An organizational change of this nature would increase CCA's access to the most research talent in the long run, for two key reasons. One is the greater access to others in the Applied Micro Team or in other teams, as described above. But another important reason for an organizational change is to improve CIR's ability to recruit and retain top researchers in the long run. The Chicago Fed has developed a comparative advantage in hiring top economists, and it has done so in part by recognizing that PhD researchers value flexibility in their work. The CIR group has a current vacancy, and all indications are that it will be difficult to fill. The CIR team is an outlier in the Research Department, because it is combined with non-researchers in the overall CCA group. On the one hand, attaching the CIR group to Community Affairs and Emerging Issues produces very useful synergies between the CIR researchers and non-researchers – the economists work immediately on new topics as they arrive and CCA makes clear the value of their work. The researchers value this link. On the other hand, grouping CIR with the other CCA groups introduces considerable uncertainty for current researchers and future job candidates as to their job duties and time allocation, and as to the nature of the likely promotion process within the Research Department. Moving CIR into a broader research group would lessen the concern that job candidates would have that CIR is a line job and lacks the full benefits, in terms of flexibility and depth, that other researchers have at the Chicago Fed. Thus, by linking CIR more directly with other economists, CCA gains ground in access to talent in recruiting and retention, and in access to existing researchers in the broader Research Department.

Delving more deeply into the day-to-day functioning of the CIR group, a more direct link to a team leader who is a PhD economist has several advantages. In any

organization, employees seek team leaders who are strong advocates for them in making salary and promotion recommendations, and in designing their job duties in a way that enables each employee to thrive. In a Research Department that is run almost entirely by PhD economists, these are very difficult tasks for a team leader who is a non-economist. And yet to attract and retain researchers devoted to CIR topics, the economists working in this area need to feel that their careers are well governed. Thus, CCA as a whole will thrive if team leaders and the Director of Research work cooperatively to find the best mechanism for attracting and retaining economists devoted to the goals of CCA but not constrained by existing CCA structure. That may mean that existing team leaders outside CCA take on more of the responsibilities of implementing the mission of CCA with high quality research.

4. Miscellaneous Issues

We would like to mention three miscellaneous issues. The first issue, career development, is not confined to any particular department. The remaining two issues are simply minor procedural issues that some researchers raised and might be easily addressed.

4a. Career Development

Any organization faces the question of how to provide incentives to employees to advance the mission of the organization. In a hierarchical organization such as research departments at Federal Reserve Banks, strong performance has generally been rewarded by promotion, which includes increase in pay and perks, as well as increased management responsibility. While higher pay and perks are universally attractive, many dedicated researchers are not particularly attracted to the prospect of spending greater amounts of time performing administrative duties and managing people. In order to provide incentives to such people, the rank of Senior Professional is available to researchers. This rank allows an individual to receive a higher salary and many of the privileges of Bank officers, without what some regard as the burden of management responsibilities. Several researchers at the Chicago Fed have been awarded this title, but many other researchers at the Chicago Fed are simply unaware of this particular title. If a major purpose of this title is to provide incentives to productive researchers who are dedicated to a career of research relatively unencumbered by management responsibilities, then it would seem to be more effective if these researchers were made aware of this title.

On the other side of the reward scale is the issue of how to help individuals in research proceed along a career path if their research productivity falls short of expectations. Research departments at Federal Reserve Banks do not have the tool of a tenure decision to force a serious evaluation of research productivity at some point in a researcher's career, and to redirect underperformers outside the institution. We are certainly not recommending any sort of such a decision for the Research Department at the Chicago Fed. Instead we simply want to point out that in the absence of a tenure-type decision, the Chicago Fed needs to explore effective ways in which to deploy individuals

who do not demonstrate a strong taste or talent for producing high-quality research. We do not see evidence that this has become a problem in the Research Department. However, if the Research Department continues to enjoy recruiting success, slots may become scarce. To pre-empt tensions that might arise if slots become tight, and some researchers are under-performing expectations, it would be helpful to have a plan to help those researchers contribute to the mission of the bank in the most effective ways. One possibility would be to ask such people to increase the share of their time devoted to client work within the Chicago Fed, but more creative possibilities need to be explored.

4b. Communication

Some researchers have indicated that there is a lack of clarity of the allocation of research assistant's (RA's) time to various individuals and projects. More specifically, we heard that some researchers are unsure about scheduling of RA time. As a consequence, partly out of a desire not to overuse a public good, they scale back their demands for RA time unnecessarily. This issue is an example of a case in which better communication might improve the allocation of resources. The lack of understanding of the Senior Professional title, discussed above, is another example. We do not sense that there is a pervasive shortfall of communication. These are some items that were mentioned and can be easily addressed.

4c. Selection of Seminar Speakers

The Macro Team uses a voting process to select people to invite to the Research Department to present seminars. The voting scheme has changed recently. Under the previous voting scheme, an individual could express strong interest in a particular speaker and thus be assured of naming one speaker per year. The new scheme does not allow this expression of intensity of interest. This means that people with minority interests might not get to name anyone to the invitation list.

5. Conclusion

The Research Department of the Federal Reserve Bank of Chicago has developed into one of the premier research departments in the Federal Reserve System. The Research Department advances the discipline of economics with its frontier level research, and it advances the mission of the Chicago Fed in formulating and guiding effective, well-grounded macroeconomic and public policy. Having been so successful in building a valuable research department, it is imperative that the Chicago Fed continue to foster and support this department. Our report has identified opportunities for two of the research teams to enhance their contributions to the Chicago Fed and to policy. For all of the research teams, it is critical that the Chicago Fed and the researchers continue to honor the bargain that allows self-directed research to push forward the scientific frontier of economics and allows the President and other clients within the Bank to marshal top-quality economic research and advice in advancing the mission of the Chicago Fed.