

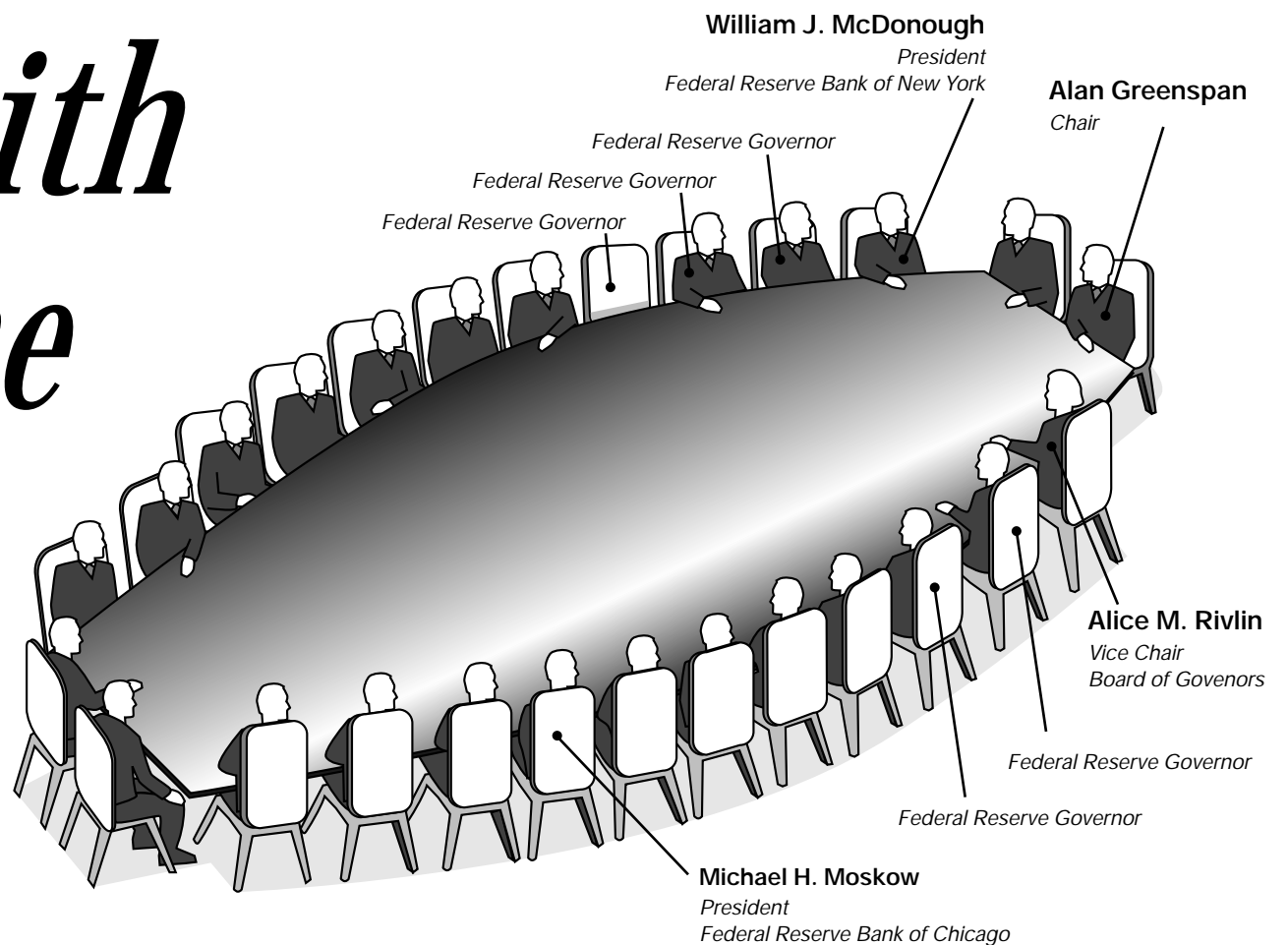
ON RESERVE

A resource for economic educators from the Federal Reserve Bank of Chicago

Number 42, December 1998

Come with Me to the FOMC

PART I



“The importance of money essentially flows from its being a link between the present and the future.” John Maynard Keynes, economist

How many people know what FOMC stands for? The answer may surprise you. As Federal Reserve Governor Laurence Meyer related in a recent speech, a very senior member of the Treasury staff asked him if he knew what “FOMC” stood for. He replied that he thought so, but asked what the Treasury official if he knew what it stood for? The reply was “Fruit Of the Month Club.” This issue of *On Reserve*, contains the first half of an edited version of the speech by Meyer, which provides an inside view of the FOMC, the committee that’s responsible for determining monetary policy. The second half will appear in the next issue of *On Reserve*. Governor Meyer invites you to “Come with Me to the FOMC.”

What is the FOMC?

For our purposes, FOMC stands for the Federal Open Market Committee. The Committee was established in the Banking Act of 1935. It consists of the seven Governors of the Federal Reserve Board and five presidents of the regional Federal Reserve Banks. The FOMC is widely recognized as the primary decision-making body within the Federal Reserve System with respect to monetary policy.

The Federal Reserve Act, passed in 1913, was “virtually devoid of policy prescriptions” and there were, in particular, no guidelines for the conduct of open market operations. The role of the Federal Reserve was viewed as more passive than active. The emphasis was on the provision of currency and reserves to meet seasonal demands and on assisting the banking system to accommodate the needs of commerce and business by allowing reserves, and therefore loans,

to expand during expansions. The amount of reserves limits the amount of loans the banking system, as a whole, can make. When seasonal or cyclical demand for loans was high, banks could bring eligible loans to the Federal Reserve for rediscounting, increasing the aggregate amount of reserves and hence lending capacity for the banking system. This meant that the Federal Reserve would lend banks reserves at a rate set by the Federal Reserve, the discount rate. Therefore the discount rate and the discounting of eligible bank loans were the central tools of the Federal Reserve in the early days.

The impetus for open market operations was the experience in the early 1920s when bank rediscounting had declined to a very low level and the Federal Reserve Banks needed another source of revenue to cover their costs of operation. The Federal Reserve, unlike most other government bodies, does not receive an appropriation from the Congress. Instead, it earns enough from its operations to cover its expenses and returns any surplus to the Treasury. We credit Treasury on a weekly basis. In the absence of revenue from its rediscounting operations, the Reserve Banks began to purchase government securities, as had been allowed in the Federal Reserve Act.

As they came to appreciate the need for coordination of such activities, they established, beginning in 1922, a series of committees to manage and coordinate these operations. The committees, initially consisting of five Federal Reserve Bank Governors (the equivalent today of Federal Reserve Bank Presidents), made recommendations about open market operations, which were then subject to the approval of the Board of Governors. However, even if approved by the Board, the Reserve Banks were not required to carry them out. Very messy and cumbersome,

and very unsatisfactory though, in practice, the Reserve Banks did, in most cases carry out the operations recommended by the committee and approved by the Board.

After a lengthy debate, the Congress decided to establish the FOMC in its present form in 1935. The Reserve Banks were thereby required to carry out the operations as directed by the FOMC. The Committee chose to continue the previous practice of centralizing its operations at the Open Market Desk of the Federal Reserve Bank of New York. The FOMC is a mix of Presidential appointees (the seven Governors) and Reserve Bank presidents who are selected by their respective Boards of Directors subject to approval by the Board. The boards of directors of the Reserve Banks have nine members, six of whom are selected by the member commercial banks in the respective Districts and the remaining three are selected by the Board of Governors. The FOMC is therefore a blend of a national board and regional input of private and public interests. Its composition has been the subject of some controversy from the very time it was created until today. The Congress concluded, at its inception, that, while there should be input by the Reserve Banks, a majority of the Committee should consist of the Board of Governors.

A Typical Meeting

It is 9 a.m. on one of eight days, usually Tuesdays, during the year when the FOMC meets. The Federal Reserve Act mandates that there be at least 4 meetings each year and the number of meetings has varied from 4 to 19 over the years. Since 1981, the FOMC has met 8 times each year. Meetings generally begin at 9 a.m. and continue until about noon to 1 p.m.

1 Twice each year, prior to the Fed's semi-annual Humphrey-Hawkins report and testimony on monetary policy to the Congress, the FOMC meets over a two-day period. For our example, we will focus on the one-morning variety.

Each member of the FOMC appreciates the heavy responsibility the Committee has for the economic well-being of the country and the importance of their personal participation in this process. Serving on the FOMC is, without question, the most important responsibility one could have if one chose economics or finance for a career.

As you enter the Board room, you will undoubtedly be struck by the impressive size of the oval table 27 feet 1/2 inch long and 10 feet 11 inches at its widest point. Members of the Committee and staff are milling around, greeting each other, but generally not talking much shop at this point. Just before 9 a.m. everyone moves to their respective chairs, just as the chairman, Alan Greenspan, walks in to take his place at one end of the table. The Chairman, by the way, enters from a door that connects to his office, one of the perks of being Chairman. Other members have to walk down a long corridor to enter through the main door of the Board room.

To the Chairman's right is the Deputy Secretary of the FOMC. To the right of the deputy secretary is the President of the Federal Reserve Bank of New York, the Vice Chairman of the FOMC and a permanent member of the Committee. The remaining Governors of the Board sit in a pre-established order. Just so they don't get it wrong, their names appear on plaques on the chairs. The Vice Chair of the Board sits to the immediate left of the Chairman. The two most senior Governors, other than the Vice Chair, sit to her left. Then, in order of seniority the remaining three Governors sit across the table, beginning next to the President of the Federal Reserve Bank of New York. The Reserve Bank presidents then sit around the table in a prescribed order that no one can seem to remember the logic for.

Only five of the presidents vote at a given meeting. The voting members are established at the beginning of each year. Initially, the Banks were separated into three groups of two and two groups of three, with one representative from each group selected by their boards of directors. In practice, that meant a rotation of each bank, some every other year and some every third year. But the New York Bank's position was deemed so important, given that it is located in the nation's and indeed the world's financial center and given the special responsibility the Bank has come to have for the actual implementation of policy, that the President of the New York Fed was, in practice, always selected as a voting member of the FOMC. The unfortunate President of the Boston Fed, the other member of that two-group, therefore, never got to vote. That was, after some experience, judged to be unfair to Boston and the Congress amended the law in 1942 to make the New York Bank a permanent member of the FOMC and to put the Boston Bank into one of the other groups, leaving three three-groups and one two-group to govern rotations of the remaining eleven presidents.

Senior staff of the Board and of the New York Federal Reserve Bank sit at the far end of the table. They will be introduced as they participate in the meeting. In addition, sitting in chairs around the outer walls of the room are other staff from the Board and the Reserve Banks. Each President, except for the one from New York, is accompanied by one staff member, usually the Bank's Director of Research. The New York delegation includes, in addition, two officers from the Open Market Desk and the Committee's Deputy General Council. Additional senior staff at the Board attend the meetings also. It is rare that any of these attendees speaks at the meeting, although there are specialists in key areas that are there in case they might be needed. Access to the FOMC meeting as well as to the material presented to the Committee in preparation for the meeting is carefully and strictly limited. While the discussion at

the meeting will ultimately become public record, the full transcript will not be available for five years. Minutes of the meeting, providing a thorough but brief account of the discussion, but without indicating who said what, will become available the Thursday following the next meeting. The information in the minutes or other aspects of the discussion at the meeting could give advantage to those who obtained this information before it was publicly released. Their confidentiality is therefore carefully guarded.

A Call to Order

The Chairman calls the meeting to order. The green light goes on in front of the deputy secretary, indicating that the meeting is being recorded.

The first order of business is approval of the minutes of the previous meeting. The minutes are sent to each of the FOMC members during the period between meetings and any recommended changes are incorporated into the draft that is then circulated in advance of the next FOMC meeting. Quite often, small changes are made in advance of the meeting. The minutes are then almost always routinely accepted by vote at the start of the meeting.

The first substantive agenda item is a presentation by the Manager of the System Open Market Account at the Federal Reserve Bank of New York. His presentation covers developments in the domestic financial and foreign exchange markets and provides details of open market operations and any foreign exchange rate intervention during the period since the last FOMC meeting. Some would expect that this would be a rather dull and unrewarding report. But most people have not yet met the Manager. This presentation is one of the highlights of the meeting, as the manager, armed with colorful charts which identify market moves accompanying key events in the last several weeks, reads into the developments in

2 the financial and foreign exchange markets the response of market participants to the flow of data, events, and comments by members of the FOMC during the weeks since the last meeting. He might note for example: "See that blip in the Treasury bond yield. That was in response to Chairman Greenspan's speech!" At the end of his presentation, he will ask for votes to ratify the Desk's open market operations and foreign exchange intervention, if any, during the period since the last meeting.

Up next is the Director of Research and Statistics at the Board, who presents the Board staff's forecast. He may share the honors with the Director of the Division of International Finance, especially when international developments are particularly important in shaping the economic outlook, as has been the case from the onset of the Asian crisis. The forecast has previously been circulated to members of the FOMC typically the preceding Thursday in a document known as the Green Book, by virtue of the color of its cover. Part I includes the forecast and analysis of the outlook. Part II includes a detailed analysis of recent developments in the economy and financial markets.

The forecast is put together by a group of about 25 staff members, beginning about 10 days before the FOMC and usually concluding the Wednesday before the meeting. It is circulated at the Board early on Thursday and arrives at the Reserve Banks during that day. It is a judgmental forecast, constructed with the help of a variety of equations which describe the way various components of aggregate demand and various prices get determined. The only issues to note here are the questions of what the staff assumes about future monetary policy in putting its forecast together and whose forecast it really is.

The staff appreciates that its role is not to forecast or prejudge the policy decisions of the Committee. But how can the staff make a forecast of what is going to happen in the economy if

it does not include in that forecast a view of how monetary policy will evolve? The compromise is, in most cases, to assume no change in policy, meaning no change in the federal funds rate, which we will soon see is the key decision that the FOMC makes at each meeting. The forecast thus reflects the staff's assessment of how the economy will evolve in the absence of any change in policy today or at subsequent meetings over its forecast horizon, which typically includes the remainder of the current year and the following year. This can be a very effective device for making decisions about policy. The FOMC gets the staff's view of what will happen if there is no change in policy and if they judge this outcome both credible and unsatisfactory, they have the necessary motivation for action to change policy. However, on those occasions where it appears clear that a constant funds rate would be greatly at variance with the Committee's objectives, the staff will incorporate into the forecast some judgment about the change in the funds rate over the forecast horizon.

Whose forecast is this? Is it really the staff's independent judgment, or is it the Chairman's forecast that the staff has dutifully adopted as their own? It is very clear that the forecast is the staff's independent judgment. That judgment is, to be sure, influenced, as is appropriate, by ongoing discussions with the members of the Board and the less frequent discussions with the FOMC. But the fact is that there are really twenty forecasts on the table, as it were, at an FOMC meeting. Each President comes with his or her own forecast, developed by the economic staff of that Bank. Each of the Governors comes with his or her own implicit or explicit forecast. None of the other forecasts is put together in so much detail, by so large a staff, and represent as many hours of careful work as that by the Board staff. Neither the Chairman nor the other members of the Board interfere with the staff's exercise of its important responsibility to use its best judgment to provide all the members of the FOMC with a careful forecast.

Each Monday the staff reports on the data and events of the preceding week to keep the Board members up to date, and Board members have the opportunity to question the staff's judgment on the interpretation of that data. On the Monday preceding FOMC meetings a more lengthy and detailed presentation of the outlook is presented to the Board by its staff. The presidents, of course, are briefed by their own staffs and also get copies of the briefings presented to the Board by its staff each week.

At the conclusion of the presentation on the staff forecast, the Chairman asks if there are any questions for the staff. Most of the questions will come from the Reserve Bank presidents because, as I just noted, the Governors have already had the opportunity to raise questions with the staff the previous day.

At the conclusion of the questions, we begin the first of two go-rounds, the core of the meeting. Each member of the FOMC presents his or her own views on the outlook in the first go-round. The current practice is that Bank presidents generally go first, because they have information that the governors do not have about developments in their own regions. The presidents, in addition to having regional information, also tend to have real-time information about consumer spending, business investment, and wage and price developments, for example, gathered from speaking to firms in their Districts. The particular order otherwise is not prescribed and evolves through what I refer to as the "wink system." Each FOMC member winks at the deputy secretary when he or she wants to be put on the list of presenters, and the Chairman calls upon the FOMC in the order on that list. The presentations are generally about five minutes long and focus on a few key points that the Committee member feels are of importance to the policy problem of the moment. The presentations do not offer detailed alternative forecasts, compared to the staff, but Committee members often seek to position themselves

3 relative to the staff forecast stronger or weaker growth, higher or lower inflation, etc.

How the chairman participates in the meeting has changed over time, depending on the preference of the incumbent. Alan Greenspan does not participate in the outlook go-round.

There is not much in the way of exchanges between members of the Committee during this process. Each member speaks, then gives way to the next. Many speak from a prepared text or a detailed outline, although there is a more than an occasional effort by each member to relate his or her remarks to what has gone before. Still, the process is not one of discussion but of a series of self-contained, only sometimes interrelated, presentations.

At the end of the outlook go-round, it's time for a coffee break. We are about to move to the crucial stage, the discussion of policy options, and the vote on policy. The time has come for your economics lesson.

An Economics Lesson

The outlook discussion has set the stage for the policy decision by interpreting the current state of the economy and assessing where it is headed over the next year or two in the absence of a change in policy. The role of policy is to move the economy from where it is and where it will be in the future in the absence of change to some preferred state, specifically related to the Federal Reserve's objectives of full employment and price stability.

The policy instrument the Fed has to accomplish this is open market operations, and these will be used to achieve a target level of the federal funds rate, the rate of interest on overnight loans in the interbank market. These loans represent the lending and borrowing of reserves among depository institutions. It is essentially the price associated with the borrowing of reserves. And everyone should know what determines the price in any market: supply and demand. The economy, by influencing

the quantity of transactions balances, determines the demand for reserves, and the Federal Reserve affects the supply. By judiciously influencing the supply, the Fed can effectively control the federal funds rate. While the federal funds rate itself is not a particularly important influence on the economy, movements in the federal funds rate (and expectations about future federal funds rate encouraged by any change) influence the broad spectrum of interest rates and financial asset prices in the economy. In this way, changes in the federal funds rate exercise an important influence on the demand for goods and services, especially those that are relatively interest-sensitive. By affecting the demand for goods and services, open market operations can affect the level of production relative to productive capacity and inflation pressure in the economy.

First, monetary policy cannot influence real variables such as output and employment in the long run (except via the contribution of price stability to living standards). This is often referred to as the principle of the neutrality of money. One of the most important disciplines for policymakers is understanding what they can and what they cannot accomplish. The Fed, for example, cannot raise the long-run rate of economic growth. It should not try.

Second, money growth is the principal determinant of inflation in the long run. This immediately makes price stability (in some shape or form) the direct, unequivocal, and singular long-term objective of monetary policy. No central bank around the world would argue otherwise. When it comes to price stability, the buck, literally, stops at the central bank.

Third, because prices in many markets are slow to react to changes in supply and demand, shocks to the economy can lead to persistent departures of the economy from full employment in both directions. This proposition offers at least the potential for monetary policy to play a role in smoothing out business cycles. This is the basis for what is sometimes referred to as stabilization policy, adjusting the level of aggregate demand so that it supports a level of production consistent with full employment.

Fourth, full employment and price stability are compatible. Indeed, we define full employment as the maximum rate of employment that can be sustained without rising inflation. Many of us define it specifically in terms of a threshold unemployment rate, the rate below which inflation rises over time. This is the concept of the nonaccelerating-inflation rate of unemployment, or NAIRU. This means that the two objectives of monetary policy full employment and price stability are compatible in the long run.

Fifth, inflation pressures arise, in part, from departures of the economy from full employment. If the economy moves below full employment, the resulting slack results in disinflation, that is, downward pressure on inflation. When the economy moves above this threshold there is continuing upward pressure on inflation. As a result, open market operations which affect the demand for output relative to productive capacity provide the FOMC with the ability to influence inflation pressures in the economy and move the economy toward its price stability objective.

Finally, short-run swings in inflation can also be driven by supply shocks, changes in prices of particular goods that are unrelated to the overall balance of supply and demand in the economy. An example would be a change in oil prices due, for example, to production decisions by OPEC or weather developments. It would be difficult, for example, to understand recent U.S. economic performance and monetary policy without an understanding of the role of favorable supply shocks. This consideration means that monetary policymakers must also try to decipher the sources and persistence of shocks to the economy.

Continued in issue #43 of On Reserve: Come With Me to the FOMC, Part II - The Decision

Bibliography for Teachers — A Summary of Recent Articles from the Federal Reserve System

Slouching Toward Utopia:

What is the History of the Twentieth Century?

J. Bradford DeLong
Regional Review
Federal Reserve Bank of Boston
Third Quarter, 1998, Volume 8, Number 3

DeLong argues that the economy has been the driving force in twentieth century history. Industrial economies have created wealth and major improvements in living standards. But the increase has not been shared equally by all nations. One of DeLong's best observations is that most of the countries that began the century poor are ending it the same way. This article is compelling in its information and style and would be a value to any teachers of history or economics. *Free.*

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Federal Reserve Bank of Boston
P.O. Box 2076
Boston, MA 02106-2076
<http://www.bos.frb.org/genpubs/catalog.htm>

Historical Origins of the Cost-Push Fallacy

Thomas Humphrey
Economic Quarterly
Federal Reserve Bank of Richmond
Summer, 1998, Volume 84, Number 3

Increased global competition, rapid technological progress, cheapened imports, falling health-care costs, declining power of trade unions—can such factors account for the persistent U.S. disinflation of the 1990s? Not according to the writings of David Ricardo, Henry Thornton, Knut Wicksell, Irving Fisher, and Gustav Cassel. They demonstrate that real shocks to costs determine the relative prices of specific goods rather than the average of all prices. Monetary policy, not real cost shocks, determines the general price level and its rate of change. (Lest we forget.) *Free.*

Public Affairs Department
Federal Reserve Bank of Richmond
P.O. Box 27622
Richmond, VA 23261
<http://www.rich.frb.org/eq>

A Question of Economics: How Can Sports Teams Afford to Pay Superstars so Much Money?

Bob Jabaily
The Ledger
Federal Reserve Bank of Boston
Fall, 1998

This article is a quick and easy explanation for a topic that most students find interesting — sports. The multi-million dollar salaries, the big game hype (when was the last time any game on TV wasn't hyped as big?), the threats to move teams, stadiums, and remove coaches (often with expensive buyouts), are all part of a topic students generally enjoy following. But what about the economics underlying all of those questions? This article provides some numbers to crunch in answering the questions. And, interestingly, gives the responsibility to the proper party — the fans. *Free subscription.*

Research Department
Federal Reserve Bank of Boston
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Analysis of Financial Crisis in Asia

Surya Sen
Chicago Fed Letter
Federal Reserve Bank of Chicago
Special Issue, December, 1998, Number 136a

This article is a summary of a recent conference held at the Federal Reserve Bank of Chicago, and co-sponsored with the International Monetary Fund. The conference discussed the origins of the crisis, the role of the IMF in the crisis and its future, the need to strengthen the regulatory framework in some Asian countries, early warning indicators, and lessons to be learned. The full conference proceedings will be published some time in 1999. But for educators, this provides a good overview of a timely topic. *Free.*

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Lesson Plans

Due to the length of this issue's main article, we are not publishing a lesson plan. However, if you develop an idea for a lesson using this article, please feel free to submit it to us and we will post it on our web site. Lesson plans should be submitted as .txt files, and can be submitted either as an attachment to an e-mail message addressed to

education.chi@chi.frb.org

Or they can be submitted on a 3" diskette, and mailed to:

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We're sorry, but diskettes cannot be returned.

The Federal Reserve Bank of Chicago may be expanding its economic education program during 1999. If this expansion takes place, we will be looking for a teacher with some classroom experience in teaching economics or personal finance at the elementary, junior high, or high school levels to join our staff. Experience in writing and curriculum development would be a plus. Sound interesting? For more information, contact:

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.... *Suggested Reading*

.... *Seventh District Winter Workshops*

Teacher Workshops in the Seventh District

ILLINOIS

The Federal Reserve Bank of Chicago

"Midwinter Teachers Conference - Understanding the Money Debate: Measures, Policy and Implications," Chicago, February 12; "Annual Consumer Credit Educators Conference," April 22, 1999. 312-322-5109.

The Center for Economic Education at Governors State University

"Economic Realities of the Workplace," Flossmoor, March 19; "Meeting State Standards in Economics," Joliet, April 16, 1999. 708-534-4925.

The Center for Economic Education at Illinois State University

"Cyber Teach: Using Web Resources to Teach Economics," Normal, March 25 and 29; "Economics and the Environment," Normal, April 8, 1999. 309-438-8625.

INDIANA

The Center for Economic Education at Indiana/Purdue University at Columbus

"Indiana and the World," Columbus, April, 1999; "Virtual Economics," Columbus, May, 1999. 812-348-7305.

The Center For Economic Education at Purdue University

"Economics of "Personal Finance," West Lafayette, January 14; "International Economics and the Demise of the Soviet Union," West Lafayette and Indianapolis, April 15; Indianapolis, April 16; "K-Works: Economics Conference for Kindergarten Teachers," Indianapolis, April 30, 1999. 765-494-8542.

The Center for Economic Education at Indiana/Purdue University at Indianapolis

"K-Works: Economics Conference for Kindergarten Teachers," Indianapolis, April 30, 1999. 317-274-8100.



IOWA

The Center for Economic Education at University of Northern Iowa

"International Trade Seminar," Cedar Falls, February 11; "CyberTeach Workshop," Cedar Falls, March 19, 1999. 319-273-2952.

MICHIGAN

The Federal Reserve Bank of Chicago in cooperation with the Berrien Intermediate School District

"Money, Banking and the Federal Reserve," Stevensville or Berrien Springs, January 14 - 15 and February 18 - 19, 1999. 616-471-7725 x304.

The Federal Reserve Bank of Chicago in cooperation with the Ingham Intermediate School District

"Using the Fed and Banking in the Social Studies: Economics, Government, and History," Mason, January 29, 1999. 517-244-1254.

Economics America of Michigan

"Economics in the Middle School," February 17, Grand Rapids; "Teaching Economics in Middle and High School," Wayne, March 29, 1999. 248-888-1075.

The Federal Reserve Bank of Chicago

"Annual Consumer Credit Educators Conference," Detroit, April 21, 1999. 312-322-5109.

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