The Changing Face of Monetary Policy

The Evolution of the Federal Open Market Committee

BY BETTY JOYCE NASH

Two presidential appointees were recently sworn in as governors of the Federal Reserve Board. As hearings in the U.S. Senate proceeded toward confirmation, the popular labels "hawk and dove" flew freely as Fed watchers sought clues for shifts in thought among the appointees. The new governors, Janet Yellen and Sarah Raskin, will serve on the Federal Open Market Committee (FOMC), the body charged with conducting monetary policy.

Labels never fit well, though, and today hawk and dove are even more relative as monetary policy has achieved a certain consensus about some issues, particularly the relationship between inflation and long-run unemployment. Macroeconomics and monetary policy today are better understood than in the 1960s, '70s, and '80s. Core principles include a priority for stable prices, an inflation target (either explicit or implicit), and the conditioning of expectations in a way that doesn't surprise markets.

Then and Now

The FOMC comprises 19 members, 12 of whom are voting members. The seven Board governors (when fully staffed) and the New York Fed president always vote, along with a rotating group of four Reserve Bank presidents. After its deliberations, the FOMC issues a statement directing the New York Fed to make the trades that influence the availability of credit in the economy. The Banking Act of 1935 created the committee and, for many years, participants and voting members alike were bankers and lawyers, not economists.

That's no surprise. Back when the Federal Reserve System was formed in 1914, the job of the regional Reserve Banks was to issue currency and, later, to sort checks. The Reserve Banks also were lenders of last resort, issuing loans to banks through the discount window. Those staffing the Reserve Banks back then were typically former commercial bankers.

In those first two decades, monetary policy wasn't considered part of the Reserve Banks' mission, says Jerry Jordan, former Cleveland Fed president. He also served on the Council of Economic Advisers under President Ronald Reagan and as former research director of the St. Louis Fed. When the FOMC was formed, Board chairman and banker Marriner Eccles wanted to minimize the role of the Reserve Bank presidents.

The first three of the eight FOMC chairmen were in business or banking. One of the longest serving and most influential was William McChesney Martin. He chaired the FOMC from 1951 through 1970. The FOMC of the 1950s generally responded to increases in expected inflation by raising the federal funds rate in a manner consistent with that of the inflation-taming 1980s and 1990s, according to economists who have studied that era.

By the 1960s, Board staff and governors included more economists, but few Reserve Bank presidents were economists. That could be a handicap at meetings, Jordan says. "So, if you had a staff in Washington conversant with economic models and some (academic) governors, then that put the Reserve Bank presidents at a disadvantage." The communication gap could be dramatic under some chairmen. For example, Arthur Burns was the first academic economist to chair the Board. A professor of economics at Columbia University, he served under Presidents Richard Nixon and Jimmy Carter during most of the 1970s.

"Arthur's style was to pick on somebody at every meeting," Jordan remembers. "By picking on him, he

Reserve Bank Presidents and Professions Since 1914

President	Term of Office	Primary Profession
Federal Reserve Bank of Atlanta		
Dennis Lockhart	2007-present	Finance
Jack Guynn	1996-2006	Public Servant
Robert P. Forrestal	1983-1995	Lawyer
William F. Ford	1980-1983	Economist
M. Monroe Kimbrel	1968-1980	Banker
Harold T. Patterson	1965-1968	Lawyer
Malcolm Bryan	1951-1965	Economist
W. S. McLarin Jr.	1941-1951	Banker
Robert S. Parker	1939-1941	Lawyer
Oscar Newton	1935-1939	Banker
Eugene R. Black	8/34-12/34	Banker
William S. Johns*	5/33-8/34	Banker
Eugene R. Black	1928-1933	Banker
M. B. Wellborn	1919-1928	Banker
Joseph A. McCord	1914-1919	Banker
Federal Reserve Bank of Boston		
Eric Rosengren	2007-present	Economist
Cathy E. Minehan	1994-2007	Banker
Richard F. Syron	1989-1994	Economist
Frank E. Morris	1968-1988	Economist
George H. Ellis	1961-1968	Economist
Joseph A. Erickson	1948-1961	Banker
Laurence F. Whittemore	1946-1948	Business
Ralph E. Flanders	1944-1946	Business
William W. Paddock	1942-1944	Lawyer
Roy A. Young	1930-1942	Banker
Wm. P.G. Harding	1923-1930	Banker
Charles A. Morss	1917-1922	Business
Alfred L. Aiken	1914-1917	Banker
Federal Reserve Bank of Chicago		
Charles L. Evans	2007-present	Economist
Michael H. Moskow	1994-2007	Economist
Silas Keehn	1981-1994	Business
Robert P. Mayo	1970-1981	Banker
Charles J. Scanlon	1962-1970	Banker
Carl E. Allen	1956-1961	Banker
Clifford S. Young	1941-1956	Banker
George J. Schaller	1934-1941	Banker
James B. McDougal	1914-1934	Banker
Federal Reserve Bank of Cleveland		
Sandra Pianalto	2003-present	Business
Jerry L. Jordan	1992-2003	Economist
W. Lee Hoskins	1987-1991	Economist
Karen N. Horn	1982-1987	Economist
Willis J. Winn	1971-1982	Finance
W. Braddock Hickman	1963-1970	Economist
Wilbur D. Fulton	1953-1963	Banker
Ray M. Gidney	1944-1953	Banker
Matthew J. Fleming	1935-1944	Banker
Elvadore R. Fancher	1914-1935	Banker

*interim

intimidated other people who were not willing to be associated with whoever was being picked on."

Over time, Reserve Banks built individual research departments, and research directors often attended FOMC meetings with Bank presidents. There, they often engaged in policy discussions. Richmond had one of the earliest departments in the system, recalls economist Dewey Daane, now an emeritus professor at Vanderbilt University. Daane joined the Bank's research department in 1939, directed from 1937 until 1949 by University of Virginia economist Elbert Kincaid. Here's how Daane recalls his introduction to the FOMC: "The [Richmond Fed] president called me into the office and said, 'I think the presidents are going to get mixed up more in the monetary side. I don't know anything about that. You'll have to help me.'" Daane later served two terms on the Board of Governors, from 1963 through 1974.

By the 1970s, more economists began moving into Reserve Bank presidencies. Some Reserve Banks have had relatively few presidents since 1914; tenure averages nearly 11 years. The Richmond Fed has had only seven presidents. "What that means is that the Reserve Bank presidents are the institutional memory of the Federal Reserve," says William Poole, who was president of the St. Louis Fed from 1998 until March 2008.

The Federal Reserve Act calls for diverse representation from not only financial, but also agricultural, industrial, and commercial, interests. In fact, William McChesney Martin objected, in 1966, to the appointment of economist Andrew Brimmer. Nothing personal, he said, he simply didn't want another economist, citing the Act, according to Allen Meltzer's *A History of the Federal Reserve*. Early Board governors were, like Reserve Bank presidents, likely to be bankers, businessmen, or lawyers.

Governors today may be economists, among them well-known academics like Ben Bernanke, but they also may be nominated for their specialty knowledge in business or law. In addition to FOMC duties, they also head committees that govern the Board. Of the current six Board members, two hold doctorates in economics.

Go-Stop

By the 1970s, more economists were serving on the FOMC, but they could not steer the nation out of growing inflation. The 1970s have been deemed a time of "disarray" in monetary policy by Marvin Goodfriend, a former long-time Richmond Fed economist now at Carnegie Mellon University. In a *Journal of Economic Perspectives* paper, "How the World Achieved Consensus on Monetary Policy," Goodfriend outlines the debates.

Policymakers debated the inflation process. The division broke down between those who thought unions, monopoly firms, or outside shocks such as oil and food prices caused inflation, and the monetarists, who blamed the increase in the money supply. A belief was widely held that expansive monetary policy, a lower federal funds rate to stimulate the

output, could permanently reduce unemployment. That policy could be inflationary, and often was. But it could be worthwhile, providing inflation didn't get out of hand.

Burns, for one, believed in "the power of many corporations and trade unions to exact rewards that exceed what could be achieved under conditions of active competition." This power drove costs and prices "that may be cumulative and self-reinforcing," according to Burns' testimony in Congress quoted by Richmond Fed economist Robert Hetzel in his book *The Monetary Policy of the Federal Reserve*. But, absent money supply increases, union or monopoly power arguably couldn't raise the general price level. Though workers might negotiate higher wages, firms would be hard-pressed to pass costs to consumers.

Burns ran the committee forcibly and fell prey to political pressure by some accounts. Former Richmond Fed President Al Broaddus attended FOMC meetings under three chairmen, including Burns. A chairman, he notes, can exert tremendous influence, sometimes usefully and sometimes not. "If a chairman discourages discussion as Burns sometimes did, in my view, you will lose the value of the debate to help understand policy challenges you need to face." But the reverse is also true. If the chairman doesn't control the meeting flow, then excessive, free-form discussion may hinder the committee's work.

The Burns era is crucial to understanding today's thinking about monetary policy. Though Burns took a public stand against inflation, the federal funds rate fell from an average of 8.02 percent in the first quarter of 1970 to 4.12 percent by the final quarter, theoretically to jump-start the economy. The rate of inflation was 4.55 percent at the end of that year, sending real interest rates below zero.

Burns' successor, G. William Miller, was inexperienced, and served a scant 18 months until August 1979, when Paul Volcker was sworn in. Monetary policy had failed to stop inflation, and the Fed's credibility eroded. The FOMC had engaged in a "go-stop" policy that loosened money to reduce unemployment by stimulating output. But when inflation grew, worries loomed, and when the FOMC tightened money by raising the federal funds rate, the policy could throw the economy into recession.

In this fashion, people began to expect inflation as inevitable and factor it into buying decisions, fueling even higher prices.

Richmond Fed's first president with a doctorate in economics was Bob Black, who began his term in 1973. He'd been president six years, a voting FOMC member every third year, when he got Volcker's call on Oct. 6, 1979, for a special meeting. Volcker wanted to change the Fed's procedures. He wanted to set the quantity of reserves rather than the price, the federal funds rate. Theoretically, the funds rate would then settle appropriately — if the money supply were targeted correctly. A fortuitous by-product was that this relieved the Fed of rate-setting responsibility. In 1982, inflation declined, and the Volcker Fed returned to targeting price rather than quantity of balances. Ultimately, inflation

Reserve Bank Presidents and Professions Since 1914

President	Term of Office	Primary Profession
Federal Reserve Bank of Dallas		
Richard W. Fisher	2005-present	Public Servant
Helen Holcomb*	2004-2005	Banker
Robert D. McTeer Jr.	1991-2004	Economist
Robert H. Boykin	1981-1991	Lawyer
Ernest T. Baughman	1975-1980	Economist
Philip E. Coldwell	1968-1974	Economist
Watrous H. Irons	1954-1968	Economist
R. R. Gilbert	1939-1953	Banker
B. A. McKinney	1931-1939	Banker
Lynn P. Talley	1925-1931	Banker
B. A. McKinney	1922-1925	Banker
R. L. Van Zandt	1915-1922	Banker
Oscar Wells	1914-1915	Banker
Federal Reserve Bank of Kansas City		
Thomas M. Hoenig	1991-present	Economist
Roger Guffey	1976-1991	Lawyer
George H. Clay	1961-1976	Lawyer
H. G. Leedy	1941-1961	Lawyer
George H. Hamilton	1932-1941	Banker
W. J. Bailey	1922-1932	Banker
J. Z. Miller Jr.	1916-1922	Banker
Charles M. Sawyer	1914-1916	Banker
Federal Reserve Bank of Minneapolis		
Narayana Kocherlakota	2009-present	Economist
Gary H. Stern	1985-2009	Economist
E. Gerald Corrigan	1980-1984	Economist
Mark H. Willes	1977-1980	Economist
Bruce K. MacLaury	1971-1976	Economist
Hugh D. Galusha Jr.	1965-1971	Lawyer
Frederick L. Deming	1957-1965	Economist
Oliver S. Powell	1952-1957	Banker
John N. Peyton	1936-1952	Banker
William B. Geery	1926-1936	Banker
Roy A. Young	1919-1926	Banker
Theodore Wold	1914-1919	Banker
Federal Reserve Bank of New York		
William C. Dudley	2009-present	Economist
Timothy F. Geithner	2003-2009	Public Servant
Jamie B. Stewart*	6/03-11/03	Banker
William J. McDonough	1993-2003	Economist
E. Gerald Corrigan	1985-1993	Economist
Anthony M. Solomon	1980-1984	Economist
Paul A. Volcker	1975-1979	Public Servant
Alfred Hayes	1956-1975	Banker
Allan Sproul	1941-1956	Lawyer
George L. Harrison	1928-1940	Lawyer
Benjamin Strong	1914-1928	Banker

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Reserve Bank Presidents and Professions Since 1914

President	Term of Office	Primary Profession
Federal Reserve Bank of Philadelphia		
Charles I. Plosser	2006-present	Economist
Anthony M. Santomero	2000-2006	Economist
Edward G. Boehne	1981-2000	Economist
David P. Eastburn	1970-1981	Economist
Karl R. Bopp	1958-1970	Economist
Alfred H. Williams	1941-1958	Economist
John S. Sinclair	1936-1941	Lawyer
George W. Norris	1920-1936	Lawyer
E. P. Passmore	1918-1920	Banker
Charles J. Rhoads	1914-1918	Banker
Federal Reserve Bank of Richmond		
Jeffrey M. Lacker	2004-present	Economist
J. Alfred Broaddus Jr.	1993-2004	Economist
Robert P. Black	1973-1992	Economist
Aubrey N. Heflin	1968-1973	Lawyer
Edward A. Wayne	1961-1968	Banker
Hugh Leach	1936-1961	Banker
George J. Seay	1914-1936	Banker
Federal Reserve Bank of San Francisco		
John F. Moore*	10/10-present	Banker
Janet L. Yellen	2004-2010	Economist
Robert T. Parry	1986-2004	Economist
John J. Balles	1972-1986	Economist
Eliot J. Swan	1961-1972	Economist
H. N. Mangels	1956-1961	Banker
C. E. Earhart	1946-1956	Banker
Ira Clerk	1/46-9/46	Banker
William A. Day	1936-1945	Banker
John U. Calkins	1919-1936	Banker
James K. Lynch	1917-1919	Banker
Archibald Kains	1914-1917	Banker
Federal Reserve Bank of St. Louis		
James Bullard	2008-present	Economist
William Poole	1998-2008	Economist
Thomas C. Melzer	1985-1998	Finance
Theodore H. Roberts	1983-1984	Banker
Lawrence K. Roos	1976-1983	Business
Darryl R. Francis	1966-1976	Economist
Harry A. Shuford	1962-1966	Lawyer
Delos C. Johns	1951-1962	Lawyer
Chester C. Davis	1941-1951	Business
Wm. McC. Martin Sr.	1929-1941	Banker
David C. Biggs	1919-1928	Banker
Rolla Wells	1914-1919	Business

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SOURCES: Multiple sources, including the Federal Reserve Bank of St. Louis, Federal Reserve Archival System for Economic Research (FRASER), Committee on the History of the Federal Reserve System.

fell from a high of 13.5 percent in 1980 to under 4 percent a few years later, and maintained a low rate. Today, the Fed's implicit inflation target is about 2 percent.

The Volcker disinflation, as the era is now called, advanced the idea that stable prices are paramount; expectations, whether of inflation or deflation, can influence economic activity.

Dissents were more frequent then, as policy was being worked out. For instance, though Black agreed with Volcker's overall strategy, he dissented often over nuances of policy. He once apologized to Volcker before voting by stating: "Mr. Chairman, it pains me to have to dissent again." He favored lower short-run money targets than the committee as a whole thought appropriate.

The Bernanke and Greenspan years seem downright calm, dissent-wise, compared to the 1970s and early 1980s. For example in 1978, members dissented 19 times in 10 of 19 meetings. In 1979, there were 20 dissents in 13 meetings, and in 1980, there were 25 dissents at 13 of 17 meetings during the year.

A longer time span shows that about 8 percent of all voting observations from 1966 to 1996 were dissents, according to economist Rob Roy McGregor of the University of North Carolina at Charlotte. From 1987 through 1999, that proportion declined to 6 percent. He has co-authored a book about FOMC decisionmaking, and says the combination of professionals and advanced knowledge may have contributed to less disagreement. "The decline in dissent might have to do with the greater number of economists, but combined with that is the sense that we have a reasonably unified framework that the committee can use."

Today, McGregor says most economists believe as Milton Friedman instructed: Inflation is a monetary phenomenon, not fundamentally driven by union or monopoly-firm wages. "That issue has become settled in the last 40 years and taken for granted by committee members." The idea that there may be a short-run trade-off but no long-run trade-off between inflation and unemployment, McGregor confirms, is fairly well accepted.

Poole's dissents were typically hawkish, but he also dissented for other reasons. He dissented in January 2008, at a conference-call meeting held one week prior to the scheduled meeting. He saw no reason for action one week ahead. "I also believed the market would interpret the FOMC's action as a response to the decline in equity prices in Europe," he explains. The stock market at home was closed because of a holiday. "And the Federal Reserve had always argued that it did not respond to the stock market."

That notion of systematic, expected policy decisions is paramount on the committee, and reflects academic work on rational expectations in the 1970s, particularly that of Nobel Laureate Robert Lucas. Before this idea had taken root on the FOMC, members couldn't fully appreciate the need to make decisions that would not shock the market.

Poole cites, by way of example, that three strong employment reports in succession would have the market

anticipating a rise in interest rates. "If the Fed raised the federal funds rate to exactly the same rate as the market anticipated, then it wouldn't be a surprise, and it would be already priced into the market," he explains. Before that idea was understood, some policymakers thought policy actions could be more effective if they jolted the market.

The rational expectations revolution in economics emphasized the importance of monetary policy following a path that is as predictable as possible, Poole says. "The market should behave as policymakers expect and policymakers behave as markets expect."

The 13th Member: The Committee

Contributing to agreement is the committee itself, where consensus is valued. Most members would say that the chairman never loses. A chairman has never been outvoted nor will he ever be, Poole observes.

Yet there's always a measure of dissent and disagreement. That produces healthy debate among the large number of well-trained economists, many of them from the Reserve Banks, and of course Bernanke himself is a thoroughly trained economist, Broaddus says. Take the idea of inflation targeting, for which Broaddus, Bernanke, and others have argued. "Others opposed it. If you have deflation developing but the Fed is aiming for between 1 percent and 2 percent, if that target is there, people will think the Fed will do what they have to do. Others don't find that argument persuasive. That's an important debate. And it's no less intense than the old Keynesian-Monetarist debate."

Today, new disputes have sprung up, including ones over the fine points of that earlier divide. The trade-off between *short-term* unemployment and inflation can provoke differences, Poole notes, as well as the nature of the process by which inflation expectations are created or changed.

Monetarism, Broaddus says, has morphed into the view that what really matters is for the Fed to clearly state its inflation objective. "That's what you might call 'Son of Monetarism.'"

More than two dissents are rare on the committee. "A third, however, would be viewed as a sign that the FOMC is in open revolt with the Chairman's leadership," former Fed governor Laurence Meyer wrote in his book, *A Term at the Fed*. That would disrupt the process of monetary policymaking and unsettle financial markets.

Disagreement can stem from many quarters, for instance, the ballooning of the Fed's balance sheet. Jeffrey Lacker, current Richmond Fed president, dissented at the Jan. 27-28, 2009, FOMC meeting. It wasn't because he disagreed with expanding the monetary base, but because he preferred to buy U.S. Treasury securities rather than target credit programs through the Term Auction Lending Facility.

Some economists think that "providing financial assistance to particular entities is more like fiscal policy than monetary policy," Poole notes. He adds that today there are probably new significant disputes, and cites the "too big to fail" concept, the Fed's credit policies, and debate over whether the Bear Stearns bailout was a good idea as examples.

Recorded dissents don't necessarily reveal members' preferences. Disagreement may not result in dissent, and those can be probed only through the verbatim transcripts of meetings. But the Reserve Bank presidents frequently give speeches, in which they may detail ideas about monetary policy, whether or not they've dissented. In this fashion, they plant ideas in the public discourse. These discussions also appear to be a way of informing the market, by conditioning expectations. The federal funds target today is 0 percent to 0.25 percent, for example, and Kansas City Fed President Thomas Hoenig has dissented at each meeting this year, signaling his inflation concerns. In contrast, President James Bullard from the St. Louis Fed has not dissented, yet has spoken out regarding his concerns about deflation, another signal to markets. FOMC statements today employ the phrase "extended period" to tell the market the rate will stay low until there's a compelling reason to move it.

And so while economists may have reached broad agreements on certain macroeconomic principles, voting members are likely to disagree as discussions proceed, in search of the best policy path. But members do seem to agree on this: Predictability is paramount, with the market's expectations aligned with those of policymakers. **RF**

Readings

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