TOP OF THE NINTH — TOP OF THE NINTH

An Introduction to the FOMC

How the Fed's central decision-making body sets monetary policy

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It has been nearly a year since I became president of the Federal Reserve Bank of Minneapolis, and during that time one of my primary responsibilities has been participating in meetings of the FOMC. I trust that *Region* readers are far more familiar with that acronym than was the government official referred to in a classic 1998 speech by former Fed Governor Laurence Meyer. "What did he believe it stood for?" asked Meyer. The reply: "Fruit of the Month Club."[1]

"Federal Open Market Committee" is the right answer, of course. But while that name may be known to the *Region*'s audience, the actual activities of the FOMC no doubt continue to be something of a mystery. I'd like to take this opportunity to dispel, at least partially, whatever obscurity and confusion might remain.

The FOMC is the Federal Reserve's principal decision-making body with regard to monetary policy, and its name reflects the fact that the Fed influences the nation's interest rates and thereby its economic activity, primarily by buying and selling U.S. government securities through the open market. The term "open market" refers to the securities markets where the FOMC's decisions are implemented through the purchase or sale of U.S. Treasury and federal agency securities in order to influence short-term interest rates;[2] these markets are "open" in the sense that dealers compete with one another on the basis of price alone.

Of course, the Federal Reserve System has other monetary instruments at its disposal, including traditional tools like the discount rate and reserve requirements. The Board of Governors is responsible for those tools. The Fed also has used less conventional innovations, such as the Term Auction Facility that was employed to great effect during the recent financial crisis.[3] Nonetheless, open market operations remain our primary tool for influencing economic activity; therefore, the FOMC has central responsibility for setting the Fed's monetary policy.

Rather than discuss the Fed's open market *procedures*—a rather technical process explained well elsewhere,[4] I'll do my best to describe the FOMC's *composition* and the *deliberations* it goes through at each of its meetings. To make this a bit more concrete, I'll offer examples from the FOMC's most recent meeting held on August 10. (For those interested in a high level of detail, minutes of each meeting are released three weeks after the meeting itself.[5])

I should begin by pointing out that the FOMC was created by Congress 75 years ago, in the Banking Act of 1935. Thus, it did not exist at the 1913 creation of the Federal Reserve, but was born of the recognition that while open market operations should be conducted centrally (by the Domestic Trading Desk of the New York Fed), information-gathering about the nation's economy and decision-making about the future of monetary policy should have a quintessentially American structure.

A federalist Fed

What do I mean by an American structure? Unlike the central banks of other countries, ours is specifically designed to draw upon the diverse insights of small-town businesses, farmers and ranchers, and large manufacturers, among others, to formulate policy. And to achieve that goal, our "central" bank has a structure that is, in fact, highly decentralized. The Federal Reserve Bank of Minneapolis is one of 12 regional Reserve banks that, along with the Board of Governors in Washington, D.C., make up the Federal Reserve System. Our bank represents the ninth of the 12 Federal Reserve districts. The Ninth District is, by area, the second largest. It includes Montana, the Dakotas, Minnesota, northwestern Wisconsin and the Upper Peninsula of Michigan.

Eight times per year, the FOMC meets to set the path of short-term interest rates over the next six to seven weeks. (Other meetings are held as necessary—either in person or by conference call. During 2008, at the peak of the financial crisis, the FOMC met 14 times. In 2010, we've held six meetings to date, with three more scheduled.) All 12 presidents of the various regional Federal Reserve banks—including me—and the seven governors of the Federal Reserve Board contribute to these deliberations. Right now, there are only four governors—three positions are unfilled—but the White House has nominated excellent candidates for these vacancies. However, the committee itself consists only of the governors, the president of the Federal Reserve Bank of New York and a rotating group of four other presidents (currently Cleveland, St. Louis, Kansas City and Boston). I'll be on the committee in 2011.

In this way, the structure of the FOMC mirrors the federalist structure of the U.S. government. Just as people from around the nation deliberate in the U.S. House and Senate, in the FOMC the district bank presidents from different regions of the country provide input into Fed policy deliberations. The input from the presidents relies critically on information from their districts about local economic performance. We obtain this information through the work of our research staffs—but we also obtain it from business leaders in industries and towns, in my case, across the Upper Midwest. The Federal Reserve System is deliberately designed so that the residents of Main Street are able to have a voice in monetary policy.

Go-rounds

So how, exactly, do the FOMC meetings work? The typical meeting features two so-called go-rounds, in which every president and every governor has a chance to speak without interruption. The first is the *economics* go-round. Participants describe their views on current economic conditions and their outlook for future conditions. Bank presidents' remarks will typically include references to their own local economies as well as the national and global situation.

As part of my contribution to the economics go-round at FOMC meetings, I typically discuss my outlook for gross domestic product (GDP), inflation and unemployment. So, at last month's meeting, for example, my input about the national economy in the economics go-round was, in essence: GDP is growing, but more slowly than we would like. Inflation is a little low, but only temporarily. The behavior of unemployment is deeply troubling; I see current and future problems in labor markets that are likely to continue to prove resistant to the tools of monetary policy.

After the economics go-round, the FOMC meeting moves to its second phase, the *policy* go-round. Again, the meeting participants have a chance to speak in turn about what they perceive to be the appropriate policy choices for the committee. We are all committed to achieving the Fed's dual mandate to attain both price stability and maximum employment—objectives set by the Full Employment and Balanced Growth Act of 1978, generally referred to as the Humphrey-Hawkins Act.

The former objective is generally understood as keeping inflation in a tight range around 2 percent. The second part of the mandate is much more of a moving target. Employment is shaped by many determinants beyond the Fed's control: demographics, social custom, taxes and so on. The Fed's job is to keep employment as high as possible, given these other factors.

Interest rates

Right now, to accomplish its dual mandate, the FOMC has to think about two quite distinct policy tools: short-term interest rates and balance sheet management. (I should stress that each of these policy tools is directed at both mandates, not one tool for one mandate and the other for the other.) I'll talk about each in turn.

Setting the federal funds rate—that key short-term interest rate targeted by the FOMC—is, again, the FOMC's central and traditional tool. For over 18 months, the FOMC has set a target of 0 to 1/4 percent. In terms of its future level, the FOMC's statement in August contains the following key sentence:[6]

"The Committee will maintain the target range for the federal funds rate at 0 to 1/4 percent and continues to anticipate that economic conditions, including low rates of resource utilization, subdued inflation trends, and stable inflation expectations, are likely to warrant exceptionally low levels of the federal funds rate for an extended period."

What do we learn from this rather long sentence? The unemployment rate is 9.6 percent. Market and survey measures of expected inflation are also low (also below 2 percent). In its August statement, the FOMC is essentially saying: We're going to conduct open market operations to keep interest rates low in order to prevent unemployment from going any higher, and we feel safe in doing so because there seems to be little threat of inflation.

Asset management

Then there is the issue of the Fed's balance sheet, the management of which has been a central concern to the FOMC in recent years. As a result of its actions to improve the health of credit and funding markets, the Fed's assets and liabilities have grown dramatically since 2008. Currently, the Federal Reserve has $2.3 trillion of assets—over 2.5 times what it owned in September 2008—and changes in these balances may have a real impact on the national economy.

So, at its current meetings, the FOMC typically discusses recent and potential shifts in Fed assets and liabilities, and sets policy accordingly. At our August meeting, for example, the FOMC deliberated about trends in the over $2 trillion of Fed assets currently in Treasuries, debt issued by Fannie Mae and Freddie Mac or mortgage-backed securities issued by Fannie Mae and Freddie Mac. These MBSs are not "toxic" assets in any sense of the word—they are backed by the U.S. government, and so the Federal Reserve faces no credit risk in holding them. But the MBSs do face so-called prepayment risk. If long-term interest rates are low, many people are likely to prepay the mortgages in the MBS. The owners of the MBS—in this case, the Fed—will then get a large coupon payment, and the MBS's principal falls.

That is precisely what has happened in recent months. Long-term interest rates declined surprisingly fast, leading more people to prepay their mortgages. As a result, the Fed's MBS principal balances have fallen. That fluctuation led the FOMC to make another decision at its August meeting, again spelled out in the statement released—as is standard practice—at about 2:15 p.m. on the final day of the meeting:[7]

"To help support the economic recovery in a context of price stability, the Committee will keep constant the Federal Reserve's holdings of securities at their current level by reinvesting principal payments … in longer-term Treasury securities."

What's behind this somewhat arcane statement? With the prepayment of mortgages and resulting decline in Fed MBS principal balances, the Fed's holdings of long-term assets were shrinking. That left a larger share of the economy's long-term risk in the hands of the private sector. The FOMC concluded that this extra risk in private hands could force up risk premiums on long-term bonds and create a drag on the real economy. To achieve its dual mandate of price stability with maximum employment, then, the FOMC decided to arrest the decline in its holdings of long-term assets by reinvesting the principal payments from the MBSs into long-term Treasuries.

The importance of independence

So, I've taken you through a typical FOMC meeting and the monetary policy situation in the United States. My discussion may strike you as rather techy and wonkish—maybe even verging on the nerdy. I'm sure that my colleagues will forgive me for saying that this nerdy quality mirrors the tone of the discussion within the meeting itself. There is no inflated political rhetoric. We are unabashed technocrats, seeking to solve an unabashedly technical problem: How do we manage monetary policy so as to ensure lower unemployment and maintain inflation at an appropriate rate? We certainly disagree with one another on occasion. But our disagreements ultimately stem from different assessments of the complicated economic situation and not from political differences.

I believe that the apolitical nature of the FOMC's work hinges critically on another aspect of central bank structure, and that has to do with the Federal Reserve's relationship with the U.S. Congress. On the one hand, the Federal Reserve is a creation of Congress. It has the power to amend the Fed's responsibilities, as the recent financial reform legislation certainly attests. The Senate approves the presidential appointments to the Board of Governors. Both chambers receive regular reports from the Board of Governors on the conduct of monetary policy, financial supervision and the payments system. In addition, the Federal Reserve undergoes regular audits of its finances and various operations.

On the other hand, Congress has intentionally removed itself from the direct conduct of monetary policy by granting the Federal Reserve the independence to perform this function on its own. In effect, Congress has said that it does not want monetary policy unduly affected by political considerations. This independence not only is a hallmark of this country's central bank, but is also a characteristic of developed economies worldwide.

Speaking on my own behalf, as I have throughout, I believe that the Fed has a responsibility to sustain the trust inherent in that independence by maintaining a high level of transparency and openness. And it can do so best through clear and frequent communication about how it seeks to carry out its designated functions. I hope that this essay contributes to that goal in some small degree. R

Endnotes

[1] Meyer, Laurence. 1998. "Come with Me to the FOMC." April 2. http://www.federalreserve.gov/boarddocs/speeches/1998/199804022.htm.

[2] Specifically, the FOMC sets a target for the federal funds rate, the interest rate at which depository institutions make overnight loans of their balances held as reserves at the Federal Reserve to other depository institutions.

[3] For a description of these programs and review of their effectiveness, see Willardson, Niel, and LuAnne Pederson, "Federal Reserve Liquidity Programs: An Update," June 2010, *The Region,* http://www.minneapolisfed.org/publications_papers/pub_display.cfm?id=4451.

[4] See Open Market Operations, http://newyorkfed.org/markets/openmarket.html, and Davies, Phil, "Right on Target," December 2004, *The Region,* http://www.minneapolisfed.org/publications_papers/pub_display.cfm?id=3310.

[5] See Meeting calendars, statements, and minutes (2005-2011), http://www.federalreserve.gov/monetarypolicy/fomccalendars.htm.

[6] See the Aug. 10, 2010, press release, http://www.federalreserve.gov/newsevents/press/monetary/20100810a.htm.

[7] See the Aug. 10, 2010, press release, http://www.federalreserve.gov/newsevents/press/monetary/20100810a.htm.