CHAIRMAN'S MESSAGE | 2007

CHAIRMAN'S MESSAGE

Bon Voyage, Captain Poole

I can't think of a better way to characterize Bill Poole's 10-year presidency at the Federal Reserve Bank of St. Louis than to summon an old expression: When sailing through rough waters, keep a steady hand at the wheel.

Whether we're talking about the national and international economic scene or the changing operating environment here at the Bank, choppy surf has been the rule rather than the exception over the past decade—a period during which the St. Louis Fed was fortunate to have Bill, an avid sailor, at the helm. On the Federal Open Market Committee, Bill's steady hand proved invaluable during crises such as the Asian financial meltdown, the 9/11 terrorist attacks and the recent subprime mortgage debacle.

What assuredly will be one of Bill's lasting legacies was his advocacy of clear communications—keeping surprises to a minimum while helping the markets understand the underlying principles behind FOMC decisions. Practicing what he preaches, Bill gave nearly 150 speeches during his presidency, often speaking on the record with reporters afterward to answer their questions and help eliminate confusion. Sometimes the Federal Reserve is accused of being overly and unnecessarily mysterious. Through his actions, Bill sought to alleviate any misunderstandings or misconceptions about the Fed.

Despite serving as the Bank's CEO for 10 years, Bill likes to say that he is always an academic at heart. And it's the teacher in him that the Bank's directors, both past and present, really appreciated. Typically, we board members are neither economists nor experts on the inner workings of the Federal Reserve. We rely on the president to educate us on the ramifications of FOMC actions, as well as the best options for us to consider on decisions we need to make. In this role, Professor Poole was unfailingly helpful to us.

I have been a member of the Bank's board of directors since 2005 and have observed Bill deal with change in a calm, yet nimble, manner that befits a seasoned executive more than it does a career academic. In fact, from the time Bill arrived in 1998, he encountered a rapidly evolving business model—one that private sector companies are used to, but the Fed was not. Nevertheless, Bill and his management team embraced the changes and made decisions that proved beneficial both to the Eighth District and the Federal Reserve System. An example of an innovative efficiency during Bill's tenure occurred in 2002, when the St. Louis and Cleveland Reserve banks formed a joint partnership to share sales and marketing functions.

In support of System-generated efficiencies, the St. Louis Fed was an early advocate of efforts to reduce redundancies across Reserve banks by converting to common software platforms for human resources and certain accounting functions. Bill also contributed to the System by serving a term as chairman of the Information Technology Oversight Committee, whose responsibilities include approving overall technology strategies and budgets for the Federal Reserve. Identifying efficiencies, though, is only one part of the story of Bill's success. The Bank can also boast of many areas of growth and leadership during the Poole era. Three worth noting are:

- **U.S. Treasury support:** Since 2001, the St. Louis Fed has been the home of the Fed's Treasury Relations and Support Office, which oversees all of the System's U.S. Treasury-related responsibilities and manages the relationship between the two organizations. In addition, the St. Louis Bank provides a wide range of tax collection and cash management applications and services for the Treasury.

- **World-class economic data:** The Research division's robust sets of online economic information and data services are renowned and relied upon worldwide. Led by the popular FRED (Federal Reserve Economic Data) database, Research's web pages received around 60 million visits in 2007.

- **Community connections:** Under Bill, the four offices in the District have redoubled their focus on areas such as regional economic research, community development and economic education. Maintaining a strong link between the Fed and local communities is critical. As we have learned with the subprime mortgage crisis, many consumers have a dire need for greater understanding of economic and personal financial issues.

Before Bill embarked on his next journey—which will include being a distinguished scholar in residence at the University of Delaware and a senior fellow at the Cato Institute, and, naturally, sailing on the Chesapeake Bay near his new Maryland home—we caught up with him for a final interview. Here in the St. Louis Fed's 2007 Annual Report, I invite you to read Bill's reflections.

Bill, on behalf of my fellow directors and the rest of the crew here in the Eighth District, I thank you for steering us through 10 often tumultuous years. We will miss your guidance, insight and wisdom, and we wish all the best to you and your wife, Gerie.

Irl Engelhardt

Irl F. Engelhardt
Chairman
Board of Directors
Federal Reserve Bank of St. Louis

LOOKING BACK:
A RETROSPECTIVE CONVERSATION WITH WILLIAM POOLE

ANNUAL REPORT | 2007

ACKLOOKING BACKLOOKIN

The decade that you spent as president of the Federal Reserve Bank of St. Louis was marked by a series of crises, such as the Asian financial meltdown of the late 1990s, the 9/11 attacks and the current subprime mortgage crisis. How would you characterize the turbulent era during which you served?

I used to think of monetary policy as dealing with generally normal periods interrupted by shocks. I've decided that it's really the other way around. In fact, the Fed has had to face a whole series of shocks interrupted by occasional periods that we call "normal." If you were to take the 10 years as a whole and divide it between periods of shocks or the threat of shocks vs. the "normal" periods, I think you'd find a lot more months in the first category.

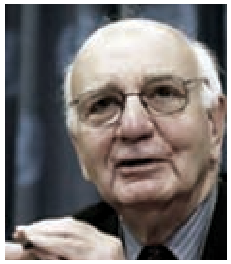
What have you learned about the best role for the Federal Reserve to play during times of crisis?

To start with, central bank credibility and low and stable inflation expectations are of critical importance. Earning that confidence is the most important thing the Fed can do in dealing with shocks as they occur. If the Fed doesn't have that underlying confidence, then all sorts of things can go wrong and, indeed, the Fed may find itself willy-nilly taking policy actions intended to maintain or restore credibility rather than dealing

Bill Poole's seminal contributions in the area of monetary theory and policy are widespread and span four decades. Whether it be his contributions on monetary policy under uncertainty, his early investigations of simple rules for setting the federal funds rate, or his analysis of rational expectations models of the term structure for monetary policy, his theoretical contributions provided fundamental insights and played an important role in developing what we now view as the core of modern monetary theory. He has continued his contributions to monetary policy as a member of the FOMC, bringing the same sound, thoughtful and consistent economic analysis to policy deliberations. I have known Bill for nearly three decades and have learned a great deal from him.

Charles I. Plosser
President
Federal Reserve Bank of Philadelphia

Recent chairmen of the Federal Reserve Board



Paul Volcker
1979-1987

Alan Greenspan
1987-2006

Ben Bernanke
2006-

with the current problem, whatever it might be. So, most of the work in dealing with the crises comes before they even happen. Where the Fed is now is a consequence of earning that credibility starting with Paul Volcker and then dealing successfully with a whole series of issues during the **Volcker, Greenspan** and now **Bernanke** eras.

Does the public expect too much from the Fed in response to crises?

You can probably address that question on several levels. There's a natural tendency for people in the markets to look to government to help them. And, often, it's very self-interested. They want to be bailed out—it's just that simple. They want someone to fix their mistakes. You see it across the board. People think that if the government will give them some money, why not take it. … It seems that the people who most often talk about regulation tying them in knots and being costly are some of the first to come asking for help and to be bailed out. So, there is nothing Fed leaders can do except make sure to have a correct, disciplined policy and then be visible in explaining the rationale for the policies they want to follow. You have to be prepared to resist pressures from Congress and make use of the independence that the Federal Reserve structure provides.

Could you give a broad historical overview of what you refer to as the monetarist vs. fiscalist debate?

The word "monetarism" refers to the way the debates were framed in the 1960s and '70s. Fundamentally, the argument at that time was about a few propositions that have been largely resolved. It's also important to understand that

"THERE IS NOTHING FED LEADERS CAN DO EXCEPT MAKE SURE TO HAVE A CORRECT, DISCIPLINED POLICY AND THEN BE VISIBLE IN EXPLAINING THE RATIONALE FOR THE POLICIES THEY WANT TO FOLLOW."

the debate was really a **pre-rational expectations debate**. (See explanation on page 23.) One of the issues being argued was the relative power or influence of monetary policy and fiscal policy. The **Keynesian tradition** (page 23) coming out of the 1930s was that monetary policy was pretty much a sideshow, and the aggregate economy was controlled by fiscal policy. **Milton Friedman** (page 23) disagreed. He said that monetary policy was central to understanding the business cycle.

How did the monetarists and fiscalists differ when it came to their views on inflation?

The monetarists thought that inflation was costly and damaging to the economy. The fiscalists argued that inflation wasn't all that costly. … The fiscalists believed that there could be a constructive tradeoff in that you could actually obtain lower unemployment if you were willing to accept somewhat higher inflation. That view was resisted at a somewhat intuitive level and then at a very, very explicit theoretical level by Friedman in his presidential address to the American Economic Association in December of 1966. There continued to be an argument for a while. The fiscalists would say, "We understand Friedman's theory, but the world doesn't really work quite that way, and, in fact, there *is* a tradeoff." The view that there was a tradeoff had a great deal to do with Federal Reserve policy mistakes because that was the prevailing view of the Federal Reserve—with the lone exception of St. Louis. … There was a whole series of policy mistakes that led to gradually rising inflation—sometimes not so gradual—at costs greater than anticipated, including, lo and behold, costs in terms of employment and certainly economic stability. So, over the course of the '70s, the debate was resolved in favor of what had been the monetarist position.

Four decades later, where does the theory of monetarism stand? Furthermore, have you changed your views about monetarism over the years?

Monetarism has become mainstream economics. We know now the following: Inflation is costly, only the central bank is responsible for inflation, the **Phillips Curve** (page 23) is vertical in the long

Bill Poole (seated at far end) at a recent FOMC meeting. Chairman Ben Bernanke is seated at the center of the facing side of the table.

run, and there is no inflation/employment tradeoff. Those are all part of macroeconomics today. … There is another issue that was not directly connected with monetarism, but you might say was sort of a fellow-traveler issue: Friedman was very much a believer in the market system and distrustful of government. He had great respect for market efficiency and great skepticism about government efficiency. So, the people who were on the monetarist side of the debate tended to have that same view. I don't know of any activist government interveners who are monetarists. They just didn't ever go together. Monetarists generally have great respect for markets. It's not to say that market decisions are infallible, but you will ask a question two, three, four times before you decide that markets are making a mistake. And I think that part of it certainly survives as being extremely important in my thinking. The immediate successors of the monetarist debate of the '60s are people like **Bob Lucas and Tom Sargent** (page 23) and the rational expectations theorists. They were the immediate intellectual heirs of the debate. I certainly come from that tradition, and a lot of my speeches have been oriented toward developing the practical application of those ideas to understanding and managing monetary policy. I don't think my views on monetarism have changed in particular. Those views are still very much a part of my thinking.

Does the Federal Reserve's decentralized structure still make as much sense now as it did when the Fed was created?

I think the rationale has changed over time. Part of the rationale was that regional Reserve banks could pursue different monetary policies to address differing regional needs. That argument has disappeared—there can be only one national monetary policy. But part of the original rationale has survived. If you look back at the Federal Reserve Act in 1913, there was tremendous distrust of Washington and New York. That's one reason why you had Reserve banks spread around the country—so that you would have decentralized power. The argument for decentralized authority still stands, but this case is not very well appreciated by the general public. A lot of people think of a centralized system as being more efficient, perhaps more democratic, if it's run out of Washington. I think those views are fundamentally wrong because I believe that the original conception of not having all the authority concentrated in New York as the financial center or Washington as the political center remains valid.

Has the FOMC reached a good state in terms of its communication, or do you think there is more work to be done?

There is more work to be done. One of the biggest innovations came in 1994 when the FOMC began to disclose what its policy decision was after each meeting. The communication since then, however, has sometimes been a bit muddled. I don't think there is a settled view in the FOMC about the value of essentially forecasting policy, or trying to give hints about where you're going to go. I've become skeptical of that approach because I think the correlation between where you go and where you can see yourself going in advance is very low. … I also think that there is unfinished business with regard to clarity of objectives. I've been an advocate since the first day I came here of a formal inflation target, and that issue is still unresolved. There is a huge amount of unfinished business in trying to define and communicate the Fed's **reaction function** (page 23). … One of the problems right now is that the FOMC itself doesn't have its reaction function very well specified. I think more discussion about regularity of the reaction function would be very helpful and would help the communication strategy by narrowing the range of uncertainty so that the FOMC has more predictable policy.

What can the FOMC do to further demystify its actions and decisions?

In the public relations profession, where there is a lot of concentration on communications strategies, people will tell you that you have to be sure of what your message is. You don't just throw a whole lot of information out there. What are

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~~RD~~ON THE RECORD~~ONTHERE~~

EXCERPTS FROM SOME OF BILL POOLE'S SPEECHES

SYNCHING, NOT SINKING, THE MARKETS (1999)

Speaking at a meeting of the Philadelphia Council for Business Economics: "When the markets and the Fed are in synch, both will have a common reaction to incoming data, and the markets will correctly anticipate Fed policy actions. An environment in which markets correctly anticipate Fed actions implies a situation in which Fed policy is widely understood, regular and predictable. The fact that Fed policy actions sometimes take the markets by surprise shows that we have not reached 'perfection' yet."

CENTRAL BANK TRANSPARENCY: WHY AND HOW (2001)

During a session at the Philadelphia Fed Policy Forum about how transparent a central bank should be: "The case for *why transparency* is clear. Transparency promotes accountability, improves market efficiency and probably improves the clarity of policymaking itself. *How transparency* is just plain hard. It is easy to find communications gaps, but not at all easy to fill them."

HOUSING IN THE MACROECONOMY (2003)

In a speech at the Office of Federal Housing Enterprise Oversight Symposium in Washington, D.C., Poole said the housing market could be at risk because government-sponsored enterprises like Fannie Mae and Freddie Mac, the biggest players in the mortgage market, are also the least capitalized. "Just three firms—Fannie Mae, Freddie Mac and Ginnie Mae—account for over 40 percent of the residential mortgage market. Ginnie Mae is backed by the full faith and credit of the U.S. government. Fannie Mae and Freddie Mac are not so backed and hold capital far below that required of regulated banking institutions. Should either firm be rocked by a mistake or by an unforecastable shock, in the absence of robust contingency arrangements the result could be a crisis in U.S. financial markets that would inflict considerable damage."

THE FED'S MONETARY POLICY RULE (2005)

Speaking at the Cato Institute in Washington, D.C.: "At a minimum, the FOMC can and should aspire to policy statements that are clear and do not themselves create uncertainty and ambiguity. The record since 2000 suggests that the balance-of-risks statement and more recently the 'forward-looking' language included in the press releases have provided consistent signals about the direction of future policy actions. … Federal Reserve policy has become highly predictable in recent years, and in the future this predictability will, I am sure, be seen as one of the hallmarks of the Greenspan era."

INFLATION TARGETING (2006)

In a speech at the Junior Achievement of Arkansas Inc. in Little Rock: "I believe that having a formal inflation objective will further enhance the Fed's credibility and, consequently, its ability to engage in countercyclical monetary policy. The reason is simple. The more open and precise the Fed is about its long-run inflation objective, the more confident the public will be that the Fed will meet that objective."

THINKING LIKE A CENTRAL BANKER (2007)

In a speech at Market News International in New York City: "A central bank cannot fix the level of employment or its rate of growth, or the average rate of unemployment. However, the central bank can contribute to employment stability. Avoiding, or at least cushioning, recessions is an important goal. This goal should not be viewed as in conflict with price stability. The most serious employment disaster in U.S. history was the Great Depression, which was a consequence of monetary policy mistakes that led to ongoing serious deflation. Similarly, the period of the Great Inflation saw four recessions in 14 years. Price stability is an essential precondition for overall economic stability."

DOLLARS AND SENSE (2008)

Speaking to the Financial Planning Association of Missouri and Southern Illinois in St. Louis: "Will housing sector problems push the economy into recession? It is too early to tell right now, but what we can do is to examine the current situation closely and try to learn from it. Perhaps 'relearn' is a better word, because the mistakes that brought us to this point have been made before. There are no new lessons here. The lessons are familiar ones that need to be more forcefully driven home and incorporated in standard financial practice in the future. … If borrowers, lenders and investors can refocus on financial basics and re-emphasize critical lessons about credit and risk, the financial future can be brighter than the second half of 2007."

For the full text of all of Bill Poole's speeches, visit www.stlouisfed.org/news/speeches.html.

"WHAT WE NEED TO DO IS NOT INCREASE THE MATERIAL THAT WE PUT OUT THERE, BUT WE NEED TO INCREASE THE INTERPRETATION AND EXPLANATION, AND WE NEED TO CLARIFY THE MESSAGE."

St. Louis Mayor Francis Slay congratulates Bill Poole during the grand opening of the Bank's pedestrian plaza in 2005.

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you trying to convey? I think that, to too great an extent, we've been throwing information out there without being clear in our minds what the message is. … And the way I've made this point in several speeches is that the issue is not transparency, but communication. Transparency implies that you throw back a curtain and let everybody look in. We too often dump the data without explaining what to make of it and why we're doing it. What we need to do is not increase the material that we put out there, but we need to increase the interpretation and explanation, and we need to clarify the message. I don't think there is enough of that happening.

Speaking of communication, you have had a reputation as one of the more outspoken Reserve bank presidents, whether it be your willingness to speak on record with the media or the nearly 150 speeches you have given. Why do you feel it has been so important for you to maintain such high visibility?

When I came here and began to give speeches, I asked myself: What exactly am I trying to do? And what purpose is being served? Here I am, out there representing the Federal Reserve, knowing that expectations are very important. And while expectations are obviously intimately connected with policy decisions of the Federal Reserve, they also to some extent reflect what comes out of the mouths, or pens, of Federal Reserve officials. So, I started to think through what to do and how to do it.

Another question I asked myself was: What can I infer and interpret from fluctuations in financial data about inflation expectations or expectations about monetary policy? These are things that are important to Federal Reserve decision-making. I came to the view that I can only make sense of all this if I put it in very simple abstract terms. And that's where the speech came from in 1999 that was called "Synching, not Sinking, the Markets." (See page 12.) I said, let's go back to the basic literature of the 1970s and the basic macro-economic model—the rational expectations equilibrium. The desirable equilibrium is that the central bank behaves as the market expects, and the market behaves as the central bank expects. That's the nature of the equilibrium: When there is new information, such as data on industrial production or housing starts, the equilibrium requires that the Federal Reserve and the markets respond to the same data in the same way. A number of my speeches have been oriented around that theme, and that provides a unifying theoretical view that ties together lots of different problems. For one thing, this view gives me a very easy way to address the questions that keep coming, such as: "How's the Fed going to set interest rates at its next meeting? What are you guys going to do?" Then I can say, "What we're going to do will depend on what the new information is. I can't predict unpredictable information. And you would not want me to commit—you would not want the FOMC to commit—as to what it is going to do come hell or high water. It wouldn't make any sense for us to ignore important new information."

I always tell people, "I'm not being coy with you. I'm telling you that I can't predict what the inflation rate is going to be in next week's CPI report. If it's an outsized shock, with no extenuating circumstances to it, then the Fed needs to take that into account when forming its inflation outlook, and that ought to affect our policy decision."

When we hired Bill 10 years ago, we knew that he was an outstanding economist and would be a valued participant on the FOMC. My perception is that he has more than lived up to that expectation. What we did not know is whether he would be able to adapt to a major executive role in leading such a large institution as the St. Louis Federal Reserve Bank. He has, in fact, exceeded our expectations in that capacity, which just proves that an old academic can learn new tricks.

John F. McDonnell
James S. McDonnell Foundation
Former Chairman of the Federal Reserve Bank of St. Louis Board of Directors

Bill Poole has had an enormous impact on the Eighth District and the Federal Reserve System as a leading economist. I also had the opportunity to see Bill excel in another Fed role, as a participant in the System's strategic direction project during my time as chairman. There, he helped define the evolving roles of the Reserve banks and helped bring clarity to the principal governance issues associated with the evolving role of the Reserve banks and the Board of Governors. Bill was a leader in setting a framework to help the banks and the governors achieve the mission of the System for the next decade. His respect for and understanding of the history and the future of the Fed served our Bank well.

Walter L. Metcalfe Jr.
Bryan Cave LLP
Former Chairman of the Federal Reserve Bank of St. Louis Board of Directors

The rational expectations model says that the market has to understand what the central bank is doing. The market understands what the central bank is doing, in part and maybe even mostly, through inferences from observed central bank actions—how we set the federal funds rate. But the communications strategy can deepen the market's understanding of what we're doing and why we're doing it, and that helps to produce a better equilibrium. That's the reason to be as open and forthright as possible.

Earlier, you mentioned inflation targeting. Is the announcement of an inflation target being hamstrung and hung up by concern about the Federal Reserve's dual mandate?

Probably. I think that, putting political pressures, which are real, aside, it's possible to explain all this easily within the framework of the **dual mandate** (page 23). If you look back in history, you see that the largest problems on the employment front have come from inflation and price instability. You look at deflation during the Great Depression, the biggest economic disaster in U.S. history by far, and then you look at the '60s and '70s, when inflation was rising, the business cycle fluctuations became more extreme, and the average rate of unemployment rose—and I don't think it's an accident that price-level stability and employment levels are connected. So, we ought to be able to explain that achieving sustained, high and stable employment requires inflation stability. We can assist in maintaining inflation stability if we have great clarity as to the objective. That's an argument that I believe and that I've made in some of my speeches. And I don't see any reason why the FOMC shouldn't adopt that as its official view.

Poole Continued the St. Louis Fed Tradition

During his 10 years as president of the Federal Reserve Bank of St. Louis, Bill Poole was widely regarded as one of the more influential members of the Federal Open Market Committee. His speeches received frequent notice in the press, and he gave many interviews throughout his tenure. Following a tradition of St. Louis Fed presidents, Poole has been an outspoken advocate of directing monetary policy toward achieving the goal of price stability. Dating back to the term of Darryl Francis, who was president of the St. Louis Bank from 1966 to 1976, St. Louis Fed presidents have consistently advocated policies to achieve and maintain low inflation.

President Francis led the St. Louis Fed during a time of generally rising, but also highly variable, inflation—a period many people now refer to as the Great Inflation. At the time, many economists and policymakers blamed the inflation on rising costs, the exercise of monopoly power and government budget deficits. Francis, however, was convinced that the Fed was responsible for inflation. Citing research from his team of economists as supporting evidence, Francis argued that inflation would not end until the growth of the money stock was brought under control. Francis' forceful advocacy of controlling inflation by limiting the growth of money, and the supporting evidence produced by the St. Louis Fed's Research department, marked the St. Louis Bank as a maverick.

The St. Louis Fed is no longer regarded as a maverick institution. Although presidents of the Bank have consistently held the monetary view of inflation and advocated policies directed toward price stability, these positions are now very much in the mainstream. President Poole built upon and continued the St. Louis Fed tradition through his unwavering and outspoken advocacy of establishing price stability as the paramount objective of monetary policy. It is his view that a central bank can best promote a stable financial system and maximum sustainable economic growth through a firm, credible commitment to price stability.

In the late 1960s and early 1970s, St. Louis Fed President Darryl Francis and Research Director Homer Jones consistently and vociferously argued that price stability could only be restored if the Fed articulated and implemented a systematic policy that restrained monetary growth. The St. Louis Bank became known as the "monetarist bank."

By the 1990s, economists understood that, in principle, other systematic approaches to monetary policy can provide a nominal anchor for the economy. Critical for the success of such approaches to policy is that consumers and firms believe that future inflation will be low and stable. For policy to succeed, the general public must understand the Fed's long-run inflation objective and how the FOMC will respond to short-run economic fluctuations. Bill Poole has been a leader, perhaps *the* leader, within the Federal Reserve System in pushing for greater policy transparency by the FOMC and a clearer articulation of a systematic implementation of monetary policy aimed at achieving price stability. In this sense, Bill has adapted and carried on the tradition of the St. Louis Fed in the 21st century.

Robert H. Rasche
Senior Vice President and Director of Research
Federal Reserve Bank of St. Louis

Switching to an issue that brought a lot of attention to you a few years ago: government-sponsored enterprises (GSEs) like Fannie Mae and Freddie Mac. You made a speech in March of 2003 (page 12) in which you questioned the long-term financial viability of these agencies. Where does this issue stand today?

That speech caused a little stir. I don't think anything constructive by way of reform has happened since. I don't take credit for disclosing the accounting irregularities, but when I look back, is there something I wish I had said or not said? The answer is no. One of the reasons I went down that track is that I have a vivid memory when I was at the Council of Economic Advisers in Washington. We had many discussions and were all very well aware of the problems being covered up in the savings and loan industry. That experience led me to rather deep regret that I had not raised that issue publicly. I might not have been in a position to do it because it was a very politically difficult issue, and many people were trying to cover it up, sweep it under the rug and ignore it. But I wish I would have somehow found a way to raise that issue and improve public consciousness. If I had been able to do that in 1982 or 1983, and if there had been some earlier action, it

"… HISTORICALLY YOU DON'T FIND SIGNIFICANT CHANGES IN MONETARY ARRANGEMENTS IN THE UNITED STATES ABSENT OF A BIG PROBLEM OR SCREW-UP OF SOME SORT."

might have saved taxpayers quite a bit of money. It probably wouldn't have made any difference, but I would have felt better.

So, part of the reason that I did push the GSE issue was a feeling that I was in a position to understand the issue and the potential gravity of it. And that's exactly what an office like this is for. I have an audience simply by virtue of speaking from this office that I would not have had as a Brown University professor; so, why not? That's consistent with my predecessors. That's what Darryl Francis did. (See sidebar on page 18.) He went out campaigning about the inflation issue and about monetary policy. He did not change policy at the time, but I think he had very substantial long-run influence on the national debate and on the Federal Reserve System. He had much more impact on dealing with monetary policy issues than I have had to date on the GSE issue.

Looking at the operating environment of the St. Louis Fed itself, what do you regard as the most significant changes that affected the Bank during your tenure?

There's no question in terms of the scale of the effects, it's the consolidation in financial services that led to ending check and cash operations in two branches (Little Rock and Louisville) and selling the buildings there. That was an enormous change, going from branches that each had 150 employees down to about eight. We have more of that coming in St. Louis and Memphis because

we'll be closing down check operations in these locations. And there is consolidation in other services, too; so, we are much less a stand-alone company than we were 10 years ago. Some IT and HR services that used to be here, for example, are now elsewhere. What's happened here is not unlike what's happened to a lot of companies that have outsourced support operations. It's not unique to the Fed.

What do you think the Federal Reserve might look like 10 to 20 years from now?

Who is it that said, "Forecasting is difficult, especially about the future?" How do I come to grips with that question, beyond saying that there's always uncertainty, and if anyone looks back at this annual report, they'll probably laugh at what I'll say, but that's the way these things always are. First of all, historically you don't find significant changes in monetary arrangements in the United States absent of a big problem or screw-up of some sort. … I would not expect the Federal Reserve Act to be opened and revised in any important respect in the absence of a significant monetary problem.

That means that we'll probably have the same basic framework in the law. It seems to me that the main thing that the Reserve banks need to do and probably will do is to manage themselves efficiently enough—which I think we do a pretty good job of doing—and provide public services through economic education, economic research and so forth that are regarded in the public debate as being worth what we spend on them. From time to time, there will probably be some attacks on us from Congress. That happens. But if we continue to perform pretty well on the macroeconomic front, I don't think we're going

The most important aspect of the Federal Reserve System is its decentralized structure. In this system, the job of regional Reserve bank president encompasses many duties, but among the most important is serving as the connection between the business and industry of the individual districts and the Federal Reserve's national monetary policy mission. In his tenure at the St. Louis Federal Reserve Bank, Bill has been very much committed to his role in the monetary policy process, bringing his insight and analysis to the deliberations.

Thomas M. Hoenig
President
Federal Reserve Bank of Kansas City

to be very vulnerable, and the attacks that occur from time to time will not have any material effect on the law. That means that the Federal Reserve banks will shrink in terms of their operating responsibilities. I think we need to get used to the prospect of Reserve banks being smaller in terms of employment, and more vigorous and more rigorous in terms of our intellectual output.

What will you miss most about being president of the St. Louis Fed?

I'll miss the excitement and challenge of the monetary policy process. That's been very interesting to observe and be part of.

Least?

I don't think anybody likes doing performance reviews and some of that administrative stuff (laughter). Fortunately, though, the scale of it is pretty small. I have said to many people, and I really believe it, that there is nothing I've done here that is as awful as grading a huge stack of exams over winter break. I'm glad I left that behind.

Are there any closing comments you would like to make?

I am through and through an academic, and I had no managerial experience coming into this job. I really enjoyed learning about a lot of modern management practices, and I felt fortunate to have some very good people do all the hard work. There are a lot of really good people here. ■

An explanation of key terms

Pre-rational Expectations Debate – In the 1970s, macroeconomic models of how monetary and fiscal policies affect the economy began to focus on how the public forecasts future values of economic data and policies. Macroeconomic models that incorporate rational expectations assume that the public uses all relevant information when making projections about future values of data and policy actions. Thus, in such models, monetary and fiscal policies have no permanent effects on output or employment because the public will anticipate and, acting in its best interest, take actions that offset the impact of policy on the growth of output and employment.

Keynesian Tradition – Refers to John Maynard Keynes (1883-1946), an English economist who proposed that high unemployment, being a result of insufficient capital spending by business, could be relieved by government-sponsored programs. He also advocated deficit spending by governments to stimulate economic activity.

Milton Friedman – The 20th century's most prominent economist advocate of free markets. A winner of the 1976 Nobel Prize in Economics, Friedman (1912-2006) was noted as a proponent of monetarism and for his opposition to government intervention in the economy.

Phillips Curve – An inverse relationship between inflation and unemployment first observed in data for the United Kingdom by the economist A.W. Phillips. Monetarists argued, and most macroeconomists now agree, that there is no long-run relationship between inflation and unemployment, and that monetary policy cannot affect the unemployment rate in the long run.

Lucas and Sargent – Refers to Robert Lucas, Nobel Prize winner and professor of economics at the University of Chicago, and Thomas Sargent, professor of economics at New York University. Both were leading proponents of macroeconomic models that incorporate the rational expectations assumption.

Reaction Function – Refers to how policymakers adjust their policies in response to new economic data and other information.

Dual Mandate – Refers to the fact that the Federal Reserve Act (as amended) directs the Federal Reserve to pursue monetary policies to achieve the goals of both maximum employment and stable prices.