Narayana Kocherlakota: Economics at the Federal Reserve Banks

Opening statement by Mr Narayana Kocherlakota, President of the Federal Reserve Bank of Minneapolis, at the Panel Discussion, American Economic Association Annual Meeting, Philadelphia, Pennsylvania, 4 January 2014.

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I thank Dave Fettig and Sam Schulhofer-Wohl for their helpful comments.

I'd like to use this opportunity to talk about the role of economic research and economists within a Reserve Bank. My main theme is that, to be successful at their host of responsibilities, Reserve Banks need economists with a wide range of perspectives and skills. Conversely, economists in a variety of fields can enjoy fulfilling and successful careers at Reserve Banks. I'll illustrate my points by using examples from my own institution, the Federal Reserve Bank of Minneapolis.

The views that I express today are my own and not necessarily those of others in the Federal Reserve System, including my colleagues on the Federal Open Market Committee.

My first observation is that, just like economists who work at universities and colleges, many economists within Reserve Banks spend a great deal of time on independent research. Many Reserve Banks – including the Minneapolis Federal Reserve Bank – have found that, especially over the longer term, this self-directed research has the power to create valuable new insights into important public policy questions. For example, back in the 1990s, Harold Cole and Lee Ohanian – then at the Minneapolis Fed – developed an exciting and important new way to think about the slow recovery during the Great Depression.[1] This work in economic history has turned out to be a valuable resource for many who are thinking about the current slow recovery.

Over the past four decades in Minneapolis, we have found that, to be effective, independent research should follow the usual rules of academic economics. More specifically, economists must be free to pursue any question, use any available tools and arrive at any answer. The quality of those answers is ultimately measured by rigorous academic peer review, not by internal managerial judgment.

So, university and Reserve Bank jobs are not all that different in terms of the role of independent research. What distinguishes academic jobs from Reserve Bank jobs for economists is how they spend their non-research time. Economists with academic jobs spend most of their non-research time teaching. Economists with Reserve Bank jobs spend most of their non-research time supporting public policy work. As I stated at the outset, my main theme today is that public policy work in a Reserve Bank relies on a much wider variety of economic specializations than might be generally appreciated.

I'll start by talking about the most visible of the Fed's public policy responsibilities: monetary policy. The president of each Reserve Bank participates in the Federal Open Market Committee (FOMC) meetings. Economists play a key role in briefing and generally supporting their president's involvement in those meetings. I'm sure that I won't be telling the people in this room anything new when I say that many of these economists are skilled at macroeconomic modeling. Indeed, there are many kinds of macroeconomic models, grounded in a wide range of underlying perspectives. To be most effective, an FOMC participant's support team has to engage fully with this plethora of approaches.

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[1] See Harold L. Cole and Lee E. Ohanian, "The Great Depression in the United States from a Neoclassical Perspective," *Federal Reserve Bank of Minneapolis Quarterly Review* 23(1), 2–24, Winter 1999; Harold L. Cole and Lee E. Ohanian, "New Deal Policies and the Persistence of the Great Depression: A General Equilibrium Analysis," *Journal of Political Economy* 112(4), 779–816, August 2004.

I suspect, too, that many in this room will not be surprised to hear that to be effective, presidents of Reserve Banks need support from economists with expertise in financial economics. After all, the Fed implements its monetary policy actions through financial market transactions. Monetary policy advice needs to be grounded in a keen understanding of financial markets, and the linkages between those markets and the broader macroeconomy. As well, financial markets are important to policymakers as a source of information about the public's expectations for the future. At the Minneapolis Fed, we continue to work on how best to use information in asset prices – as encoded in so-called risk-neutral probabilities – to inform monetary policy choices.[2] This is a joint effort that involves several parts of the Bank, and we have benefited from interactions with other economists around the System and in academe. We see it as a critical area for future research.

What is perhaps less understood is that people who are not specialists in macroeconomics or finance also play a key role in monetary policy support. For example, the Fed is charged with making monetary policy so as to promote maximum employment. The challenge is that the level of employment that is indeed maximal is largely outside the control of monetary policy and, moreover, varies over time. Hence, the Fed engages in continual efforts to obtain measures of the maximum level of employment. These efforts are fundamentally grounded in the work of many labor economists around the System, but I'll cite an important recent example done in Minneapolis. My research director, Sam Schulhofer-Wohl, and his co-author and former Minneapolis Fed economist Greg Kaplan closely studied the recent decline in internal migration in the United States.[3] Some policymakers had expressed concern that this decline indicated that the Great Recession had caused a sudden increase in structural unemployment. But Sam and Greg's research provided compelling evidence that this view was mistaken – rather, the decline in internal migration was better understood as being part of a very long-run trend.

Let me transit to another Fed responsibility: supervision of financial institutions. The financial crisis made clear the fundamental linkage between the condition of large financial institutions and the macroeconomy. That lesson has translated into a more complete integration of economists – with expertise in banking, finance and macroeconomics – and the supervision of financial institutions. Monetary policymakers continually assess systemic financial risks, and this assessment is informed in part by supervisory information. Conversely, economists contribute to the supervision process by helping to build a better understanding of risks that face the financial sector.

I could illustrate this Systemwide effort to build more connections between economics and supervision in many ways. I'll just mention two of the several lines of attack undertaken in Minneapolis. Minneapolis Fed economist Motohiro Yogo and his co-author Ralph Koijen are studying the incentive effects of regulatory policies on insurers' risk-taking. Their work has shed important new light on "shadow insurance" risks from off-balance-sheet liabilities of life insurance companies.[4] As well, my head of supervision, Ron Feldman, and his team are using option price data – again, as encoded in risk-neutral probabilities – as a source of information about tail risks for large financial institutions.[5]

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[2] See Narayana Kocherlakota, "Optimal Outlooks," presentation at Conference on Extracting and Understanding the Risk Neutral Probability Density from Options Prices, New York University Stern School of Business, New York, N.Y., Sept. 20, 2013.

[3] See Greg Kaplan and Sam Schulhofer-Wohl, "Interstate Migration Has Fallen Less Than You Think: Consequences of Hot Deck Imputation in the Current Population Survey," *Demography* 49(3), 1061–74, August 2012; Greg Kaplan and Sam Schulhofer-Wohl, "Understanding the Long-Run Decline in Interstate Migration," Federal Reserve Bank of Minneapolis Working Paper 697, revised December 2013.

[4] See Ralph S. J. Koijen and Motohiro Yogo, "The Cost of Financial Frictions for Life Insurers," April 2013; Ralph S. J. Koijen and Motohiro Yogo, "Shadow Insurance," November 2013.

[5] See Estimates of the Future Behavior of Asset Prices.

I’ve talked a lot about monetary policy and the supervision of financial institutions. But these are only two of the many public policy roles of Reserve Banks. Let me briefly mention a couple more: the payments system and community development. Reserve Banks have recently formulated an ambitious strategic plan regarding their responsibilities in the payments system – the variety of mechanisms by which people and businesses transfer funds to one another. This strategic plan was informed in part by contributions from a large number of economists around the System who specialize in payments systems. In terms of community development, Reserve Banks engage in a number of activities to encourage private-sector investment in low- and moderate-income communities. Microeconomic analysis underpins these activities in important ways. For example, in Minneapolis, over the past dozen years, our Community Development function has worked closely with tribal representatives on initiatives to help Native American tribes select and build a sound legal infrastructure that can support private business development in Indian Country. We are engaged in efforts to buttress this work by using microeconometric techniques to measure the impact of these legal infrastructure improvements on economic outcomes.

I have argued that Reserve Banks need a wide range of skills and perspectives to fulfill their public policy missions. These considerations have helped inform the evolution of our Research department in Minneapolis in the past four plus years since I became president. In that time, we’ve greatly expanded the group, by hiring folks from top universities like Stanford, Penn and Princeton, as well as from elsewhere in the Federal Reserve System. These new economists have skills in financial economics, labor economics, international economics, econometric forecasting and monetary economics. The department’s expansion has helped make the Minneapolis Fed even more agile and effective with respect to its public policy contributions, while maintaining its historical excellence with respect to independent research.

But the skill diversity that I’ve been emphasizing is valued throughout the Federal Reserve System, not just in Minneapolis. To see this, one need not look any further than the key Research leadership positions around the Federal Reserve System. The Research director in Philadelphia is an economist with expertise in banking. The Research director in Chicago is an economist with expertise in labor economics and industrial organization. The Research director in New York is an economist with expertise in payments systems.

I’ve described a Federal Reserve System in which each Reserve Bank has a broad-based group of economists. Some listeners might ask: Why not put all the economists in Washington? Or why not have each bank specialize in a different subfield of economics? I have a couple of answers to these questions. The first is grounded in the nature of monetary policymaking at the Federal Reserve. The essence of the Federal Reserve System is that each of the 12 Reserve Bank presidents brings a distinct perspective to monetary policy deliberations. But these perspectives need to be appropriately informed by economic analysis – and, as I’ve argued, that kind of support requires a broad range of skills to be effective.

Second, I view geographic diversity as a necessary ingredient to generating valuable intellectual diversity across the System. Back in the 1970s, the Minneapolis Fed Research department played a key role in fostering the “rational expectations revolution” that has helped transform the making of monetary policy around the world. Would these economists have played this same role had they been working in Washington – or anywhere else in the System, for that matter? I believe that the answer to this question is no. The ideas in the Research department were generated by synergistic interactions between Minneapolis Fed economists and University of Minnesota economists – synergies that owed a lot to the geographical proximity between the two institutions. I see those same intellectual synergies as critical to the Minneapolis Fed’s, and the System’s, thinking as we move forward.

Let me sum up.

Most of you know that many economists work in Reserve Banks. What I wanted to communicate to you today is that these economists have many different fields of specialization. This diversity is essential – Reserve Banks need that large variety of skills to fulfill our public policy missions. As a result, many kinds of economists can enjoy successful careers within the Federal Reserve. What it takes to be successful in our organization as an economist is extraordinary dedication to, and belief in, our public policy mission.