

# **Report of External Review Committee for Research and Market Analysis Group of the Federal Reserve Bank of New York**

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[edited for external distribution]

Not everyone appreciates external scrutiny, let alone invites it. We congratulate the management of the Research and Market Analysis Group (RMAG) for taking the initiative to convene a panel of external reviewers.

The process we followed in evaluating RMAG began by reviewing a significant amount of written information prior to our visit. We also talked to a range of economists at other places to solicit their views on RMAG. We then visited the New York Fed August 7-8. During two full days, we met with the former and acting Bank President, several Executive Vice Presidents and other senior management, and many people from within the Group. An appendix provides details on the information used in preparing this report.

The most important issue in assessing the group is the objective function or benchmark against which it should be evaluated. We asked this question before and during the visit. Our understanding is that the aspiration of the Group is to be one of the very best central bank and international organization research departments. In terms of a comparison with university economics and finance departments, the aspiration is to be able to compete with departments between 10 and 20.

## **1. Overall evaluation**

Our summary evaluation of the overall status of the RMAG is very favorable. The current staff is of high quality. They appear to be happy overall and the atmosphere is collegial. Twenty-five current members of the staff have published in a leading journal in the last four years, and some are quite visible in their fields. The management of other groups in the Bank expresses a remarkable degree of respect and appreciation for the role of the RMAG. Prior to our visit we had compiled a list of the staff who had not been publishing in top outside journals. Importantly, virtually every one of these people was volunteered by the clients as examples of staff providing outstanding support to clients. And we already knew that the Current Business Conditions function serves the Bank President very well. The demographic mix of staff is in line with that found in top academic departments.

Academic departments and government agencies can fall prey to a familiar list of bureaucratic afflictions: excessive accumulation of deadwood, turf battles, budget problems, and unhealthy lack of mutual respect between those devoted to scholarly research and those more attuned to the demands of clients. We came to our reviewing task alert to these possible dangers. We are pleased to report that we did not find evidence of them.

There is universal agreement that the revolution undergone by RMAG in 1994, when President McDonough brought Frederic Mishkin in as Director, had a major favorable impact. This new regime has continued under Directors Stephen Cecchetti and Christine Cumming, who have capably maintained a favorable trajectory. The quality of the group is far higher than it was ten years ago. Christine Cumming specifically has done an excellent job, bringing expert management to the group, smoothing out some rough spots, and fostering an exceptionally congenial working environment.

There are, however, at least four important concerns facing the Group at this time.

First, we detect some anxiety over the future direction of the department. A few people (at different levels of the organization) express some concern as to whether the Bank will retain its commitment to having excellent staff that have the freedom to on average spend half their time doing basic research. This arises partly because the organization is maturing and the original problems identified by Mishkin have been tackled. So it is not surprising that the staff wonders whether there is a new vision as to where to go next. The fact that a new Bank President could also prefer a different direction is also a concern.

Second, this last year was difficult in terms of hiring. A number of offers were declined and some groups ended up with slots that were unfilled. This is surprising since many universities faced tighter than usual budget constraints, so it should have been a good year for organizations that did have positions available. Particularly worrisome is the number of candidates who turned down the NY Fed in favor of other employers who the Bank would not consider to be peer institutions.

Third, over the last few years the Bank has seen some of its most productive and visible research staff depart for other jobs. Having some successful researchers move on to top departments is undoubtedly a sign of strength. But it is important to keep replacing them. Given the aforementioned recruitment problems, these departures have not been adequately offset by new hires.

Finally, there is the ongoing challenge to manage the unique problems associated with the position of the Federal Reserve Bank of New York. The New York Fed plays a pivotal role in the U.S. financial system. No other Reserve Bank has as many critical operating areas that require expert analytic firepower on an on-going basis. Yet, the only way to maintain a staff with this expertise is also to have a world class research environment, as current management in the Group and the Bank well understand. Indeed, we commend Christine Cumming and her senior staff for having the aspiration of competing for and retaining staff that could get jobs in the top 10 to 20 economics and finance departments.

In terms of where the research department is at the moment, our evaluation is that they are in the top 10 in terms of a comparison with research departments at other central banks and international organizations. However, we believe that in terms of competing

with top 10 to 20 economics and finance departments the RMAG has some distance to go. In subsequent sections we identify several commitments that we believe will be necessary to improve this situation.

## **2. Diagnosis**

A number of the reforms implemented by Directors Mishkin, Cecchetti and Cumming have allowed the Group to make great progress. The first of these is the commitment to basic research in addition to outstanding client work. Although we have some reservations about the points system for journals at the margin, this does appear to have produced a mechanism for conveying to the staff how important it is to publish in the leading academic journals. The rotation of function heads like department chairs in universities is also an important improvement. Finally, the move away from having management responsibilities as being necessary for advancement and instead allowing people to progress through professional achievements in research and client work is also a vital innovation.

However, we see five challenges facing the Group if it is to meet its quality objective. In addition we have a sixth category of more minor issues.

1. Lack of researchers with an international or profession-wide reputation.
2. Clarifying the research career path.
3. The departure of people working on monetary policy.
4. Competing with business schools.
5. Fully exploiting research and policy synergies.
6. Miscellaneous specific issues

We outline each of these in turn and suggest possible remedies in the next section.

### *1. Lack of researchers with an international reputation.*

First and foremost, the recent difficulties in attracting and retaining personnel appear to be more than a random one-year blip. We have considered a number of possible explanations. Salary offers to new Ph.D.s were apparently below-market last year, but the RMAG leadership already recognizes this and has made plans to address it during the next recruiting season. Likewise, post-September 11 fears may have cost the group a few people. But we do not believe that either of these two factors is the main explanation.

Instead, we have concluded that the biggest group-wide problem is the absence of economists with a marquee name – people with a world-class reputation that would be

evident to all members and potential members of the staff -- at a senior level in the department. We believe that the presence of people of the stature of Frederic Mishkin and Stephen Cecchetti was of considerable importance in hiring very high quality junior people in previous years. There are many first rate people on the current staff who are well known in their fields but they do not have quite this stature.

This is partly a question of signaling the group's commitment to high-quality research. There is no doubt in our minds that this commitment is as great under the current management as under Mishkin and Cecchetti. But outsiders often do not know that. When job candidates come to visit, or when their advisers advise them, their decisions are highly responsive to how many names they recognize on the roster. Having one or a few well-known scholars at a senior level in the group would thus be a tremendously important signal. The other purpose of having prominent senior people is that they can be mentors and provide feedback to young scholars. When young researchers make decisions about where to go this is undoubtedly an important factor.

Finally, if the Bank is to achieve the goal of academic standing comparable to a top 10 to 20 university department, it is necessary to have some marquee scholars on the staff. A distinguishing feature of such organizations is the presence of at least a few people with international reputations.

## *2. Clarifying the research career path.*

There is a concern among some of the most research-oriented staff as to what the future might hold for them. This appears to have been a factor in the departures of at least some of the active researchers. Currently there is no very senior role model for younger researchers as to how a research-driven career within the Bank would evolve. Although the Bank's senior management has stressed the existence of a professional track without extensive management responsibilities there is currently no example of somebody who has done this. The vacancy of the Presidency and possibility of a regime switch exacerbates this concern.

## *3. The departure of people working on monetary policy.*

The recruiting and retention of monetary economists is an important issue. The Bank seems to have slipped below the critical mass of the number of experts working on the core issues related to the design of monetary policy. Aside from one person who just completed his Ph.D. this spring, there is no one in the domestic research area working on topics like inflation targeting, the monetary policy transmission mechanism, and monetary policy rules. Given the fundamental importance of these topics for the Federal Reserve System we view this as a critical deficiency.

## *4. Competing with business schools.*

An issue in the Capital Markets and Banking Studies groups is that RMAG must compete with business schools for staff. This is a particular problem in the field of Finance where full-year salaries for new Ph.D's on the academic job market last year (without any NY area cost of living adjustment) was around \$180,000.

*5. Fully exploiting research and policy synergies.*

The synergies between research and policy work that make the New York Fed such a unique place to work are not exploited quite as well as they might be. Three success stories illustrate the sort of synergies we have in mind. Some of the work on the effect of wealth on consumption, which has achieved much prominence, started as a policy question. Research on Treasury market liquidity resulted from policy issues and interactions with the Markets group, as did research on the market microstructure of the foreign exchange market.

*6. Miscellaneous specific issues*

The current organization of seminars seems somewhat problematic. There are too many and as a result they are poorly attended on average. The administration of travel budgets could also be improved. It seems that the current system does not encourage members of the group to go out and extensively present their research in conferences and seminars. In order to build the academic reputation of the group, it is important that this kind of exposure be encouraged.

### **3. Proposed Solutions that RMAG can implement**

We outline some steps below that we believe will help solve these problems. In this section we focus on solutions that RMAG can implement itself. In the next section we focus on actions which require outside cooperation.

*1. Acquiring researchers with an international reputation.*

In the long run we believe that it is important that RMAG itself produce some researchers with an international reputation. We think it is likely that some of the researchers that have recently left will be in this category in a few years. We discuss below changes to try and ensure promising junior people are attracted out of graduate school and stay at RMAG.

In the short run it will be necessary to acquire senior scholars with an international reputation from outside. We can think of a variety of ways of adding one or more high-visibility researchers. These specific recommendations are not mutually exclusive; we favor pursuing them all to the extent possible.

Starting with the most modest approach, we suggest adding a stable of visiting scholars who come in on a regular basis (weekly or bi-weekly). Frederic Mishkin used a group like this to serve as an informal advisory board on a number of strategic issues. We

believe that rehabilitating this model, albeit with some modifications, would be desirable. As under Mishkin, it would be important to select the consultants with the mutual understanding that they have a long horizon and that they accept the responsibilities that are associated with having a stake in the institution. This means that scholars would participate in medium term roles such as conference planning and, especially, recruiting.

In contrast to the Mishkin model, we recommend expanding the set of outsiders to include two clusters, one around macro and international, and a second around banking, capital markets and payment systems. In particular, it is important that almost all potential members of the department see the visiting scholars as a pool of experts that make the Bank a stimulating place to work. Allowing the staff to play a role in identifying candidates will create excitement and momentum going into this year's recruiting season.

We favor going this route even if budget constraints require giving up one or two full-positions to pay the consultants; it is important that the compensation for the scholars is benchmarked with other Reserve Banks and that a possible adjustment is made for the local market and opportunity set. However, we believe the budget would permit landing world class visitors if the program is organized well.

A second recommendation is to formalize a program of having one-year research visitors each year. They would receive the same salary as from their home institution with no specific responsibility. The Bank of England has a program that is very successful and has a growing reputation. Other Central Banks (e.g. Japan, New Zealand, Hong Kong) also have active programs. We suggest that RMAG consider having at least two positions of this type each year, again one in macro and international, and a second in banking, capital markets and payment systems. It would be particularly beneficial to advertise these positions and commit to having people signed up this fall for next year, so that this can be communicated to job candidates during this year's recruiting. We do not think that it will be difficult to fill these positions with first rate people. For example, one of us mentioned this to a senior faculty member at NYU and he said he would certainly be interested in this kind of position.

A third and more advanced version of this model is to look for a 2-year visitor to take a position as Economic Advisor with the rank of Senior Vice President to serve as a research leader. This position could be modeled after the rotating two-year position in the IMF Research Department that has in the past been occupied by Max Corden, Guillermo Calvo, Barry Eichengreen and others. The logic here is that the pool of leading academic economists who might be willing to take two years of leave from their university is vastly greater than those who are willing to move for a longer period of time (which in practice often means giving up academia permanently). This position would not have administrative responsibility, but would serve as a mentor and inspirational leader for researchers.

Finally, our boldest suggestion and our preferred arrangement is to create a Senior Vice President or Executive Vice-President position for someone with an international

reputation in the economics profession. The position would be ear-marked for research and largely free from administration. This person initially would probably have to be from outside the bank. The hope would be eventually to promote someone from within to such a position. Although staff have been repeatedly assured that there exists a path of advancement without major managerial responsibilities, in the absence of a concrete example/role model most of them don't believe it. Thus an eventual internal promotion would serve this role as well. We are aware that the title of Executive Vice President is a high position, implying a regular working relationship with the President and other EVPs. This proposal would work best if the incoming President felt that the use of an Economic Counselor, in addition to the Director of the Research Department, could be valuable to him or her. Of course there would be nothing wrong with combining the two positions at some future date -- the Mishkin model -- if someone could be found who is of the appropriate academic stature and welcomes a long-term commitment that includes administrative duties. In any case, as a matter of policy we believe that this is the single best way for the Bank to signal unwavering commitment to having a world-class staff of economists.

Needless to say, these initiatives would be mutually reinforcing. If all our recommendations were pursued, the RMAG group would have deep relationships with a host of very visible scholars. The external reputation of the group would be solidified and recruiting and retention would be come much easier.

## *2. Clarifying the research career path.*

One important issue in many central bank research departments is the extent to which it is possible to have a research career for one's entire career comparable to the opportunities in academia. In order to progress in terms of rank and salary people have traditionally had to take management roles. The senior management has stressed to us that this is no longer the case at the New York Fed. They accept the principle that professionals without management responsibilities can rise to at least the level of Senior Vice President.

The problem at the moment is that it seems that all the Senior Vice Presidents in the RMAG have had managerial roles. There are no examples of people with pure research careers comparable to those in academia. It is important that in the near future some people without extensive managerial experience be promoted to make it credible that this type of career is possible. At the moment it is perceived among the more junior researchers that one needs to do client work and be visible in the bank in order to be promoted and do well.

As we understand it, until recently people who became function heads stayed in these positions until they retired or were promoted to other positions. Because of the burdens associated with these jobs many people gave up being active researchers. We believe it is a desirable innovation that being a function head should not be a permanent position but should rotate in much the same way that being department chair rotates in university departments. Although it should not be a precondition that function heads be active

researchers, we believe that going forward this should be encouraged more than it is currently. We found a feeling among the more junior ranks that people doing active research would be better able to judge their progress, manage their time and protect them from disruptions associated with client work that had a negative impact on their research productivity.

We think it important that people within the group perceive that becoming Director of Research from within RMAG is possible. Also once a person has become Director of Research going back to being a senior researcher should be possible. An example of the latter at another Federal Reserve System bank would be Marvin Goodfriend at the Richmond Fed who is Senior Vice President and Policy Advisor.

### *3. Attracting and retaining monetary policy researchers.*

The dearth of monetary economists can be reversed quickly by putting priority on making several appointments in this field. The Bank needs to be pro-active in its search (considering both junior and more experienced candidates). The envisaged stable of macro and international scholars should be used as a resource for identifying candidates, especially among established economists.

### *4. Competing with business schools.*

Salaries at the Bank can increase with age, whereas in academia salaries in the field of finance are strikingly flat, with relatively little difference between junior and senior people. As a result, it is easier to hire people who are several years out rather than hiring new Ph.D.'s. The RMAG has been successful in adopting this strategy. The group may also be particularly able to hire new Ph.D.'s in years when the market is poor from the viewpoint of these students.

Furthermore, the committee understood from Mr. Stewart that other areas of the Bank deal with differences in salaries in different fields by having midpoints and ranges for each rank depending on the area in which they work. We think that this should be considered for Financial Economists. For instance, in the efforts to retain people who left for business schools, this kind of mechanism might have been helpful.

One important issue associated with having staff in areas other than Economics per se is that the incentive system needs to reflect the standards in the person's particular field. An example would be the ranking of journals. In top finance departments the *Journal of Finance*, *Journal of Financial Economics*, and *Review of Financial Studies* are all ranked equally. They are ranked on a par with the top Economics journals like the *American Economic Review*, *Journal of Political Economy* and *Econometrica*. The second tier Finance journals are the *Journal of Financial and Quantitative Analysis*, *Journal of Business*, *Journal of Money, Credit and Banking*, and *Journal of Financial Intermediation*. For people to be attracted from Finance Departments we believe that it is important that the incentive system for people doing finance reflect that in Finance Departments. The points system should be changed to reflect this. Otherwise it will be

more difficult to attract seasoned Finance people or rookies who would at some point like to return to academia. Similarly in other specialist areas such as insurance, it is important that people be judged by the standards of economists in their own field.

#### *5. Fully exploiting research and policy synergies.*

A great advantage that people have from being a member of RMAG is constant exposure to many fascinating policy issues and practical problems that the bank faces. Although we noted important examples of people exploiting synergies from this exposure, there seems to be a feeling among a range of the people that we spoke with that there is scope for more.

We have a couple of suggestions for helping this process along. The first is to have regular “brainstorming sessions” with the heads of the key operational groups within the Bank. Some of the EVPs that we met with indicated that they would be willing to participate in such sessions. These could perhaps occur on a biannual basis, or even quarterly. The second suggestion is to make it clear that rotations through the operational departments are possible if both sides agree. (We are not suggesting that people should be forced to rotate.)

#### *6. Miscellaneous specific issues*

We understand from several people that the organization of seminar series is being reconsidered. It appears that right now there are too many seminars, with the result being uneven attendance. (We have had some feedback from outsiders who were surprised at the low turnout at their talks.) Cutting back the number of talks and increasing the attendance levels would be wise. Coordinating with NYU and Columbia is always a good way of getting speakers, of course.

Several people mentioned that the travel policy is problematic. A limit of \$2000 per year for an active scholar is too low: for instance, this could preclude attending the American Economic Association/American Finance Association and the Western Finance Association meetings. It appears now that in practice a productive scholar can exceed the limit. But this is accomplished only because some people do very little travel and the function heads seem to transfer money amongst people. This leaves the person with multiple seminar or conference invitations feeling guilty and sends the signal that visibility is not strongly encouraged. The budget for travel should reflect the productivity of the person in question, with the stars being explicitly encouraged to travel to show off their strongest papers. Having people present research at conferences and seminars is a very good way to raise the research profile of the group. However, being on the program should not be a precondition for attending a conference that is paid for by RMAG.

#### *Summary of specific recommendations*

- Attract one or several scholars with an international or field-wide reputation on a permanent full-time basis. We see the absence on the current roster of any

economist with a marquee name as the biggest problem for recruiting, due to signaling.

- Institute a revolving two-year position to be held by an academic scholar with an international reputation.
- Establish and widely advertise two staff positions for one year visitors. One of these scholars should have either macro or international interests, the other should have interests in banking, capital markets or payment systems.
- Attract several part-time visitors in the areas of macro and international, and banking, capital markets and payment systems.
- Clarify the research career path in the group. Make tangible that it is possible for someone sufficiently good at research to attain promotions without substantial administrative duties.
- Place priority on hiring in the specific area of monetary policy.
- Modify the evaluation system and compensation structure to be able to better compete with business schools.
- Try to exploit fully the synergies between research and policy work by having brainstorming sessions with the operational groups and facilitating rotations.
- Cut down the number of seminars. Reform the travel budget system to encourage more visibility of RMAG researchers.

#### **4. Recommendations for changes that lie outside RMAG**

Finally, we have a couple of specific suggestions that lie outside the control of the RMAG.

- We strongly encourage the Bank to appoint a leading academic economist to the Board of Directors. Some districts, such as Boston, have used academic economists heavily and successfully in this role. An economist could add to the dialogue and policy discussions among the Board. Moreover, an economist would be able to explain the value of research to the other Directors and would serve as another strong public signal about the value the Bank places on research.
- It strikes us that the current arrangement whereby virtually every Federal Reserve District has its own equivalent of the Economic Policy Review bulletin and Current Issues publications is excessive. We do recognize an important role for such publications, outside the readership of Ph.D. economists. For example, these articles are often perfect for undergraduate reading lists. But it appears that there

is considerable redundancy in the current system and that these resources could be better used in a variety of ways.

## **Appendix**

The Documents that we reviewed in advance of the visit included:

Suggested Issues for External Review of Research (the remit that we were given).

Introduction to Research (The document given to potential hires to give them an overview of the department).

Strategic Objectives of the Research and Market Analysis Group (The mission statement for the Group.)

### Publications

<u>Client Work (2002)</u>	<u>CV and client work details by Function</u>	<u>CV and client work details by Salary Grade</u>
<u>Public Speaking</u>		
<u>Referee Work</u>		
<u>Press Citations</u>		
<u>(Nexis)</u>		

Salary Structure for Economists

Demographic Information

Five-Year Strategy for Research

Budget Information

Recruiting After-Action Review Note

Improving the Research Environment (MS Word)