Federal Reserve Board Oral History Project

Interview with

Edward W. Kelley

Former Member, Board of Governors of the Federal Reserve System

Date: September 22, 2010

Location: Washington, D.C.

Interviewers: Lynn Fox, Winthrop P. Hambley, and David H. Small

Federal Reserve Board Oral History Project

In connection with the centennial anniversary of the Federal Reserve in 2013, the Board undertook an oral history project to collect personal recollections of a range of former Governors and senior staff members, including their background and education before working at the Board; important economic, monetary policy, and regulatory developments during their careers; and impressions of the institution's culture.

Following the interview, each participant was given the opportunity to edit and revise the transcript. In some cases, the Board staff also removed confidential FOMC and Board material in accordance with records retention and disposition schedules covering FOMC and Board records that were approved by the National Archives and Records Administration.

Note that the views of the participants and interviewers are their own and are not in any way approved or endorsed by the Board of Governors of the Federal Reserve System. Because the conversations are based on personal recollections, they may include misstatements and errors.

Contents

MS. FOX. This is Wednesday, September 22, 2010. We are interviewing Edward W. Kelley, known as "Mike," as part of the Federal Reserve Board's Oral History Project. Mike Kelley joined the Board on May 26, 1987. He was reappointed in 1990, and resigned December 31, 2001. I am Lynn Fox, a senior adviser in the Board's Office of Staff Director. I am joined by Winthrop Hambley, a senior adviser in the Office of Board members[, and David Small of the Board's FOMC (Federal Open Market Committee) Secretariat in the Division of Monetary Affairs]. The interview is taking place at the Board of Governors in Washington, D.C.

I thought we would start with some background about your pre-Fed years.

Background

MR. KELLEY. Out of college, I went into the navy and served for two years. After that, I went to work for a year at a small company ($3 million in sales) that my father had owned. My mother kept it after he died, and it sort of existed; it hadn't done much. I soon realized that, if I was going to do anything in this world, I had to get additional education, so I applied and went to Harvard Business School. I was there from the fall of 1957 until I graduated in the spring of 1959.

In the spring of 1959, a couple of longtime employees from our company came to me and told me confidentially that there were some things going on that Mother and the other board members were unaware of—things that were way, way wrong. I investigated and found out that was true, so I took a short break from school, went home, and had that management fired. I ran the company from the Harvard Business School for the last two months that I was up there. [Laughter] It was mostly a wholesaling firm at that point. I ran it over the telephone while I finished up my degree. I took my last exam, flew home from Logan Airport, and was president of the company on Monday morning. That wasn't quite as crazy as you think, because I'd been working there off and on all my life, since I was a kid. I'd done just about every job in the place except run it. I had some fine people there who weren't themselves quite up to running the place, but they were very strong helpers. This was in Houston, Texas. I ran that company for 22, 23 years—from the spring of 1959 until I sold it in the spring of 1982. We had some pretty good success. We'd grown a lot. When I sold it, we had sales of about $50 million (which would equate to perhaps $175 million today) and about 800 employees. So the company had done well.

For several years, I went into some venture capital things and was chairman of the board of a money management firm run by a friend who was a wonderful market person but not a very good manager. For a long time I had said that I would love to go to work for the government at some point, but the only job that I would really love to have was to be a Governor of the Federal Reserve Board. I said that for years!

MS. FOX. Did you study economics?

MR. KELLEY. I never took an economics course in my life. But I did study economics. I worked on it a lot. I was not a total naif when I arrived at the Board, although by Fed standards I certainly was a beginner. I'd been very interested in economics, in macroeconomics and policy, for a long time and had read a lot of it. Even though I never took a formal course, I was into it and certainly interested in it.

Nomination to the Board

It was amazing. You have to be careful what you ask for. Every once in while you get it! [Laughter] In my case, I got the nomination to the Board, and it was wonderful. I've talked to any number of Governors about how they got here. There is no standard way to do it. Everybody's story is different. I suspect mine may be one of the most unusual of all, because it involves an incredibly low-probability congruence of a number of individually highly unlikely probabilities.

About 1984 or 1985, the Dallas Fed, which had not had a Governor on the Board for some time, started to agitate for that. I don't know anything about the process by which they were agitating to get it, but they told me they were. After a while, Washington signaled Dallas that they were looking for a new Governor who had business experience. They thought that they had an overabundance of macroeconomists and not enough business experience on the Board. The Fed has a lot of business involved in it—it is a business organization. The Reagan Administration wanted to find somebody who had a business background that could reasonably be a Fed Governor. That could have been any one of 100,000 people. At any rate, the chairman of the Board of Directors of the Dallas Fed, Bob Rogers, who was a friend of mine, asked me if I knew anybody who would be appropriate for that role.

I went home and talked to my wife, Ellen. She said, "You've been talking about this for a long time, so put your money where your mouth is or shut up. Either raise your hand or don't come to me about it anymore." So I thought about it for about a day, and I went back to Bob and said, "How about me?" And he said, "We'll see."

MS. FOX. Had you been on the Dallas Fed's board of directors?

MR. KELLEY. No. I was known to them because the chairman of the board, Bob Rogers, was a friend of mine. He was the chief executive of Texas Industries, which was a good-sized publicly held company, and I was on the board of that company.

Well, time passed. And at some point along the line, the Secretary of the Treasury called me. The Secretary of the Treasury happened to be Jim Baker, whom I had grown up just a block away from. We had been friends almost since we were in the crib. He's a year and a half older than I am, but we had grown up together in Houston and played sports together. And, of course, we all know what Jim Baker became when he grew up. [Laughter]

Jim called and said, “Kelley, your name’s on a list here of people that we should consider as possible Governors for the Federal Reserve. Do you really want to do that?” I said, “Well, Jim, I don’t think my name would be on there if I hadn’t already said I would like to do that.” He said, “Okay,” and hung up. Some time went by, and at least one more Governor appointment went by. I think it was Robert “Bob” Heller, perhaps Wayne Angell. I’m not sure. Then, lo and behold, in late 1986, I got a call—I think it was from the press—saying that it had been leaked that I was on a short list for the next seat. I said, “I don’t know anything about it, and I certainly don’t have anything to say about it.” Sure enough, I was asked to come up and visit in Washington, and, by golly, in January 1987, I was selected. The rest of that is history.

MR. HAMBLEY. You said that you have always wanted to be involved in government service and you thought that you really wanted a position on the Federal Reserve Board. What was it about the Fed that made you have that desire?

MR. KELLEY. Well, I was not interested in partisan politics. My philosophy was basically Republican, as Republican was known in those days—not anymore. I had worked for Richard M. Nixon and been a state finance chairman for John Tower, so I had a little bit of Republican background, but I did not want to pursue that as a career track. I was interested in economics and business, and the Federal Reserve seemed like a nonpartisan place where the work of the world in that area got done.

MS. FOX. In the business world, you had many conversations about monetary policy and what was happening.

MR. KELLEY. Particularly after I sold my little manufacturing company and went into the money management business. They care a lot and give a lot of attention to the Fed. So that was fairly intensive for those several years.

MS. FOX. Did you know any of the Governors?

MR. KELLEY. I did not know any of the Governors. When I was named, I received a phone call from Manley Johnson welcoming me into the Board, telling me that he was looking forward to our meeting and asking what he could do to help me. I'll never forget it. I appreciated the call so much. That's the first time I'd ever had any contact with anybody on the Board.

MS. FOX. Back to the moment after the press called and you had no comment—what happened next?

MR. KELLEY. A few days after that, I got a call from Secretary Baker saying that the President wanted to nominate me. He asked me whether I was ready to go. I said, "Yes, I guess so." [Laughter] A couple of days after that, I got a call from somebody else. I can't remember who. It may have been John F.W. Rogers, who was assistant secretary of the Treasury for management. The caller said, "Your nomination is going to be announced later on today. You're probably going to get some calls from the press." Boy, did I ever, and I'd never gotten a call from the press before in my life. So the game was on.

MS. FOX. During that period between the first call from Baker and that call from the press, did you have additional contact with the Treasury and the White House?

MR. KELLEY. No.

MS. FOX. Did you interview at the White House?

MR. KELLEY. I interviewed with Beryl Sprinkel, who was chairman of the Council of Economic Advisers [1985–89]. I had two interviews in the Office of Presidential Personnel. The work of that office was divvied up into sections of the government. In the finance area, Mark Sullivan [associate director for legal and financial affairs for the Office of Presidential Personnel] was in charge. He was a lawyer and longtime Republican activist. Mark and I got along famously, and we're good friends to this day.

MS. FOX. What did they ask you in those interviews?

MR. KELLEY. Pretty standard stuff—my background, why did I want to do this, what did I think about the Fed. I can't remember the details of those interviews, but they were cordial and businesslike. They were professional and arm's length and very appropriate. They were sending signals to me like it was a done deal, like we were just kind of going through motions.

MS. FOX. Thank you, Jim Baker.

MR. KELLEY. Yes, exactly. [Laughter]

MS. FOX. How many people knew you were interviewing at the White House?

MR. KELLEY. Very few.

MS. FOX. What was your wife's advice at that point?

MR. KELLEY. "Go for it. Do your best. Let the chips fall where they may. If you're supposed to be there, you'll get it. If you're not, you won't." I had a distinct impression, and when I went to National Airport to fly home that night, I called her and said, "This may happen." [Laughter] And it did.

MS. FOX. Tell us about the public announcement and other phone calls from the Board or other advice that you got in those first hours.

MR. KELLEY. I don't recall any other phone calls from the Board.

MS. FOX. Board staff from the Public Affairs Office didn't call to tell you not to talk to the press? [Laughter]

MR. KELLEY. Jim Baker told me that. [Laughter] I didn't get a call from anybody at the Fed at all, sure didn't. It went off into this maze of things that you have to do in the way of filling out incredible forms, first of all for the White House and then a whole separate set for the Senate Banking Committee. Then the FBI comes around and interviews all of your friends and next door neighbors and wants to know what you think. When I was reappointed two years later, the FBI went through the whole thing again, and they went back to many of the same people. My friend Dan called me and said, "Hey, Mike, I just got another call from the FBI, and I started to tell them the truth this time." [Laughter]

MS. FOX. When was your Senate confirmation hearing?

MR. KELLEY. My hearing was in early May [May 5, 1987]. The process took a long time. There were no hang-ups in the Senate. It just took a long time to do. Finally, the hearing was scheduled. I came up to the Board and went through the intensive series of briefings that you get from the Board staff, which was just wonderful. God!

MS. FOX. When did you first come to the Federal Reserve Board's building?

MR. KELLEY. The first time I came here was with my friend Bob Rogers, when he was chair of the Board of Directors of the Dallas Fed. He said, "I've got to go to Washington to the Board. You want to come with me? I'll introduce you to Volcker and show you the Board." I said, "Sure, I'd love to." So I came up here with him. That must have been February or March, somewhere in there, when I was subject to an intent to nominate, which they do until they get the papers back. I was under that for a long time. Then, almost at the last minute, they literally nominate you. Then the nomination goes over to the Senate.

MR. HAMBLEY. So the delay you were talking about was the background checks.

MR. KELLEY. Right. The delay wasn't in the Senate.

MS. FOX. When you came to the Board with Bob Rogers, was that the first time you talked to Chairman Volcker about the job?

MR. KELLEY. Yes. Not long after that, when I was getting ready to start doing the briefings, Paul Volcker asked me to have breakfast with him, which I did. I wasn't aware of it at the time—I became aware of it later—but there were already, apparently, tensions between Volcker and the Administration, which resulted in Volcker finally deciding that he would resign. I strongly suspect, but was never told, that he'd been told he wasn't going to be reappointed, so he jumped in front of that train. At any rate, he was still in charge.

It was clear to me that my name just came out of the blue, and he didn't know me from a load of coal. All he knew about me was that I was a good friend of Jim Baker's. That's what the press kept endlessly reporting. Volcker really didn't know what to make of me, probably didn't trust me, and wondered why I was being put here. When we had breakfast, he was very arm's length. I finally said, "Paul, it's clear to me that there is not a complete level of acceptance here, shall we say," or some words to that effect. I said, "I strongly suspect it's because of my relationship with Jim Baker. I just want to tell you that, as far as I'm concerned, I was asked by the President to come serve at the Federal Reserve for two and a half years," the remaining period of time on that term. "I said to the President that I would come if confirmed. I am not coming with any agenda whatsoever. Jim Baker has not asked me to do anything or say anything or tell him anything. And if he had, I would have refused the nomination on the spot," which I would have. "So there's nothing there. I'm going to come here and help you, if I can, in any way you want me to." From that minute until now, I have [had] a great relationship with Paul Volcker.

MS. FOX. After that breakfast, what happened?

MR. KELLEY. After that breakfast, Paul was wonderful to me. He was down here as a bachelor. His wife was ill in New York. I came up here "baching" it myself for the first six months. Paul and I frequently had dinner together. He was terrific, and he's still terrific. There's nobody I think more highly of, both personally and professionally. That was a major plus, a big help.

MS. FOX. Do you remember any of the Senate courtesy calls?

MR. KELLEY. I did some of those, but not too many. I was lucky. At the time I was going through the nomination process, the focus was on the Iran–Contra flak. Everybody in the Administration and the Congress was completely absorbed with that. They could have cared less about some new guy becoming a Governor at the Federal Reserve. It just wasn't on their radar screen at the time.

Senator William Proxmire was chairman of the Banking Committee. He did his job in a responsible way. I went and had a long talk with him and maybe one or two others. I don't remember who. I'm sure there were other visits. The Fed assigned somebody to take me around.

MS. FOX. It might have been Anthony "Tony" Cole.

MR. KELLEY. That sounds right. At any rate, I got shepherded around to meet a few Senators, but not too many.

The only thing I remember about the staff briefing was that it was like taking a drink through a fire hose. I was climbing a vertical learning curve [laughter], scratching my way up, and learning an incredible number of things. The staff members were all very patient. They were willing to go back to the 101 level and work up from there when we had to, which was quite frequent. I didn't know anything about the inner workings of the Federal Reserve. I don't think many new Governors do. I'm sure many of them knew more than I did, but I think everybody that comes here has a learning curve to climb when they first arrive.

MS. FOX. How did you feel in positioning yourself in those briefings with the staff whom you were ultimately going to direct?

MR. KELLEY. No problem at all! I was here to learn, and they were willing to teach. I learned a great deal and came a long way. I had much, much more to learn and kept on learning for 14 years. But I sure got a lot in that first week from those people.

MR. HAMBLEY. Were you surprised by the breadth of things that the Fed did?

MR. KELLEY. Very much so. For instance, I knew nothing whatsoever about the extent of the financial services business, which is what I came to spend a big part of my time on after I was here a while. I was delighted to find it, because this is a competitive business in a competitive industry. I was very comfortable with that. I had to learn about check processing, but the essence of that business was not strange to me at all. So that was very helpful. My economist colleagues didn't want to do that type of management work. They were happy to have me do it, and I was happy to do it.

MS. FOX. During the briefings, when staff talked about monetary policy, did you feel comfortable with their perspective on the economy?

MR. KELLEY. It was fairly academic. If we had talked about how this stuff would impact the man on the street and the businesses that employ people, which I talked about a lot once I got on the Board, I would have felt much more comfortable. I'd run a company for 20 years. But that came later.

In the area of monetary policy mechanics, particularly, a lot was new to me. I had a huge learning curve to climb there. But I came to have my own style. How I worked, participated, and contributed was a little bit different than the professional economists because my background was different from their background.

MS. FOX. Senator Proxmire was oftentimes critical of the Fed. He was against inflation and tough on potential candidates.

MR. KELLEY. He wasn't tough on me, but he wanted to know if I had any idea what I was doing. And I was barely able to convince him that that part was okay. [Laughter] He was polite and professional. He was not antagonistic at all. He probed and was very complete. And we made it through.

MR. HAMBLEY. Other than that, the confirmation process wasn't too tough.

MR. KELLEY. No, it wasn't too terribly bad. I was so new to all of this. I was just on the edge of my chair all the time. But thanks largely to the staff and what I knew about what was going on in the economy, I was able to satisfy him, and we got through the confirmation hearing okay. Aside from Proxmire, no other member of the Committee was at my hearing. But they all voted for my nomination, including Jim Bunning. [Laughter] That's almost an insult, because Bunning opposes everybody that comes into the Fed—but he voted for me. At the time, I thought that was great, but after a few years I realized that wasn't necessarily a compliment. We're not going to say bad things about people. At any rate, he was a difficult Senator.

MR. HAMBLEY. There was a story that your prepared statement for the Banking Committee somehow had gone off into the ether.

MR. KELLEY. Yes. I'd forgotten about that.

MR. HAMBLEY. So there was nothing that you said in that statement that provoked questioning from Senator Proxmire?

MR. KELLEY. No! They didn't pay it any mind. I had a written statement that I was advised by Board staff to prepare. You're supposed to submit it 24 hours before the hearing, which I did, duly. Apparently, it wasn't distributed to the Committee members. That was something on the part of the Hill staff. It just disappeared into the ozone. But that was fine, because what Proxmire asked me was a lot of that same stuff. And I'd been working on that.

At the hearing I was paired with somebody from some other agency. [Carl D. Covitz had been nominated for undersecretary of the Department of Housing and Urban Development.] He and I sat up there for about an hour and a half, and he never ever got a question. It was entirely directed to me. He also got a unanimous vote from the committee. Interesting counterpoint to that: Two years later when I was nominated for my own term and went up there for my hearing, I was paired with David Mullins, who was a bit of a lightning rod at that point, coming off of that study that they had done about the October market breakdown.[1] He had been at the Treasury, and he had been involved in that study, and he was rather outspoken. Several Senators were kind of laying for him. So at that confirmation hearing, I was paired with him. I sat there for an hour and a half and never got asked a question.

MR. HAMBLEY. What did it feel like to be sitting in front of the Senate? Was there much anticipation? Were you worried?

MR. KELLEY. Absolutely.

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[1] U.S. Presidential Task Force on Market Mechanisms and U.S. Department of Treasury (1988), *Report of the Presidential Task Force on Market Mechanisms: Submitted to the President of the United States, the Secretary of the Treasury, and the Chairman of the Federal Reserve Board* (Washington: Department of Treasury).

MR. HAMBLEY. Did you have a huge sigh of relief when it was over?

MR. KELLEY. I got a big hug from my wife, and we went out of there. It was easily the most intense single thing I've ever had to do. But it went all right.

Swearing-In

MS. FOX. Tell us about your swearing-in.

MR. KELLEY. Well, the actual swearing-in was immediately after I was confirmed by the Senate. Just a couple of days after the confirmation, I was sworn in by Volcker in the Chairman's office. As I recall, my wife was still back in Houston. It was very quick and informal. I walked out of Volcker's office, and there was a stack of work that had to be done by tomorrow morning. [Laughter]

About a month after that, there was an official swearing-in, and it turned out to be a bit of an event. We asked a number of my friends from Houston to come, never dreaming any of them would, and damn if they didn't all come. So there was a pretty good crowd. It was in the Board Room, and the swearing-in was repeated. Jim Baker swore me in this time, and he made a few remarks. I believe that was probably the first time I met Alan Greenspan. At that point, he had been named to be the successor. When Volcker went out, almost like that [snaps his fingers] they named Greenspan.

MS. FOX. You said a couple of funny things at your swearing-in ceremony.

MR. KELLEY. Houston was in a big recession at that point. So I said to Jim Baker, "Jimmy, you're probably as surprised as I am to see so many of our mutual friends here. I think it happened because Houston's in a deep recession, and the word got around that one of our group had found steady work." [Laughter]

MS. FOX. That was when you started calling yourself the LIFO Governor.

MR. KELLEY. I am astonished that you picked that up. I'd forgotten. I had been here a few months, and I was asked to address the officers' luncheon, which I did. We had some questions and answers after that. The subject came up about how long I was going to be here. My term was the next one that was going to run out. I was also the most recent Governor that had been named and had come on board. As you know, LIFO is an inventory management term for "last in, first out." So while I was answering that question that I probably wasn't going to be here very long, it just popped in my head. I said, "I think I'm going to be the LIFO Governor—last in, first out." Well, they all knew that term, and that broke everybody up. That's the last I've heard about that until you asked this question. [Laughter]

MS. FOX. It didn't turn out to be true—

MR. KELLEY. —because George Bush got elected President, and I was named to my own term.

Texas and the Economy in the 1980s

MS. FOX. Tell us about the Texas that you were coming from and the 1980s. What was confronting the economy when you were nominated?

MR. KELLEY. In Texas at that time, two busts happened in succession, and one caused the other. In early 1982, there was a recession in the oil industry. In those days, Houston and Texas generally were the center of the world's oil. The configuration of that industry at that time didn't look anything like it looks today. It was very Texas-centered.

There was also a boom going on in commercial real estate in Texas. New office buildings were going up all over everywhere. When the oil industry went bust, they found out—to their surprise, apparently—that the real estate boom was entirely derivative of the oil industry's boom. When the oil industry went bust, the real estate industry went right after it. In the mid-1980s, two of the mainstays of the Texas economy were deeply in the tank at the same time. That was a very rare occurrence for the economy down there.

MR. HAMBLEY. Did that also have implications for the banks in the area?

MR. KELLEY. Well, yes. They had not been in any trouble, particularly, but they were certainly challenged, because they were all into both those industries and largely dependent on them. There was no banking crisis at all, but there were certainly tougher times in the banking industry, for sure. The banking industry then was still managed far more conservatively than has been the case in the last few years up here. You could get through a time like that without turning your toes up.

MS. FOX. Did the oil profits generate the building boom, or was there crazy financing going on?

MR. KELLEY. It was literally profitable to lose money in the real estate business because of the tax law.

MR. HAMBLEY. It was accelerated depreciation—

MR. KELLEY. Accelerated depreciation contributed enormously to that boom. But by the time that, all of a sudden, was removed and all of the air went out of the room, there were a few years in there where you could see right through certain skyscrapers—and all over the state.

MS. FOX. You had been in Texas all your life. The Board's culture is pretty "Eastern establishment."

MR. KELLEY. Oh, yes! It may surprise you—and probably still would surprise a lot of people—to know that not everybody that lived in Texas was a cowboy. A lot of us that lived down there went to great lengths to make sure that we weren't like that. This business of wearing big cowboy hats and boots in New York, those people didn't dress like that in Texas.

They dug that stuff out and took it in their suitcase and put it on when they got to New York! [Laughter] There still was a cowboy culture in Texas, but it was largely mythological at that point. And the J.R. Ewing phenomenon, from the television show *Dallas,* was the cowboy transferred over to the oil industry. It was the same sort of mindset. Most people in Texas weren't like that.

MS. FOX. So when you came here, you didn't feel out of place in that regard.

MR. KELLEY. I didn't feel out of place, and I was never made to feel out of place by anybody here. But I was teased some about some of the Texas phrases that I would use. I had a long-running deal with Dave Shannon about that. He loved all those Texas phrases I'd come up with instinctively, and he made a great point of not understanding what I meant—but, of course, he did. When there was something that looked like it was going to be a little bit of a problem, I'd say, "I think there's dust on the horizon," which refers to the possibility that there are Indians over there.

Three Months under Volcker Fed

MS. FOX. You arrived here at a time when Chairman Volcker was dealing with a difficult relationship with the Administration and with perhaps even some of the newer Governors. There had been a discount rate vote against the Chairman prior to your arrival.

MR. KELLEY. I don't think that ever achieved the kind of attention in the press that it would today if the same thing happened. It was not a big public event. It was a very big event in this building, but it never got a heck of a lot of sophisticated attention. I don't remember much about it, and I was paying careful attention. I knew it was going on, but it wasn't a big deal across the country at that time. By the time I got here, it had long since healed over. In fact, when I got here and was sworn in, it was only at the most two weeks, maybe less, when Volcker announced that he was not going to accept reappointment if offered.

I was told subsequently by staff and some of my colleagues on the Board that things changed instantly when he said that. The way that the Board had worked and reacted and interacted changed. The pace of the Board changed immediately. I never really experienced life at the Fed under Volcker.

MS. FOX. In what ways did they change?

MR. KELLEY. I wasn't here, and I can't tell you. I was just told it had changed. What I saw of living under Volcker was his last two months here, when he had already announced that he was a lame duck and was leaving and Greenspan was coming. It was very much of an interim time here. I did not experience life at the Board under Volcker.

MS. FOX. Do you recall anything about following that episode or following Preston Martin?

MR. KELLEY. It was all over and gone by the time I got here. I met Pres. He was here every once in a great while. His relationships, as far as I could see, were perfectly cordial; there was no problem at all. But I never got to know him well. Whatever scar tissue may have remained from whatever caused him to leave was long since healed over hard and fine.

Fed Colleagues

MS. FOX. Tell us about your introduction to your colleagues and how you spent time with them initially. You said Manley Johnson called you first.

MR. KELLEY. He was great when I got here. It meant so much to me. From that day forward until I left here, every time a new Governor was nominated, I called and made a point of trying to help them understand what went on here. And I made a lot of good friends doing that. It all stemmed from the fact that Manley had been so great to me.

MR. HAMBLEY. What would you say to them?

MR. KELLEY. I would say, "Congratulations. Look forward to meeting you. As soon as you come up here, let me know you're coming. Let's have lunch together. I'll tell you about life at the Board. Any way I can help you, please let me know." I had an early lunch with every single one of them. Even the people who were very sophisticated in macroeconomics and had been part of the public debate—like, say, Alan Blinder—didn't know how life at the Board worked. So I was able to help at that point and was very happy to do that.

MS. FOX. In addition to Manley Johnson, who were the members of [the] Board when you arrived?

MR. KELLEY. Bob Heller, Wayne Angell, and Martha Seger. And, of course, Paul was here when I first came. Everybody was nice, and everybody was helpful. They were all very professional, and they were all very much into their own thing. Each one of them had a different thing and a different style.

First Board and FOMC Meetings

MS. FOX. Do you recall your first Board meeting or your first FOMC meeting?

MR. KELLEY. I don't recall much about them. They were just a blur. I was still climbing that learning curve like crazy and trying to listen. I don't remember what I said at the first FOMC meeting, but I did speak. I'm sure it was not very relevant. That was an experience. The Bank presidents were all great. I came to be good friends with all of them.

MS. FOX. Do you recall your feelings about the level of the conversation and the kind of information that was being exchanged?

MR. KELLEY. Oh, very much so. It was on a very high level, and I had to struggle with a lot of it. There's a certain shorthand that goes on in that room. You learn it fairly quickly, but you don't know it the first day you're in there. A certain amount of stuff was going right over my head. Everybody else got it, and I didn't. But you get past that fairly quickly.

MS. FOX. In the go-around part, when each of the Reserve Bank presidents talk about business conditions in their Districts, you must have felt comfortable.

MR. KELLEY. Well, I did. I always liked that part. I went to probably 125 FOMC meetings, I guess, and I always enjoyed that.

I was on the Board's Bank Activities Committee, which became the Bank Affairs Committee later, and I got to know the members of the boards of directors of all of the 12 District Banks, who were terrific. All were leaders in a different industry. Fairly early on, and all through my tenure here, I made it a point, a few days before every FOMC meeting, to call a number of them and just say, "What do you see? What's happening? What's going on?"

One of the best of those contacts that ever came down the pike was not mine at all. It was William "Bill" Poole's [president of the Federal Reserve Bank of St. Louis, 1998–2008]. He came to be very good friends with the CEO of FedEx. There is no better early warning about what's going on in the economy real-time than FedEx! Bill would contact him, and he'd tell Bill all about how things were at FedEx. I'd call my friend out in Seattle who was running Nordstrom, and he'd tell me how the retail business was going and what sort of stuff was moving and so forth. I'd call my friend down in Atlanta who made cardboard corrugated boxes. That's another very good contemporary indicator. He'd tell me how the box business was. I'd call my friend who was a big developer out on the West Coast and ask how leasing was going on in his new office buildings. Terrific!

The government data that you get is always at least a month old. All of the econometric studies and models of the economy that the staff generates all have to be backward looking. When they try to get forward looking, then they're making assumptions, just like everybody makes, and the whole value of that work goes out the window, as far as I was concerned, because they're dealing with the future, and the future is uncertain. You can't project the past into the future. You need to know it, because it tells you a lot about the vectors of how things are going, but it's never up-to-the-minute. Those guys out there running companies have to have a pretty good feel for the future, too, because they've got to know—or have a view, at least—in order to be able to run their own business. I'd been in that chair. I knew that. I personally managed an inventory system.

So those were the kind of things that were extremely valuable to me.

Board Committee Assignments

MS. FOX. How did you get your Board committee assignments?

MR. KELLEY. Well, not long after I got here, Paul put me on a couple of committees, and I started going to those meetings. I think he just said, "You're on these committees," as I recall. [Laughter] I don't remember being asked. After I started helping Greenspan work with that process, at his request, I always asked guys what they wanted to do and was usually able to give them what they wanted.

I was on the Board's Committee on Research and Statistics, which was a joke. That committee was never a functioning committee while I was here. Manley Johnson chaired the Committee on Payment Systems Policy. That was substantive, and there were things going on. I didn't understand them for a time. But I was glad to be on that committee, because that was a wonderful learning experience.

Then we had a system whereby you had the functional committees of the Board that oversaw the policy work of the staff in the individual areas. Also, each division had a Governor that oversaw the administrative process of that division—promotions and compensation levels and mundane administrative stuff, not policy stuff. I got that job in a couple of places. That was okay. I knew how to do that.

And right way I was put on the Federal Reserve Bank Activities committee, as it was known then. I was glad to do that, because that was strictly a governance job, and I'd been doing corporate governance all my life. Wayne Angell was chair of that committee. Wayne ran his committee a good deal differently from the way I tried to run it after I got it. At any rate, Wayne and I got along fine. We would disagree, but we'd go shut the door and talk it out.

First Impressions of the Board

MR. HAMBLEY. When you first came to the Board, what were some of your impressions of the place? Did you feel comfortable right away? Did it take a while to get used to it?

MR. KELLEY. I felt comfortable right away, but it did take me a while to get used to the place. Everybody was always cordial and helpful. I never felt like I was being treated as a stranger or somebody that wasn't part of the team. I always felt good about that. All of the staff officers were always ready to be helpful. Some of them went way out of their way to be helpful. That was terrific.

MS. FOX. There is a certain lore that sometimes it's hard for a Board member to develop effective information-sharing relationships with staff, or that it's a lonely, quiet place on the second floor.

MR. KELLEY. I never felt that way. It is true that the staff members are highly professional, knowledgeable, longtime people who have been here. And everybody knows that's different from the Governors, who are going in and out. I think Governors depend on that and respect it. That doesn't mean that they're necessarily going to buy every policy position that the Board staff comes to them with. There's certainly room always for a dynamic conversation there. With rare exceptions, it was able to be talked through. If a Board committee, for some reason or other, insisted on going in a different way than the staff wanted to go, that prevailed, and properly so. But I think the staff probably knew how to come back later on and get a lot of what they wanted.

MR. HAMBLEY. You said that you had a steep learning curve. Would you have people come into your office and give you one-on-one briefings?

MR. KELLEY. They were always very good about it. They were very patient. Maybe in their mind they were rolling their eyes, figuratively. But they didn't roll their eyes and were just hugely helpful. I always enormously appreciated that. The first six months I was here, my wife had not yet moved up here from Houston. I lived in a little apartment. I didn't do anything but come to work here for 12 hours a day, get a little exercise, eat, and study. I was putting in 120 hours a week, climbing learning curves, for the first six months I was here. When I finally left here, I was probably working maybe 60 to 65 hours a week, something like that. But that was long after I had learned the ropes. [Laughter]

MS. FOX. People have been asked many times over the years, "Is being a Board member a full-time job?"

MR. KELLEY. Oh, I was asked that many times too. I couldn't believe this! Bankers asked me, "How many times a year do you have to go to Washington?" Give me a break.

Alan Greenspan

MS. FOX. Tell us your recollections about Paul Volcker's departure and then Alan Greenspan's arrival.

MR. KELLEY. I don't have any strong recollection of Alan introducing himself here, except that he was very low key. He was always very confident. I think he knew more about how the Board worked than anybody else that had come here. I'm sure he spent a lot of time with the staff also. At any rate, he was always quiet. He was always confident. He was always ready to talk about whatever the subject was, fully prepared. I'd be glad to talk about him a little bit as I came to know him later and over the years.

I have tremendous respect for the man. He was a wonderful person to work with and work for. He had a great, wry sense of humor. And he was very smart, as we all know. At the same time, he was a very good listener and took into account what you said. You didn't get the impression that he was just doing this pro forma, and it was going in one ear and out the other. I would not represent that I was ever able to change Alan's mind on a point of monetary policy. No. But he wanted to know what everybody thought. On monetary policy, he had a wonderful ability to articulate positions that could create a tent big enough for almost everybody to get into. As a consequence, his leadership on the FOMC was never really challenged. It was strongly supported. I'm sure that the people who influenced him never, ever convinced him to do something he didn't want to do. My most intimate relationship with him was, over the years, when I had the Bank Affairs Committee and the several years when I had Supervision and Regulation. Incidentally, I had both of those at the same time for about three or four years. That was sort of wild.

MS. FOX. No wonder you worked so many hours.

MR. KELLEY. Yes! [Laughter] Anyway, Alan was not particularly interested in the administrative process of running an organization. He didn't care about doing that. He wanted to focus on policy. But he was smart enough and experienced enough to know that he needed to have a good, strong, well-functioning organization here behind him in order for the work under his chairmanship to be effective. So, as a consequence, if you ever needed a decision or needed to talk out something that you felt was a little bit over your pay grade, you could call him up, and he saw you just like that [snaps his fingers]. He would make a decision. Incidentally, that's one thing that didn't always happen, I'm told, before he took over.

Alan would make a clear decision, then he'd give it to you to run with. He was wonderful about that. Boy, you had to be ready to go when you'd call down to Anne [the Chairman's administrative assistant] and ask to see the Chairman about some concern you were dealing with. Three times out of four, she said, "Can you come right now?" And it was never more than 24 hours unless he was out of town on a long trip. He'd see you right away and deal with it. When you went down there to talk about something with him, you'd better be ready. You'd better have done your own homework, be able to answer whatever penetrating question you were going to get. And you got them. He was going to put you through it, and you knew that. I would do all my homework, and I would absolutely be ready to go before I ever even called Anne, because I learned I'd better be ready right away. [Laughter]

He had a great, wry sense of humor. I'll tell you a story that I remember, which I got a big kick out of. The Board would meet with the staff in the Board Room, which happened all the time, for a wide variety of purposes. The Board always sat up at one end of the table and the staff always sat down at the other end of the table. That Board table is at least three, maybe four times as long as it is wide. So after Alan was here a little while, he announced that we were going to change the seating arrangement. We were going to move to where we sat across the table instead of from end to end. The Board would sit on one side, and the staff would sit on the other. We were much, much closer together. Alan's explanation to all of us about why he made that change was that he didn't feel like he'd been getting information from the staff quickly enough. [Laughter] That was typical Greenspan humor.

Challenges Facing U.S. Banks in the Late 1980s

MR. HAMBLEY. Could you talk about the major challenges facing U.S. banks when you came to the Board?

MR. KELLEY. When I came, things were in the first stages of changing dramatically. Probably more than anything else, it was the computer explosion that we know revolutionized any number of industries in any number of ways. It influenced the banking industry as much if not more than any other industry in the whole economy. The ease and speed of transmission of information changed banking altogether.

Historically, we had a unit banking system. There were a jillion banks, and they could only operate in one place and do everything right there and nowhere else. I remember reading that in the early 1930s, when Bonnie and Clyde were going strong, there were something like 35,000 banks. They were almost like Starbucks or 7-Elevens are today—they were on every street corner. Many were tiny little things, because they could only operate in one location. By the time I got here in 1987, that had shrunk by half, and there were something like 16,000 banks still in the economy. Now it's shrunk again by more than half—it's down to about 7,000 to 8,000. It was just about to go into a radical change in 1987. First, they could go to branches. Then they could go out into different states. Then there were new businesses they could go into. It was enormously challenging to banking and to regulators, because the industry was doing things that it had traditionally done in a totally different way and doing some things that were brand new that bankers had to learn how to do efficiently and effectively.

Over the course of the 14 years I was here, we saw a complete revolution in the banking industry, which unfortunately came to an unhappy end six years after I left, with the big collapse that started in 2007. What happened was really just an in extremis version of the process that had been going on for over a decade.

Deregulation

MR. HAMBLEY. At your confirmation hearing, they had some questions about deregulation. I think you were considered to be an advocate of deregulation.

MR. KELLEY. I was.

MR. HAMBLEY. How did you come to those views? What particularly did you think would be the most important things that could be done?

MR. KELLEY. I had been a bank director for a number of years. I was a director of three different banks. I first became a bank director right after I got out of business school and started running my own company. I was a bank director always, if you will, and I could see this change coming, from that perspective. I could see that banks needed to have—and there was no reason that I could see why they should not have—broader powers to operate more like other businesses. The talk of my generation who were interested in businesses growing, and banking in particular, was that banks should and could—and did—become operated much more like other kinds of companies in other kinds of industries, operated as a business rather than as an idiosyncratic thing called a bank. I was a great believer in that process. I backed away from it a little bit since the banking industry went to such outrageous extremes and needs to be reined in now. But at the time, and for a long time, I believed that was the way to go, and that the supervision and regulation process had to adjust to those kinds of changes.

The Fed is really a business organization just like any other, in the sense that we had a product line—three different product lines, actually. One of them was supervision and regulation. Any organization that exists to provide a product to a constituency—whoever that constituency is—has to provide that product in a way that is relevant to the way the customer—in this case, the banks—needs to be serviced. In all of our product lines, we needed to evolve and adopt. We had to do it through the provision of financial services. We had to do it in supervision and regulation, because, all of a sudden, we had to look at the provision of new powers, new businesses banks were going into, branching across Districts.

Providing Cash Services

The way cash services were provided also had to change, because these large organizations were across Federal Reserve District lines and had many different branches that worked out of some central location. We had to learn how to provide our services, our products, to banks in a way that they needed in their evolving business. If you don't do that, you will lose relevance to your customers. If you lose relevance to your customers, eventually that's going to work its way up to having an adverse influence on monetary policy. So we had to learn to evolve from the very District-specific kind of culture that had always been there and had been serving the banks effectively over their long history of being unit businesses in one location. The Federal Reserve Districts were relevant to the banking industry when it was structured like that. They were comfortable with it. They knew how to do it. Every Federal Reserve banking District had developed a culture that was quite different, one from another—which was fascinating to learn and get a feel for—yet within the framework of exactly the same statutory assignment and exactly the same statutory mission. They all had the exact same business to conduct, but they all developed totally different ways to do it—different systems, different relationships. Name me anything the Fed does relative to banks, and I can show you where that needed to be changed under the new, evolving relationship with the banking industry.

MS. FOX. You said that if we weren't dealing effectively with the customers, the banks, it would ultimately have an impact on monetary policy. Did you mean that through operational channels or through political channels?

MR. KELLEY. The influence on monetary policy primarily would come through the information you were able to gather through the supervision and regulatory process and the relationships you had with the boards of those respective Federal Reserve Banks, including the branches. It was important to know the branch directors as well as the head office directors. I knew them all and made a point of having relationships with them. If we had allowed ourselves to get way out of sync with that, the whole process would have suffered enormously. It took us a long time to learn how to do it. We spent the whole decade of the 1990s readjusting the way the System's longtime, long-serving professional staff—with longtime, long-in-place ways of doing things and thinking—thought. It did not come quickly.

MS. FOX. Was that true in the supervisory world as much as in the operations world?

MR. KELLEY. I think the change came more easily through supervision, because it probably was not as profound a change. But they all had to go to school and learn how to supervise banks that were exercising these new powers. They had to learn new ways. Like the provision of credit through the window. Each [Reserve] Bank did it in a different way. Each Bank had slightly different standards. Each Bank had relationships that had evolved over the years. That had to change.

MS. FOX. Those kinds of relationships weren't by happenstance. In fact, from the original design of the Federal Reserve System, they were supposed to think locally.

MR. KELLEY. That's right.

Changes in the Federal Reserve System in the 1990s

MS. FOX. What were some of the bigger forces at work that made that a less effective way to do business in the 1990s?

MR. KELLEY. Let's take the credit extension process. You might still have a relationship with the same chief financial officer in a bank. But his world had changed a lot, in most cases. You had to evolve your analytical process. And the way you related to that CFO and that credit extension and so forth changed. The analytical process had to change.

In the operations area, the change was much more profound. There were 37 different check offices at that point. And they did things 12 different ways. Each District had its own way of doing things. First thing you knew, these banks had operations in different Districts, and their branches or subsidiaries out in District B had to be processed in a different way than they were over in your home District C. It just messed things up, and we had to learn how to organize a Systemwide system.

MS. FOX. It was a direct result of those legislative changes that allowed interstate banking and the problems in Texas where banks were sold out of state.

MR. KELLEY. Right. Texas Commerce Bank was the strongest bank in Texas, and one morning we woke up, and they'd sold themselves to Chemical Bank. Oh, my God! But it turned out they were the only big bank in Texas whose stockholders prospered through that era. Most of them went bankrupt, and stockholders lost all of their equity in those big banks. Texas Commerce came under the umbrella of Chemical and went right on. But, at that point, whoever had a relationship with the CFO of the Texas Commerce Bank, which was a pretty big bank, all of a sudden found out that it was now a subsidiary of a big money center bank in New York.

MS. FOX. So for supervisors, much less the processing piece, it was a challenging era.

MR. KELLEY. Yes.

MS. FOX. And the Board strongly supported interstate banking.

MR. KELLEY. Well, it was the way things had to go. There was enormous pressure from the industry to do it, but it was appropriate.

MS. FOX. Do you recall operational discussions in that period that went something like, "This is going to be a profound change for our internal operations in the Federal Reserve. How are we going to deal with it?"

MR. KELLEY. Yes, I remember those discussions. Our staff here didn't have any problem repositioning themselves to get going in this new way. I think most of the senior staff was supportive of the whole idea, or at least they were relatively quiet about opposing it, if they did. They got right with it. But the individual Federal Reserve Banks took a while to come around. The individual Banks had their culture, and they had their ways of doing things, and it had been successful for a long time. They started providing financial services competitively for fee and profit in the early 1980s. They'd gone through a difficult time orienting themselves to that.

MS. FOX. And that was in response to the Monetary Control Act of 1980.

MR. KELLEY. By the time I got here in 1987 they'd done it, and we were pretty competitive but still operating in a unit bank world. The Reserve Banks were doing fairly well at controlling their costs. We got better, and they were fairly competitive. Then, very quickly after that, we went into a much more profound evolution, and the Federal Reserve System had to become a system instead of 12 separate units. I was always and still am fascinated by, and quite respectful of, the 12 District cultures that grew up in the 12 District Banks over a long period of time. They were proud of their culture and protective of it. When we started to need to do things as a whole system—take check processing, for instance—and work towards having a single system solution, that was a problem. Nobody overtly fought us, but, boy, there were a lot of obstacles to overcome. It took a while to do it. I felt like I spent virtually my whole time here—I guess it was pretty well over by Y2K, but I spent the decade of the 1990s as, what shall I say, the "prophet" of the new era, trying to convince Reserve Banks that in order to remain relevant to their customers, they had to buy into a Systemwide approach.

MS. FOX. But for the commercial banking industry, it was a matter of dollars and cents.

MR. KELLEY. That's right. They had a challenge to do it, but they wanted to do it. They had the know-how, the expertise, the point of view, everything it took to do it. And they did do it quite successfully. They were way ahead of us for five or six years, and they were complaining. We heard about it in the Federal Advisory Council all the time.

MS. FOX. The Federal Advisory Council is composed of a banker from each District.

MR. KELLEY. That's right. They all badly wanted things to be systemized. We were inhibiting their ability to put their organizations together completely, by virtue of the fact that they had to get their cash from us, and they had to clear checks through us. For a while, we were inhibiting them. It took a while for us to embrace the fact that we had to make that change and then to make it.

MS. FOX. What would you say slowed the Fed down? What made it a challenge?

MR. KELLEY. What made it challenging was that each bank believed that it was doing what it was doing in a very effective way. Bankers were pretty well correct—for the environment that had been there historically. They were proud of their systems. They were comfortable with their systems. They were dependable, which is very important. They were reluctant to give that up. I respect that. But they had to.

MS. FOX. Were there governance issues that frustrated you then?

MR. KELLEY. I talked a lot with many Reserve Bank presidents and senior officers about how we needed to solve these problems. They were legitimate problems and legitimate concerns, but we had to work through them.

MS. FOX. Did you ever want to say, "I am Mike Kelley, CEO, and you do it because I say so."

MR. KELLEY. No, the System didn't work that way. I learned that fairly early on. To some extent, I had operated that way for 20 years when I had my own company. But one of the things that I saw I needed to learn, and hope I did learn, was not to try to be the great dictator in this System. People were too smart for that. Power was too diffused. It was not an effective way to work.

MS. FOX. Thinking back on it and assessing it now, is it a good thing that the Fed is organized that way?

MR. KELLEY. Oh, yes! Sure, it was a good thing the Fed worked that way. It made for a much better organization than if we had been some sort of a great monolith. I don't manage a business anymore, and I doubt if I'd even know how to do it. But by far, the consensus way of managing companies now is much more like the way we worked to become than had been the historical way of managing companies, which I had learned in business school as recently as the late 1950s, for instance. Basically, it was the old Prussian general staff system. You asked people what they thought, and you delegated certain responsibilities. But if you were the boss, you're the boss. That was not the way this organization worked, in most cases, and appropriately so. It worked okay until we had to become a single system. And it took the Reserve Banks a while to learn how to do that. They evolved a way to do it that was pretty effective and yet consistent with consensus management. They put together these committees of three or four presidents. One of them would be in charge of a certain area for a couple of years, and they rotated that around. They respected each other's authority. That system evolved and was enormously helpful. It helped us to get where we needed to go. But I was still preaching the gospel as late as 1999 in that interview with the Minneapolis Fed.[2] It wasn't a fully done deal, even in 1999.

MR. HAMBLEY. When the world went interstate, you could see that the Fed had to become a system, and then you just had to bring people along over time.

MR. KELLEY. Yes, that was what it was. We never had to bring the Federal Reserve Board staff along. They were with it. They were pretty frustrated about how they were having trouble getting this, that, or the other thing done. Let's just work through it, you know? It'll be much better if we work through it and they're on board even if it takes a little longer, which it usually did.

MR. HAMBLEY. You mentioned lending through the discount window. If you had a bank in several places, you have to figure out who's doing it. And I think you mentioned checks, too. But there were other things, like Fedwire® or ACH.[3]

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[2] In September 1999, the Federal Reserve Bank of Minneapolis interviewed Governor Kelley on Fed policy, organization, and the future of the System. During the interview, he said, "It's necessary for the Federal Reserve to evolve with it [the nature of the banking system], as indeed any organization must as its customer base evolves, in order to maintain relevance to it. We've learned to act much more as a system, in a much more seamless way, both in terms of the cost structure that we incur and the services we provide, which have historically been District-based and have evolved in quite District-unique ways."

[3] Editor's note: Fedwire is a registered servicemark of the Federal Reserve Banks.

MR. KELLEY. I'll run through an example of one of the things that was important to get done and eventually did get done. When we [were] first starting coming up with Systemwide solutions—maybe it was check processing, maybe it was Fedwire—one of our big, major systems, we got them all to work together and put together an organization, headquartered in Richmond, that was going to be the data center for the whole System. I can't remember what system it was that came on first but one of the big, crucially important systems. We worked through it. We put it together. We tested it, and 11 Reserve Banks came on board.

New York flat refused to do it. Gerry Corrigan was president of the New York Fed. Wayne Angell was chairman of the Board's Bank Activities Committee. And if there ever was a case of oil and water, it was Wayne and Gerry. They came to total loggerheads on that. New York said, "The system's not reliable enough for us. We're the big money center. We have to work. We've developed our own system. We are not going to adopt this risky system that everybody else is working under, period." That's where it stood when Wayne left the Board [in February 1994] and Gerry Corrigan left New York [in July 1993].

All of a sudden, it's Mike Kelley and Bill McDonough. McDonough and I got along fine. I went to Bill, and I said, "Bill, the relations that have grown to exist between Board staff and New York staff under our predecessors is just not acceptable. We cannot operate that way." Bill totally agreed. I said to him, "Let's tell everybody that you and I are going to try to win the Nobel Peace Prize"—we used that term—"and we're going to find a way to help get the Board staff and the New York staff to work together. The first thing we're going to do is find an acceptable way to bring New York into this big important new system that we've got down in Richmond." I suggested that the way we do that was to ask the New York staff to think through and write down all of the ways in which they perceived that the new Fed Systemwide system was not acceptable to the New York Bank—What's wrong with it? What concerns you? Why will you not come in?—then ask our group from the Banks and the Board staff to analyze that, and then come up with a proposal of how they could meet those standards. Mike and Bill will cause them to sit down and work through the differences until they can come up with a consensus. The Reserve Banks will say, "We will do these things to satisfy New York," and New York will say, "If you do those things and we concur that they've been satisfactorily done, we will come in."

They did it! It took a while. They did it and came out with a better system. New York had some valid stuff that they wanted done. I don't remember what it was now. The Board and the Reserve Banks, working together, found out that they could and would and should accommodate those things. New York went down and looked at all that stuff and said, "We're satisfied. We'll come in." It has worked fine ever since. Not long after that, they came up with a proposal of putting that big new Systemwide data center in New Jersey. A lot of it went back under the aegis of New York. We desperately did need New York to participate, but we needed them to participate in a way that they were comfortable with. In a process of working through that, we came out with a better system.

MS. FOX. The process you describe sounds very much like the negotiations that go on between the regulators.

MR. KELLEY. It takes longer. But it's the way to run things in a critically important, complicated system like the Federal Reserve. No single person is smart enough to be dictator of that System. Nobody should try it. It needs to be run on a consensus basis. It can be, and it has been. I've been out of here for eight years now. I don't know how that's evolved.

Thrift Crisis

MS. FOX. What are your recollections of the thrift crisis?

MR. KELLEY. I don't remember much about it. I didn't have much to do with it. We all knew about it, and it was very important, but I don't remember that it was a dominant discussion point around here. I wasn't chairman of the Bank Affairs Committee or Supervision and Regulation at that time.

The way the Board committees work, the chairs of the committees are supported by the other Governors, but they are very much the leaders in their area. They work in the name of the Board. They take charge. The chairs of those committees are the point people. I was not particularly involved in the nuts and bolts and gut-fighting that I'm sure must have gone on.

International Banking

MS. FOX. What about international banking? At the time, there was a lot of concern about competitiveness across borders and about lax supervision versus more precise supervision. And capital rules were a center of attention.

MR. KELLEY. Right. The Basel I deal was just being consummated when I got here. It was done. It was fully ready for a vote. Somebody may research it and find out it wasn't as early as I think, but, as I recall, the first I learned about it, it was coming to the Board for a final vote. I was excited. I thought it was wonderful, and I happily supported it. But I didn't have a thing to do with working it up.

MS. FOX. What about Basel II?

MR. KELLEY. We worked on Basel II forever. I worked on Basel II for about three years before I left, and it still wasn't done. It was endless!

Basel I, in retrospect, was fairly primitive and simplistic. At the time, it was a huge breakthrough, and everybody was proud and excited about it, and should have been, appropriately. But it became pretty clear, particularly because it happened just as a new era was evolving not only here but internationally, that it was not adequate. We started going to work on it. But, oh, my God, talk about musclebound and stuck in the mud in details. We just did that endlessly. It definitely had not been adopted when I left. And the process went on and on and on after that. Was it 2004, 2005?

MR. HAMBLEY. It was later.

MR. KELLEY. I don't believe it ever got really fully adopted. Did it?

MR. HAMBLEY. It was adopted in Europe, and we were in the midst of the transition process.

MR. KELLEY. Then, all of a sudden, we were in 2007, 2008.

MS. FOX. In that period, what were some of the motivating forces to push for international agreement?

MR. KELLEY. Number one, there was concern that there was a competitive race for the bottom, of who could be the most open and allow their banks to do the most things. A lot of people quickly saw that that was a way to big-deal trouble. That was a motivation to come up with an international standard. The other one was to come up with an international standard that had some teeth to it and had some strength to it. So they came up with this idea of Tier 1, Tier 2, Tier 3, and divvied up different kinds of capital into that. It turned out that that had not been terribly well done, but for a de novo concept, it was very well done. As I say, that was pretty well accepted as gospel by the time I got here. It was a matter of, how do you implement it effectively.

The Board's Responsibility for Regulating Consumer Financial Services

MS. FOX. Beginning in 1968, when the Truth in Lending Act became law, the Congress starting giving the Board responsibility for regulating consumer financial services. Did you deal much with consumer issues?

MR. KELLEY. I never felt, and do not now feel, that the central bank has any business with that much responsibility in that area. I managed to never be on that committee and never did anything much about it except when things came to the Board to be voted on, and I tried to do that responsibly.

MS. FOX. What's your rationale for thinking that it shouldn't have been a central bank responsibility?

MR. KELLEY. It is a perfectly legitimate area of concern for the government. I don't have any problem with the government being involved there. I don't have any problem with the Consumer Financial Protection Bureau they just set up in the Dodd-Frank bill except for the fact that it's inside the Fed. I just don't think that's central bank business. It's not bad business, it's not wrong business, it's just not central bank business. At the central bank, it's an orphan child. It's a distraction. It is not central to the things that go on in a central bank. I don't think we did it badly. The Governors that went to it either did a workmanlike job when they had the responsibility or else they were enthusiastic about it. I think Edward "Ned" Gramlich was quite enthusiastic about it. Lawrence "Larry" Lindsey was not, but he did a very responsible, workmanlike job when he had that committee. Enough said.

Consolidation of the Banking Industry

MR. HAMBLEY. The Board encountered this enormous consolidation of the banking industry—some of it was bank failures, and a lot of it was transactions that the Board had to approve. As that was happening, did you feel relatively comfortable with that? Do you feel, in retrospect, that the Fed should have had a few more questions about what was being created?

MR. KELLEY. That has been more of an issue and more of a legitimate consideration in the present crisis. I understand why the Fed was not right on top of these excesses that took place. That said, we should have been. I think we should have been a little more nimble there than I think we were.

MR. HAMBLEY. I'm talking about the so-called megamergers, where you had enormously more complex banks being created. Do you think the Fed should have thought a little more deeply about the world that it was on the verge of helping to bring into existence?

MR. KELLEY. To the extent that it's possible for human beings to be prescient about what the future's going to hold, maybe we could have. I didn't feel badly about anything that we actually did up until the time I left. Obviously, it led to excesses that became extremely serious. But I can't honestly say that I saw that coming or that I thought maybe we had done some things that we shouldn't have done.

MR. HAMBLEY. As a business manager, did you ever have any concerns that it might become difficult to run a company that was so complex?

MR. KELLEY. I did not have that intuition, no. I thought it was possible.

MS. FOX. One of the arguments at the time was that these companies had to be big to be able to serve their customers around the world. And if they weren't of a certain size, didn't have certain capital, and didn't have certain complexity and ability to offer products, they were going to be run all over by their competition.

MR. KELLEY. That argument was made. And we probably bought it, to a degree. I no longer think that's completely valid, because I think that they went way past that. I do not believe it's necessary to be as big as some people would imply that you must be in order to serve a worldwide market. I think it can be done on a somewhat smaller level—not small, but smaller than what happened in 2008.

Banking Supervision and Regulation

MR. HAMBLEY. We were talking about the banking system and your responsibilities for the Board Committee on Supervision and Regulation. What do those terms mean to you?

MR. KELLEY. We always used the phrase, and the press does—supervision and regulation—like it's all one big word and one big activity, whereas actually it is two totally different things. Regulation is the public policy business of establishing the infrastructure of how a given industry—in this case, banking—is going to operate. You set up a regulatory structure, and it necessarily needs to evolve and be maintained in an appropriate way. That's a public policy consideration, a rulemaking consideration, and a legal consideration that has to be approached in that context.

Supervision is totally different work. Supervision is the business of examiners going into individual organizations. The examiners look at the books and look at how the organizations work in a detailed way. They have the training and experience to understand what they're looking at and make a judgment about how strong that bank is and how well it's doing.

MR. HAMBLEY. What are the principal things that you try to accomplish through supervision that couldn't be done any other way?

MR. KELLEY. You advise the banks. You counsel with the banks. You say, "Look, I think maybe you ought to do some work over in this area and strengthen yourself." And then, when you go back in there next time, you see whether or not they're doing it. If, for some reason or other, they're getting themselves in trouble—in the myriad of different ways that they can get in trouble—you have to be able to look at the flow of their balance sheets and operating statements and identify those areas. That requires a whole separate level of expertise and a very high level of expertise, particularly when you're dealing with these large companies that are much more complex and sophisticated. So we need to have people who have the ability to perform a "pseudoconsultant" relationship—a friendly relationship—and at the same time make sure that they stay very much at arm's length and are able to go in a totally dispassionate way and accurately identify what's going on in a given office or a given bank and where its strengths and weaknesses are.

MR. HAMBLEY. You described supervision as a service for the banks. And, in that respect, they were the Fed's customers. There are people who would find that an amazing description of supervision, but a lot of it can be cooperative. In some sense, you both have the same interest, ultimately.

MR. KELLEY. You have exactly the same interest. You have an interest in that bank and, cumulatively, all banks being successful serving the public, at a profit, being healthy, and not getting in trouble.

MR. HAMBLEY. So it's entirely appropriate for you to work with banks rather than as an adversary. And sometimes you have to correct them.

MR. KELLEY. You certainly don't need to be an adversary. It needs to be arm's length and independent. You can't allow yourself to have an overly buddy-buddy, cozy-cozy personal friendship. You've got to maintain your independent professionalism, but that doesn't prevent you from being positive about it.

MR. HAMBLEY. How do you maintain independence and objectivity in this function?

MR. KELLEY. I'm not sure that there is any one way that I would know how to answer that. You just have to maintain that point of view. And you have to maintain an awareness that that's your role, and that you have to be careful to maintain it. You have to learn how and be able to sustain a satisfactory level of personal discussion, contact, and acceptance with bank executives but still maintain an arm's length relationship so that you have the ability to see problems if they're there and confront them. I don't think there's any single answer I can give you to how you do that. Probably no two people do it exactly the same way.

MR. HAMBLEY. I suppose not being there all the time in the same place would probably be helpful.

MR. KELLEY. Yes, sure. That's right. You're aware of a whole array of different companies that you go into, and that helps your independent, professional view.

MR. HAMBLEY. As a Board member, you would sometimes see cases where the cooperative approach hadn't worked, and you'd be involved in enforcement actions. How did you approach those?

MR. KELLEY. It did happen, but, fortunately, it was rare. Frequently, there were minor corrective actions taken that never come to the Board. If you're talking about the Board of Governors and its involvement, not very much of that gets there. Usually it's the larger matters and the more egregious matters that do, and you're ready to take that on. Usually it's not a company where you personally know anybody in any depth whatsoever. You might have shaken hands with somebody and said, "Hello," but you're not personally related to them in any way. If you were, and I don't think I ever saw this happen, you'd have to recuse yourself. I never saw anybody need to recuse themself.

MR. HAMBLEY. Did it take any getting used to that you were going to have this kind of power over other people?

MR. KELLEY. Well, I'm sure it did. This matter of having power—I never looked at it as power. I looked at it as responsibility and duty. It involves power and sometimes the exercise of it. But if you start thinking of it in "power" terms, you're going to get yourself in trouble. I tried studiously to avoid that.

Payments System

MR. HAMBLEY. The Fed plays an important role in the payment services business. While at the Board, were you always involved in payment system issues and Reserve Bank services issues?

MR. KELLEY. One of the first committees I was assigned to was the Committee on Payment Systems Policy. Wayne Angell was the chair. I had to start learning something about it right away. The whole product line—which we call Financial Services—all of the nuts and bolts of that business were new to me. I had been involved at the Board level and operationally, too, in a fairly wide variety of different industries. Every one of them has its own skills and things that you need to understand how to do. Presumably, there are people in there who are professionals. You tried to learn as much as you needed to learn about it, but you never will learn as much as they know. You have to come to have a fairly decent working level of awareness in order to be able to oversee effectively. There were a wide variety of those things. Gee whiz. Check processing was a huge deal for us, and for many years. I understand more recently it has almost disappeared, but it was a huge deal then.

We were the only providers of cash services. That was a natural monopoly, but we tried not to treat it like a natural monopoly. We treated it like we were providing a service to people and promoted that attitude, hopefully, with some success. So I don't see where there's any inherent conflict whatsoever between working to be a helpful, positive influence and still being independent and dispassionate about exercising your responsibilities.

Fed as Service Provider and Supervisor

MR. HAMBLEY. Historically, the Fed was created, in part, to be a service provider to banks. Outsiders who look at the organization and know something about the history get a little worried when they see the Fed also as supervisors. There is a separation, and the Fed tries hard at it.

MR. KELLEY. There is. And there always has been criticism about the fact that we had all these diverse powers, which included the very obvious muscle of being a supervisor. Many central banks do not have supervisory authority. I was and am very supportive of it. While you need to have a Chinese wall there so that the credit extension operation, for instance, and monetary concerns, generally, do not get involved in any way in supervision, there is a macrolevel information flow that comes up through supervision and regulation that is extremely valuable to the FOMC and all of its participants, individually, in understanding what's going on out there in that industry. I think it's valid for that reason.

MR. HAMBLEY. It's hard to imagine the Fed responding to the financial crisis without knowing the kinds of—

MR. KELLEY. It is! It's very difficult. And I think it's going to be a new challenge all over again now with this new law that's in place, because the Fed has the potential of exercising a whole range of stringent new powers that are, at this moment, still foreign to us.

Bank Affairs Committee

MR. HAMBLEY. How did the Board's Bank Affairs Committee carry out that responsibility?

MR. KELLEY. Well, we tried to have a lot of contact with the Reserve Banks. We encouraged the staff to have a lot of contact with the Banks. We just tried to communicate a lot. I always tried to make the Reserve Banks understand that I was regarding my role as helping them be successful, and I wanted to help them do what they felt like they needed to do. That, by no stretch of the imagination, meant that I was going to give them carte blanche to do anything they wanted to do. But I wanted to talk to them. I wanted to hear what their concerns were, where they were having trouble, is there any way that we can help you with this, that, or the other. Because, basically, in the long run, for an organization—be it the Federal Reserve or any other organization—to be successful in meeting its responsibilities, that has got to be the cumulative result of how successful all of the people, and all of the different parts of that organization, are in doing what their jobs are. If we had 12 dysfunctional District Banks or 2 dysfunctional District Banks, it would drastically impair the entire System's capability of meeting its responsibilities in financial services or anywhere else.

So it's always important in any organization for the person or the group in charge to have the point of view that they need to help the components of their business be successful at carrying out the pieces for which they're responsible. I tried to project that through the presidents and the senior officers, whom I got to know, in the 12 District Banks and tried to develop a personal relationship where I could talk to them and they would be willing to talk to me about whatever. Sure, I didn't fully get there. I was not under any illusions about that. But it definitely was how I wanted them to perceive us.

MR. HAMBLEY. Along with the philosophy that you just stated, did you find it was often necessary to remind the Banks that, for some purposes, the Board would be answerable, and that if they didn't find a way to help pull together in a common direction, the Fed would take the heat, and that they needed to help the Fed, too?

MR. KELLEY. I hope I did that. I can't think of any specific instances, but that was my approach to life. So I would hope that I got that over.

Testifying before the Congress

MR. HAMBLEY. The Federal Reserve's budget is predominantly the budget of the Banks. Did you testify before the Congress on the Fed's budget?

MR. KELLEY. Interestingly enough, I never testified about that. Maybe the first year or two that I was here, I went to congressional hearings and sat beside Wayne Angell when he testified on those budgets. I never opened my mouth. Then the Congress ceased holding those hearings. I never ever personally testified about the Federal Reserve budget that I can recall. I testified about all kinds of different things, but not that.

MR. HAMBLEY. After a period of intense scrutiny, the testimony completely stopped.

MR. KELLEY. Well, there were a lot of testimonies in the area of regulation and these new powers and what did the Board think about this and that. There were testimonies along those lines that we all did. Of course, the Chairman took the biggest part of the brunt of that. He was wonderful about maintaining relationships with the Congress not only in how he conducted himself in formal hearings, but he was also down there and around those people and talking with them all the time.

Year 2000: Y2K

MR. HAMBLEY. You were involved in preparing both the Federal Reserve and the banking system for Y2K, or the Year 2000 rollover. What was the nature of the problem?

MR. KELLEY. The basic problem is well known and well documented. In the early days of computer technology, there was a distinct shortage in memory size, so people who did systems and programming work were always looking for ways to cut down on the amount of capacity required to achieve different things. Whenever something had to be dated, and virtually everything did, instead of putting down the full four-digit term "1997," they cut it short and used "97." That was done in virtually every program by everybody. I endlessly heard Alan Greenspan recite his favorite tale that he was part of the problem, because he had personally written programs when he was a consultant in New York using that kind of technology. So he felt a personal responsibility. He was tongue-in-cheek, of course, but I'll bet I heard that story 15 times in speeches and answers to questions and recitations in congressional testimony and so forth. Anyway, the use of two digits instead of four was ubiquitous.

Suddenly it became conscious to professionals in the area who knew what they were talking about—if this carried over into a new century, where all of a sudden the "19" became "20," was this going to totally screw the operation of many or perhaps even virtually all computers, and, if so, how? Nobody knew the answer to that question. All systems had just this two-digit component. Everybody who was aware of computer systems and how they worked was quite confident that it would foul up virtually every computer system. But they were pretty late beginning to articulate that.[4]

[4] One concern was that in moving into a new century—the year 2000—computers might compute the date as 1900 instead of 2000 because of the two-digit technology.

I first heard about it, absolutely de novo, from Elaine Geller, a junior officer of the San Francisco Reserve Bank. She called my office, when she heard I was coming out to San Francisco, in the middle part of 1997. She asked if she could see me one-on-one. So I said, "Sure. I'll be glad to do that." I told her supervisor that she'd asked for that. And he said, "I know what she wants to talk to you about, and that's fine. You go ahead and do that."

She laid out this problem, which I'd never heard of before—what the consequences could be, and that it could be absolute disaster for the way that the Federal Reserve System cleared banking items every day through Fedwire. She said it could be a disaster in an infinite number of different ways throughout the whole economy when the computer script rolled over and suddenly the thing became "2000" instead of "1999." Nobody knew what was going to happen or how computers were going to react, except that all computer professionals were willing to predict that it would be a total mess. And it was imperative, she informed me, that the Federal Reserve become aware of this and get on top of getting itself and the banking system ready.

That hit me like a ton of bricks. I came back and I went to see the Chairman at 8:30 the next morning and told him about this. As I recall, he had not heard much about it, but he immediately identified with the problem and said, "Oh, sure." He understood it far better than I did at that time. I said, "We've got to get after this not only for ourselves, but for the banking system." He said, "You take it and run with it." So I did. And everybody in the Fed immediately got after it. I'd never heard it mentioned before, but when I started talking it around [snaps his fingers], it was just like this.

There were two separate problems. One was getting the Federal Reserve System itself ready, and the other was getting the banking system ready. Almost nobody was doing anything about this! There were a few people here and there who were, but it was not broadly understood, broadly conceived. We started to work on it right away. I was sent by the Chairman to a White House meeting of the heads of all the agencies to assess the problem. Everybody sent a representative. Not all the Cabinet came, but they were all told to be represented. The Fed Chairman was invited, and he asked me to go. There was a meeting in the Executive Office Building, and somebody from the White House staff wanted to know what we were doing about getting ready for this system changeover. I don't think anybody had come up with the term "Y2K" yet. It wasn't yet the catchword. Virtually nobody was doing anything. This was late 1997. I was able to tell them we were doing a lot and lay out what it was. They said, "Huh?" Then everybody got on top of it.

Not long after that, President Clinton established a commission on it [President's Council on Year 2000 Conversion]. John Koskinen chaired the council, and the government got aggressively after it. Here at the Fed, Rich Spillenkothen [director of the Division of Banking Supervision and Regulation] gave me Howard Amer, who was seconded full time to working on this project on the banking industry side. We got after the FDIC and the Comptroller, and they established their groups. And we approached all of the states, and they mobilized their banking commissions. Howard did a wonderful job. He was the point man that really set it up for the financial system of the United States. Nominally, we were just working with the holding companies and our banks. Fact of the matter was, we led for the whole banking system. It went far beyond the banking system. It got into the investment banking world. We didn't have any formal responsibility there, and they got going on their own hook. That paid big dividends when 9/11 came along.

MS. FOX. There was a lot of time spent dealing with the electrical utilities and the telecom system, which we never thought of as a banking risk.

MR. KELLEY. Well, yes. Howard and his people—he had some very good people—set up a system of markers—mileposts, I guess, is what you'd call them—of preparedness, where banks had to meet a certain set of standards and a certain set of readiness capabilities by certain dates that got closer and closer to being fully prepared for anything. We decided that every bank and every bank holding company had to be able to demonstrate that they were totally prepared by the end of the third quarter of 1999. We set up these mileposts along the way to get them there. We had the great benefit of having bank examiners who were going to go into every single one of these organizations. We got them up to speed and got them checked out. They made sure for us that every single bank met these milestones. It was beautiful!

We had so much going for us. We knew exactly what the nature of the problem was, which seldom is the case. We knew exactly, to the second, when it was going to hit, which is seldom the case. We knew exactly how serious it could be if it didn't get fixed, which is seldom the case. All those things worked for us. We sold it, and we worked for it. That's how we got ready. I became the public point person. I was on lots of different TV shows and testified a number of times. I went around the country and made speeches. I was exposed to TV in a way I never had been exposed before or since. And it went pretty well. You were very helpful in that, Lynn.

MS. FOX. You chaired the Y2K Council, which consisted of a group of people from around the Federal Reserve System.

MR. KELLEY. Yes. Here is where the work that we'd been doing for the whole decade, getting the System to think like a system, paid off in spades. We thought like a system right from the get-go. And every Federal Reserve Bank worked together. Every Bank had a part of it. Cathy Minehan, who was an old operating person herself, understood operations cold. At that point, she was president of the Reserve Bank in Boston. The Lord looks after us. She was already in charge of the operating relationships, chairman of that Bank committee. She was a natural one to lead that, and did. She put together a great group with every Bank participating, the Board staff participating. We set up our own system of guideposts and spent probably $100 million or more fixing our problems. And the Banks were ready beautifully. They did a great job. Everybody had their own role. I said I was "head cheerleader." [Laughter]

Alan started getting media questions early in 1999. We convinced him to hold off discussing the issue until late in the game, and then we would use him heavily. You were part of that strategic development, Lynn.

MS. FOX. Yes. You had the perfect skill set. Much of the success is, I think, quite attributable to the way you organized it. You were the head cheerleader in a consistent, focused way. "We're going to get this done. We'll deal with this problem. We're going to do it on a consensus basis."

MR. KELLEY. That's right.

MS. FOX. To this day still, there are people who work in some of the Federal Reserve functions, like public information, that recall Y2K as their finest moment and Mike Kelley as the best leader we ever had for a project like that.

MR. KELLEY. Well, I appreciate that no end. We saw it as a very important thing to do that was going to take a lot of careful organization. We put a lot of thought into that. The staff here helped with that public relations strategy. We brought Alan in late, and he was tremendously effective!

MS. FOX. Yes. The strategy was that the Fed would spend a lot of time explaining. We had speakers from the Federal Reserve Banks going out to the banks. We had a telecast. We had a training broadcast.

MR. KELLEY. We had newspaper interviews. Do you remember the day we went over and spent the morning at *USA Today*? We had a closed-circuit broadcast to bankers; we had literally thousands of bankers on that. We assembled all of the key players from the Board and the Reserve Banks. We got every one of them into the act. By that time, Steve Malphrus (director of the Board's Division of Information Resources Management) was in charge of information systems. And, of course, they were into it up to their ears. He was very effective.

MS. FOX. We used Alan Greenspan and you. The public didn't start paying attention until close to the time. The big fear for the Fed was that the public would lose confidence in the banking system—they would be afraid that the ATMs wouldn't work, and they would suddenly convert all of their accounts to cash or put money under the mattress. So the Fed had a big public campaign to help assuage people's fears. We brought Alan Greenspan out at that point to explain, "I caused the problem. It's easy to fix. We're going to do it. And there are going to be glitches." We had a big discussion about what word we would use—glitches—because, certainly, things were likely to happen.

MR. KELLEY. Everybody was concerned that if this happens and all the systems go kerflooey, we're going to have to operate the economy on a cash system. And, my goodness, how do we get enough cash out? We worked through that problem. We had cash in 90 different locations. We had cash within 12 hours of any place in the United States. You know how much of that got called on? Zero. Not one dollar of that ever was asked for. On TV we'd say, "When you want to go to the ATM, there probably will be a few ATMs that are out. There are a few

ATMs that are out every day. ATMs are a mechanical system, about halfway between your car and your refrigerator. They're sometimes going to be out. They'll be back on. We'll get them back up. We'll have cash there." I think that helped.

I've also often thought that, on the 1st of January of the year 2000, we probably had a higher incidence of operating ATMs than we have ever had before or since, because every bloody bank manager in the country made bloody sure that their ATMs were up! [Laughter]

MS. FOX. At midnight, they were probably standing there.

MR. KELLEY. They were. We got all these reports. All these banks would call in. The bank manager had spent the day driving around [laughter] to all of his ATMs making sure not only that they were working, but that there was still cash in them.

MS. FOX. I became the head of the Public Affairs Office in 1998. You'd done a lot, but that was just when we were gearing up for the public side of the event. In the first meeting I attended of the Y2K Council, you stated what everybody's responsibility was. Some of it was technology. Some of it was dealing with the large banks, the small banks, and the discount window. There was a lot of monetary policy action to prepare as well. Then you said, "Lynn's job is maintaining public confidence" [laughter], which everybody laughed at except me, because it sounded pretty scary.

MR. KELLEY. It was!

MS. FOX. Then we had a meeting of Public Affairs. You were very hands on, in a helpful way. You came to a meeting of a small group of the Public Affairs people and said, "This is what you need to do. There are a lot of strategies. I'll help you do it. We'll do whatever's necessary. But you need to think through ways that we can let the public know what's happening and how we're responding and increase their level of confidence. You can't guarantee anything. The only way you can increase their confidence is to educate them about the problem and how we're resolving it." As a result of that, we hired the Gallup organization to do a survey of Americans about what they thought about the prospect of Y2K failures. We had never done something like that before.

MR. KELLEY. It was a small part of our $100 million. [Laughter]

MS. FOX. It was an important small part and not expensive, comparatively. We repeated that survey as the time went on and publicized it heavily, because it indicated that people were becoming more comfortable and more educated about Y2K. It was a useful tool that was inspired by your conversations. In a lot of ways, that was a home run for the Fed.

MR. KELLEY. I remember our big "Aha!" moment was in New York. You were supposed to be there and couldn't come. I really missed you. There was a big meeting of all of the heavy hitters in the media that I think John Koskinen called. All of the big TV anchor people were there, and the news executives were there. It was held in one of their offices. A panel of us was supposed to talk to the media about Y2K and answer their questions. It was at the very highest level. There were probably a hundred of them there. This was in June 1999. The Aha! moment was, somebody said, "I just talked with the bankers in my area, and they're not ready yet, Governor Kelley." I said, "Of course they're not. They don't need to be. They're not supposed to be. They've been meeting their milestones, and they met their last milestone. They'll be ready on September 30th, when their last milestone comes along." And it was an Aha! moment. Things sort of went better after that.

MS. FOX. What about the arguments that the Fed got way too excited and spent way too much money?

MR. KELLEY. As I recall, that was the last testimony we had to give before the Senate, in about April 2000. Nothing had happened, and they wanted to know why we spent all that money. To this day, you'll occasionally see a reference to the "supposed crisis" of Y2K. To this day, people will maintain that nothing ever would have happened, that it was all manufactured.

We couldn't afford to take that chance. If the Federal Reserve System, particularly Fedwire, had gone down, this economy would have effectively closed up within 48 hours. Because the banking system, which is the cumulative expression of every single financial transaction that takes place from day to day—every individual check that gets cashed, every individual credit card that gets used—every day the banking system settles with itself across the books of the Federal Reserve System. And the Federal Reserve System gets instructions from every bank that this bank owes money to a thousand other banks. The Federal Reserve charges them for how much the total of that is and then disperses it out of its own Federal Reserve funds. It's called Federal Reserve money. Every day it goes out to every bank so that every bank is able to settle with every other bank every day, risk free. That is the most single liberating system that allows a modern financial system to work. If it were to break down, that couldn't occur. We'd go on cash for a little while, and then things would progressively start to go to pieces. Then, to come back up after you had missed, we'll say, two days, would be a humongous challenge, a humongous problem. We could not afford to run any avoidable risk that that was going to occur. And we didn't. And it didn't.

MR. HAMBLEY. Mostly the people that don't understand about the plumbing of the financial system tend to be skeptical that there would have been any problems.

MR. KELLEY. Yes. Almost nobody understands the plumbing of the system, including a lot of bankers.

MR. HAMBLEY. No, it's hard. You mentioned going on cash. If there had been a number of ATM outages or banks couldn't provide cash, that could have caused a run on the bank[ing] system or individual banks.

MR. KELLEY. You would run quickly out of cash availability. An awful lot of people, including me, took some cash out of the bank and put it in a drawer over that weekend.

MS. FOX. We advocated, "Go to the bank. Get what you spend in a week or two on grocery money."

MR. KELLEY. That's right. I didn't want you guys worried about what was happening in your house when we needed you here. And I suggested that you do that.

MS. FOX. Then the Fed told the public to do that.

MR. KELLEY. But we could have gotten a lot of money to them quickly. That would have been a tide-over, but it would have started to break down quickly.

MR. HAMBLEY. The modern economy is not going to function on cash.

MR. KELLEY. Our systems had to work. And everybody worked diligently. We had to set up a parallel organization for how we were going to work through Y2K problems if they occurred. We decided, and I recommended, and the banks agreed to keep that as basic as possible so that people would be working, under that kind of stress, with people that they already knew. The parallel organization that was on standby never had to be implemented—but the standby organization, if we'd had a breakdown, was very close to our regular working organization so that people would be able to understand who they were working with and what those people could and couldn't do.

MS. FOX. Where did you learn your lessons about crisis management, exactly that kind of theory?

MR. KELLEY. I never have been through one before. [Laughter] I just had to work through it in my own head. And I had time. Thanks to our good friend out in San Francisco, we had enough time. And even the government had enough time. John Koskinen moved heaven and earth to get the government and the public more broadly aware. And he was, barely, able to do it in time.

MR. HAMBLEY. Why was this problem not brought to your attention by Board staff?

MR. KELLEY. I don't know. But nobody had talked about this problem at that point, in the middle of 1997. There were a few technology people who understood it and were aware of it, but they had not made operating management anywhere aware of it.

MS. FOX. They were fixing it as they went—

MR. KELLEY. They were preparing to.

MS. FOX. Newer systems didn't have the problem.

MR. KELLEY. That's right.

MS. FOX. As a result of your efforts in the 1990s, some of our newer systems were already up to date.

MR. KELLEY. We had lots of people, praise the Lord, who were perfectly capable of moving in on this and did a super job.

MS. FOX. Do you remember the premium that you got paid in those days if you were a computer programmer?

MR. KELLEY. Yes! People were working many overtime hours. And there was a huge demand for people who knew how to use COBOL (Common Business-Oriented Language—one of the oldest programming languages) and all those languages. Most of them had retired. Everybody was scrambling around to find them and hire them for very handsome compensation to come in and fix their COBOL problem. We did a certain amount of that here, because we had a huge amount of work to do. But we also had a large number of people who knew what to do and how to do it.

MR. HAMBLEY. We had moved on to single systems for various things. That probably made it far easier for us to adopt, ourselves.

MR. KELLEY. If this had come up out of the blue in the context of the way we operated in 1987, I have no idea what we would have done or could have done.

MS. FOX. So as it got close to the turnover, as a matter of caution, everybody wanted to be more liquid in their asset program, because if something happened, you wanted ready access—

MR. KELLEY. The Reserve Bank of New York came up with a fabulous idea to sell options on Federal Reserve cash availability. If they saw themselves getting into problems or some of the banks in their area got in problems, the banks could buy options on risk-free, question-free calls on the Fed. That was put into effect. Those things were sold. None of them were ever called, but they were a huge popular success.

MR. HAMBLEY. You buy the option and you'd have the right, if you chose to exercise it, to acquire cash from whom? From the Federal Reserve?

MR. KELLEY. From the Federal Reserve Banks.

MS. FOX. Yes. And the Fed's monetary policy stance was easy right before the turnover.

MR. KELLEY. Yes. We really put out a lot of liquidity in the middle part of December. We always had the capability to put more money into the banking system if you want to do it. And we did that. Going across that weekend, the banking system was very liquid. We withdrew that almost right away and pulled all of that extra cash back in. That was potentially a large expansion of the monetary base that didn't happen.

MS. FOX. Would you argue that the impact of that episode on the Fed's monetary policy stance was negligible?

MR. KELLEY. I would. It was a very strong concern for a brief period of time. Then it was over and gone.

MR. HAMBLEY. If Fedwire didn't work properly, then the federal funds market couldn't work, and you'd have a distribution of reserves. And maybe the funds rate would skyrocket, or maybe there wouldn't be a funds rate.

MR. KELLEY. I have no idea what would have happened if any of those systems had broken down.

MR. HAMBLEY. You have the potential for cascading problems in the interbank lending markets. If that most fundamental market might not have functioned properly, then other arrangements would have come unglued.

MR. KELLEY. You may have heard my famous story—I repeated it any number of times, and Greenspan put it in his autobiography—this wonderful headquarters that Steve Malphrus decided to put in place in the Martin building.

MR. HAMBLEY. System Command Center.

MR. KELLEY. We were all sitting up there as the dateline crossed, starting at the initial crossing of the dateline, midnight, everywhere as it went across. Every big city had a celebration at midnight, going into the new century. And every TV network from around the world picked up every one of those. It went through District after District, time zone after time zone. New

Zealand had the first celebration. Then it marched west, time zone after time zone. We were sitting up there with our televisions watching all of these celebrations. They all had fireworks.

We weren't looking at the fireworks. We were looking to see if the lights were on over there in the distance. And, lo and behold, they always were! We'd call the banking systems as they got four or five hours into this. "How are you doing?" "Fine." It was zone after zone after zone after zone. The United Kingdom was the last one. Then we went into the twilight zone as midnight crossed the Atlantic. Every single time zone had crossed it successfully, even Russia. And here we were. We were saying, "Oh, my God. We'd better be okay. We have been putting pressure on everybody around the world. We have done all this talking, spent all this money, and done all this work. If we don't make it, oh my." We did! [Laughter]

There was a huge sigh of relief in the Command Center. There were only a few minor little reports. Our staff in the Command Center was bored to death. They lost their holiday so that they could monitor their Districts and were desperately trying to find something wrong that they could report. A few ATMs here and a few minor things there, but nothing that became even a District issue, let alone a national systems issue.

We all drank some nonalcoholic sparkling cider. We didn't go home. We stayed there all night. But it was boring.

MS. FOX. I brought in hats and things hoping that we would be able to enjoy them.

MR. KELLEY. Yes, we had hats. Alan and Andrea visited us, which Alan recounts in his autobiography. There's a picture in there of Steve, I think, Don Winn, and me with the two Greenspans. We were wearing dumb hats and really looking stupid. Your fault, I guess!

MS. FOX. My fault, but we were happy. We were all relieved. Then we kept that command center. We had T-shirts.

MR. KELLEY. Yes, we all had T-shirts.

MS. FOX. We called it the Y2K SCC.

MR. KELLEY. "Systems Command Center" or something like that. I've got one of those to this day.

MS. FOX. We kept that up and would meet several times each day to assess the fallout. And there were, as we said, glitches.

MR. KELLEY. They were there, but they were of no consequence.

September 11, 2001: 9/11 Terrorist Attack on the United States

MR. HAMBLEY. We talked about Y2K and how it helped, in part, to get us ready for the future. The next thing I want to ask you about is 9/11. You intended to leave the Board at the end of December of that year.

MR. KELLEY. That's right. I was in my hiatus period at that point.

MR. HAMBLEY. How did you learn about what was going on? And what do you remember about your response and the Fed's response to that very troubling event?

MR. KELLEY. I remember it well. Everybody remembers where they were and what they were doing on 9/11. I was on holiday in Maine visiting a friend who had a home on the coast there. My wife and I were staying at a bed and breakfast. The Fed always knows where they can find you, and I got a call early that morning from the Federal Reserve. I went to the phone and picked it up. It was Bill McDonough, in New York, who told me that there had been a bomb attack on the World Trade Center, which is just down the street from the New York Fed. They weren't sure whether they were going to have fallout on their building or have to abandon it for some other reason. He just was calling me to let me know that. Whoa, boy! I got to a television and I was sitting in front of the television when the second plane went into the second building. I saw that happen live, like everybody else did.

We had a rental car that we'd gotten at the Providence, Rhode Island, airport and driven on up into Maine. We just took off and kept the car. It took us about 14 hours to get to Washington. We drove straight through to get back down here. That was how long—nine years ago now? None of us had cell phones in those days, as recently as nine years ago. Think about how ubiquitous cell phones are now. I can distinctly remember, about every half an hour all the way down, every time we'd go through a town we'd try to find one of those little phone booths on the corner and scrounge enough change to make a phone call. I'd get Roger Ferguson, who was the only one here, to see how things were going and what could we do, and keep up with it. We got back that night, and I was here, of course, the next day. By that time, things had already begun to stabilize.

We had a number of people in New York on 9/11. They were staying in the Marriott hotel next to the World Trade Center, where we generally stayed up there. Everybody got out of that hotel safely. I can't remember who it was now, but we had several people, I think a couple of Bank presidents, who lost all their luggage. They were told to "Get out of this hotel right now," and they got out with nothing except what was in their hands. So that was quite an event. That's my recollection of it.

From there on, it was trying to get the systems back up. We found that the work we had done with all the banks—particularly with the money center New York banks—to get them ready for Y2K paid off bigtime. Part of what they had done was learn where all their contingency partners were in other banks and other institutions. How do you get them? What do they do? What are their names? They had to physically meet each other, which they had never done before. Then here comes 9/11, and a large part of the System's capacity was wiped out. Yet the banks were able to get themselves back together quickly, because they knew who to talk to and how to do it from the work that they had undertaken just a year and a half before. That was still fresh in their minds. It was an enormous help.

And, particularly, it was a help in getting the New York Stock Exchange back up much quicker than anybody ever dreamed would be possible. They had been through drills with all of those financial institutions about what to do if there were a breakdown in the communications. They had set up test protocols that they were able to take off the shelf and use to see if their workarounds were working and so forth. They got back up in three or four days, maybe on Monday of the following week. It happened on a Tuesday, as I recall. Next Monday they were up. The main reason they were able to do this, they tell us—it's not my story, it's their story—is that they were able to take their Y2K work off the shelf and put it into place and then find out that they were able to successfully get themselves back together and working again. So that was a nice Y2K payoff that came a year and a half later.

MR. HAMBLEY. What were some of the things that the Fed itself did to minimize the damage that had occurred?

MR. KELLEY. Well, of course, Roger, acting on his own, but totally appropriately—he was the only one here—reassured the banks that the Fed was online, open, and ready to extend credit to anybody who got extended as a result of this. That went a long way toward getting everybody settled down right there. Everybody had a different tale to tell about how they managed to get back here from wherever they were.

Thankfully, the New York banks and the other banks around the country had virtually no disruption except for their communications with their New York correspondents. They were able to get back up. The Stock Exchange came back up. So, as far as the financial system went, 9/11 was a relatively minor disturbance, and we got out of it okay. That's not, of course, to address the human toll, which is another story altogether.

MR. HAMBLEY. There was a big upsurge in discount window lending for a few days. Checks were credited before the Fed could collect them. So there was a big float issue.

MR. KELLEY. I'd forgotten about that. Yes, we did have a brief severe float problem.

MR. HAMBLEY. The Fed also cut the funds rate dramatically.

MR. KELLEY. Yes. And we took it right back to where it was. That demonstrated that we were sensitive to the problem, on top of it, and ready to accommodate it, and did accommodate it. The financial system, for its part, got back up on stream amazingly successfully.

Monetary Policy

MR. SMALL. Governor Kelley, you came at the tail end of the Volcker era. In *Maestro,* there's a story that when Greenspan came on board, he was much more concerned about the stock market from the get-go.[5] He was pushing the staff and the Board in the direction of being more concerned about that. Were there other differences that you observed in the way Volcker and Greenspan operated or looked at the economy?

MR. KELLEY. I got here at the end of the Volcker era. A week or two at the most after I was sworn in, he announced that he was not going to go for a renomination for another term. I don't know anything about his relationship with the Administration. At any rate, almost right away after I was here, he was a lame duck. And shortly after that, Greenspan was named. I was told by any number of people that the Volcker era, as it had been lived by them, changed

[5] Bob Woodward (2000), *Maestro: Greenspan's Fed and the American Boom* (New York: Simon and Schuster).

immediately. So I never experienced life under Volcker. It changed, apparently, right away. We had this hiatus period for six or eight weeks, and then Greenspan took over, and he had a whole new era. So I can't tell you much about Volcker.

MR. SMALL. How did it change right then?

MR. KELLEY. While I have my impressions of the Greenspan era, I don't remember ever sitting down with anybody and having a long explanation of how it differed from the Volcker era. I think Volcker's style, both in monetary policy and also in running the Board of Governors, was very different from Greenspan's. But virtually my entire experience was with Greenspan.

Let me say a word before you, as a professional economist, start to interrogate me [laughter], and I start to get stuttery. I had no formal background, coming in here, in economics. I'd never taken a course in economics, although I had been interested in economics. I had done a lot of independent reading in economics and kept up with it. And I had always been interested in the Federal Reserve Board. But I did not know then—and, to a large extent today, still I do not know—much of the craft of being a professional macroeconomist. If I were here today, my view of monetary policy would still be pretty much the same. I had been a business executive. I had run a company for 20 years. I'd been on a number of boards in a number of different industries. I had broad exposure to Main Street, U.S.A., business. I felt like I had a pretty good feel for how businessmen thought and how they reacted and responded and how that might relate to monetary policy. The United States has an economy that is far more varied and complex than any other economy in the world. We had, and still have, world-leading companies and world-leading industries in any number of different areas of the world's economy, yet we only are able to have one monetary policy at any given moment. And I've always felt, still do, that in any given moment, whatever monetary policy regime is in place, it is the wrong policy for somebody.

You try to make the best judgment you can about what is best for the economy overall, what are the economy's needs overall. I'll be interested to see if it's still true or not as we come out of the situation we're in now. In those days, we used to go through a series of rolling recessions. One industry after another, or maybe one geographic area after another, would go into the tank and have their problems. But it was almost always under an umbrella of overall prosperity everywhere else. An individual part of the economy was in trouble at any given time—maybe it was the rust belt automobile industry, the energy industry in the Southwest, or the textile industry in the Southeast. There were a whole series of rolling recessions that went on over a long period of time but under the umbrella of overall prosperity. As a consequence, the impacted area of the economy had an opportunity to come back because it was operating in a basically healthy overall economy. And they did come back. The first thing you knew, they were part of this healthy umbrella again and helping to protect whoever was the next one that went into the tank. There were a long series of those. And you had to be aware, in my view, where this cyclical, rolling economic change took place. Every once in a while there'd be enough of a mass of slow areas so that the aggregates would look like a recession and maybe become a recession. Most of the time it did not.

From my experience living in business on Main Street, I felt that what business most needs and wants is some sense of confidence about the climate that they're living in. They do not like change. They do not like uncertainty in the macro climate. A businessman's perfectly ready, an entrepreneur's perfectly ready to take a risk based on how he evaluates his skills and his business relative to his market. He takes those risks all the time. But he is not comfortable taking risks that are going to impact his ability to succeed, that come from some far off abstraction halfway around the world in the form of some change in policy or regulation that he didn't have anything whatsoever to say about, that impacts his ability to make his plan work, and that under the worst circumstances maybe even prevent a workable plan from working. Businesspeople like an environment that has, as high as possible, a level of certainty to it.

I brought that to the way I thought about monetary policy. We had to do what we had to do. I voted for many interest rate changes, up and down, over 150 or whatever FOMC meetings. Basically, my approach was to keep things as stable as you can keep them and as predictable as you can keep them. As a consequence, that's going to set up the healthiest environment for the economy that you can have.

MR. SMALL. At some points you have to choose your poison, because you might have to be aggressive in interest rates to keep inflation and output—you can't be stable everywhere.

MR. KELLEY. Absolutely. No, I said "as much as possible." And I deliberately pre-answered your question. I voted for a lot of increases and a lot of decreases. You have to do them. But I was always coming from the point of view of trying to have as much continuity and as much certainty as was reasonable.

MR. SMALL. Do you think that coming to the Board lengthened your horizon, that it's the long-run inflation and output, and that you sometimes had difficulty communicating to the business people—

MR. KELLEY. I learned so much from the economists here, I couldn't begin to summarize it all. That was certainly part of it. I got a far, far broader view of the inputs and how they can affect the macro situation than I brought with me when I came. But I think I had this view that might have been idiosyncratic just with me—that the highest level of certainty and stability and continuity that was reasonable, in the light of our two joint mandates, was highly desirable to achieve. Of course, we had to achieve our two mandates—full employment and stable prices. So it was within that context that I was always trying to work.

MR. HAMBLEY. Whatever else the Fed does, it has to maintain price stability. That was Greenspan's approach, too. That is one kind of certainty or stability.

MR. KELLEY. That's right. And everybody here, Board and staff, was deeply into that. And I got into it and signed on to it totally.

MR. HAMBLEY. You probably were of the view that you can achieve the Fed's dual mandate as much as it could be achieved if you focused primarily on price stability. Is that correct?

MR. KELLEY. Yes, I think that's right. We were in a strong era. We all know what the 1990s were. It was the golden era. We're unlikely to have another economic era in any country ever in history like we had in the 1990s. In the most fundamental sense, we were living with a growth economy. We had a lot of confidence in it—turned out maybe too much. As a consequence, we probably sweat price-level stability, if you will, more than we had to sweat growth or full employment. We always had those two proxy terms we used. But, basically, we were talking about growth and lack of inflation.

MR. SMALL. Volcker had just brought the economy through this painful experience to get inflation down. Then the Fed has a new Chairman and a new Board, and you're here. You guys better not undo this great legacy. [Laughter] Was there a sense, at the first signs, that we've got to preserve these gains because it's expected?

MR. KELLEY. Oh, absolutely. And we needed more. When I got here in 1987, we had not achieved what we considered to be a satisfactory level of price-level stability. There was more to do. I always conceived that our strategy was to keep monetary policy in a path that basically tilted inflation down. Sometimes it went up. Sometimes it went down rather rapidly. It didn't stay steady.

MR. SMALL. Down in the inflation [rate].

MR. KELLEY. In a path basically downward in the inflation rate, without unduly weakening the economy in the process. Try to manage it in such a way that you can have a strong economy—and we had a basically strong economy—but still keep the inflation level, over time, in a downward-tilted path. We were on that track from 1987 to right around the year 2000, or somewhere in there, when we finally got down into the 2 percent or close to 2 percent CPI range.

MR. SMALL. You had several episodes of preemptive tightening. Was that nerve-racking, in the sense it was so forecast based, and who knows if this is right?

MR. KELLEY. Well, it always took a lot of soul searching, if that's saying the same thing that you're suggesting. Yes. But we did it, and I did it. I voted once against tightening. I only dissented twice in all those meetings, once against a tightening move and once against an easing move. And damn if I remember what the specific circumstances were. But I did dissent on one tightening move at one point.

MR. SMALL. On your first round of tightening—1988, 1989—there was a presidential election coming up, George Herbert Walker Bush, "Bush 41." Were there tensions?

MR. KELLEY. Well, there was tension that I always felt was completely unwarranted, and I never could get anybody in the Administration to listen to me. They thought that the Fed was one of the main reasons they lost in 1992, which I totally, utterly, absolutely disagree with. The economy was already coming back. They never picked that up. Bush could have sold that:

"We had a mild slowdown here, but we're on the way back up. Clinton is dead inaccurate that the economy's going down." It was beginning to come back during that election, but that was not the rhetoric of either side in the campaign, so we were blamed.

Between 1988 and 1990, Bush held Greenspan hostage for a while. I'll tell you a little story. This is one of my favorite minor stories. I personally had the opportunity to name the Chairman of the Federal Reserve Board—me—when Bush was holding Greenspan back and his term as Chairman ran out, unlike the term of a Governor, which runs until his successor is named. If a Governor's term runs out, he or she stays on. Not so with the Chairman. When his term is over, it's over. If there's no nominee and the President hasn't got anything going, which he did not, then the statute provides that the Federal Reserve Board will name a temporary Chairman from within its membership. At that time, I was senior to Greenspan in service, as far as that's concerned. I was the senior member of the Board when we were in that period. So Virgil Mattingly, the Board's General Counsel, and I got together and read the statute. And Virgil told me it was my responsibility. We had no Vice Chairman. As senior member of the Board, it was my responsibility to take the lead on that. So I canvassed my fellow members and we decided, lo and behold, that we would select Alan Greenspan to be the acting Chairman.

MR. SMALL. We can't exactly give you credit for picking this diamond out of the rough from total obscurity, though.

MR. KELLEY. That's all right. I'm the one that brought the nomination to the Board. And the vote was unanimous.

MR. SMALL. The Latin American debt crisis occurred in the early 1990s.[6]

MR. KELLEY. The early 1990s, when you had those two back-to-back recessions.

[6] Editor's note: The debt crisis in Latin American countries occurred in the 1980s; Mexico's peso crisis began in late 1994.

MR. SMALL. And there was a credit crunch. Thrifts were going under. The banks were exposed to Latin America. Did your business background help in those financial crises?

MR. KELLEY. Not in those crises. Those crises were largely handled by the Chairman personally. He may have talked about it to some of the professional macroeconomists that were on the Board at the time. He didn't talk to me much about it, and it wasn't discussed very much in the Board *en banc*. Greenspan and the Secretary of the Treasury largely handled those crises, which was all right with me, because he knew much more about it than I did. At any rate, that's how it was done. As a Board, I'm sure we had to take some votes on some things, without a doubt. I don't remember what they were. Ted Truman and his people were involved in the negotiations and the analysis up to their ears. And the Chairman largely did that work.

MR. HAMBLEY. You mentioned your two dissents in your long career at the Board. Considering that your background wasn't in economics, it strikes me that both of them would have taken courage. You substituted your judgment, and all these people are going in another direction. I presume that you were on the losing side in both of those cases. Is there a strong tendency, particularly among Board members, to want to vote with the Chairman—a tendency that, in this case, you probably had to resist?

MR. KELLEY. Well, the situation is most stable and comfortable for the markets and everybody else if the markets feel that the Board is acting together and with the Chairman. And that is the case, most of the time. You didn't have too many dissents over the Greenspan years. The FOMC was pretty well together. If you felt yourself slipping away from what your sense of the consensus was, you thought about it long and hard, sure. But if you came to the conclusion that you just flat out didn't agree, then it's your duty to disagree, and I didn't hesitate to do that. It just didn't happen very often.

MR. HAMBLEY. Sometimes you may have a slight difference of opinion about the magnitude or the timing, but unless you feel strongly, you don't break with the Chairman, probably for the reason that you mentioned. You don't want to cause a big commotion if you're not going to take a lot—

MR. KELLEY. I would concur with that. I would change one thing. I think everybody had enormous respect for the Chairman, and everybody wanted to support the Chairman. And the consensus of the FOMC was what was desirable if you could achieve it. That, of course, was led by the Chairman, articulated by the Chairman. But it's important to understand that there's an entity there that is larger than the Chairman. He'd be the first to agree with me on that. We tried to achieve consensus. One of the things that Greenspan was able to do so well was to articulate a position that was close enough for most, if not everybody, to say, "I can agree with that. It's not something I have to leave the fold for." Greenspan was a good listener and a good articulator of an umbrella position. Most people, sometimes barely, would scurry to get under the umbrella, but they get under it. A few times, a few people—twice, in my case—couldn't and didn't. And that was all right. But you really preferred to. And Greenspan could articulate a position that, most of the time, most of the people could come along with.

MR. HAMBLEY. In the days when you did a Directive to the New York Fed with a tilt, if individual members didn't get exactly the funds rate change that they wanted, they could be brought on board by "Maybe we're going to do something in the future."

MR. KELLEY. Yes, that's correct.

MR. HAMBLEY. Greenspan was good at not only listening, but also giving this opportunity for the tent to be big enough for the—

MR. KELLEY. Well, I think that's exactly what I've been saying. And I totally agree with it.

MR. HAMBLEY. It was a skill that's not so obvious, if you simply hear about the meetings or the aftermath or you look at the number of votes: "It was unanimous." Sometimes you had to work hard to get that and do little things on the side, too.

MR. KELLEY. Yes. A lot of times it was the tilts that brought people under the umbrella. You didn't really like to dissent on a tilt. That began to look nitsy. It happened, but not often.

MR. HAMBLEY. Sometimes you get on the tilt what you couldn't necessarily get on the funds rate or something like that.

MR. KELLEY. I gather that's substantially different today. Obviously, I don't know anything about what happens in FOMC meetings today, but I gather that's a lot of the problem Thomas M. "Tom" Hoenig (president of the Kansas City Fed) has been having.

Transparency

MR. SMALL. Did the knowledge of the transcripts being public, with a five-year lag, change the tone or the dynamics of the FOMC?

MR. KELLEY. Well, we were all a little worried about that, including me. But we got over it. The biggest part of the whole episode occurred right at the very first, where we all learned that the meetings had been taped all those years and nobody knew it. Since 1976 or something like that, there were transcripts of every meeting, word for word that everybody ever said. Nobody on the Committee knew that. Boy, that came down as a bombshell. After that, we worked forward from there and progressively eased up a little more and a little more on how much was going to be made transparent. A lot of us had some concerns about that at each stage of the game, but it always worked out fine.

My concern, which was not realized—I recognize that I was unnecessarily concerned—was that if we started talking too much about what we were saying in those meetings, the market would start guessing us ahead of time, which they had never been able to do before, and the market would almost be able to make monetary policy for the Board before the Board was ready to make it. Maybe a little of that happened, but it didn't turn out to be the big problem that I thought it would. I was particularly concerned that when we started to publish the tilts, that was an undesirable clue that the market might take and run away with. But it didn't turn out to be too bad a problem. Now, the way it settled in here, it is definitely a much healthier way to go. So that was a concern I and others had that I think was unwarranted.

MR. SMALL. Do you think the discussions at FOMC meetings were affected?

MR. KELLEY. Not that I could tell. Wait, I think that did happen. We changed from everybody speaking pretty extemporaneously. Everybody always came in there with a position. Everybody came in there with some idea of what they thought. But nobody was writing out their statements, you just talked. You reacted to what you heard other people say. It was pretty much stream of consciousness.

That went away. And we all, me too, started writing our statements. When you were called on by Norm and your turn came to speak, you read your bloody statement. Was something lost in that process? You could make a case that maybe it was. Certainly, some spontaneity was lost. Did it impact what happened? I can't say that it did. I don't know. But it was a change.

MR. HAMBLEY. Before that change, if you came in and spoke about whatever your position was, was there a back-and-forth among the members of the Committee, saying, "Well, what about this, Governor Kelley, or what about that?" Did that also change?

MR. KELLEY. That happened a little bit, but it never did much for the very good reason that there were so many people waiting to speak. It just took too long. It was hard. You've got 19 healthy egos in there—12 voters, but 19 people are participating—and they all have their point of view, and they all think that they're right. They have open minds, but they think they're right and have something to say. That's a hard way to have an open give-and-take discussion. Greenspan adopted the policy where he would let everybody speak, and then he would speak and summarize it. After he did that, it had pretty well been summarized.

MR. SMALL. Where were the sources for banging around ideas, especially after the meetings became more reading transcripts?

MR. KELLEY. I know what I did. I don't know what everybody did. I often wondered how much of that went on between the presidents. They all had their own economic staffs, and they all had their own briefings and discussions in their Banks with their own staff. How much they talked to each other, I don't know. Here at the Board I made a point of talking to all of the Governors a lot, because I was learning from them, for one thing, and I cared a lot what they thought. They were all, at one time or another, important inputs to me.

MR. SMALL. So Governors could feel free to go into another Governor's office and say, "Is this a stupid idea or not?"

MR. KELLEY. I did. There was nothing wrong with that. How much it went on, I don't know. But I did it a lot. And they were all ready to talk and anxious to talk, particularly if they thought they were telling me something that might bring me around to where they were. That was fine.

Interaction with Board Staff

MR. SMALL. Did you have the same access to staff?

MR. KELLEY. Yes, I had good interaction with staff. I had a good bit of one-on-one with staff.

MR. SMALL. You didn't feel they were protected for the Chairman's use?

MR. KELLEY. No, I did not get that impression. Maybe they were, but I couldn't recognize it as such. Some of the Governors who were professional macroeconomists themselves were always unhappy that they never heard any minority views out of the staff. They used to complain about that from time to time, but it never changed much.

MR. SMALL. Where does the staff go wrong?

MR. KELLEY. Well, I only experienced one staff operating one way. So how it would have been if it had been different, I don't know. I found it quite satisfactory. It was fine with me.

MR. SMALL. They aren't too wedded to Keynesian economics? The Greenbook wasn't too powerful in the FOMC meetings?

MR. KELLEY. The Greenbook was the consensus staff vision of the economy, and the recommendations carried a powerful weight. But I think everybody on the Committee thought it through for themselves and came to their own conclusions. In advance of an FOMC meeting, I studied all of the data I could and read all of the staff work that was done, absorbed it, asked questions about it, and considered it.

I used to talk to many of the Reserve Bank directors, who were running substantial companies in every different conceivable industry, and I got to be good friends with a great many of them. I'd call them up and ask them, "How are things, Mr. Nordstrom, in the retail business?" One of the best sources that we ever had came from William "Bill" Poole, president of the St. Louis Fed; he developed a close relationship with FedEx. To this day, I have never found as good a contemporary reading on the economy as you can get from FedEx plus a wide variety of different industries. I'd call up guys. I asked a big developer of commercial properties, "How's your leasing going?" I asked a chairman of a steel company, "How's steel demand?" Yadda yadda. That was a big help to me, because that was my background.

I also felt, fairly or unfairly, rightly or wrongly, that I had some sort of feel myself for how Main Street business looked at policy and reacted to policy and expected policy. I could bring that to the table myself. I tried to, at the meetings. So you would talk to people and talk to your peers here at the Board and talk to staff. Don Kohn, as head of the Monetary Affairs Division, was an enormous help to me, repeatedly, for years. He was very patient with me. I talked to him an enormous amount. Then after you do all of that, what do you do? You sit there at your desk chair, you look out the window at the trees waving at the breeze, you think, and you make up your mind. I don't know what else to tell you.

MR. SMALL. Alan Greenspan went into the weeds of the data and the numbers far beyond anyone else and made sense of it all.

MR. KELLEY. He did. He would amaze you all the time with the stuff that he had at the tip of his fingers. I've seen people who are wonderful at having an accurate view of the big picture of things. I've seen a lot of people who had a wonderfully accurate grasp of the data. He, more than anyone else that I've ever seen, had an incredible amount of detailed data at his fingertips and in his memory bank and had the ability to bring that to the big picture, which he also had. As a consequence, when he spoke about the economy, he could do it, and did it time after time in his summaries. He could do it in a way nobody else could. Get those Board books that are transcripts now and read them. Some of his summaries were amazing. They really were. I don't think anybody else could have done that to the degree that he did.

MR. SMALL. He certainly was not shy about challenging the staff on the forecast.

MR. KELLEY. Oh, no, he was not. He probably got minority views. And maybe, back channel, other people did too. But you didn't get them in the Greenbook, and you didn't get them in the presentation at an FOMC meeting. There was a staff view, period.

Conducting Policy in the 1990s

MR. SMALL. So would you say that the Fed didn't have its eye on the financial markets and mortgage markets and Glass-Steagall as clearly as it had on production and inventories? Is that fair?

MR. KELLEY. Well, I'll tell you what. I hope it's fair. I did. I had my eye more on the real economy and what was going on out there across the country than I did about what was happening on Wall Street. Wall Street certainly had an influence and certainly was important. But was the United States dancing a jig to Wall Street's tune? Not in those days. I think not.

MR. SMALL. Some of the problems with Fannie Mae got started at the very beginning. One could say that the markets will take care of it, or one could be concerned about government subsidies implicit in it.

MR. KELLEY. Well, for a long time, the enormous size and extent of the impact of Freddie and Fannie wasn't as clear. I'm not sure Wayne Passmore even knew that it was becoming what it became. [Laughter] It definitely became the tail that wagged the dog toward the end of the thing.

The Federal Reserve, officially, was very concerned about Freddie and Fannie through the 1990s. In those days, when we had those concerns, I don't think they were what they became almost overnight in the last few years before everything collapsed.

MR. SMALL. But the Fed maybe bought into this golden era of the United States winning the Cold War, productivity, the high-tech boom. A lot was going right.

MR. KELLEY. We knew we were in a golden era. You can look back. I was reading back through some of these background materials. I was interested to see the references that run all the way through the 1990s about how this is a golden, unique era, in my comments, which are what's in this book of background materials. We all knew that we were on top of the world and we were in the middle of something that the world had never seen before. What I don't think we saw was that there was an abyss emerging out there. I certainly didn't.

MR. HAMBLEY. A lot of things happened during the long period of expansion in the 1990s that were hard to understand initially. How did your own views about what was going on change over time as this continued to go on and on much longer than anybody thought?

MR. KELLEY. Well, I'm not really sure what you're asking about, and I'm not sure, as a consequence, how to answer it. But I distinctly remember the first time we went over the cliff was right after Y2K, when there was this great collapse of the tech companies and tech stock prices and so forth. That's the first time we went over the cliff [laughter], I think. Maybe you define it differently. But that didn't bother me all that much. That much of a decline seemed to me to be a reasonably expectable and absorbable event, given what had gone on throughout the 1990s and what went on right around the Y2K event, which was only a matter of weeks before that collapse. The whole cycle of investment and high-tech equipment got thrown off. Then, lo and behold, in early March the thing collapsed. That was a concern. I don't remember exactly what we did about that with monetary policy, if anything. But it seemed like a fairly reasonable, absorbable reaction.

MR. HAMBLEY. Through the 1990s when the economy went through a long period of expansion with, as you mentioned, generally declining inflation at the beginning, everybody who thought traditionally about macroeconomics thought, "Here we're getting close to the NAIRU. Gee, we're getting below the NAIRU." People that are worried about inflation keep thinking inflation is going to start going up.

MR. KELLEY. Then we went way under the NAIRU, and inflation kept coming down. How do you answer that, Mr. Small?

MR. SMALL. The same way Larry Meyer did. [Laughter] "The NAIRU fell! The NAIRU fell!"

MR. KELLEY. Well, it did! It did!

MR. HAMBLEY. In some sense, you were less invested—not being an economist, but just a practical person with a business background—in a particular explanation of what was going on.

MR. KELLEY. That's an interesting thing to say, and I think that's right. I did not have the investment in it that they did. That's true.

MR. HAMBLEY. So what did you think as time went by? How did your views of what was going on change? Did you come to think that it might go on a lot longer?

MR. KELLEY. Well, I don't think I or anybody else thought that it was going on at that pace forever. But I did not have the prescience to see that it was going to end in a great debacle.

I thought that we would go ahead having a garden[-variety] recession from time to time, we'd respond with monetary policy, and things would get back on track. I mentioned the fact that I saw us having a whole series of mini-recessions in industry or different parts of the country. We'd continue to have those. We'd absorb them. So, to the extent I thought about an endgame, first of all, why would it end? It was going to evolve. I saw it evolving slowly, and essentially the same way it had been evolving for a long time—a slowdown, maybe a recession, different parts of the economy doing better than others. We'd absorb those.

I guess I just saw it going on, and that, sure, at some point we would have to slow down. We couldn't continue to get that kind of productivity growth, for instance, that was allowing these 4 percent growth rates to occur. That wasn't going to go on forever. We'd slow back down to 2½ or 3. Could unemployment stay at 3½ or 3¾, where it was we bottomed out? It probably could not. But we'd keep it under 5 or 5½. Historically, 5½ percent is pretty good. No reason we can't do that.

That's about as much as we worried about this long-term evolution that I think you're asking about. I did not foresee anything like the way the whole system would run amok and eventually totally crash. I didn't think it had to end that way or would end that way.

MR. HAMBLEY. Yes, but it look a long time for that to happen.

MR. KELLEY. It took a long time. That's right.

MR. SMALL. I'll do a mea culpa on one of my shortcomings, which is sitting in staff briefings or the FOMC meetings or whatever and listening to Alan Greenspan pull all this together, with productivity and a reference to Pluto and gravitational pulls and globalization. To an economist who likes formal models, it's not a standard way of looking at things. I had asked myself, "Is this goofy?" And then, of course, the facts come in, and he was on the mark. But at

[the] time, I think there was a fair amount of skepticism from the more disciplined, formally trained economists.

MR. KELLEY. What did you think the end of it was all going to be?

MR. SMALL. I would have said that there will be this unpleasant day of reckoning where, "Oh, my goodness, the NAIRU [laughter] really was 5, and here we're playing around as if it's 4," and all of a sudden inflation is going to start rising.

MR. KELLEY. And if I had been in that discussion with you, I would have said, "We'll deal with it when we get there!"

MR. SMALL. And I would have said, "This is how problems start."

MR. KELLEY. Going back to a 5 NAIRU is not bad, historically. You like your models and your econometrics. That's comfortable in your models and your econometrics. If it rises like that, we'll lean into it appropriately.

MR. SMALL. I would have tried a "big think" on you about the grand sweep of history, and this is how we got into trouble in the 1960s and 1970s. "A little uptick isn't so bad. We can take that increase in inflation out when we need to." But the time never came. [Laughter]

MR. KELLEY. That's why we're here. We're supposed to be smart enough not to make that error again. Our staff members are going to have to be the ones that tell us when we're getting in danger of doing it!

MR. SMALL. I would have given you a false read. [Laughter]

MR. KELLEY. Anyway, that was where I was, to the extent that I worried about where we were going to be in the year 2010. First of all, I didn't worry very much. Second of all, I didn't see any reason why the rhythm of the ebb and flow of how policy, and the ebb and flow of the economy, went had to be much different than it had been before. The context would have been a little different and so forth. But does this have to end in a crash? I would have said, "Huh? Why that? We ought to be able to deal with it."

MR. SMALL. Were you talking to your business contacts in high tech about a bubble or irrational exuberance?

MR. KELLEY. Sure. But we thought we would come out of it in due course, just like we had come out of all these other mini-recessions that we had in energy, construction, textiles, and automobiles. We'd been through all of that stuff. And every time we did, everybody would wring their hands. The economy might even go into a slight recession, but it would turn right around and come back out.

MR. SMALL. What happened wasn't terrible. The unemployment rate didn't increase dramatically afterwards. The recessions weren't terrible. It was nothing.

MR. KELLEY. That's right. Yesterday's *New York Times* had a graph of what happened to unemployment 15 months after the trough of a recession. They all went right back down until this one. The one in 1990, 1991 did not respond that way. The one out in 2000 did not respond that way. And this one did not.

MR. SMALL. After the 1987 stock market crash, I remember Greenspan saying that free markets and high tech gave the economy much more resiliency.

MR. KELLEY. If we had looked at those graphs—and I guess we did, their equivalent—in 1990 and again in 2000, while the unemployment rate didn't go down greatly like it had in the earlier years, it hung there where it was, it was nowhere near the kind of level that we've got now. It didn't have so far to come back. It wasn't so painful for it to be there. Sure, we wanted it to get better, and sure, the politicians would wring their hands, but it wasn't the kind of box that we're in now with this one. So we didn't panic when we didn't have much recovery from unemployment in 1990 or even 2000. We wanted to get it, and we did get it, ultimately. But it wasn't a cause for absolute despair and fear, like we have this time, when we have that nonresponse to a much higher level of unemployment. Is that fair?

MR. SMALL. Yes. Is that because this time the excesses were that much larger going in, with subprime and the housing market?

MR. KELLEY. I think it probably is. The story hasn't entirely been written yet, but I would think probably so, yes, something like that. Another thing that was happening, sub rosa. Nobody saw it, I don't think. Perhaps a few people did. I remember so well. After Alan Blinder left here, he wrote an op-ed piece in the *New York Times*—in 2006, I believe—about how the structure of American employment, with jobs going overseas and large improvements in productivity, was changing in such a way that, over the course of the next three decades, we were going to structurally lose from 20 [million] to 40 million jobs in this country that were going to have to be replaced with something totally new and different. I read that now and I say, "Oh, boy. Was that ever a nice piece of insight." I talked to Alan about it. He and I are on a board together, and I reminded him of that. He was very flattered that I remembered it. I said, "Are we still on that track?" He said, "Yes." There's going to be a structural loss of some large number of jobs over the course of the next couple of decades, which we're now in the middle of and which is going to make it more difficult than it already was for us to come back out of the recession this time.

Current Financial Crisis

MR. SMALL. A fair amount of blame is put on the financial markets for this recession—the market got too complicated, too many layers of derivatives stacked on derivatives, getting away from Glass-Steagall.

MR. KELLEY. They got too greedy and got way overleveraged, too. Add that. That was very much a cause of the collapse of Lehman particularly, but others as well—Bear Stearns, even Goldman and Morgan Stanley.

MR. SMALL. Is that problem addressed at all in the new financial regulation, or is it just greed is going to be greed?

MR. KELLEY. Many of the hedge funds have not been doing as well in the last couple of years as they were doing before that. So a certain amount of it has already come to pass. I'm going to be fascinated, if I'm ever able to find out from anybody, how it goes with Morgan Stanley and Goldman now being bank holding companies. That's going to be interesting to watch! Is the New York Fed going to get in there and do what it ought to do with those companies? I hope it does. Then they won't go back to where they were, in terms of the leverage that they had.

MR. SMALL. Do you think the Fed—through the Reserve Banks doing some bank examination, with the board of directors, some of whom are bankers—is built to be aggressive enough in regulating and supervising?

MR. KELLEY. I think, over history, we were. When I was on the Board's Committee on Banking Supervision and Regulation, and I was chair of it for three years, we didn't have any big problems, thank God. It was a quite mild time. We thought we were busy dealing with stuff, and we were, but there was nothing remotely close to what we've seen recently. The banks were stronger. From the time that Robert "Bob" L. Clarke, as Comptroller of the Currency [1985–92], had to oversee saving Citibank in 1989, we didn't have any more of that kind of stuff for a while. Again, it was part of this golden era we went through in the 1990s. Now, could supervision have been much more aggressive from 2003 forward? I wasn't here, but if you look at what happened, you'd have to say, "I guess so." I hope they could have and would have.

I can understand how the Fed was late coming to the party on what was happening with all of these outrageous and illegal loans that were taking place in the housing industry. There's a lag that's inherent in the supervisory process and that all happened so incredibly swiftly and incredibly adversely. Even if we had no way of stopping it, we could have used the bully pulpit. But I gather that it really was not recognized until almost ex post. I'm not going to criticize anybody for that, but it sure would have been nice if it had been possible to identify the problems sooner.

MR. SMALL. You mentioned some of these investment banks becoming bank holding companies where they would be supervised by the Fed and have access to the discount window. Do you like the bank holding company concept as a way to manage risks and put up firewalls?

MR. KELLEY. I've been away from this for eight years, and I don't know much about how it has evolved. When I left, it was still under control, I thought. Win and Lynn were after me this morning a little bit about that. Effectively, they were asking me, "Didn't you see these companies getting too big for their own ability to control themselves?" I would have to say that, as of the time I left at the end of 2001, no, I didn't see that. Certainly we saw them getting gigantic. But I was still deeply in my business school model, assuming that really good managers can manage what needs to be managed. It didn't turn out to be true, or at least these managers didn't manage it. Maybe they could have, but they didn't. They were so busy making incredible amounts of money, they lost sight of fundamentals. Could those companies that failed in 2008 have survived under other regulatory and supervisory regimes? Not if the other stuff was going on at the same time. Somebody would have had to have seen it and stopped it earlier.

MR. SMALL. In the recent financial regulation legislation, do you think there are missed opportunities or key issues that are not addressed or insufficiently addressed?

MR. KELLEY. I think the record categorically has to tell you that the answer to that question is "Yes." And it's too bad. It happened so fast. A lot of it was deeply and quite deliberately hidden. You take the way Lehman was doing those 509 things.

MR. HAMBLEY. The 105s, the repo operations.

MR. KELLEY. That was a deliberate attempt to deceive counterparties and supervisors. Quite deliberate—in my opinion, criminal.

MR. SMALL. Is there something in the new regulation that you would have put in that was not put in? Is there a missed opportunity, as far as new regulations?

MR. KELLEY. I don't think we're going to know the answer to that until we find out what a new crisis looks like some day and whether or not we can handle it when it happens. My view of this regulation that just got passed is "Okay." It was the best thing that the Congress could come up with politically; it was the best that they could pass now. The question becomes: Are you glad they passed it, or would you sooner have had the status quo ante? Faced with that question, I'm glad it passed. I think regulation is considerably stronger today than it was before.

Timothy "Tim" Geithner and Henry Paulson are quite right when they say that the government did not have the legal ability to save Lehman in the last hours of that Sunday night. They didn't. And if they had done something extralegal, you would have had the hounds trying to put them in jail for it now. They might have saved Lehman, but they might be going to jail. I don't know. Now they have that capability. Is it going to work? It's awfully awkward. There are things about it that I think may very well prevent it from working. But we won't know for a while—I hope for a long time. I asked my Republican friends this, and they stammer around and sometimes say, "No." But I say, "If that's the only law that could have gotten passed, are you glad it passed, or would you sooner have the prior regime that we had for years before that?" My answer is, "We're better off where we are than we were then."

MR. SMALL. Partly because of the new resolution authority.

MR. KELLEY. That's certainly part of it. I'll be interested to see if it works. I thought that Morgan Stanley and Goldman Sachs would be in a highfalutin hurry to get out of being a bank holding company now that they didn't need it any more. But I'm told they intend to stay that way, and if they do, great. I hope the New York Fed gets some people in there that can handle those guys.

MR. SMALL. Why do you think they want to stay? Is it for access to the discount window?

MR. KELLEY. I thought they'd want out. Maybe it'll turn out they do. There are a lot of things that haven't played out yet.

MR. HAMBLEY. It's not easy for them to get out.

MR. KELLEY. Well, it probably isn't. But I have been told, on pretty good high-level New York authority, that they don't have any intention of trying to get out. Will that turn out to be true? I don't know. But there you are. As we sit here today, that's the state of play.

Accomplishments and Changes in the Fed

MR. HAMBLEY. During your time here at the Fed, what was particularly satisfying that happened to you or that you accomplished here? What major changes did you see that would strike somebody who came when you came and left when you left?

MR. KELLEY. Well, I think we've talked all morning about the biggest change, and that is the fundamental evolution of the bank system itself. It became a very different thing than it was in its dying days when I got here in 1987. So that was the fundamental change.

There were two things that I get great satisfaction out of. One of them we've talked about at length is Y2K. I feel very happy about the experience we all went through on that, and I'm proud to have had a small part in it. The other happened way back in 1990, when I was the Administrative Governor—we changed the compensation system of Board officers. That was a big deal.

MR. HAMBLEY. That was when the Board basically declared independence from the civil service schedule.

MR. KELLEY. We declared that we were going to exercise the independence that we had always had and never exercised, and we went off on our own. We designed from scratch a whole new compensation system that changed not only the level of the pay structure, it brought up a lot of highly skilled professionals a great deal from where they were stuck under the old GS system, which was the biggest part of the point, for me. We put in mandatory officer evaluations. We changed the fact that you couldn't accumulate lots of vacation and cash it out when you retired after having never taken a vacation while you're working for 30 years. That's nonsense, and we stopped that. That was one part of the new compensation system that I think was pretty unpopular. But people liked the raises they got.

I was proud of it because I had been sort of on a crusade before I got here about the fact that professionals in certain areas of the economy were being grossly underpaid by society. It was teachers that I had been primarily upset about. But I saw a close analogy between teachers and a number of highly educated, highly competent people we had doing professional work at the Fed. They were stuck in that old GS system. Teachers still are not properly compensated. I thought it was a shame that you had such things. For example, take some 35-year-old football coach in a high school who was having a wonderfully positive influence on a bunch of young men that played for him. He was getting paid $18,500 a year. He had a couple of kids in high school that he was soon going to want to send to college, so he left the profession. He quit and went to sell insurance, because he had to make more money—he didn't want to quit. That was happening here with many very good people.

People at the Fed were going back to academia. People were taking jobs in the big banks and other places. They were leaving because they had kids coming up. It seemed like there was a breakpoint, somewhere in your middle or late 30s, where you would have to decide you're either going to stay at the Fed and live with the salary because you like the work and you want to make the contribution, or else you're going to protect the interests of your family and leave. I hated people having to make that choice. That's why we changed the compensation system. I honestly believe that we held a lot of wonderful people here through the rest of their career; that was really important to this place. That's how I feel about it. I regard that as having been important.

MR. SMALL. Were you involved in recruiting Governors or talking to people about who might be a Governor?

MR. KELLEY. In one or two cases.

MR. SMALL. Is it hard to get good former bank executives in because of compensation?

MR. KELLEY. No. As chairman of the Board's Committee on Federal Reserve Bank Affairs, I was personally and actively involved in the selection of 13 Reserve Bank presidents. I regarded that as an important thing to be doing, and doing well. Without any exception, these efforts were led by the boards and selection or evaluation committees that they set up inside their own board, but we worked closely with them all the way through. Time after time, they came up with superb choices. Some of them were in-house. You had Al Broaddus [president of the Richmond Fed, 1993–2004], Jack Guynn [president of the Atlanta Fed, 1996–2006], and others. Some of them came in from outside, like Michael H. Moskow [president of the Chicago Fed 1994–2007]. Some of them came up through supervision and regulation: Tom Hoenig; operations: Cathy E. Minehan [president of the Boston Fed, 1994–2007]; and economists: Al Broaddus. They came from inside and outside. I thought they were all good, and I was proud of all of them.

MR. SMALL. What about Federal Reserve Board members? They're under a more restrictive set of rules.

MR. KELLEY. They are. I don't want to talk about when I was involved, frankly, if you'll excuse me. But I didn't have much to do with that. That came from other sources. But one way or another, willy-nilly, the process, presidential nomination, and Senate confirmation worked slowly but very well. I thought that we got one good Governor after another down through the years. I've been proud of them and proud to work with them. Of course, there's a whole new group since I've left. But I don't have any reason to feel that's changed.

MR. HAMBLEY. In the selection process of Reserve Bank presidents, did the board of directors of a Reserve Bank make one nomination? Was there ever more than one nomination?

MR. KELLEY. There was always more than one nomination, because we insisted on it. They almost always had their favorite. But the Board always insisted—and as chair of the Bank Affairs Committee, I did it for the Board—that we have three names, because we did not want to be backed into a corner where we had to select somebody we didn't want. Over 13 selection processes, I can think of a couple that were tricky. I'm not going to name them. But for all the rest, we worked right alongside the Banks' board of directors here while they went through the process. First of all, we could tell them something about how to do it. More importantly, we didn't want to wind up with a train wreck right at the end.

The way the process works is that the Banks come up with their own nominees, but the Board has to approve it. The Board has the final say. I always felt that the best way to make sure that process went smoothly was to work with them along the way. They were always very good about that. And I always reciprocated by bending over backwards to support the person that they liked best. In one or two cases that I will not mention, a Reserve Bank's first choice was not necessarily who I thought was the very best person, but I supported them, and the Board ultimately supported them. And there were no cases where we outright overruled a board of directors on their first choice. There were a couple where the Board itself would have probably made a different first choice, but we were comfortable with their choice. We felt that, where we could, it was best to let them have their way. And I would do that again.

MR. HAMBLEY. That's an aspect of governing the Federal Reserve System. While the Board might literally have the power to deny a particular nominee for Reserve Bank president, it's not the kind of power the Board wants to use.

MR. KELLEY. That's right.

MR. HAMBLEY. Has there ever been a case of the Board removing a president?

MR. KELLEY. No, there never has been. It could. The Board can do it without cause. To my knowledge, it's never even been discussed.

MR. HAMBLEY. The Board does not exercise certain powers, doesn't always insist on its prerogatives, doesn't try to whip everybody into line.

MR. KELLEY. That's the way we've worked over the years that I had the chairmanship. It had not been that way, upon occasion, before. And, once again, I will not get more specific than that.

MR. HAMBLEY. Although the Board could prevent somebody from becoming a president or could remove them, the System wouldn't have worked well that way.

MR. KELLEY. The best way to make sure that you never get there is to work closely with people all along the way. My personal philosophy was, while we had the power, if we wanted to use it, to stop anything that was going on in a Reserve Bank, it's the last thing in the world we wanted to do. We wanted them to feel as fully independent as they could. They always knew we were there. There were always a few directors here and there, bull-of-the-woods-type guys, who didn't like that. We had a few eyeball-to-eyeball conversations over things like that with a few people, but it never got to be a problem.

MR. HAMBLEY. Governor, thank you, so much, for joining us.

MR. KELLEY. Well, I've enjoyed this process. Thank you very much. You've been very patient with me. When I see a transcript, I hope that I'm not going to say, "Oh, God! Did I say that?" [Laughter]