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Fed's Most Interesting Man Exits

Dec 17, 2014
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Narayana Kocherlakota, to borrow from a much-lampooned beer commercial, is the most interesting man in the Fed. Kocherlakota has just declared that he will not seek reappointment as president of the Federal Reserve Bank of Minneapolis, ending a tenure that has seen quite a lot of controversy and the most dramatic policy reversal in recent memory.

The Minnesota Fed is famous for its association with the University of Minnesota, which is famous for a certain kind of macroeconomics. That university is where Ed Prescott developed his landmark Real Business Cycle theory, which included no role for monetary policy in fighting recessions. Prescott once famously quipped that Fed monetary policy "is as effective in bringing prosperity as rain dancing is in bringing rain." Prescott and his colleagues built strong links between the University of Minnesota and the Minneapolis Fed -- many researchers would hold joint positions at both institutions. One might suspect that this would lend a hawkish cast to the Minneapolis Fed's attitudes toward monetary policy, and indeed, that Fed bank was renowned for its suspicion of money-printing.

When Kocherlakota became president of the Minneapolis Fed in 2009, he looked like a classic hawk. Shortly before assuming the position, he had signed a Cato Institute-sponsored petition against President Barack Obama's stimulus bill.

Kocherlakota remained hawkish for the first two years on the job. In 2010, he gave a notorious speech in which he suggested that low interest rates would cause deflation instead of inflation, causing a firestorm of protest in the blogosphere. In 2011, he was one of only three Federal Reserve governors to vote against keeping interest rates low -- the other two were Charles Plosser and Richard Fisher, the most hawkish of the hawks.

But in 2012, Kocherlakota made one of the greatest reversals in economics history. Switching abruptly from hawk to dove, he began to argue that the Fed needed to keep interest rates at zero for many more years. He claimed it was new academic research that changed his mind -- a rare case when macroeconomic theory had convinced a policy maker to change his mind in real time.

Kocherlakota began to vote with the doves. Where he used to dissent from the Federal Open Market Committee on the hawkish side, he now began writing dissents in favor of keeping interest rates lower for longer! He hired more labor economists, and created a research team that uses macroeconomic models of a decidedly non-Minnesota type.

Naturally, given the overall tenor and atmosphere of the Minneapolis Fed, this was bound to cause friction within the institution. In 2013, he dismissed two prominent Prescott disciples, Patrick Kehoe and Ellen McGrattan, from their positions at the bank. This was no minor shift -- Kehoe and McGrattan were the first- and third-ranked researchers on the Minneapolis Fed's staff. It isn't clear whether the firings were prompted by intractable differences over economics, or by personality conflicts, but it seems obvious that the former was at least present in some form.

Whatever the impetus for the firings, they caused a firestorm of protest. Prescott warned that "something very good is breaking down rapidly." Stephen Williamson, then of Washington University in St. Louis, and a rather hawkish type in his own right went further:

Basically, Kocherlakota has declared war on his own research department, and seems intent on destroying the place as a research institution...he should quit - and do everyone, including himself, a favor.

Williamson has gotten his wish -- Kocherlakota is quitting.

Actually, Kocherlakota's latest surprise move may not be that big of a surprise. His term expires in 2016, and to secure another, he would have had to have received the backing of the board of the Minneapolis Fed. That board is composed of private business people -- mostly bankers -- from the region surrounding Minneapolis. If they appointed Kocherlakota as a superhawk in 2009, and supported earlier presidents who built the institution into a bastion of hawkishness, it seems unlikely they would bring back Kocherlakota after his radical 180-degree conversion. In other words, Kocherlakota is probably just gracefully bowing to the inevitable.

With Kocherlakota leaving, the future of the Minneapolis Fed is in doubt. It remains to be seen if the directors will replace him with a classic Minnesota hawk, and whether his replacement will reverse the changes Kocherlakota made at the bank. But whatever happens, Kocherlakota has made an important impression on the broader world of macroeconomics -- he has shown that it's possible to change one's mind about substantive issues, to buck local culture and stick to one's guns in the face of academic politics.

He was…the most interesting man in the Fed.