

# The Philadelphia Fed Policy Forum: Summary of the 2001 Policy Forum and Announcement of the 2002 Policy Forum

BY LORETTA J. MESTER

**O**n November 30, 2001, the Federal Reserve Bank of Philadelphia held its first Philadelphia Fed Policy Forum, “Three Questions for Monetary Policymakers.” This event, sponsored by the Bank’s Research Department, brought together a group of highly respected academics, policymakers, and market economists, for discussion and debate about important macroeconomic and monetary policy issues the Fed needed to address in the coming year. The Policy Forum was not intended to be a traditional academic conference on monetary policy, nor was it intended to be a discussion of issues relevant to the next FOMC meeting. Rather, we took a longer term perspective and tried to engage the right people in a discussion of current macroeconomic research and its implications for monetary policy.

Last year’s Policy Forum addressed three questions facing monetary policymakers: How Should Monetary Policy React to Asset Prices?; How Should Monetary Policy and Fiscal



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Policy Interact?; and How Transparent Should a Central Bank Be? \* In my closing remarks, I noted that because conferences have to be planned so far in advance, there is always a danger of focusing on topics that lose their relevance as the event approaches. And the economic changes that occurred between November 2000 and November 2001 were striking, as the economy headed into recession and the September 11 tragedy unfolded. Still, in

\* Many of the presentations reviewed here are available on our web site at [www.phil.frb.org/conf/policyforum.html](http://www.phil.frb.org/conf/policyforum.html).

my view, the topics discussed at the Policy Forum turned out to be even more relevant as the economic landscape shifted, and the day’s program generated interesting debate and discussion and provided numerous insights.

President Anthony M. Santomero of the Philadelphia Fed began the day, pointing out that Chairman Greenspan moved one aspect of the first issue, “How Should Monetary Policy React to Asset Prices?” to the forefront several years ago and, in the process, introduced a new phrase into the financial lexicon. During a speech in December 1996, with the Dow at 6437, he posed the now famous question: “... how do we know when irrational exuberance has unduly escalated asset values?” As Santomero said, since that time, the Chairman’s question has gotten tougher to answer. And the follow-up questions — How do dramatic shifts in asset values affect aggregate spending? Should they figure into the Fed’s monetary policy decisions? And if so, how? — are equally tough to answer. In Santomero’s view, the Fed must take into account the potential impact of asset markets on the real economy. Meanwhile, asset market participants must take into account the Fed’s impact on financial conditions, real-sector performance, and hence the returns on their portfolios. In his view, the Fed and the asset markets are locked into a complicated game. The question is: What are the rules of that game, and how should the Fed play it?

Santomero said that the second Policy Forum question, “How Should Monetary Policy and Fiscal

Policy Interact?” has also grown more important and has become more complex. The Fed can move monetary policy quickly, but the effects of its actions unfold slowly. Fiscal policy actions usually take longer to implement, but their impact may come more quickly. (Andrew Abel, another speaker, elaborated on this point.) It is important to address how policymakers should use the two to provide steady support for the economy going forward, add strength if necessary, and ease back when appropriate.

In addressing the third question, “How Transparent Should a Central Bank Be?” Santomero indicated the case for transparency is a strong one. Making the Fed transparent is one way to cut through the complex interplay between financial markets and the Fed. The Fed states its policy goals and its intended path for achieving them. Financial markets process the information efficiently and adjust accordingly. Uncertainty and the risk of confusion are minimized; efficiency is maximized. Transparency also serves the broader goal of building public confidence in the Fed as an institution. But Santomero also made the point that in assessing whether there is a need for greater transparency one must consider a tradeoff. Greater transparency can improve the Fed’s clarity and increase its accountability. But it can also limit the Fed’s resourcefulness and slow its response times. Wise and timely policy decisions are the product of frank discussion and open debate among the policymakers, and maintaining the confidentiality of those proceedings helps preserve their frank and open character. In Santomero’s view, the issue is striking the right balance of transparency and confidentiality.

In closing, Santomero made the point that the issues being discussed were relevant not only in the U.S. but to policymakers around the world.

## HOW SHOULD MONETARY POLICY REACT TO ASSET PRICES?

As pointed out by discussant Mark Watson of Princeton University, the first session’s three papers illustrate that the answer to the question “How Should Monetary Policy React to Asset Prices?” depends on the imperfections and frictions in the economy. The three papers reached different conclusions about how monetary policy should respond, since they assumed different causes for variations in asset prices.

### The optimal monetary policy depends on the level of risk aversion, since inflation facilitates risk sharing.

Fernando Alvarez of the University of Chicago presented a paper that investigated how optimal monetary policy changes when market participants’ level of risk aversion changes. In his model, stock price fluctuations arise from variations over time in the level of investors’ risk aversion. The optimal monetary policy depends on the level of risk aversion, since inflation facilitates risk sharing. Market participants trade in the market (incurring transactions costs) to insure against idiosyncratic shocks to their income. Inflation reduces the income of all economic agents, and at the margin, it compresses the distribution of income, thereby reducing the need to trade for insurance purposes. But too much inflation leads everyone to trade and incur transactions costs. The optimal inflation rate balances these two forces. Risk aversion affects the amount of trading and therefore the need for inflation to reduce cross-sectional income dispersion. When risk aversion is higher than average, the

optimal monetary policy is to choose a lower inflation rate than average; when risk aversion is less than average, the optimal monetary policy is to choose a higher inflation rate than average. Thus, high risk aversion leads to lower prices of risky assets and to lower levels of inflation, and in this sense, optimal monetary policy is procyclical.

Bill Dupor of the Wharton School, University of Pennsylvania, discussed his work on how monetary policy should optimally respond to movements in asset prices. According to his model, optimal monetary policy is contractionary in response to an inefficient boom in the stock market or in investment. Thus, in contrast to Alvarez, the optimal policy is countercyclical. In Dupor’s model, firms make investment decisions to maximize the expected present value of their real profits, but they sometimes mis-estimate the future return to their investment. These mis-estimates drive investment and asset price movements in the model. When firms overestimate future returns to capital, they increase physical investment and asset prices appreciate. Optimal monetary policy works not only to reduce nominal price fluctuations in the economy but also to reduce these nonfundamental asset price movements, since these movements indicate that firms’ investment decisions have been distorted. By running a contractionary policy in the face of inefficiently high asset prices, the monetary authority reduces the return on investment and lowers the distortion. Dupor’s model provides a formal justification for monetary policy to respond to nonfundamental movements in asset prices at the expense of nominal price stabilization.

The third presenter, Mark Gertler of New York University, summarized and updated his recent work with Ben Bernanke. Asset price bubbles can cause fluctuations in spending and inefficient business cycles,

but in designing optimal monetary policy, the central bank must remain cognizant of the fact that it cannot be confident about whether fundamentals (like an improvement in technology) or nonfundamentals (a bubble) are driving asset prices. Gertler also pointed out that even if the central bank were certain that a rise in stock prices was a bubble, there is a great deal of imprecision between high frequency moves in asset prices and spending. In Gertler's view, the best feasible policy for dealing with the harmful effects of asset price bubbles is a flexible inflation-targeting strategy in which the central bank commits explicitly or implicitly to adjust interest rates to stabilize inflation over the medium run. A central bank that follows an inflation-targeting strategy should respond to changes in asset prices only to the extent that such changes affect the central bank's forecast of inflation or deflation, or movements in the equilibrium real interest rate. This strategy would lead the central bank to accommodate asset price movements driven by fundamentals but offset nonfundamental asset price movements that generate inflationary and deflationary pressures. Thus, the central bank should not ignore asset prices; the central bank should include them in the information set with which it forecasts inflationary pressures or movements in the equilibrium real interest rate. In Gertler's view, inflation targeting provides a nominal anchor for monetary policy and has worked well in practice, although, he points out, such a strategy has not been stress tested by large swings in asset prices.

In their work, Gertler and Bernanke simulated how the economy would react to a boom and bust cycle in asset prices when the central bank practices inflation targeting, that is, when the monetary policy interest rate instrument responds primarily to changes in expected inflation. They

find that inflation targeting yields good outcomes, substantially stabilizing both output and inflation, when asset prices are volatile. As in Dupor's model, the central bank offsets purely speculative increases or decreases in stock values that are driven through aggregate demand, and it accommodates technology shocks. They found little additional gain from allowing monetary policy to respond to stock price movements over and above their implications for inflation. Gertler also pointed out that aside from the model predictions, it might be dangerous to have the central bank attempt to influence stock prices, since the effects of such attempts on market psychology are very unpredictable. Finally, Gertler presented results suggesting that there is only an imprecise link between short-term changes in asset prices and spending. While more permanent changes in asset prices, which change wealth, lead to changes in consumption spending (the wealth effect) and investment spending, the evidence indicates that short-run changes in asset prices do not have a large impact on spending. In Gertler's interpretation, this again suggests there is little to be gained following policies that target asset prices.

Mark Watson of Princeton University, the first discussant, pointed out that the three papers all conclude that monetary policy can act in a way to ensure and improve macroeconomic stability. But they differ in their recommendations of how policy should behave: Alvarez's model suggests the central bank should ease monetary policy in response to rising asset prices; Dupor's model suggests the central bank should tighten in response to rising asset prices; and Gertler-Bernanke suggest that the central bank should essentially ignore asset prices except to the extent that asset prices help forecast or signal something about the overall state of the economy or inflation. But how useful are asset prices in forecasting future

inflation or future output? As Watson points out, the answer is very mixed in the literature. Watson's comprehensive study with James Stock of Harvard University of seven countries and 38 asset prices, forecasting over two time periods (1971-1983 and 1984-1998), indicates that asset prices are useful for predicting inflation sometimes and somewhere, but there is little consistency and there is a lot of instability across time. For example, trying to rely on one or two asset prices to forecast inflation or output would be a mistake — the forecasts are too noisy. But if one combines information from many asset prices in constructing forecasts and averages across many asset price predictors, one obtains forecasts that are better than those that ignore asset prices — essentially, one can average out the noise.

Ben Bernanke of Princeton University (and current member of the Federal Reserve Board of Governors) stated that the Alvarez and Dupor papers provide nicely worked out theoretical analyses of the case for monetary policy to respond to the stock market over and above the extent implied by the market's implications for inflation. Bernanke pointed out that this is true even in the Bernanke-Gertler model, since stock market bubbles lead to excessive volatility in investment. However, in Bernanke's view the real question is whether, in practice, we have sufficient confidence in our understanding of stock market behavior and its response to monetary policy to improve over an inflation-targeting rule. He is skeptical that we do or that the Fed does, and he feels that history argues against trying to stabilize the stock market. While he strongly encourages the central bank to make emergency responses to financial crises to protect the payments system (for example, the 1987 stock market crash, the Russian default, September 11), Bernanke pointed out that past attempts

to prick stock market bubbles have led to some very bad outcomes.

Jeremy Siegel of the Wharton School, University of Pennsylvania, the session's final discussant and moderator argued that while there is some empirical evidence that asset prices might not be that informative about the economy, in his view, they are becoming increasingly informative. For example, consumer confidence is more linked to the stock market and the cost of capital is dependent on equity prices. In his view, there are signals in equity prices that the Fed should pay attention to. And he also believes that the Fed should respond to them, but not with the aim of pricking a bubble. For example, to the extent that the late 1990s stock market boom reflected an increase in productivity and therefore a rise in the potential growth rate of the economy, the equilibrium real interest rate rose. Had the Fed not raised interest rates, inflationary pressures would have built. On the other hand, if the central bank believes that the market is too high, then in Siegel's view, trying to prick the bubble can be risky because there are lags in the effect of policy and interactions between policy and the market.

### HOW SHOULD MONETARY POLICY AND FISCAL POLICY INTERACT?

A panel of four speakers addressed our second question. Andrew Abel of the Wharton School, University of Pennsylvania, started by laying out and commenting on some of the channels of interaction between monetary and fiscal policy, some of which he feels are more relevant now than others. These include financing and monetizing government deficits; the effect of inflation on tax rates and revenues; open market operations in Treasury securities; the liquidity trap; lags in monetary and fiscal policy; and short-run vs. long-run uses of policy.

The first channel, financing the government deficit, is the oldest and simplest issue, according to Abel. During World War II, the Fed cooperated with the Treasury by keeping interest rates low to reduce the Treasury's financing costs. But since the Treasury-Federal Reserve Accord of 1951, the Fed has become independent of the Treasury, which is not to say that fiscal policy has no effect on monetary policy.

Inflation affects effective tax rates, since the tax code is not indexed to inflation. Abel pointed out that Martin Feldstein estimated that a 2-percentage-point reduction in inflation would increase welfare by 1 percent of GDP per year, through its impact on effective tax rates. In Abel's view a simple and desirable way of remedying the problem would be to index the tax code.

Another issue that has become more topical is how monetary policy should be conducted in a world with shrinking government debt. Abel thinks this is an interesting question; however, he points out that over the longer run, it will be much less of an issue, since government debt will be "back with a vengeance" in the long run.

Abel said that contrary to some economists, he does not think the issue of the liquidity trap applies to the U.S. at the moment, although it might apply to Japan, where interest rates had gone so low that monetary policy had become an ineffective tool for stimulating spending. In Abel's opinion, the structural problems in Japan, for example, the weak banking sector, are quite different from those the U.S. was facing at the time of the Policy Forum.

In thinking about how monetary and fiscal policy interact, Abel outlined three types of lags. The recognition lag — how long it takes to figure out there's a need for policy action — is short for monetary policy, since the meetings are frequent, and short to medium for fiscal policy. The

decision lag — how long it takes to implement a policy change — is incredibly short for monetary policy and usually long for fiscal policy. Finally, Abel cites Milton Friedman's "long and variable lags" as a good characterization of monetary policy's action lag — how long it takes policy to affect the economy once it is implemented; the action lag for fiscal policy, Abel stated, is medium to long. Based on this lag structure, monetary policy should be used for short-run stabilization, since it generally has shorter lags. But in the long run, monetary policy should focus on keeping inflation low and stable. Fiscal policy should be used to achieve the following long-run goals. First, assess whether programs are worth what they cost; whether there are market failures that need to be corrected; and what public goods need to be provided. Then set taxes to collect sufficient revenues to fund these expenditures in a way that respects economic efficiency and equity and that minimizes distortions, and perhaps meets some redistributive goals. In Abel's view, any short-run stabilization through fiscal policy should generally occur through automatic stabilizers.

R. Glenn Hubbard, chairman of the Council of Economic Advisers, said he was also skeptical of using fiscal policy for short-run stabilization. He believes that the fiscal policy applied in 2001 was appropriate, viewing the tax rebates in the spring 2001 tax act not as a cyclical measure but as down payments on a permanent tax cut. Hubbard said the question of how fiscal and monetary policy should interact is an important one. He said the key was cooperation, not coordination. When monetary policy is made, it must consider current and future fiscal policy, and vice versa. The fiscal and monetary authorities need to understand what each is doing. At the simplest level, this means talking to one another, and there are a variety of ways

in which the Administration and the Fed do communicate with each other. This is different from coordination. Hubbard agrees that monetary policy independence is a key ingredient of good policy and benefits the economy. He pointed to the combination of monetary and fiscal policy in 2001 as an illustration of the harmonious working of monetary and fiscal policy in the U.S. And he stated that he believes that monetary policy and fiscal policy are committed to their long-term goals — for monetary policy, its long-run goal of price stability and for fiscal policy, its long-run goal of improvement in long-term budget balance.

Laurence Kotlikoff of Boston University disagreed; he thinks that monetary and fiscal policy have exactly the wrong long-term goals and direction. He does not believe monetary policy

and fiscal policy should interact; we do not want to use monetary policy as a fiscal instrument. However, Kotlikoff believes that in the U.S. they *will* interact because of the nature of our long-term fiscal problems. Based on his research, our fiscal policy is highly unsustainable. Kotlikoff and co-authors have used generational accounting to compare the size of the government's bills now and in the future to the amounts available to pay those bills now and in the future. These are not in balance in the U.S. — future generations will face a much higher tax burden than the current generation, since we are passing on a large debt to them. According to Kotlikoff's research, in the U.S. it will be difficult to achieve generational balance whereby the lifetime net tax rates of future generations equal that of the current

generation. Other countries facing a similar problem have used hyperinflation to bring about balance. Kotlikoff outlined some alternative policies that could be used to achieve generational balance in the U.S., including tax increases and cuts in transfers and government purchases. For example, according to his and his co-authors' estimates, as of summer 2001, the U.S. would need to raise federal income taxes 68 percent or all taxes (local, state, and federal) 26 percent to achieve generational balance. Alternatively, it would take a cut of 44 percent of all government transfers. Kotlikoff said that these numbers were so scary because the demographics are that bad — he stated that in 30 years the U.S. will have twice as many old people and only 15 percent more workers. Kotlikoff pointed out that some have argued that



economic growth will bail out the U.S. from this problem — as the population ages, there will be a lot of wealthy older people relative to young workers, which will lead to more capital per worker, higher real wages, and capital deepening. This would mean that we would have a higher tax base and that tax rates would not have to rise as much. Kotlikoff does not subscribe to this view. He presented the results of some simulation exercises that indicate that instead of capital deepening, the economy could experience capital shallowing during the demographic transition, since payroll tax rates might have to rise so much. In conclusion, Kotlikoff said that the menu of things the U.S. needs to do to solve its fiscal problem is very painful, but the unsustainability of our current fiscal policy should not be ignored, given the great harm that has been inflicted on other countries' economies by their pension liabilities.

In his response, Hubbard said that the government's fiscal situation is less harrowing than the version presented by Kotlikoff. He interprets Kotlikoff's research as making the important point that delay in addressing the problem is very costly; it is important to take action. In Hubbard's view, action is being taken. In his opinion, there is nonpartisan recognition of the need to shore up entitlements and avoid the crisis Kotlikoff discusses, and progress is being made.

Christopher Sims of Princeton University concluded the session by discussing his research program on what determines the price level in terms of monetary and fiscal policy jointly, the so-called fiscal theory of the price level. Sims explained that this way of thinking about the price level recognizes that monetary policy is fiscal policy; there is no clean distinction between the two. This might seem to contradict the notion of central bank independence. But in most countries, central bank

independence is a convention about which aspects of fiscal policy are handed over to the central bank. Monetary policy has a direct impact on the interest expenditure component of the federal government. A change in interest rates affects the nominal value of these expenditures, and inflation affects the real value. As Sims sees it, monetary policy independence is a convention by which the effects of monetary policy on the federal budget aren't subject to policy dispute and argument between the Treasury and the central bank. For example, the Treasury doesn't complain to the Fed that there wasn't enough seignorage this year or ask the Fed to lower interest rates because the interest component of the budget has increased. Moreover, the Fed and the public are confident that when the Fed raises interest rates, the fiscal system will absorb the costs of increased interest expenditures in the budget, for example, by cutting other expenditures or raising taxes. If this were not the case, a rise in interest rates could lead to inflation rather than having the desired dampening effect on economic activity. This convention has arisen to help control the historical tendency of fiscal authorities to systematically use seignorage and inflation as a source of revenue.

Independence is a good idea in normal times, but it is possible only over a certain range of conditions. Sims argued that if we don't understand its nature, that is, that central bank independence is a convention and monetary policy has a fiscal impact, then we can get into trouble in certain historically unusual circumstances. For example, during a liquidity trap, the central bank might have to change how it implements monetary policy in order to have an effect. Instead of buying short-term nominal government debt, it might have to purchase other assets, like long-term bonds, foreign government bonds, or loans from banks, which would

expose the central bank's balance sheet to risk. Were the central bank's balance sheet to succumb to the risk, the Treasury would need to recapitalize the central bank, and it should do so, even though this would be a breach of the usual independence between the central bank and the Treasury. Another extreme circumstance is wartime. During almost every war the U.S. has fought, a substantial fraction of the financing of the war has come from seignorage and inflation. In Sims' view, a surprise inflation that reduces the value of outstanding government debt — if used at times of fiscal stress when the alternative is increased distortionary taxes — may be a good thing to do. Sims added that it is obviously not a good thing to do regularly, and indeed, it would work only if it were a surprise.

In relating his work to the economic situation at the time of the Policy Forum, Sims said he thought it most likely that the U.S. economy would not find itself in either of these circumstances (that is, liquidity trap or fiscal exigency). However, he said that one thing we have learned is that extremely surprising things can happen. Thus, it is worthwhile having the discussion.

## HOW TRANSPARENT SHOULD A CENTRAL BANK BE?

Our final session tackled the issue of central bank transparency, that is, how the central bank communicates and explains its actions to the public. In the view of all the speakers, transparency is beneficial, and central banks have made progress toward greater transparency in just a short time. Our speakers did differ in their assessments of the amount of progress that has been made and that still needs to be made.

William Poole, president of the Federal Reserve Bank of St. Louis, began the discussion, pointing out that the real questions are how, in fact, to be transparent and what being transparent

really means. Poole said that transparency means providing “the fullest explanation possible of policy actions and the considerations underlying them, in as timely a manner as possible.” One benefit of transparency is that it helps policymakers themselves develop coherent views. Having to explain things helps clarify one’s own thinking. The success of monetary policy depends on market expectations and market confidence, and those will be more accurate and complete, the better market participants understand the Fed’s actions. In Poole’s view, the macroeconomics literature supports the case for policymakers to provide as much information as it can about policy. This does not necessarily mean that all disclosures are beneficial, since meetings held in the open would yield a different type of deliberation, not necessarily better policymaking, and the public might become confused more than enlightened. But Poole said that releasing transcripts of FOMC meetings with a five-year lag, as is current practice, does not inhibit his discussion at meetings and provides a valuable record for scholars. Poole also discussed some of his research, co-authored with others at the St. Louis Fed, showing that prompt disclosure of policy actions significantly improved the accuracy of market forecasts of policy actions. Poole concluded his remarks by indicating two ways to improve Fed transparency: announcing an explicit inflation objective and reducing the statement released at the end of FOMC meetings to simple, boilerplate language (since the current statement is open to a variety of interpretations and may increase uncertainty in the market).

Michael Prell, consultant and former director of Research and Statistics at the Board of Governors of the Federal Reserve System, indicated that the amount of information released by the Fed has increased greatly over the last 30 years. Prell says this has

served several purposes, including meeting the demands of Congress, lowering the “suspicions in some circles that a secretive, non-elected body is manipulating the financial markets,” and increasing the effectiveness of policy by allowing the markets to better anticipate Fed policy actions. But in Prell’s opinion, the Fed has been wary of transparency over the years. In his view, there has been some concern that greater openness could jeopardize the Fed’s independence and that markets might overreact to indications of potential Fed policy actions, thereby causing noise that distorts the signals the Fed could otherwise draw from the market about underlying economic pressures. He does say that the challenge of transparency is greater because Fed policymakers can have disparate analytical views about the economy, but he is against trying to regiment these “many voices of the System.” Rather, he favors allowing these voices to speak, but in a clearer fashion. In his view, the post-meeting announcements by the FOMC are an advance in transparency, although they fall short of desired clarity. In conclusion, Prell says that the answer posed in the session, “How transparent should a central bank be,” is “As much as possible, without jeopardizing its mission.”

Mickey Levy, chief economist of Bank of America, provided a private-sector view. Levy believes the Fed has dramatically improved its implementation of monetary policy and its transparency, with the Fed being more straightforward and understandable. However, he thinks further improvement could be achieved. In Levy’s view, the announcements made by the Fed after FOMC meetings suffer by emphasizing current economic conditions rather than the Fed’s long-run goals. Levy discussed his analysis of 18 FOMC policy announcements made between February 2000 and November 2001. These announcements were

made after the Fed shifted from providing a statement about its “bias” to providing a “balance-of-risks” statement. In Levy’s view, these announcements fuel market speculation about near-term monetary policy, just as earlier announcements that included the bias statement did. He also said that the phrasing of the announcements could mislead the public into believing that the central bank’s objective is to limit economic growth in order to control inflation, a mistaken view of the inflation process. In Levy’s view, the Fed announcements should “reinforce its long-run objectives and establish guidelines to achieve them,” as one of the goals of transparency is to build credibility. Confusing statements can be counterproductive.

Our final presenter on the topic of transparency was Alan Blinder of Princeton University, a former vice chairman of the Federal Reserve Board of Governors. Blinder based his discussion of the “why, what, and how” of central bank transparency on a recent monograph he co-authored on transparency at central banks around the world (“How Do Central Banks Talk?” A. Blinder, C. Goodhart, P. Hildebrand, D. Lipton, and C. Wyplosz). In his view there has been a revolution in central bank thinking on the subject of transparency over the past five to 10 years — a very short period of time. Blinder and co-authors begin with the presumption that central banks should reveal almost all information; while there will be some pieces of information that should not be revealed, the central bank must have a good reason not to reveal them. In other words, the central bank should reveal enough information so that interested observers understand what it is doing, why it is doing it, and how it makes decisions, and this includes forward-looking information.

For the “why” of transparency, Blinder cited two reasons. First, transparency is important for democratic

accountability. Second, transparency aids the effectiveness of monetary policy, which works through expectations. Blinder said that in his FOMC experience, one of the more difficult parts of setting monetary policy was in understanding the transmission of changes in the fed funds rate to other interest rates and asset prices in the economy. In his view, transparency helps tighten the “gearing” between what the Fed does and what the market does in reaction to what the Fed does. The central bank should try to condition expectations and teach the markets to think like it does. Blinder thinks that theoretical arguments for mystery and surprise do not hold up well to real-world circumstances.

The “what” of transparency involves the central bank’s articulating its objectives. This is more difficult for central banks such as the Fed that have multiple objectives (price stability and sustainable economic growth), and somewhat easier for central banks with a single objective, such as inflation-targeting. Blinder said the central bank also needs to reveal its methods, including forecasts and models, for reaching policy decisions. He noted that the details of the forecast (for example, forecasts of housing starts seven quarters from now) are less important to most people than the broad contours of the outlook. He also favors the central bank giving forward-looking indicators (for example, the “balance-of-risks” or the “bias”) of future policy actions.

The “how” of transparency depends on how monetary policy decisions are made at the central bank. Blinder and co-authors categorize central banks into three types: decisions made by an individual (for example, the Reserve Bank of New Zealand); decisions made by a collegial committee that works to reach a consensus (for example, the European Central Bank);

and decisions made by an “individualistic” committee in which people vote what they believe and the majority rules (for example, the Bank of England). Blinder and co-authors believe that the modes of being transparent are different in these three cases. As a simple example, consider the question of how much to reveal in statements versus in the minutes of the meeting. When the decision is made by an individual there is no meeting and so no transcript to issue. But then it is important for the individual decision maker to explain fully his or her rationale for the decision. With an individualist committee, it is difficult to explain the diverse views in a

## Transparency aids the effectiveness of monetary policy, which works through expectations.

statement. For Blinder and his co-authors, if the committee is collegial, there is a real danger in having a cacophony of voices, which may provide a lot of noise without providing any new information. However, if the committee is an individualistic one, differences in opinions across committee members are very relevant and give forward-looking information to the market. In this case, Blinder (like Prell) thinks communication should be encouraged.

Blinder agreed with the other speakers that the Fed has become more transparent over time, pointing out that it was only in 1994 that the Fed began announcing its decision after FOMC meetings. Unlike Levy, he views the “balance-of-risks” statement as a vast improvement over the “bias” statement. He agrees with Prell that the statements

have improved over time, but he also agrees with Prell and Levy that there is further to go in making the statements more informative. And while he “philosophically” agrees with Poole that the transcripts are valuable scholarly records, he believes the cost has been too great in terms of stultifying conversation and debate; so he favors discontinuing verbatim transcripts of FOMC meetings. To conclude, Blinder laid out what he would like the Fed to do: clarify its objectives, publish its forecasts, and make fuller statements. In particular, Blinder said this will become much more important in the post-Greenspan era, when the markets have to learn and understand the Fed’s decision-making under a new Chairman.

### KEYNOTE ADDRESS: THE CENTRAL BANK OF BRAZIL: TRANSFORMATION TO TRANSPARENCY

Dr. Arminio Fraga, Governor of the Central Bank of Brazil, delivered the keynote address. Fraga presented an overview of the reforms that have been implemented by the Central Bank of Brazil to increase the level of transparency. Included in the reforms was a move to inflation targeting. Fraga discussed the steps the Central Bank has taken to announce its targets and disclose information about its policy meetings and its economic models. He also discussed the benefits of such reforms and the progress that has been made on the inflation front in Brazil since the reforms have been implemented. In Fraga’s view, over the years, Brazil has been a laboratory; it has had to deal with many of the issues research economists in the Federal Reserve System, other central banks, and academia have studied. In Fraga’s opinion, the Central Bank of Brazil’s transparency has been beneficial to the economy of Brazil. 



# The Philadelphia Fed POLICY FORUM

We will hold our second annual Philadelphia Fed Policy Forum on November 22, 2002 (the Friday before Thanksgiving). This year's topic is "Crises, Contagion, and Coordination: Monetary Policy Issues in a Global Context." At right is the program. The Policy Forum brings together a group of distinguished economists and policymakers for what we hope will be a rousing discussion and debate of the issues. For information on attending this year's event, please contact us at [PHIL.Forum@phil.frb.org](mailto:PHIL.Forum@phil.frb.org) or visit our web page at [www.phil.frb.org/conf/policyforum2002.html](http://www.phil.frb.org/conf/policyforum2002.html).



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# The Philadelphia Fed Policy Forum

## *Crises, Contagion, and Coordination: Issues for Policymakers in the Global Economy*

November 22, 2002

The Pennsylvania Convention Center, Room 113

### Presentations

#### Welcoming Remarks

Anthony M. Santomero, *President, Federal Reserve Bank of Philadelphia*

#### Financial Crises

**Moderator and Discussant:** Loretta J. Mester, *Director of Research, Federal Reserve Bank of Philadelphia*

#### “Financial Crises in Emerging Market Economies”

V. V. Chari, *University of Minnesota*

#### “Foreshadowing LTCM: The Crisis of 1763”

Hyun Song Shin, *London School of Economics*

#### Financial Contagion and Business Cycle Correlation

**Moderator and Discussant:** Sylvain Leduc, *Senior Economist, Federal Reserve Bank of Philadelphia*

#### “Financial Stability and Currency Areas”

Franklin Allen, *The Wharton School, University of Pennsylvania*

#### “Globalization of Financial Turmoil”

Graciela Kaminsky, *George Washington University*

#### Policy Coordination

**Moderator, Presenter, Discussant:** Lawrence Christiano, *Northwestern University*

#### “The Gains from International Monetary Cooperation”

Kenneth Rogoff, *Economic Counselor and Director, Research Department,  
International Monetary Fund*

#### “On the Fiscal Implications of Twin Crises”

Martin Eichenbaum, *Northwestern University*

#### “Monetary Policy After a Financial Shock”

Lawrence Christiano, *Northwestern University*

#### Policymaking in a Global Context

**Moderator and Panelist:** Anthony M. Santomero, *President, Federal Reserve Bank of Philadelphia*

#### Other Panelists:

Urban Bäckström, *Governor, Central Bank of Sweden*

Paul Jenkins, *Deputy Governor, Bank of Canada*

Robert Parry, *President, Federal Reserve Bank of San Francisco*