**Foundations for Sound Central Banking**

**For the session on *Global Challenges in Monetary Policy***
Global Interdependence Center (GIC) Abroad in South Africa
Cape Town, South Africa
March 28, 2008
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## Introduction

Let me thank the Global Interdependence Center for inviting me to participate in this very interesting program. I also want to thank the South African Reserve Bank as well as the other central banks represented here for their participation. The theory and practice of central banking have come a long way in the last three decades. But there is still a lot to learn and new challenges are, it seems, always emerging. One of the great benefits of conferences like this one is to learn from others and share our thoughts so that best practices can emerge.

In my remarks today I want to focus attention on some of the principles that I believe make for sound and effective central banking. I believe that adhering to these principles can enhance the effectiveness of monetary policy in these challenging times. In doing so, I will also share my personal views about some of the specific ways these principles can be implemented, although I recognize that implementation may vary among central banks.

One of the most significant developments in economic theory during the last quarter of the 20th century was the recognition of the importance of expectations in understanding economic behavior. Expectations of the future play an important role in the decisions of both households and businesses as they make their economic choices. This is particularly evident in financial markets, where expectations of the future play a role not only in investment decisions but also in the valuation of securities. Of course, to the extent that they are important for economic outcomes, expectations of future monetary policy decisions will be important as well, particularly as they pertain to the future path of inflation. Thus, monetary policymakers must make decisions with the understanding that those decisions may affect the public's expectation of future decisions — which in turn will affect the choices market participants make today.

The recognition of the important role played by expectations leads me to focus on four main principles of sound monetary policy that I would like to touch on today.

- The first principle is that a central bank should make a commitment to well-articulated and achievable objectives.
- The second principle is that a central bank should seek ways to make that commitment credible.
- The third principle is that the central bank should be transparent in its communications.
- The fourth principle is that a central bank should set monetary policy with a great deal of independence from the fiscal authority. This is a critical element of successful monetary policy and, in part, supports the ability of the monetary authorities to implement the first three principles.

Clearly these four principles are inter-related and, in many cases, act to reinforce each other. But they are distinct nevertheless, and different central banks have approached their implementation in different ways.

**Commitment to Well-Articulated and Achievable Objectives**

The first principle of sound central banking is to be clear about the goals and objectives of policy. Of course, it makes no sense to seek goals that the central bank cannot achieve. Another way of saying this is that monetary policymakers must be clear about what monetary policy can and cannot do. Saying that monetary policy will achieve some objective it is incapable of delivering is a sure way to lose credibility. Let me illustrate this point in the context of the objectives the U.S. Congress has established for the Federal Reserve.

The Federal Reserve is charged by Congress with conducting monetary policy "so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates." These are all desirable goals, yet most economists, myself included, agree that focusing on achieving one of them — stable prices — is the most effective way monetary policy can support the other two.

Moreover, we have to remember that sustained inflation is always a monetary phenomenon and that in a world of paper or fiat money, the central bank has the obligation to preserve the purchasing power of the currency so that markets are not distorted by the ravages of inflation.

Maintaining a stable price level allows the economy to function in a more efficient and thus more productive fashion. If people and businesses don't have to worry that inflation will erode the purchasing power of their money, they won't have to divert resources from productive activities to conserve their money holdings or to hedge the risks of inflation (or deflation). Stable prices also make it easier for households and businesses to make long-term plans and long-term commitments, since they will know what the long-term value of their money will be. Indeed, former Fed Chairman Alan Greenspan suggested that an operational definition of price stability is "an environment in which inflation is so low and stable over time that it does not materially enter into the decisions of households and firms."

Price stability also promotes efficiency in product markets. In a market economy, prices give signals about the relative supplies and demands of goods and services. With a stable price level, changes in prices can easily be recognized as changes in relative prices. With price signals undistorted by inflation, individuals and businesses are able to make better decisions about where to allocate their resources. Thus, price stability helps a market economy allocate resources efficiently and operate at its peak level of productivity.

Price stability also works to promote moderate long-term interest rates. First, it reduces the level of compensation built into long-term interest rates to make up for the loss of purchasing power due to inflation. Second, it reduces the need for an additional risk premium to compensate for the risk that arises from inflation uncertainty.

In short, price stability is not only a worthwhile objective in its own right. It is also the most effective way monetary policy can contribute to economic conditions that foster the Federal Reserve's other two objectives: maximum employment and moderate long-term interest rates.

But while price stability enhances the economy's ability to achieve its maximum potential growth rate, monetary policy plays no role in determining what that growth rate is. In the long run, the economy's potential growth rate largely reflects two factors. The first is the growth rate of the labor force, which is determined by demographic factors like the birth rate, age distribution, and immigration. The second is the growth in the productivity of the labor force, which depends on both physical and human capital and incentives for research and innovation. Monetary policy cannot be used to achieve a long-run growth rate that is inconsistent with these economic fundamentals.

Central bankers all over the world face this situation. Unless a nation has chosen to peg its currency to some other country's currency and rely on that mechanism to control domestic inflation, central bankers bear a unique responsibility for price stability in their nations. The corollary to this emphasis on price stability is that *monetary policymakers should not commit to what they cannot deliver*. It is not possible for a central bank to achieve a specific rate of real economic growth or unemployment. And it is not desirable to lead the public to believe it is within the central bank's power to do so.

Unfortunately, what the public has come to expect of monetary policy, and central banking more generally, has risen considerably over the years. Indeed, there seems to be a view that monetary policy is the solution to most, if not all, economic ills. Not only is this not true, it is a dangerous misconception and runs the risk of setting up expectations that monetary policy can achieve objectives it cannot attain. To ensure the credibility of monetary policy, we should *never ask monetary policy to do more than it can do.*

## Making Commitments Credible

The second principle that is important for sound monetary policy is that the central bank must go beyond just stating its objectives — words are not enough. It must also make those commitments to achieve its goals credible and take actions that are consistent with them.

As I mentioned at the outset, expectations of the future play a crucial role in all sorts of decisions that people and businesses make today. If the central bank does not deliver on its stated objectives, the central bank creates expectational errors and unnecessary economic volatility.

If a central bank is to avoid contributing to economic instability, it must not only articulate its goals, but it must also make a credible commitment to take actions that will deliver on the objectives it has laid out. How central banks obtain the public's confidence that they are credibly committed to their monetary policy objectives and to their plans for achieving those objectives is not an easy task. In democratic societies it is not possible to obtain complete commitment. But there are a variety of ways that governments and central banks have used to make their commitments more credible with the public.

Policymakers, for example, can earn a reputation for delivering on the objectives by acting in a consistent way that convinces the public they are committed and credible. To maintain that credibility or reputation, policymakers must continue to act in a way that is consistent with their goals. If they deviate from those goals, then policymakers run the risk of losing credibility.

In the U.S., the Federal Reserve has built a reputation for having a commitment to keep inflation low and stable. This hard-earned reputation has been an important contributor to economic stability for the last 20 years. But that reputation can be lost if we do not continue to act in a way that is consistent with it. From my perspective, reputational capital is always tenuous — it is hard to acquire but easy to lose and so it must be protected.

Some governments and central banks have adopted institutional mechanisms to make their commitments more credible to the public. Many countries have passed legislation that spells out the objectives of the nation's central bank, and many of those have clearly assigned the central bank the task of maintaining a stable price level or a low level of inflation. Some governments have spelled out what level of inflation the central bank should target. In other countries, the central bank itself has adopted an inflation target. In either case, the commitment becomes a form of institutional commitment, not just the choice of a specific individual at a point in time. As such, it strengthens the credibility of the commitment.

Of course, it is not enough to adopt an inflation target. The central bank must also act in a way that is consistent with that target. Words alone are not enough to make commitments credible.

At one time, many countries used the gold standard as a way to commit to the long-run stability of the value of their currencies. In more recent times, some countries have pegged their currencies to another currency, which can limit inflation in their countries.

Some central banks have experimented with adopting rules — or at least they have engaged in rule-like behavior. Some rules involve having the central bank's policy interest rate respond to changes in either money growth or certain financial or exchange rate conditions. Other rules involve adjusting the policy interest rate in response to deviations of inflation from some target as well as to deviations of output (or economic growth) from its potential. In a recent speech, I argued that research has suggested that simple rules such as those modeled on the Taylor rule appear to perform quite well in a wide range of economic models. This implies that using simple rules as a guide to setting policy is a useful way to make monetary policy more systematic and predictable.

One important characteristic of simple rules is that they can be more easily explained to the public. That makes it easier for the public and for financial market participants to form expectations about policy. Simple rules could enhance the credibility of monetary policy, help anchor expectations, and better align the public's expectations with the central bank's intentions, which would minimize policy surprises and the detrimental effects often caused by such surprises.

**Transparency and Communications**

The third principle is transparency. At one level, transparency in monetary policy is simply a part of making credible commitments. Central bankers must clearly articulate to the public their objectives and their plans to achieve those objectives, as well as explaining those occasions when they have reason to deviate from their plans.

In my view, one of the benefits of greater transparency is that it can help align the public's view of what monetary policy is doing with the central bank's objectives. In this way, the public's expectations about the economy and inflation can be better aligned with policymakers' objectives and their plans to achieve them. Although the Federal Reserve is now much more transparent about its monetary policymaking than it was 20 years ago, in my view, this is one area in which central banks in many other countries are ahead of the U.S. Other central banks often provide the public with much more detail about their policy deliberations than we do.

For the public and financial markets to understand when and how monetary policy will be adjusted, they need a clear picture of the central bank's outlook. They need to better understand policymakers' thinking and what goes into the decision-making process. Consequently, I believe that the Federal Reserve's announcement last November of its decision to provide quarterly releases of information on the economic projections of participants in the Federal Reserve's policy committee (the FOMC) is a major step in providing a clearer picture of what goes into our deliberations. With more information about the Federal Reserve's outlook, individuals and market participants will all be able to make their own economic decisions armed with a better understanding of what the central bank expects to happen in the economy.

I believe there is another important benefit to transparency. Transparency increases the central bank's accountability to the public. In a democratic society it is important that institutions with the delegated authority to act in the public interest be as clear and as transparent as possible regarding their actions. Failing to do so risks the loss of confidence and credibility — two essential ingredients for sound central bank policymaking.

## Independence of the Central Bank

The fourth principle of sound central banking is independence. Research has suggested that countries with more independent central banks have benefited from lower rates of inflation, on average, without sacrificing real economic growth.

Central bank independence has many dimensions. However, the essence of all the metrics is the stress on the freedom the central bank must have to decide how best to achieve its goals. One of the primary reasons that make this essential is that monetary policy works with long lags. So central bankers must take a longer-term view of their policies. Having to take such a longer-run view is undoubtedly one of the reasons that more central banks around the world have been given greater independence from their nations' treasury departments or finance ministries and the political process. Freeing central bankers from the short-term pressures that inevitably manifest themselves in the political arena helps monetary policymakers better balance the short-term and long-term factors inherent in their decisions. And this independence underscores the need for accountability, and therefore, transparency, my third principle.

## Central Banking and Financial Stability

Much of my discussion so far stresses the importance of four principles that I believe contribute to sound monetary policy. However, central banks are also responsible for promoting financial stability. It is reasonable to ask if the principles are relevant to this aspect of central bank policy.

Most economists believe that an important responsibility of a central bank is to serve as a lender of last resort, the ultimate policy tool that supports the stability of the banking system. The lender of last resort provides the banking system with a source of liquidity that limits the potential for contagion and systemic risk. The current disruption in the financial markets in many countries around the world has once again focused attention on this well-known, but infrequently exercised, feature of central banking.

I believe that the four principles of sound monetary policymaking apply in this arena as well. If a central bank is to assume the responsibility of being a lender of last resort, it should clearly articulate its objectives in doing so. It should make credible that commitment and act in a way that is consistent with that commitment. It should clearly communicate its lending policies to the public. What's more, the independence of the central bank's decision making from short-term political interference is essential to sound policymaking in this arena as well.

**Summary**

Let me close by briefly summarizing the four features that I believe are essential to sound central bank policymaking.

First, central banks should commit to well-articulated and achievable objectives.

Second, central banks must seek ways to make their commitments credible. This must occur through words and actions.

Third, central banks must transparently communicate and clearly explain both the central bank's objectives and how it will conduct policy to achieve them.

Finally, history has shown that a central bank's independence from the short-term vagaries of the political process is an important contributor to sound policymaking.

I believe that these four principles are important for any central bank and provide a useful perspective for thinking about the critical features of sound policymaking. How different central banks implement these principles in their home countries will vary, and some approaches are likely to have more success than others. I, for one, hope we can all learn from such different experiences in order to find ways to improve, over time, the effectiveness of monetary policymaking in all of our countries.