Strengthening Our Monetary Policy Framework Through Commitment, Credibility, and Communication

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Global Interdependence Center's 2011 Global Citizen Award Luncheon

November 8, 2011

Union League Club, Philadelphia, Pennsylvania

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Federal Reserve Bank of Philadelphia

FEDERAL RESERVE BANK
OF PHILADELPHIA

The views expressed today are my own and not necessarily those of the Federal Reserve System or the FOMC.

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Good afternoon. I am deeply honored to be this year's recipient of the GIC Global Citizen's Award. For the past five years, I have had the pleasure of observing and participating with the GIC in its efforts to foster an international dialogue on economic matters of global importance. I have been very impressed with the breadth and reach of the programs the center has put together.

The GIC's efforts to promote such a dialogue have been especially timely as the world economy continues to wrestle with the consequences of a financial crisis and a severe global recession. The GIC's convening of central bankers, policymakers, and business leaders from different nations and different industries has created opportunities to leverage knowledge and experiences in these challenging times. Yet even as the world economy recovers, we all have learned that our economies are increasingly intertwined, and therefore, I believe these GIC programs will remain relevant and valuable in the years to come.

In the past few years, the global financial crisis has led central bankers around the world into uncharted territory as extraordinary disruptions in financial markets led them to take extraordinary actions. However necessary these actions may have been, unusual and unexpected policy choices do shape the public's views and expectations about future policy, even if policymakers do not intend to do so. This is especially true when policymakers take unusual or highly discretionary policy actions without communicating a clear framework for those actions.

For example, the rescue of Bear Stearns' creditors in March 2008 led many investors to expect that other investment banks would receive similar treatment should they run into trouble, even though no such promise was made or intended. This belief probably encouraged investors and firms to take more risks, perhaps excessive risks, which they might not otherwise have undertaken. This likely led to unexpected losses with the failure of Lehman Brothers in September 2008, adding to the turmoil in the markets. Thus, taking highly discretionary policy actions without communicating to the public the implications of those actions for the conduct of future policy can be problematic and destabilizing.

More generally, economic research in the past 30 years has shown that setting monetary policy in a systematic or rule-like manner leads to better economic outcomes – lower and less volatile inflation and greater economic stability in general.[1] As I have discussed on many occasions, there is value in conducting policy in a systematic manner in both good times and bad.[2] Systematic policy helps the public and markets better understand how policy will be conducted in the future and thus enables them to make better decisions today. But the benefit depends on the public's understanding of the policymaking framework being used, and that requires commitment, credibility, and effective communication by the central bank.

Today, I would like to step back and discuss specific ways to strengthen the framework for U.S. monetary policy through enhanced commitment, credibility, and communication and, in so doing, improve economic stability. Of course, these are my views and do not necessarily represent the views of the Federal Reserve Board or my colleagues on the Federal Open Market Committee.

The Goals and Objectives of Monetary Policy

In order to discuss the framework for achieving our policy goals, we need to have a clear understanding of those goals. Congress set the goals of monetary policy in a 1977 amendment to the Federal Reserve Act and then reaffirmed them in 2000. This mandate requires the Federal Reserve to conduct monetary policy "to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates."

Many people think these objectives conflict with one another, but in fact, they are complementary. Economists have come to understand that achieving price stability is the most effective means for monetary policy to promote the other two goals. Price stability contributes to the economy's growth and employment prospects in the longer term and helps to moderate variability of output and employment in the short to medium term. Price stability allows the economy to function in a more efficient and a more productive manner by giving individuals and businesses more confidence that the purchasing power of the dollar will not erode.

Failing to maintain price stability can often lead to more instability in employment and output. One way to see this is to recognize that if inflation rises to unacceptable levels, as it did in the 1970s, monetary policy may be forced to react to restore price stability. This, in turn, could lead to an increase in unemployment as it did in the recession early in the 1980s. Thus, increases in inflation in the near term risk creating unemployment in the future – as a result, we end up with less stability, not more.

Price stability also helps to foster financial stability and moderates long-term interest rates by minimizing the inflation premium that investors demand to hold long-term assets. Because moderate long-term interest rates follow so directly from the price stability mandate, many people have come to refer to the Fed as having a "dual mandate" – price stability and maximum employment.

Yet, the price stability and the employment goals are materially different in nature. The most significant difference is that the level of prices and thus inflation is a monetary phenomenon

[1] See Kydland and Prescott (1977).
[2] See, for example, Plosser (2008) or Plosser (2010)

over the intermediate to longer term, and so the inflation rate can be chosen and controlled through monetary policy. The same cannot be said for the goal of maximum employment or the unemployment rate. These are largely determined by factors that are beyond the direct control of monetary policy.

In the long run, maximum employment depends on such things as demographics, taxes and regulations, labor productivity and skills, unemployment benefits, minimum wage laws, and a host of other factors. This means that maximum employment will fluctuate over time. Monetary policy cannot and should not be used to offset these longer-run changes in maximum employment. Even in the near term, the modern approach to macroeconomics recognizes that employment will fluctuate with forces that affect supply and demand, such as oil price shocks, earthquakes, or decisions by households to save more, or deleverage, perhaps due to a fall in the stock market or in house prices. In this framework, it is neither desirable nor efficient for monetary policy to try to prevent market forces from making the necessary adjustments to such disturbances, even if they have consequences for employment. Instead, monetary policy should be set in a way that allows the economy to efficiently use its resources given the economic disturbances it has experienced – it allows for the best economic outcome given the environment.

Because monetary policy can deliver price stability, I believe it makes sense for the central bank to be clear in setting a numerical objective for medium-term inflation. But because employment is affected by many other factors in both the long and the short run, it does not make sense for the Fed to set explicit numerical objectives for employment or unemployment. By creating an environment of low and stable inflation, monetary policy will make a valuable contribution to maximum employment in the short and long run. A credible commitment to price stability helps anchor inflation expectations and affords the central bank the flexibility to adjust monetary policy to support output and employment adjustments in the face of economic disturbances.

Flexible Inflation Targeting

What I have just described is the modern textbook view of how to conduct monetary policy. It is commonly referred to as **flexible inflation targeting**. This approach combines a credible commitment to a medium-term inflation objective, which, in turn, allows monetary policy to adjust to economic shocks in a manner that helps promote the return of output or employment to a more desirable value without undermining inflation expectations. It emphasizes clear and transparent communication with the public about policymakers' views of current economic conditions, the economic outlook, and its decision-making framework.

Flexible inflation targeting is widely practiced by major central banks around the world. While details often differ, key themes include a commitment to an explicit medium-term inflation objective and transparent communication about the economic outlook, the policy process, and how policy decisions relate to changes in economic conditions. It is important to recognize that by being more explicit about its objectives and more transparent and systematic about its decision-making framework, the central bank enhances its credibility. This also increases its accountability to the public. It is harder to make commitments that you will be unable or unwilling to keep, if you know the public can call you to task for failing to meet your commitments.

Improving the Federal Reserve's Monetary Policy Framework

The Federal Reserve has not explicitly adopted a flexible inflation targeting framework. Indeed, monetary policymaking in the U.S. has historically been conducted on a highly discretionary basis, and the Fed has resisted adopting a specific framework or numerical objective. Yet, over the last two decades or so, Fed policymakers have gradually taken steps toward the more mainstream approach of flexible inflation targeting. In particular, the Fed, especially under Chairman Bernanke, has become increasingly transparent and has worked to improve its communications with the public and the markets. It has recognized and stressed the importance of keeping inflation expectations well anchored. It has become more transparent regarding the Committee's economic outlook over both the short and the intermediate term through the publication of its Summary of Economic Projections, or SEP for short, which is published four times a year.

All of these efforts have moved us closer to having an explicit monetary policy framework. Of course, such a framework does not solve all of our difficult policy choices. A good deal of judgment needs to be used in setting appropriate monetary policy. Still, having an explicit framework within which to consider our policy choices in a systematic way would improve monetary policy's effectiveness in meeting our mandated objectives while increasing transparency and accountability. Yet, I believe there is more the Fed could and should do to further improve and strengthen its approach to policymaking. The minutes of the September FOMC meeting, for example, indicated that most participants favor taking steps to further increase the transparency of monetary policy. This includes providing more information about our longer-term policy objectives and factors that influence our policy decisions. So, let me offer my own views about the steps we could take.

First, let's clarify and make explicit our inflation objective.

The effectiveness of monetary policy in achieving its dual mandate is enhanced if the public understands and finds credible the Fed's inflation objective. The FOMC's inflation mandate has been interpreted as being 2 percent or a bit less. This interpretation arises from the quarterly SEP, in which the majority of participants have said that under "appropriate monetary policy," 2 percent is their longer-run "forecast" of inflation.[3] So I see no reason for the FOMC not to simply make explicit that its longer-term inflation objective is 2 percent. Making such a clear and explicit statement should give the public confidence that the Fed's commitment to its price stability mandate is a credible one. Being explicit about our inflation objective is fully consistent with the Fed's statutory dual mandate. Given that dual mandate, the structure of the economy, and the magnitude and frequency of typical economic disturbances, I would anticipate that when inflation deviates from the objective in the short term, it could be brought back to 2 percent within two to three years or less. But the timing would depend on the size and nature of the shocks to the economy. In deciding how quickly to move toward the inflation objective, the FOMC would always take into account the implications for near-term economic and financial

[3] The SEP reports the longer-run forecast of the year-over-year change in the overall personal consumption expenditure (PCE) chain-weighted price index.

stability and would continue to appropriately use its judgment in setting policy to promote fulfillment of the dual mandate.

Being explicit about our inflation objective would help anchor expectations and reduce uncertainty about future policy steps. Also, stabilizing inflation expectations and increasing the credibility of the central bank to maintain stable prices can actually change the inflation process itself. In particular, inflation will become less responsive or sensitive to short-run supply and demand disturbances. This means less volatility in monetary policy and less volatility in output and employment.

Second, let's provide more information about the expected path of policy.

Many central banks that set explicit inflation targets also provide information about the expected path of policy. For example, Norway, Sweden, and New Zealand all do so, although they each do it in their own way.

The Fed has also, at times, provided information about the expected path of policy, albeit in less effective ways. The Fed has used phrases like "extended period," or, in the Greenspan era, the Committee talked about policy moving at a "measured pace." More recently, the Committee indicated that rates were likely to be kept low until "mid-2013." These examples illustrate ways of communicating what central bankers call "forward guidance." Yet such approaches are not very satisfactory. "Extended period" is vague and can be interpreted differently by Committee members or market participants. I believe policy should always be a function of the state of the economy, rather than an "extended period" or a specific calendar date. Indeed, one of the reasons for my dissent in August was over the use of the "mid-2013" language. I was concerned that this would be misinterpreted by the markets as suggesting that monetary policy was no longer contingent on how the economy evolved. In my view, it was the wrong way of communicating forward guidance.

The Summary of Economic Projections provides a better and more natural way to convey the Committee's sense of the future path of policy. Currently, the SEP indicates individual policymakers' forecasts of the key economic variables, including output, inflation, and unemployment conditional on each policymaker's assessment of "appropriate policy" in the absence of further shocks. I think a more appropriate and meaningful way for the Committee to convey forward guidance would be to report information about Committee members' underlying view of "appropriate policy." This additional information would provide a useful picture of the range of views of future policy as envisioned by the policymakers. These views would not constitute a commitment to follow a particular path but would evolve as economic conditions changed. This information would add a useful signal to the markets as to the thinking of the Committee on an ongoing basis.

Third, let's be more explicit about the Committee's reaction function.

Policymakers can promote greater economic stability if the public is better able to predict future policy actions. Because policymakers do not know with certainty how economic conditions will evolve, they cannot say with certainty what policy will be in the future. But policymakers can provide information on what factors will influence their policy decisions. I have long argued for more rule-like or systematic policymaking. This means making policy decisions using available economic information in a consistent and predictable manner. We don't know what the future holds, but we can be more systematic about how we use economic data in formulating our policy.

Currently, the FOMC looks at a variety of information in formulating policy, including several different versions of monetary rules. We are some ways from choosing one rule or reaction function as a guide for policy. Yet, research has found that some simple rules perform fairly well in a variety of models. These rules involve policy responding aggressively to deviations of inflation from its target and also responding to deviations of output from some concept of potential. In addition, the rules tend to involve some smoothing of the policy rate over time rather than sharp jumps in rates.

The practice of looking at a variety of rules or reaction functions and what they tell us about appropriate policy imposes an important discipline on policymaking. We made some progress in November 2009 when the Committee indicated in its statement that we were conditioning policy decisions on measures of inflation, inflation expectations, and resource utilization. This was a good first step, but we should go further. In addition to describing the set of conditioning variables that we consider as we formulate policy, we should communicate our policy decisions in terms of the changes in these important conditioning variables. If the Fed chooses a consistent set of variables and sticks to them, the public would better understand our reaction function and thus have a greater ability to form judgments about the likely course of policy. This approach would reduce uncertainty about policy actions and promote stability.

What Not to Do

I have spent some time discussing how I would strengthen our monetary policy framework by completing our move to flexible inflation targeting. This would include an explicit numerical objective for inflation. Given the current state of the economy, there has been some recent public discussion of the perceived benefit of having the Fed aim for an inflation rate higher than 2 percent. Some have argued that since the unemployment rate is higher than anyone would like and since the federal funds rate is stuck at the zero bound, we should target higher inflation as a means to reduce unemployment. Others have suggested that higher inflation could inflate away the debt overhang problem. Sometimes these arguments are opportunistically couched in terms of alternative policymaking frameworks, such as nominal GDP targeting, or price-level targeting. Regardless of the name, though, I believe the main motivation for many is to raise inflation.

By increasing inflation, some argue that we could lower the real rate of interest and increase monetary accommodation for as long as it takes to bring the unemployment rate down by a substantial amount. At that point, the goal would be to return inflation to a lower, more stable level. But for this strategy to work, the public must have complete confidence that the Fed will be able and willing to bring down inflation in the future. If that confidence wanes and inflation expectations begin to drift up, this strategy will fail. And the consequence could easily be a repeat of the 1970s, when monetary policymakers' effort to target a lower unemployment rate allowed inflation to steadily drift upward. The outcome was a steady rise in inflation with no commensurate fall in unemployment. To pursue such a strategy would be very risky. The effort to try to chase the unemployment rate in the 1970s ultimately failed, leading to a severe recession and even higher unemployment rates as policy worked to bring down the inflation rate. This is a clear example in which price stability and employment are complementary to each other.

Others argue that we should strive for a higher rate of expected inflation as a means to drive down short-term and longer-term real interest rates. Moreover, a higher rate of inflation would begin a process of inflating away many of the bad debts that people think are holding back economic recovery. Here, too, I am very skeptical of such a strategy. In the aftermath of the financial crisis and the severe recession, some people and businesses do indeed face losses, including the many mortgages that remain under water. However, in my view, using inflation to assign winners and losers associated with these bad debts is poor monetary policy. It is probably poor fiscal policy too, but it would undoubtedly mix monetary policy and fiscal policy in a way that could undermine the independence of the central bank and its ability to maintain price stability.

Summary

Over the last couple of decades, the Fed has taken steps toward a flexible inflation targeting framework for monetary policy decisions that aim to achieve our statutory dual mandate of long-run price stability and maximum employment. The Fed has stressed the importance of keeping inflation expectations well anchored and has strived to improve its communications with the public and the markets about the monetary policy decision-making process.

It is time for the Fed to explicitly adopt the flexible inflation targeting framework and in doing so take three steps to strengthen its approach to policymaking. First, clarify and make explicit that our long-run inflation objective is 2 percent year-over-year PCE inflation. Second, publish information about the individual FOMC participants' assessments of the appropriate monetary policy that underlie their economic projections in the FOMC's Summary of Economic Projections. Third, provide information on the FOMC's reaction function. That is, communicate policy decisions in terms of changes in the economic conditions that the FOMC is using to formulate policy. By helping the public to better understand the policymaking process and better anticipate policy changes, these three steps can make monetary policy more effective in promoting economic stability in accordance with our dual mandate.

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