Transparent Communications: The Journey Continues

National Economists Club

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Introduction

It is a pleasure to be here today. I am particularly pleased to join the list of distinguished speakers who have appeared before you over the years. Today, I would like to discuss the Federal Reserve's journey to improve the clarity and transparency of its communications. Of course, it may seem obvious that all communications should be transparent – otherwise, you really aren't communicating. However, it has taken central banks some time to appreciate the benefits of clear and transparent communications about monetary policymaking. Some observers think that monetary policy should remain a bit mysterious. They believe that efforts to communicate "too much" can backfire or result in confusion. Yet, this is most likely to be the case when communications lack clarity. Others seem to equate clear communications with providing a degree of omniscience about the future – omniscience that, of course, doesn't really exist.

Yet, central banks, including the Federal Reserve, have made important progress recently. Therefore, it seems like an opportune time to remind ourselves of the benefits of transparency in central banking. I will review some of the steps that the FOMC took in January toward increased transparency. Then I will suggest some additional initiatives I believe would be beneficial. Of course, these are my views and not necessarily those of the Federal Reserve System or my colleagues on the FOMC.

Benefits of Transparency

Over the last 30 years, economists have come to understand that expectations play an important role in the economy. Whether we think about labor markets, product markets, or financial markets, expectations affect the decisions made by households, businesses, and investors. Economic actors form expectations about a wide variety of things that affect their decisions, including tax policies, inflation, monetary policy, real economic growth, as well as other factors that may affect the supply and demand conditions that might prevail in various financial and product markets.

Monetary policy can influence expectations and thus economic choices through a couple of important inter-related channels. First, monetary policy can affect the expected path of inflation. Uncertainty about this anticipated path can wreak havoc on financial plans and cause businesses and households to expend valuable resources to insulate their plans from unexpected and volatile movements in inflation. Thus, increased transparency about the central bank's goals and objectives regarding inflation can improve economic efficiency and help anchor expectations of inflation.

Second, long-term interest rates are important for many economic decisions and monetary policy can affect long-term interest rates through the expected path of a short-term rate, which is the standard instrument of monetary policy. Consequently, a better understanding of how policymakers will react to economic events over time can reduce uncertainty about the expected path of the short-term interest rate and so reduce the uncertainty and volatility of long-term rates.

Reducing uncertainty about monetary policy, therefore, can help anchor expectations, improve the effectiveness of monetary policy, and reduce economic volatility. It also improves economic efficiency by allowing households and businesses to make more informed decisions. Given these benefits, central banks have sought to improve transparency about the goals and objectives of monetary policy and how monetary decisions are made.

Transparency has other benefits as well. For example, transparency enhances the central bank's accountability and independence. Central bank independence is a fundamental tenet of sound central banking and leads to better economic outcomes. But independence must be accompanied by accountability. And accountability is more easily achieved when there is transparency. The public can best hold a central bank accountable when its goals are clearly stated and feasible. Assigning the central bank responsibility for things it cannot achieve or expecting the central bank to achieve a set of objectives that is too expansive makes it nearly impossible for the public to hold the central bank accountable. As the old expression goes, responsible for everything and accountable for nothing. Transparent and clear communications of monetary policy goals and a decision-making framework help ensure accountability and preserve central bank independence.

Transparency can also enhance a central bank's credibility. A central bank that is transparent will be less willing to make promises it cannot keep. When policy pronouncements are more credible, policy is more effective. Transparency can also make it easier to explain changes in policy without damaging the central bank's credibility.

We've Come a Long Way

The Fed has been on a journey toward greater transparency for some time. But the pace of change has clearly accelerated under Chairman Bernanke. It may seem hard to believe, but it was not until 1994 that the FOMC began to publicly announce the policy decisions made at the FOMC meetings. Up to then, the markets were left to infer the policy action from the Fed's behavior in the market.

Prior to the 1990s, policymakers were concerned that giving the public more information about the rationale for policy decisions or even releasing the statement and directive given to the Open Market Trading Desk would lock policymakers into certain actions even if economic conditions changed. There was a strong desire to maintain flexibility.[1] Indeed, many of the arguments against transparency focused on the idea that it reduced the Committee's discretion in setting policy. Yet, we now know that discretion is generally not optimal. 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.[2] Such systematic policies are more predictable and thus allow for better decision-making by consumers and businesses.

Since 1994, when the Fed began to announce changes in the federal funds rate target, it has taken a number of steps to improve the public's understanding of policy decisions, including the most recent initiatives announced in January of this year.

In 2000, the Fed began to release a statement after each meeting regardless of whether a policy action was taken. The statement included a description of the state of the economy and the rationale for the policy decision. It also offered an assessment of the risks to the economic outlook.

Two years later, in 2002, the Fed began to release the votes of the individual members and the policy preferences of any dissenters in the post-meeting statement.

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[1] See Alan S. Binder, "Making Monetary Policy and Talking about It," U.S. Monetary Policy Forum, Washington, D.C., March 9, 2007.

[2] See Finn E. Kydland and Edward C. Prescott. "Rules Rather Than Discretion: The Inconsistency of Optimal Plans," *Journal of Political Economy*, 85 (January 1977), pp. 473-91.

In 2004, the Fed decided to speed up the release of the FOMC minutes after a three-week lag.

After the appointment of Chairman Bernanke in 2006, the FOMC increased its efforts to communicate more clearly with the public. In 2007, the Fed started to produce quarterly economic projections of FOMC participants and expanded information regarding the heterogeneity of views.

In 2009, the Fed expanded the projections to include participants' assessments of the long-run tendencies of key economic variables.

Then in 2011, the Chairman initiated a quarterly press conference coinciding with the release of the economic projections.

Most recently, in January 2012, the Fed took two more steps on its march toward enhanced transparency. First, it issued a statement about monetary policy's long-run goals and strategy, including an explicit target for inflation. It also began including information on the policy path assumptions underlying the FOMC participants' economic projections.

I will describe these two steps in greater detail, but I want to emphasize that this trend toward more central bank transparency has not been confined to the Fed. Different central banks have taken different approaches, in part, reflecting their diverse institutional structures. The now widely adopted practice of inflation targeting is only the first step. While inflation targeting establishes a clear goal, it lacks precise policy prescriptions for how to achieve that goal. In order to have policy decisions well-understood by the public, central banks with explicit inflation targets augment their communications with inflation reports, press conferences, and speeches so that the public will better understand how policy will be conducted.

Recent Steps to Enhance Transparency

Let me now turn to the FOMC's most recent initiatives to improve the clarity and transparency of our policy framework, beginning with the consensus statement of its long-term goals and strategy released in January. The statement made four important points. First, the Committee reaffirmed its commitment to its mandated goals of maximum employment, price stability, and moderate long-term interest rates.

Second, the statement acknowledged what economists have known for over 200 years – that in the intermediate to longer run, inflation is a monetary phenomenon and thus determined by monetary policy. Therefore, it is appropriate for the Fed to set an explicit long-run target for inflation. The target selected was 2 percent, as measured by the year-over-year change in the personal consumption expenditures chain-weighted price index. By being explicit about its numerical objective for price stability, the Fed enhances the credibility of its commitment to price stability. This helps anchor inflation expectations, thereby fostering price stability and moderate long-term interest rates. Another benefit of such an explicit objective is that it provides the public with a numerical metric by which it can, and should, hold the Fed accountable.

Of course, articulating an inflation target is now a very common feature of what is viewed as best practice in central banking and is a key step in achieving the benefits of transparency.

The third important feature of the statement explained why it is not appropriate for the Fed to establish a numerical objective for the maximum employment part of its mandate. This is not because the employment part of the mandate is less important, but because the economic determinants of employment are different from those of inflation. Maximum employment is largely determined by factors that are beyond the control of monetary policy. These factors include such things as demographics, technological innovations, and numerous government policies, including tax policy, minimum wage laws, unemployment benefits, and the like. All of these factors can and do vary over time. Thus, the maximum level of employment will vary. It is also difficult to measure and not directly observable. Moreover, different economic models often lead to different conceptual views of how to define maximum employment. Therefore, it is inappropriate for the central bank to set a numerical objective for something it does not control and cannot measure with any degree of certainty.

Finally, the statement pointed out that the goals of monetary policy are complementary over the longer run. Price stability promotes economic efficiency by giving households and businesses more confidence that the purchasing power of the dollar will not erode. This simplifies the decision-making of economic agents, allowing the economy to function more efficiently and more productively. Conversely, the failure to maintain price stability can often lead to greater instability in output and employment.

However, in the short term, it is possible that the maximum employment and price stability parts of the Fed's mandate could be in conflict. The statement makes clear that in such circumstances the Fed will pursue a balanced approach to promoting its objectives. Admittedly, this statement does not give much guidance as to how policy will be conducted, but I will have more to say on that in a few minutes.

The second new communications initiative launched in January involved the Survey of Economic Projections, or SEP. As I mentioned earlier, these projections are reported four times a year and provide information about the range of individual policymakers' assessments for key economic variables, including output, inflation, and unemployment. Each FOMC participant's assessment is conditional on the policymakers' assessment of "appropriate policy," that is, the policy path most consistent with achieving the Fed's longer-term goals. Starting in January, the FOMC began releasing information on these assumed policy paths.

This additional information has two benefits. First, having more information on the underlying policy paths should help the public better understand the projections. For example, they will have a better understanding of whether inflation is expected to return to the long-term goal as shocks work their way through the economy or whether policymakers anticipate that further monetary policy actions will be needed to achieve the Committee's objective.

Second, as views of appropriate policy evolve over time as economic and financial conditions change, the public will be able to draw better inferences about the relationship among current economic conditions, the economic outlook, and appropriate policy. Thus, over time, the public will gain a better understanding of how policy is likely to react in the future to changes in the economy.

Further Steps

The steps taken in January are important steps forward for the FOMC, but more can and should be done. As I noted in my discussion of the Committee's longer-terms goals and objectives, the Committee's description of how policy will be conducted is not entirely clear. Yet, we know that when monetary policy is conducted in a systematic way, it is more transparent and easier to communicate.

By systematic policy, I mean policy that functions in a rule-like way. That is, there is a systematic relationship between changes in economic conditions and the policy actions and choices made by the central bank. I have already discussed some of the benefits of transparency, and a systematic approach to policymaking is a way of achieving greater transparency. The better the public and the markets understand how policy is likely to be adjusted as the economy changes, the more predictable policy becomes, which promotes price stability and better economic outcomes.

Of course, policymakers do not know with certainty how economic conditions will evolve. So they cannot and should not say with any certainty what policy will be in the future. But policymakers can provide information about the factors that will influence their policy decisions. Some call this a policy rule or reaction function.

I believe that the Fed should provide more information about its reaction function and communicate its policy choices in terms of that reaction function. It is not just about transparency. The practice of using systematic rules as guides to monetary policy imposes an important discipline on policymaking as well as improving communications and transparency. For example, at times it may be important for policymakers to deviate from the guidelines. But then policymakers will be forced to explain why they deviated and when they anticipate returning to more normal operating practices. Requiring this type of transparency raises the bar that policymakers face to engage in discretionary policies in the first place.

I suspect that the FOMC participants are not ready to agree on a specific policy rule or reaction function because they use different models and have different loss functions. However, there is reason to be optimistic since there is a growing literature on robust rules that work well in a range of models and reasonable loss functions. In the meantime, it does seem feasible that participants could agree on a set of economic variables to which monetary policy should react. The academic literature suggests using rules that respond aggressively to deviations of inflation from the central bank's target and less aggressively to deviations of output from some concept of "potential output" or some alternative measure of resource utilization.[3] We would not have to specify the

[3] See Athanasios Orphanides and John C. Williams, "Robust Monetary Policy Rules with Unknown Natural Rates," *Brookings Papers on Economic Activity* (2002), pp. 63-118.

precise mathematical rule but would provide assessments of key variables and then communicate our policy decisions in terms of changes in these key variables. If policy were changed, then we would explain that change in terms of how the variables in our response function changed. If we choose a consistent set of variables and systematically use them to describe our policy choices, the public will form more accurate judgments about the likely course of policy – thereby reducing uncertainty and promoting stability.

Finally, I think that the FOMC could improve communication and transparency by preparing a more comprehensive monetary policy report on a regular basis, perhaps quarterly. Currently, the Chairman testifies before Congress twice a year and submits an accompanying written report. In addition, the Chairman holds press briefings four times a year to summarize the SEP. I think there is an opportunity to combine these efforts into a more comprehensive report on monetary policy as many other countries do. The report would offer an opportunity to reinforce the underlying policy framework and how it relates to economic conditions in addition to summarizing the SEP.

Conclusion

To summarize, the FOMC is on a journey to improve the transparency of its monetary policy decision-making process. The benefits of transparency are now accepted by policymakers across the globe. Transparency not only improves the effectiveness of monetary policy, it also improves the central bank's credibility and accountability with the public. The FOMC's recent moves to publish guidelines on its longer-run goals and policy strategy and the policy assumptions that underlie FOMC projections are great strides toward this goal. However, transparency is a journey, and not a destination, and more can be done. In particular, I believe the FOMC should continue to work toward increasing the public's understanding of how policy will react systematically to changes in economic conditions.