

A Progress Report on Our Monetary Policy Framework

Forecasters Club

New York, New York

February 29, 2012

Charles I. Plosser

President and CEO
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.

A Progress Report on Our Monetary Policy Framework

Forecasters Club
New York, New York

February 29, 2012

Charles I. Plosser
President and Chief Executive Officer
Federal Reserve Bank of Philadelphia

Introduction

I am pleased to be here today, and I will do my best to avoid all the hackneyed forecaster jokes. I am sure you have heard them all anyway. I will simply note that I have often said that forecasting can be a humbling experience in the best of times but I have learned some lessons along the way. For example, one Thursday morning not long ago, a reporter asked me what I thought the monthly employment numbers would show when they were released the next day. I responded that I had been around long enough to learn never to predict anything about which I can be proven right or wrong within a week and certainly not within 24 hours. It simply doesn't pay.

So, in lieu of a typical forecasting speech today, I would like to discuss the recent steps taken by the Federal Reserve to improve the transparency of monetary policy. These important initiatives are intended to increase the effectiveness of monetary policy as well as the accountability of our central bank.

Over the last few years, I have spoken frequently about the need to improve transparency and to bring our monetary policy framework into the 21st century.¹ In my view, there are four interrelated dimensions to a stronger monetary policy framework. The first is to ensure that the central bank commits to a set of clearly articulated objectives that can be feasibly achieved by monetary policy. The second element requires the central bank to be transparent and clear in its communications. The third element, related to the second, is for the central bank to conduct monetary policy in a systematic or

¹ See Plosser (2010) and (2011), among others. As always, these views are my own and not necessarily those of the Federal Reserve Board or my colleagues on the Federal Open Market Committee.

rule-like manner.² The fourth element, and arguably the most important, is for the central bank to set monetary policy independently from the fiscal authorities.

As many of you know, last year Chairman Bernanke asked Governor Yellen, Governor Raskin, Chicago Fed President Evans, and me to serve on a subcommittee whose task was to develop recommendations to improve the Federal Open Market Committee's communications. In January, the FOMC adopted two initiatives brought forward by the subcommittee.

I want to review these initiatives today and how they relate to my broader views on a stronger monetary policy framework. Of course, improving policy transparency will always be a work in progress. So, I will also talk about additional steps I believe we could take to further improve our framework for conducting policy.

Statement of Principles

The first communications initiative adopted by the FOMC was to issue a consensus statement of principles about its long-run policy goals and objectives. The statement makes four very significant points in clarifying our policy objectives.

First, the statement reaffirms the Committee's commitment to its congressional mandate to promote "maximum employment, stable prices and moderate long-term interest rates."

More important, the statement gives texture to those objectives in a way never before articulated. In particular, the statement's second significant point stresses that inflation over the longer run is mainly determined by monetary policy. In this sense, the FOMC acknowledges what every economist has known for over two centuries: inflation is a monetary phenomenon. Therefore, it is both appropriate and feasible for the monetary authority to set an inflation goal and be held accountable for achieving it. The Committee, therefore, adopted a long-term inflation goal of 2 percent, as measured by the annual change in the price index for personal consumption expenditures. By establishing an explicit inflation target, the Federal Reserve is adopting a practice used by most major central banks around the world and one that is acknowledged as a best practice by academics and central bankers.

² See Dotsey and Plosser (2012) and Plosser (2008).

A third important point made in the statement is that it is not appropriate for the central bank to set an explicit numerical goal for the maximum employment part of our mandate. Maximum employment is mainly determined by nonmonetary factors, such as demographics, technological change and productivity, the structure of the labor market, and governmental policies – for example, minimum wage laws, unemployment benefits, retirement incentives, and taxes. Since these factors change over time, the concept of maximum employment can also change over time. While policymakers consider a wide range of indicators to assess employment, the value of such indicators is subject to considerable uncertainty. Economists, for example, can, and often do, have very different assessments of what the level of maximum employment is at any point in time. This arises because different models suggest different conceptual definitions, most of which are not directly observable. So, monetary policy should not seek to achieve an explicit objective for something it does not directly control and cannot accurately measure.

Fourth, the statement notes that, in general, price stability and maximum employment are complementary. Price stability promotes economic efficiency by giving individuals and businesses more confidence that the purchasing power of the dollar will not erode. Conversely, the failure to maintain price stability can often lead to greater instability in employment and output. When inflation rises to unacceptable levels, as it did in the 1970s, monetary policy will be forced to react to restore price stability. This, in turn, could lead to increased instability in employment and output, as it did in the recession in the early 1980s. But the FOMC’s consensus statement of principles also acknowledges that in the short run, the maximum employment and price stability parts of the Fed’s mandate could be in conflict. In such circumstances, monetary policy will seek to follow a balanced approach in promoting its statutory mandate.

The consensus statement does not provide answers for all the hard policy choices. How best to implement this balanced approach requires judgment and may well differ across policymakers who may have different models of the economy even as they work to promote the same long-term goals for monetary policy.

Improvements in the Summary of Economic Projections

The second important step the Committee took in January toward increased transparency involved the economic projections that the FOMC releases four times a year. The Summary of Economic Projections, or SEP for short, summarizes the individual FOMC policymakers’ views on the economy as reflected in

several key economic variables, including output, inflation, and unemployment. Yet, these projections are not forecasts in the usual sense. Each policymaker's projections are conditioned on the policymaker's assessment of "appropriate policy," that is, the policy path that he or she views as the most likely to yield the best outcomes for the economy in the absence of further shocks.

This policy path isn't necessarily the most likely path; instead, it is the path viewed as being the best policy. Thus, the projections should not be compared with the forecasts of private-sector forecasters who try to predict what the Fed's next move might be. Instead, each policymaker makes economic projections based on an assessment of the best policy path to achieve the most desirable outcomes.

Until January, the SEP did not reveal any information about the appropriate paths assumed by the participants. This lack of information about the underlying policy assumptions made it difficult to know what the SEP represented. For example, two participants may be projecting the same long-run inflation rate, but they may believe it will take very different policy paths to achieve that outcome.

Other central banks, such as those of Norway, Sweden, and New Zealand, have provided information about the assumed path of policy. In January, the Fed joined them and began releasing information on the underlying policy paths assumed by the participants in their economic projections. These policy paths are summarized in two charts. The most important chart displays the level of the federal funds rate assumed by each participant at the end of each calendar year for three years out and for the longer run. This information provides a useful picture of the range of views of future policy assumed by policymakers. Note once again that these are assumptions, not forecasts in the usual sense. For example, I might submit a very different projection of inflation rates if I were asked to use someone else's policy path or even the policy path implicitly assumed in the fed funds futures market.

It is also important to emphasize that these policy assessments do not constitute a commitment to follow a particular path but will evolve as economic conditions evolve. In fact, I believe that changes in this chart over time will prove to be a far better way to provide information about the path of policy than using calendar dates, as we are currently doing in our FOMC statements. Policy should be conditioned on the state of the economy, not the calendar. Observers watching how these policy paths evolve as the economy improves are likely to learn more about the timing and magnitude of future policy actions. This then will reveal more about the policymakers' reaction function, on which I will have more to say in a moment.

From my perspective, our actions in January were important steps forward. We clarified our goals and objectives, and we became more transparent about our views of future policy.

More to Do

Of course, as I mentioned at the outset, improving the transparency of our communications and strengthening our policy framework is a work in progress. More can be done.

First, as a way to increase transparency, I believe the SEP should include more information about the linkages among the economic variables and the associated policy paths. Even with the recent improvements, the public cannot link a policy path to a particular set of projections for output, inflation, and unemployment in the SEP. That is only possible when individual policymakers choose to reveal such information in their speeches and other public communications. A natural next step would be to include a matrix of output, inflation, and unemployment, and the associated policy path assumptions that each policymaker submitted. This would make the information in the SEP easier to interpret and give a better sense of the linkage between changes in economic conditions and policy.

Second, I believe the Federal Reserve should do a more comprehensive monetary policy report four times a year. Currently, the Chairman testifies before Congress twice a year – in fact, he is doing so today – and that testimony is accompanied by a 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 in a more comprehensive report on monetary policy. Most central banks that have adopted an inflation target have also sought to improve communication and transparency through the publication of a regular policy report. In the U.K., for example, the Bank of England issues a quarterly Inflation Report. Other countries produce a Monetary Policy Report that discusses the central bank's forecasts and the longer-term context of policy. These reports offer an opportunity to reinforce the underlying framework the central bank has adopted for the conduct of policy. I think the Fed should consider producing a similar report to elaborate and reinforce its policy framework and how it relates to economic conditions. These reports will help improve the public's understanding of policy, which will help make policy more effective and the central bank more accountable.

Third, I believe the FOMC should adopt clearer guidelines on how policy evolves with economic conditions. 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.

The history of U.S. monetary policy is filled with stops and starts and changes in direction, yet the Fed has communicated little about what drives those decisions. Indeed, historically, central bankers have tended not to reveal such information, since they preferred discretionary policy over systematic policy.

Of course, policymakers do not know with any degree of 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. Milton Friedman advocated a rule in the form of a k -percent growth rate of the money supply. John Taylor devised a rule that depends on a measure of inflation relative to a target and some measure of resource utilization. Other versions of the Taylor rule involve a degree of smoothing to minimize sharp swings in the policy rate. A policy rule is also called a reaction function or response function because it describes how policy will evolve as key economic conditions evolve.

I believe that the Fed should provide more information about its reaction function. The practice of using systematic rules as guides to monetary policy imposes an important discipline on policymaking and improves communication and transparency. This is because systematic rules make policy more predictable and therefore helps the public and markets make better decisions. Moreover, if policymakers choose to deviate from the guidelines, they are forced to explain why and how they anticipate returning to normal operating practices. Systematic policy also reduces the temptation to engage in discretionary policies.

I believe the Committee is still some way from agreeing on one systematic policy rule or reaction function. Such choices will involve elaborate discussions and agreement on the appropriate class of models and an agreed-upon loss function. One way to move toward more systematic policy would be to describe the variables that are important for our response function. 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." Research has found that such rules perform fairly well in a variety of models and frameworks.³

³ See Orphanides and Williams (2002).

Thus, it is reasonable and feasible for the Fed to describe policy in terms of the variables in a rule that is robust across models. We would not have to articulate a precise mathematical rule but would provide the key variables and then communicate policy decisions in terms of changes in these key variables. If policy were changed, then we would explain that change based on how the variables in our response function have changed. If we choose a consistent set of variables and systematically use them to describe our policy choices, the public will have a greater ability to form judgments about the likely course of policy. This would reduce uncertainty about policy and promote stability.

There is one more item on my list of things to do. At the beginning of my remarks, I stressed the importance of maintaining the independence of the central bank. That independence is now under attack. Last week, I gave a speech on the fraying boundaries between monetary and fiscal policy.⁴ I noted that while monetary policy and fiscal policy are intertwined through the government's budget constraint, there are good reasons to maintain clear boundaries between the two. Specifically, in a world where fiscal discipline is lacking, governments without the institutional or constitutional guarantees of an independent central bank often resort to money creation as a solution to fiscal problems. This, of course, is a recipe for high rates of inflation and, in the extreme, hyperinflation. For this reason, countries throughout the world have moved over the last 60 years to strengthen the independence of their central banks. It is simply good governance to keep a healthy degree of separation between those responsible for tax and spending policies and those responsible for monetary creation.

The pressure on independence stems, in part, from fiscal imbalances and the inability of governments to develop credible and sustainable plans to finance public expenditures. In turn, the pressure can manifest itself in calls for higher inflation or for central banks to act as lenders of last resort for failing governments. Yet central banks have also contributed to the breakdown of the boundaries by engaging in credit allocations to particular sectors, such as housing, and bailouts to particular firms, such as Bear Stearns. Thus, the fiscal authorities and supposedly independent central banks have acted in ways that undermine central bank independence. I believe this is a dangerous path and one that needs to be changed. We need to restore the boundaries.

⁴ See Plosser (2012).

Conclusions

To summarize, the FOMC has taken significant actions toward greater transparency, most recently with the historic steps adopted in January. These steps in turn help to promote better public understanding of the rationale behind the FOMC's decisions. First, we released a statement clarifying the long-run goals of monetary policy and our policymaking strategy. Second, we began releasing information about the policy paths that underlie our economic projections.

Yet, I believe there is more that can be done. We can and should provide more details about the interplay between economic conditions and policy. We can also better define our reaction function, to enable the public to better understand and anticipate future policy actions. Economic research has shown that increased transparency can improve the effectiveness of monetary policy, as well as the Fed's accountability with the public. These benefits underscore the importance of our continued pursuit of finding better ways to communicate our framework for monetary policy decisions.

References

Dotsey, Michael, and Charles I. Plosser. "Designing Monetary Rules in an Uncertain Economic Environment," Federal Reserve Bank of Philadelphia *Business Review* (First Quarter 2012).

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

Plosser, Charles. "The Benefits of Systematic Monetary Policy," speech to the National Association for Business Economics, Washington Economic Policy Conference, March 3, 2008.

Plosser, Charles. "Credible Commitments and Monetary Policy After the Crisis," speech to Swiss National Bank Monetary Policy Conference, Zurich, Switzerland, September 24, 2010.

Plosser, Charles. "Strengthening Our Monetary Policy Framework Through Commitment, Credibility, and Communication," speech to Global Interdependence Center's 2011 Global Citizen Award Luncheon, Philadelphia, Pennsylvania, November 8, 2011.

Plosser, Charles. "Fiscal Policy and Monetary Policy: Restoring the Boundaries," speech to U.S. Monetary Policy Forum, University of Chicago Booth School of Business, New York, New York, February 24, 2012.