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Philadelphia Fed Policy Forum: How Transparent Should a Central Bank Be?
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I had two immediate reactions, when I was invited to participate on this panel: The first was, "Do we really need another discussion of this issue?" The second was, "What a great opportunity to vent my frustrations with Fed communication!" Obviously, in a sense, my second thought provided at least a potential answer to my first. Unless I'm terribly unrepresentative of the Fed's audience, there may indeed still be reason to discuss the issue of central bank transparency.

I'm going to focus my remarks on the Fed. To be sure, much of the recent dissatisfaction with central bank transparency has focused on the ECB. But, as I'll indicate shortly, we're dealing with a rather complex subject, and I'm more comfortable discussing it in the context of the Fed, with which I've had a few decades of experience. Hopefully, though, at least some of my observations will have broader relevance.

Since retiring from the Fed, I've been consulting with firms that have, shall we say, a deep interest in the course of the economy and, particularly, of financial asset prices. In that context, there's an enormous appetite for insight into what the Fed is up to—and will be up to in the future. Indeed, the focus on the Fed seems excessive, given the degree to which developments outside the very short end of the fixed-income market are driven by other forces. But, there's no getting around the fact that the Fed is an important piece of the picture.

The Fed today provides a good deal of grist for the information-processing mill. The changes over the past 30 years in this regard have been substantial, and they've not always been entirely volitional: Congressional pressure played a role at many points. Notably, the requirements of the early- and mid-1970s for periodic reports on monetary growth—the so-called Proxmire reports—were formalized in the Humphrey-Hawkins Act in 1978. Subsequently, the Fed found itself boxed into including in the Humphrey-Hawkins reports quantitative projections of economic activity and inflation. Congressional pressure for more information on the Fed's thinking about the economy led to publication of the so-called "Beige Book," a slightly sanitized version of previously internal document; this was viewed in the Fed as less intrusive than would have been the release of its staff analyses and forecasts. External pressure has also encouraged the FOMC to produce quite substantial minutes of its meetings, albeit with a lag so long that they can be rather stale news.

At the same time, there was an increase in the Fed's communication with the public via speeches by Board members and Reserve Bank presidents. Sometimes the result can be almost cacophonous, as the policy makers express their individual views, rather than adhering closely to any party line. But, as I'll argue, given the structure of the Fed System, the apparent noise is an essential feature of transparency.

More recently, the FOMC decided that it should not only announce changes in its target for the federal funds rate, but that it should also communicate something of the rationale for its decisions and its thinking about the outlook. The precise form of the announcements issued just after each meeting seems still to be evolving, but within the framework described in a January 19, 2000, note. That note highlighted the confusion—inside and outside the Fed—about the meaning of the prior "bias" component of the FOMC's directive for open market operations, and it established the current forward-looking "balance of risks" sentence as a fixture of policy announcements.

All this enhanced communication is intended to serve several purposes. One, as I've noted, is meeting the demands from the Congress, from which the Fed's monetary powers devolved. But it has also been viewed as helpful more generally in enhancing understanding—and hopefully support—of Fed policy, and in the process diminishing the suspicions in some circles that a secretive, non-elected body is manipulating the financial markets for purposes other than the commonweal. Finally, there has, I think, been a growing view that, by providing the right information, markets will better grasp the objectives of policy and will better anticipate the responses of the Fed to events, thereby increasing the chances that adjustments in market prices will be prompt and conducive to the achievement of the policy aims; stated in extremely simple terms, the notion is that, if all goes well, there should be no surprises.

The last thought is one to which the Fed came gradually over the years, and I'm not sure has totally bought into yet. The Fed's wariness about transparency has always involved a concern about how greater openness might lend itself to greater intrusion into its affairs and less independence of action. Chairman Greenspan's recent remarks about how difficult it would be to conduct FOMC business in public convey a hint of this thinking; in addition, it was felt that if the Fed were to indicate where policy rates might be headed next, it would attract greater pressure than it already faces from the Congress or other interested parties.

But, the wariness about transparency has also always involved a concern that the markets would overreact to any indications of potential policy actions. Given that the future is to some extent unknowable, the Fed can never be absolutely sure what its subsequent course of action will be. The fear is that the markets will respond to statements about probable events or contingent actions as if they are certainties--potentially creating needless, and presumably costly, noise, distorting the signals the Fed might otherwise usefully draw from the markets about underlying economic pressures, and even hampering the effective transmission of policy. The extent to which all of this is true is debatable, but that it's been a concern of the Fed's is undeniable. And I believe it remains a concern and one of the fundamental reasons why the Fed seems still to be wrestling with the precise form and content of its announcements.

So, what might the Fed do in the area of transparency that would not jeopardize its independence and would foster better transmission of policy? In answering that question, it's important to recognize the nature of the Fed beast: in particular, that it has

19 heads. Fed policy is determined by seven Board members (well, occasionally seven) and twelve Bank presidents (though only five vote on the FOMC at any time). As I suggested earlier, while there is some sense of corporate purpose, these folks see themselves as independent actors. In theory, one could envision them hammering out a specific and concrete consensus view of the economy and of policy prospects, but in fact that's not likely to occur spontaneously. The reality is that the FOMC largely focuses on reaching incremental policy decisions without coming to grips with the disparateness of the members' factual and analytical views—let alone with the differences in their personal tastes with respect to the short-run ranking of multiple policy objectives. The ability to gloss over sometimes deep-seated differences of opinion probably has helped the Fed avoid any greater visible dissension than is suggested by (often misleading) reports of battles between "hawks" and "doves." And, rightly or wrongly, the Fed has long valued an image of cohesion and consensus in its policy decisions as a confidence-builder for the financial markets and general public and as a way of avoiding giving potential political attackers some extra leverage.

Institutional changes might, of course, alter the impediments to more coherent communication. For example, the number of decision-makers could be reduced. Or the Fed's macro-policy mandate could be narrowed—or even within the current dual mandate, at least some quantification of the Fed's view of "price stability" could be required. I find the current verbal definition of price stability (that is, a state in which inflation isn't a factor in people's decisions) less than satisfactory: It would seem to leave open the possibility of damaging money illusion, and it leaves the target so vague that, for example, in the current circumstance, one doesn't know f or sure today—when there is talk about not falling into a Japan-like trap--whether the Fed perceives the likely rate of inflation over coming quarters as too high, too low, or just right. This obviously makes Fed reactions more difficult to gauge, and arguably reduces the likelihood of constructive market responses to incoming data. Such subjects are worthy of attention, and have received it elsewhere, but for now I'll focus simply on the institutional structure as we have it today.

I personally am willing to accept that the Fed will speak with many voices, and to shoulder the burden of piecing the mosaic together to gauge how the group is likely to respond to the underlying economic tendencies I foresee them facing. But I do believe that it's reasonable to ask for more straightforward and clear communication from the policy makers within the current framework.

Here's where I vent my frustrations. I want to avoid getting too petty about this. But let me cite a few examples of the sorts of behavior that I find annoying.

I should say that, unlike Mickey Levy, I'm not the least bit upset when the Fed talks about short-run trade-offs between unemployment and inflation. That's not simply because of my understanding of how the world works: It's also because I think that's really how most Fed policy makers perceive it. Better they say that than, for political purposes, deny that the Phillips curve notion has any utility and yet tighten policy because they are concerned that the labor markets are getting so tight that increased inflation is a threat.

Another quaint example of Fed non-transparency is the times when the FOMC decided not to announce its true expectations for monetary growth, as seemingly required by the law, but rather indicated the growth rates it thought would be consistent in the long run with price stability. At one point, a concern was that, if they announced an expectation of more rapid money growth (which seemed likely in light of prospective velocity movements), it would be perceived as a weakening of anti-inflation resolve. On other occasions, it was thought undesirable to change ranges mainly because it would arouse suspicions that the aggregates might be a more important focus in operational decisions. My own, perhaps naïve, view was that it would have been both feasible and preferable to adjust the ranges and explain why and what their significance might be.

The FOMC's post-meeting announcements are a considerable advance in transparency. But they fail to achieve their full potential, because they fall short of the clarity that I think is possible and desirable.

Again, it is important to recognize that these announcements—along with the minutes--are not instruments solely for communication with the public, but also for addressing conflict within the committee. By acknowledging the views of a sizable or adamant minority, it often is possible to gain their assent to the specific policy decision—especially if that acknowledgement involves some apparent circumscription of future policy options. But all that doesn't explain what I perceive to be distinct oddities of drafting that leave people scratching their heads for no reason.

Take the "monitor closely" phrase in the announcement last December, which evidently reflected the agreement to hold off on easing until additional information could be considered in a between-meeting discussion. That unfamiliar language presumably was intended to alert the markets that some change in the funds rate target might occur soon; but, given the FOMC's practice, one couldn't foresee the likelihood of action being taken before the next scheduled meeting. If they had said that they were contemplating an earlier action, is it clear that the markets would have done anything other than re-price in a way essentially consistent with the expected value of the funds rate that the Committee members themselves had in December? And would that have been bad?

Or, what about the reference to 275 basis points of easing in the June announcement, which accompanied the first 25 bp cut in the funds rate after a string of 50 bp reductions this year? It was generally construed as an indication that the Fed thought that it had put a lot of monetary policy stimulus into the pipeline and that any further rate reductions would be cautious. But what is the point of not simply saying that, rather than leaving it to people to guess about.

Things like this are generally clarified eventually by the minutes, but the announcements presumably are intended to provide more timely information. I suspect that some quirks of the announcements arise simply because of poor drafting (certainly the grammatical and syntactical errors often do), combined with a weak editorial process: Criticism of the proposed texts may be viewed as discordant or needlessly time-consuming and nitpicky. However, I suspect that they also reflect conflicting feelings about disclosure and some inclination to be oracular, which is more troubling. I'd be happier if the Fed's attitude toward communication didn't seem so well captured by Chairman Greenspan's frequent laugh-getter that, if you understood what he just said, he must have been speaking too clearly! The fact that the Fed finds it necessary to call in reporters or others from time to time for off-the-record conversations to correct market misperceptions of its thinking and intentions is, to my mind, a sign that its approach to communication has some shortcomings.

To sum up, I would say the answer to the question of this session, " How transparent should a central banks be?" is "As much as possible, without jeopardizing its mission." That might seem pretty obvious, but the alternative—"No more than it is forced to be"—probably was once the mode and still has some gravitational pull. However, the Fed has come a long way in transparency, and it would be difficult to reverse course. The vehicles are in place for providing as much information about its actions and intentions as probably is feasible, given the institutional structure. On a small point, I'd like to see a greater availability of the research underlying what the policy makers say, and I think the characterization of the Fed staff forecast in the minutes probably is excessively vague. However, one thing I'd <u>not</u> want to see is a curtailment or regimentation of the many voices of the System, in the interest of a clearer message; such clarity would be a false one, given the characteristics of the decision-making structure. What is important is that those voices speak in a straightforward fashion.