Fed Transparency: TMI?

BY CHARLES GERENA

"Central Bank Transparency and the Crowding out of Private Information in an Experimental Asset Market." Menno Middeldorp and Stephanie Rosenkranz, Federal Reserve Bank of New York Staff Report No. 487, March 2011.

Chairman Ben Bernanke gave his first press briefing on April 27 after a meeting of the Federal Open Market Committee. Such efforts are meant to provide the public additional context for monetary policy decisions. They are also intended to make the Fed's policies more predictable.

Menno Middeldorp, a senior economic analyst at the New York Fed, and Stephanie Rosenkranz, an economist from Utrecht University, question the latter rationale in a recent paper. They suggest there may be a point where financial market participants receive so much information from the Fed that they feel less compelled to invest in their own sources of private information on monetary policy. This undermines their ability to predict the course of policy, which may lead to increased market volatility surrounding policy decisions.

There are several ways to test how a more transparent central bank affects market stability. For example, one could look at interest rates after monetary policy decisions. The less movement in rates, the more likely they had already factored in the impact of those policy decisions. In several studies, interest rate volatility declined after the FOMC began announcing its rate decisions in 1994 and Norway's central bank began releasing interest rate forecasts in 2005.

Other empirical research has looked at indirect measures of monetary policy expectations (such as the price of Fed futures) and direct measures (such as predictions from professional forecasters). In both cases, the gap between expectations and outcomes narrowed after central banks released more information about their policy decisions.

Middeldorp and Rosenkranz took a different approach. They conducted a controlled experiment with groups of 16 to 20 young adults to see how their trading of imaginary risky assets was affected by the presentation of public information and the offer to acquire additional private information. The experiment closely mirrored a model which predicted that "more accurate public information can crowd out private information to such an extent that the market's ability to predict monetary policy deteriorates," the researchers note.

The results of their experiment roughly confirm the model's prediction. "Although an experimental asset market is inherently limited due to the use of a small number of unsophisticated traders, our evidence does appear to be applicable to real world markets," the authors conclude. "Sessions with more numerous and experienced subjects produced a stronger effect."

"The Great Recession's Effect on Entrepreneurship." Scott Shane, Federal Reserve Bank of Cleveland Economic Commentary No. 2011-4, March 2011.

One defining trait of entrepreneurs is their ability to hear opportunity knocking at the door when others hear silence. Companies like Microsoft and CNN started during a recession when a lot of labor and capital were idled.

Scott Shane, a visiting scholar at the Cleveland Fed and a professor at Case Western Reserve University, looked at how entrepreneurship fared during the historic recession of 2007-09. He found that there was a net reduction in entrepreneurial activity during that painful period.

For example, while more people became self-employed during the recent recession, an even greater number of people transitioned out of self-employment. As a result, the ranks of the self-employed shrank about 4 percent between December 2007 and June 2009.

Also, from November 2007 to June 2009, the number of self-employed who incorporated their businesses fell 8.9 percent while the number of unincorporated self-employed decreased only 0.5 percent. This has important implications. "Corporations have more of an economic impact in general than sole proprietorships," notes Shane. Therefore, it appears that "the more substantial type of entrepreneurial activity was more adversely affected by the recession than the less substantial kind."

"Facts on the Distributions of Earnings, Income, and Wealth in the United States: 2007 Update." Javier Díaz-Giménez, Andy Glover, and José-Víctor Ríos-Rull, Federal Reserve Bank of Minneapolis *Quarterly Review*, February 2011, pp. 2-31.

José-Víctor Ríos-Rull, an economist and consultant at the Minneapolis Fed, has worked with a colleague from Spain for more than a decade to track various aspects of economic inequality. Their latest paper revealed some interesting details about America's poor, rich, and middle class.

According to the Survey of Consumer Finances, household earnings increased by 13 percent between 1998 and 2007, while income (earnings plus government and private transfers) increased by 18 percent. During the same period, wealth increased by a noteworthy 54 percent.

Growth in income and wealth has not been evenly distributed, however. "The three variables have become more concentrated in their very top tails, and the bottom tails have changed little," note the paper's authors. **RF**