Transparency in the Practice of Monetary Policy

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This has been a very useful conference in my view, and I am honored by this opportunity to be a part of it. As some of you may know, I was the second choice for this slot, but that doesn't bother me at all because the first choice was Don Brash, the Governor of the Reserve Bank of New Zealand and a pathbreaker in bringing both transparency and accountability to central banking in practice. I won't be able to fill Don's shoes completely, but I have a strong interest in this topic, and I am very happy that Bill and Dan saw fit to give me the opportunity to share some thoughts with this distinguished group.

Actually, it is hard to imagine that anyone interested in improving the conduct of monetary policy would *not* be interested in this topic. There is a growing consensus among monetary economists at this point that the impact of monetary policy on expenditure is transmitted primarily through the effects of policy actions on expectations regarding the future path of short-term interest rates rather than the current level of the overnight rate.[1] Further, the more financial markets know about the reasons for a central bank's current policy actions and its longer-run policy intentions, the more likely it is that market reactions to policy actions will reinforce these actions and increase the effectiveness of stabilization policy. It follows that central banks should be highly transparent regarding both their long-term policy objectives and the shorter-term tactical actions they take with policy instruments.

Against this background, it seems to me that the Fed, along with other central banks, has made considerable progress in increasing transparency in

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[1] See Woodford (2001, p. 17).

recent years. When I first joined the Fed back in 1970, to the extent that anyone thought explicitly about transparency issues at all, the idea seemed to be that limited transparency—or even no transparency—was best. Central banks in industrial democracies were thought to work most effectively behind the scenes, away from the glare of public scrutiny, at least in part because they could then quietly take appropriate actions that might be politically unpopular, or, more broadly, difficult to explain to a public not well versed in the intricacies of finance.[2] There was also a belief in some quarters that central banks could enhance the effects of certain policy actions—most notably foreign exchange market intervention operations—if they kept market participants uncertain about their intentions.

Attitudes toward transparency appeared to change in the 1980s, partly reflecting progress made by economists in understanding the monetary policy transmission mechanism, and probably partly because of public demand, particularly in the United States, for greater openness in government and public policy generally. (As you may recall, the most widely read popular book about the Fed and Fed policy in the 1980s was somewhat derisively titled *Secrets of the Temple*.) Further, in the early 1980s, Chairman Volcker publicly took responsibility for reducing inflation from its then high level, and subsequently took strong and temporarily painful actions to accomplish the reduction. Some public explanation of the need for these steps was required, and this need probably facilitated the transition to viewing transparency more favorably. In any case, given the normal resistance to change in bureaucratic organizations, I believe the Fed has made remarkable progress over the last decade or so in opening up its conduct of monetary policy to market and public scrutiny.

Since the Fed is now quite open regarding many important aspects of its policy strategy and operations, and in view of the strong performance of the U.S. economy in recent years, at least up until the last several quarters, one might reasonably ask whether still greater transparency is necessary or even desirable in U.S. monetary policy. I think it is, and I will try to make this case in the next few minutes. Let me comment briefly on four points: (1) the transparency of our long-term inflation objective, (2) what I'm going to refer to as the "intermediate-term transparency problem," (3) the transparency of our policy directive, including its "tilt," and (4) the role of testimony, speeches, and other public statements by Fed officials in providing transparency.

[2] See Goodfriend (1986).

1. TRANSPARENCY OF THE LONG-TERM INFLATION OBJECTIVE

Probably the most important thing the public wishes to know and needs to know with some precision about Fed monetary policy is our long-term objective for inflation. Longer-term inflation expectations are obviously critical to households and businesses in committing to long-term investments, home purchases, insurance contracts, and wage and benefit agreements. Conversely, the Fed needs the public to understand and trust its long-term commitment to low inflation to achieve maximum benefit from this long-term strategy.

How to convey this objective credibly to the markets and the public has been a major focus of our policy research at the Richmond Fed for a long time. For many years I've personally been convinced that controlling inflation should be the Fed's overriding objective, that this objective should be explicit, and that it should be supported by a congressional mandate. At one level, abstracting, for example, from political obstacles, this seems obvious. We know that the Fed has the ability to determine the long-run inflation rate with monetary policy, and theoretical analysis and all of our practical experience suggest we should use that power in the public interest to maintain low and stable inflation over time.

An explicit long-term inflation objective supported by a congressional mandate would be a substantially beneficial step, in my view, even if it were limited to a verbal statement along the lines of the language in the proposed Neal Amendment to the Federal Reserve Act.[3] Quantifying the objective in terms of an explicit numerical rate (say, 2 percent per annum using the core PCE inflation index) would make the objective even more transparent and probably more effective.

Committing to an explicit inflation objective would achieve at least three things. First, it would help anchor longer-term inflation expectations and therefore facilitate the longer-term transactions I noted earlier. Second, it would help prevent inflation scares in financial markets, which would allow the Fed to act more aggressively in response to downside risks in the economy with less concern that rising long-term interest rates might neutralize the effect of the action.

Third, and most importantly, an explicit inflation objective would discipline the Fed to explain and justify short-run actions designed to stabilize output and employment against our commitment to protect the purchasing power of the currency over the long run. An explicit objective would force such explanations and justifications to be more sharply focused than in the current regime without such an objective. Routine, clear explanations of short-term actions would build confidence in the Fed's commitment to price stability and

[3] See Black (1990) and Greenspan (1990).

over time help reinforce credibility for low inflation. If the explanations were made in testimony before Congress, supplemented perhaps by a written inflation report along the lines of the Bank of England model, Congress would be positioned to enforce an accountability for monetary policy that arguably is now weaker in the United States than in the United Kingdom and the European Monetary Union.

One final point here: The Fed's long-term commitment to price stability is now largely embodied in our current Chairman's demonstrated commitment to this objective, rather than being institutionally grounded in an explicit objective. It is therefore inherently tenuous since its continuance will depend on the preferences of future Chairmen and their susceptibility to political pressure to pursue other goals.

For all these reasons, it seems clear to me that the increased transparency that would be provided by an explicit long-term inflation objective would increase the probability that we will attain our goal over time. Some argue strongly for a dual objective that refers explicitly to output or employment as well as inflation. But both theory and experience indicate that the Fed cannot control real variables directly with monetary policy, and in my view there are reasonable grounds to presume that the Fed will optimize its contribution to the economy's overall performance by maintaining credibility for low inflation.[4] A unitary goal focused on low inflation would strengthen credibility by making the Fed's commitment to this objective definite and unambiguous.

It is one thing to advocate an explicit inflation objective; it is another to actually put one in place. I doubt seriously that an explicit objective set and announced unilaterally by the Fed would be credible. Any explicit inflation objective would need to be accepted by the government as a whole through legislation or some other formal agreement, as such objectives are in countries that employ them. With its public standing high, the Fed seems well positioned currently to make the case for such a mandate.

2. INTERMEDIATE-TERM ISSUES

Even if the Fed obtains a price stability mandate, transparency issues are still likely to arise in practice—specifically, when current inflation or near-term inflation projections deviate from the long-term objective. For example, inflation may rise above its objective at a time when real output is below potential and unemployment is rising. It would be difficult or impossible in this situation for the Fed to ignore the weakness in the real economy and act aggressively to bring inflation quickly back to target.

[4] See Goodfriend and King (2001).

Some have argued that precisely this possibility makes an explicit inflation objective for the United States impractical. I don't find this objection particularly compelling. Especially if the Fed has previously established credibility, inflation may remain above its objective for some time without undue damage to the Fed's credibility if the Fed is transparent regarding its medium-term strategy for bringing inflation back to path. Even with established credibility, explaining this strategy clearly and convincingly to market participants and the general public would be challenging. Strategies and the accompanying explanations will have to be tailored to each case. In particular, the Fed may anticipate bringing inflation back to the objective more quickly in some cases than in others. Consequently, it may be useful for the Fed to announce intermediate-term inflation forecasts to assist the public in making financial and business decisions during the transition back to the long-term objective.

Beyond this, even if inflation is stable at or near its long-term objective, unanticipated shocks may push employment and output growth temporarily away from their sustainable noninflationary rates. Here, too, Fed transparency about its intentions will help the public gauge how production, employment, and interest rates will evolve in the medium term as the economy adjusts to the shock. Transparency is in the Fed's interest as well since it can help build confidence that, first, monetary policy can be effective in dealing with temporary departures of real activity from its long-term potential, and, second, that the Fed has the competence to exploit this capability. More generally, I believe that the Fed's expertise regarding the functioning of the U.S. economy—while far from perfect—is now of high enough quality that transparency of our thinking about the economy's medium-term prospects can build public confidence and trust in periods of economic stress. To be sure, actual developments may deviate from our announced expectations in particular situations, but trust can be maintained if the Fed provides reasonable explanations for the deviations.

3. TRANSPARENCY OF THE FEDERAL FUNDS RATE TARGET AND THE DIRECTIVE "TILT"

Having dealt with longer-term and intermediate-term issues, let me now make a few comments about transparency as it relates to short-term policy tactics: specifically, transparency regarding the current Federal funds rate target, the "tilt" of the directive language, and the statement released to the press after each Federal Open Market Committee (FOMC) meeting. It is in this area that the greatest progress has been made in increasing transparency over the last decade. The funds rate target set at a particular FOMC meeting, previously released only after the next FOMC meeting, since February 1994 has been announced shortly after adjournment of the meeting where it is set. So, markets now know the current target. And the Committee has released the tilt (or absence of a tilt) in the directive language along with the current funds rate target since its meeting on May 18, 1999. Previously, it too had been released only after the next FOMC meeting.

This increased instrument transparency, in my view, is all to the good. I believe the immediate release of the tilt language is especially useful. Again, the effect of monetary policy is transmitted to the economy not only through the current level of the funds rate target but also through market expectations about the *future* level of the target, which are reflected in the short-term yield curve. Market participants are going to form these expectations in any event. By announcing the tilt immediately, the FOMC shares its best current estimate of the most likely direction of any near-term change in the funds rate target, which should increase the efficiency with which markets form their expectations, help prepare markets and the public for changes in the target, and reduce short-term disruptions caused by leaks. In particular, since markets know the current tilt, they are better positioned to interpret the likely policy implications of incoming current economic data. For example, the release of strong data after disclosure of an upside tilt in the directive language should increase the probability that long-term rates will be bid upward in response. Consequently, immediate disclosure of the tilt should enable long-term interest rate adjustments to perform their stabilizing role in the economy more effectively.

While, again, considerable progress has been made in increasing the transparency of the Fed's short-term instrument settings, and its short-term expectations regarding at least the direction of future settings, there is room for further progress in my view. In particular, there may be different views about the extent to which a tilt in the directive in one direction or the other commits or obliges the Fed to a future funds rate change. To the degree that markets interpret a tilt as committing the Fed to future action, failure to take action may surprise or "whipsaw" markets. It should be possible for the Fed to mitigate this problem by emphasizing publicly that a tilt only implies a greater likelihood that any near-term change in the funds rate will be in a particular direction and is not a commitment to any action. It might seem tempting to consider eliminating the tilt in the formulation of short-term policy to remove any confusion it may produce. But such a reduction in transparency would deprive the FOMC of the benefits of announcing the tilt noted above. Moreover, beyond these benefits, abandoning it would deprive the Committee of a useful way to keep in touch with the strength of its internal consensus regarding policy at any point in time and of a valuable supplementary tool for reaching agreement on a funds rate target when there is a significant divergence of views regarding the appropriate level of the target.

Finally, it is important to recognize that the language of the press statement announcing the funds rate target and any tilt after each meeting also influences market expectations regarding future policy actions. This language is widely reported and interpreted currently in media coverage of FOMC meetings. In essence, the language in the statement, like the tilt language in the directive, is viewed by market participants as an additional short-term policy instrument.

4. TESTIMONY AND SPEECHES

The role of the Fed's explicit policy announcements in shaping market expectations of future policy actions is obviously important, but as anyone even slightly interested in Fed policy is well aware, public statements by individual FOMC members (including Reserve Bank presidents who are not currently voting Committee members) are at times especially important. This is particularly so in today's environment where media coverage of these utterances by cable television financial news channels, instant e-mail transmission of market analysis, and the like are much more extensive than even just a few years ago. Obviously, the Fed Chairman's remarks in congressional testimony (including answers to questions as well as prepared testimony), his speeches, and his interviews are followed more intensely than the comments of other FOMC participants since the Chairman is clearly the most influential Committee member and only he speaks for the Committee as a whole. At times, however, comments of other participants can affect market expectations, at least in the short run, if, for example, a comment is the Fed's first public reaction to a new economic report (particularly if the content of the report was unanticipated by markets), or the comment comes at a time when markets are especially uncertain about near-term policy prospects. Consequently, we also receive our share of media attention. Bill Poole, I, and, I expect, all of our colleagues at other Reserve Banks can tell stories about being covered by several reporters even when making speeches in fairly remote parts of our respective districts.

Some argue that this form of Fed transparency may be counterproductive, at least at times, if the views expressed in these comments seem inconsistent—particularly if they appear to conflict with a recent FOMC decision or a public statement by the Chairman. On occasion I have personally received criticism and complaints from market professionals and others when they have found my statements at variance with other Fed statements or confusing in some other way, and I will acknowledge that on a few occasions my remarks may have briefly complicated the formation of market expectations.

Over time, however, speeches and other public statements by individual FOMC participants provide markets and the public with a more robust and complete understanding of thinking inside the Fed about current economic and financial conditions and near-term prospects than that provided by the policy announcements I discussed a minute ago alone. Also, it is important to recognize that market analysts are adept at filtering and appropriately weighting press reports of individual FOMC participant remarks in the context of the broad range of Fed public statements from all sources. In short, I believe a convincing case can be made that the public remarks of individual Reserve Bank presidents and other FOMC participants increase the efficiency with which markets form short-term policy expectations.

I would offer one other—admittedly speculative—note on this point. It is obvious, again, that the Fed Chairman speaks with by far the most influential voice among FOMC participants. It might appear superficially that comments by other participants that seem to be "off message" might create confusion about the Fed's intentions and undermine the force of the Chairman's statements. As I just suggested, there might be a little of this from time to time, but I doubt these instances are of much significance. Again, markets are well aware of the much greater weight of the Chairman's statements and discount the remarks of other FOMC participants accordingly. Perhaps more importantly, public commentary by other participants reinforces the Chairman's credibility in the eyes of informed observers of Fed policy since it demonstrates that the Chairman leads, builds consensus among, and speaks for a thoughtful, competent group of policy professionals who naturally have diverse views on specific policy choices. If the public believed the Chairman was conducting policy unilaterally, he or she would be more vulnerable to an abrupt loss of public confidence. This might not be a risk for the current Chairman, who justifiably enjoys exceptionally high public respect, but it could be a problem for a future Chairman.

5. CONCLUSION

Again, I have enjoyed participating in this panel discussion. This conference has addressed what is clearly a crucial topic in understanding how monetary policy affects the economy and how it might be improved. The subject deserves continued research. Thanks to this conference, I am confident it will get it.

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