

Roger Ferguson, Jr: Transparency in central banking: rationale and recent developments

Remarks by Mr Roger W Ferguson, Jr, Vice-Chairman of the Board of Governors of the US Federal Reserve System, before the National Economists Club and Society of Government Economists, Washington, DC, 19 April 2001.

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It is a pleasure to have this opportunity to address this joint meeting of the National Economists Club and the Society of Government Economists. I would like to discuss a topic that is of particular interest to me - the transparency of central banks. As you know, transparency relates broadly to the openness of a central bank in stating its monetary policy decisions and explaining the reasoning behind them. I would like to make two main points: First, there is a strong rationale for a high degree of transparency in central banking; second, the world's major central banks have become quite transparent in recent years.

Of course, the views expressed are my own and should not be interpreted as the position of the Federal Open Market Committee or of the Board of Governors.

The past and recent trends in transparency

In the past, central banks around the world tended to operate with considerable secrecy. The need for and appropriateness of such secrecy was virtually unquestioned - it was part of the culture of central banking. Indeed, the one word of advice for a new central banker was probably "mystique." That single word encapsulated much of the tradition and wisdom of how central banks related to the public just a few years ago. As you are aware, the Federal Reserve and other central banks have moved considerably away from mystique and toward transparency in recent years.

For example, the new European Central Bank has incorporated a number of transparency aspects in its policy process and has emphasized the importance of communications. To highlight this importance, Otmar Issing, the Bank's chief economist and a member of its Executive Board, characterized communications as the "hidden pillar" of the ECB's monetary policy strategy. The Bank of Japan, likewise, has taken steps toward greater transparency, particularly following the revision of its governing law in 1998. In the United Kingdom, the Bank of England Act of 1998, which established the operational independence of the Bank, also strengthened transparency measures that the Bank had implemented earlier in the 1990s. Like the Federal Reserve, these central banks announce policy changes after meetings of their monetary policy committees and hold press conferences or publish minutes to explain policy deliberations. They also regularly offer detailed accounts of developments in the economy and provide projections for inflation and economic activity.

Reasons for transparency

Why is increased transparency viewed as such an important issue? The primary task of central banks is to get monetary policy right - that is, to pursue policies that effectively promote the objectives established by their legislatures or parliaments, such as stable prices, full employment, and maximum sustainable growth. Communicating what the central bank is doing, and why it is doing it, is of secondary importance to getting it right. Nonetheless, transparency is important, and even valuable, for two reasons.

Transparency, independence, and accountability

First, over recent decades it has become increasingly clear that central banks need to have a considerable degree of independence to carry out their jobs effectively. Of course, central banks are part of their governments, ideally subject to a well-defined legal framework. But there is now a broad consensus that central banks should be able to apply their own professional judgment in setting their operational instrument, usually a short-term interest rate.

To be sure, this independence does not refer to the goals of monetary policy. In a democracy, it is appropriate that the central bank's ultimate goals should reflect the common good and, in that spirit,

should be set by voters' representatives. Rather, independence applies to the instrument settings and other policy choices made by the central bank to achieve the ultimate policy goals. The main reason that central banks need to be independent in using their instruments is that effective monetary policy requires a distant time horizon. The monetary policy most appropriate for long-run stability and growth of an economy may not be politically popular in the short run. But along with a high degree of independence, central banks are required to account for their decisions in various ways. This, too, is appropriate in a democracy: The public has a right to know what its unelected, as well as elected, officials are doing, and why. And this is the reason that transparency is so important for supporting the independence of the central bank. Transparency facilitates a broad understanding of what the central bank is doing and thereby gives the public the tools to hold the independent central bank accountable.

Transparency, in fact, can play a valuable role in reinforcing the institutional independence of a central bank. History has shown that, even with the best intentions and safeguards, the independence of a central bank can come under strain when the appropriate long-run policy is unpopular in the short run. The clarity transparency brings to the objectives and strategy of policy can greatly help a central bank explain its decisions in relation to the objectives of long-run price stability and sustainable economic growth.

Transparency and policy effectiveness

The second reason transparency is important is that clarity and predictability of policy decisions may enhance the effectiveness of monetary policy. The Federal Reserve controls a very short-term interest rate - the overnight federal funds rate - but, as you know, theory and empirical evidence make clear that longer-term rates matter most for the economy. Those longer-term rates, in turn, reflect expectations of future short-term rates, as well as premiums for uncertainty. If the monetary authority can be clearer about what it is doing now and what it plans to do - not in the sense of setting future moves in stone, but rather in terms of explaining risks that might influence future policy - then market participants can improve their expectations of future short rates. Also, less uncertainty about monetary policy might reduce the premium for uncertainty. Thus, transparency ought to bring the rates that matter most for the macroeconomy into closer alignment with the intentions of monetary policymakers. In effect, greater transparency allows policymakers to work with the market, not against it.

The benefits from better communication and greater transparency can also be appreciated by considering the role of credibility and its effects on inflation expectations and, hence, the longer end of the term structure of interest rates. If the public is unclear about the strategy and objectives of the central bank, the credibility of monetary policy may suffer. Current economic developments or policy actions directed toward short-run concerns could have an outsized influence on perceptions regarding the more distant future - especially long-run inflation expectations and, therefore, long-term interest rates. Because such changes in perceptions could be counterproductive, concern about triggering them might discourage a central bank from taking action that otherwise could have been appropriate and beneficial for the economy in the near term. Lack of transparency and lack of credibility, in this sense, could reduce the effectiveness of monetary policy in stabilizing the economy against transitory shocks. A concrete example of this can be seen in recent developments in the United States. Consider the pickup in inflation that we saw last year, which many economists would attribute at least in part to the temporary effects of increased energy costs. Had the FOMC not been transparent and credible about its long-run objective of price stability, the public might have raised its perception of long-run inflation as a result of this unfavorable development. Such a shift would have greatly complicated the policy judgments that led to the easings that the FOMC implemented earlier this year. Transparency and credibility about the Federal Reserve's longer-term intentions, however, and the accompanying stability of longer-run inflation expectations, provided greater flexibility in taking action.

To be sure, greater transparency on the part of the central bank does not guarantee that markets will accurately forecast interest rates. As you well know, forecasts can prove inaccurate simply because the economy changes unexpectedly. And, despite efforts toward better communication, neither market participants nor central banks can forecast all the twists of a rapidly evolving economy. The central bank needs to be flexible, acting prudently but forcefully when required.

And another caveat: The accurate anticipation of policy by market participants is not a panacea. Though a tighter link between monetary policy expectations and long-term interest rates may lessen the need for the central bank to move its policy instrument as much or as quickly, market adjustments are not a substitute for monetary policy action. Market movements in response to anticipated central

bank actions must be validated by the central bank when they are, in the view of the policymakers, correct, in order for financial markets to continue to reflect the intentions of policymakers.

Definition of transparency

So far, I've avoided giving a precise definition of transparency. In part, that's because providing an exact definition is difficult.

Fundamentally, transparency refers to being forthcoming about goals and short-term tactics and, therefore, being easily and clearly understood. But being understood can have very different meanings depending on the particular aspects of the monetary policy process one considers.

Certainly, transparency should encompass clear communication of the longer-run objectives and strategy of monetary policy. In the United States, for example, by law we have objectives for both employment and price stability, neither of which is quantified in statute. Indeed, in our case, stating a numerical target for the inflation rate of some specific price index, for instance, might not enhance transparency but instead diminish it. One could argue that, despite the best efforts of government economists and statisticians, inflation measures based on our various price indexes are not sufficiently refined to offer an accurate basis for defining price stability. Some indexes undergo conceptual redefinitions from time to time and are subject to frequent revisions. And we all know that all price indexes can be subjected to outsized influences by special factors that may obscure meaningful underlying trends. For a variety of reasons, measures of inflation based on various indexes can differ considerably at any point in time. And none is known to always offer the superior reading. Thus, in evaluating risks with respect to our price stability objective, I believe that it is preferable to consider all the various measures and not be unduly influenced by a numerical target for any specific index. Obviously, under these circumstances, changing policy just because a single, specific price index is out of line might not always be sensible, especially if doing so might have detrimental consequences for our other objectives. For this reason, it seems to me that defining our price stability objective in terms of a numerical target for the rate of inflation of some specific price index could well be problematic. Indeed, I see considerable advantages to this operating definition of price stability: Price stability is a situation in which economic agents need not take account of expected changes in the general price level in their economic decisionmaking.

A second aspect of transparency is public announcement of changes in the short-run operating target. In general, when central banks target a short-term interest rate, this aspect of transparency is reasonably easy to implement because an interest rate is easy for financial market participants, members of the legislature, and the general public alike to understand. But transparency may be more difficult to achieve when the central bank employs other operating targets, such as the reserve targets that the Federal Reserve used in the early 1980s. Changes in such targets could often reflect technical developments and not changes in the desired policy stance. And yet, there are instances when quantitative targets may be more informative about the basic intent of policymakers than a short-term interest rate. For example, when the overnight rate of interest is nearly zero, a monetary policy easing may be rather difficult to communicate in terms of that interest rate. Last month's decision by the Bank of Japan to change its operating target from the overnight rate of interest, which was already near zero, to a target for reserves, may reflect, in part, this consideration.

A third aspect of transparency has to do with the central bank's attitudes toward the future - the risks facing the economy. In pricing longer-term financial instruments - bonds, equities, and derivative instruments - market participants need to factor in the longer-term economic and policy outlook. Investors' ability to make such judgments is enhanced by giving them information about how the central bank sees the probable evolution of the economy in the foreseeable future, in part so that market participants can better judge the likely evolution of monetary policy.

A fourth dimension of transparency has to do with the extent of information on the central bank's rationale for its policy moves. Such information helps market participants formulate their own outlook for the economy and monetary policy and therefore their projections of future interest rates and financial asset prices. And it also helps the public put monetary policy action in context so that accountability of the central bank is as informed as possible.

And a final aspect has to do with the regularity and predictability of the timing of policy decisions and communications. When a central bank is reasonably predictable in its policy timing, its decisions are likely to raise fewer questions and are therefore relatively easy for the public to comprehend. When

policy achieves a high level of transparency in this sense, unexpected or rapidly evolving economic developments and not policy changes are the news.

This, of course, is not to say that a central bank will never surprise the market. As I mentioned earlier, the most important task of a central bank is to get monetary policy right. At times, getting policy right will involve taking action unexpected by the market - for example, in its timing or magnitude. This situation is most likely to arise when economic or financial conditions are changing particularly rapidly. This might be associated with financial or economic crisis - as in the fall of 1987 or 1998 - but it need not be. These cases are relatively infrequent, but they do occur. The presumption against taking a surprise move, in timing or magnitude, should be strong, but it is a rebuttable presumption. The challenge is to weigh the good that comes from taking a move that a rapidly evolving situation appears to call for against the cost of a diminished sense of regularity in the policy process, which should be the norm in supporting transparency.

US practices on transparency

In February 1994, the FOMC adopted the practice of immediately announcing changes in its policy stance and, in effect, began to disclose immediately the expected federal funds rate. In subsequent FOMC meetings, when no policy action had been taken, no formal announcement followed. However, in the absence of a policy action the media were informed that the meeting had ended and that there would be no further announcement. In this way, from that point on, the FOMC immediately disclosed changes in its policy and its decisions not to take policy action at its scheduled meeting.

Though these steps clarified the current stance of monetary policy, the Committee recognized that it could further enhance the transparency of its actions by providing timely indications of factors that might influence the future direction of policy. The idea was that providing more information about the Committee's views of the economic outlook would allow financial market prices to reflect more accurately the probable future stance of monetary policy. When the stance of policy changed, the statement disclosing the action could be and was used to provide an indication of the factors likely to influence the Committee's future decisions. Such information, however, was not provided when the Committee decided not to change its policy since no announcement accompanied such decisions.

To bridge this gap, the Committee decided at its December 1998 meeting to announce major shifts in its view about prospective developments even in cases when the current policy setting remained unchanged. This step toward additional disclosure was first implemented in May 1999. In August 1999, the FOMC established a Working Group on the Directive and Disclosure Policy to study the Committee's disclosure procedures and propose further improvements to them. After discussion of the Working Group's proposals, the Committee in December of that year adopted the procedures that are now in place.

Under the current procedures, which were announced in January 2000, the FOMC issues a statement to the public immediately after every meeting. The statement provides information regarding the policy stance adopted at the meeting and the Committee's view about prospective developments. It is issued whether or not the Committee changes either its policy or its view about the future.

With the new procedures, the Committee adopted new language to describe its views about the economic outlook. The language indicates the Committee's sense of the balance of risks in the outlook against the background of the Committee's long-run goals of price stability and sustainable economic growth. Specifically, it indicates whether the Committee believes that the risks are "balanced with respect to prospects for both goals," "weighted mainly toward conditions that may generate heightened inflation pressures," or "weighted mainly toward conditions that may generate economic weakness." By economic weakness, we do not just mean recession; I believe that the Committee would be justified in recognizing risks weighted toward economic weakness if it saw prospects for subpar growth - that is growth below the rate of increase in the economy's potential.

None of these changes has altered the way in which the FOMC decides the appropriate course of policy action. The FOMC has not viewed the issuance of the balance of risks statement as a substitute for needed interest rate changes. To repeat, the most important task of a central bank is to get monetary policy right. Regardless of changes in its disclosure procedures, this has always been and remains the Committee's foremost goal.

Current economic conditions and outlook

Let me close by linking this discussion of transparency to the current economic situation. Since late last year, evidence has accumulated that the economy would be unlikely to meet the Committee's goal of maximum sustainable noninflationary growth. Therefore, the FOMC has moved aggressively, cutting the federal funds rate 200 basis points since the turn of the year. Two of those actions were taken between meetings - January 3 and, of course, yesterday. Over this period, economic conditions were changing rapidly. And, in the current situation, we were facing an unusually long intermeeting period.

Although some fog always surrounds the outlook, there is more than the usual amount of uncertainty at this juncture about the economic future. Clearly, many businesses were surprised by the extent of the slowdown in sales late last year, and inventories became uncomfortably high in some sectors. There also is talk of an overhang of high-tech capital, although quantifying the magnitude of that overhang is very difficult. Some producers of high-tech equipment may have misjudged the short-term demand for such equipment, perhaps, in part, because they assumed that the strength in investment experienced during 1999 and the early part of 2000 would continue. Moreover, a number of high-tech companies have failed over the past year, reducing the demand for new investment - both directly through the absence of their own spending and indirectly by increasing the supply of nearly new equipment on the second-hand market. These imbalances will take some time to be corrected. But businesses are moving quickly to adjust levels of production. And final demand should be supported by the lower interest rates put in place by the financial markets and the Federal Reserve. Despite the decline in stock prices, I believe that the underlying technical advances that have been so important to macroeconomic developments over the last five years will continue and will provide support over time for business and consumer spending.

But what interest rates will be associated with a return to healthy growth in spending remains an open question. Incoming data have remained mixed, but on balance suggest that the economy has been expanding very slowly. As our announcement yesterday noted, we are especially concerned about the outlook for capital investments. Profit expectations have been revised down, and reports that businesses have been postponing capital improvements are widespread. Moreover, the downward revisions to earnings expectations have hit the stock market hard since last fall, and declines in equity wealth could begin to show through more forcefully to consumption spending. All in all, I think it is too early to have a strong conviction that the economy is reaching the end of this period of quite slow growth. As the FOMC noted yesterday, the risks remain toward economic weakness.

Conclusion

Our announcement yesterday was part of an ongoing effort to communicate with the public at large and with markets. This desire to be transparent has led, in the last several years, to numerous changes in the procedures of many central banks. I do not know what future changes, if any, might be called for, but I am confident that central banks will continue to look for ways to make certain that their objectives and policies are clear.

Thank you for your attention.