Donald L Kohn: Recent and prospective developments in monetary policy transparency and communications – a global perspective

Remarks by Mr Donald L Kohn, Vice Chairman of the Board of Governors of the US Federal Reserve System, at the National Association for Business Economics Session, Allied Social Science Associations Annual Meeting, New Orleans, Louisiana, 5 January 2008.

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I appreciate this opportunity to review recent developments in Federal Reserve communications.[1] As you know, the Federal Open Market Committee (FOMC) decided last October to expand the medium-term economic forecasts of its members and to release that information to the public. I will discuss why I believe this is a very important and beneficial step, and then briefly discuss our communication efforts over the recent months of market turmoil.

Good communication is essential to successful central banking. It is critical to preserving the democratic accountability and public legitimacy of central banks that, for good reasons, have been granted a high degree of insulation from short-run political pressures. And good communication strengthens the effectiveness of good policy, largely because expectations are so important to the choices that households and businesses make about spending and saving and about prices and wages, as well as to the asset prices that help shape those choices. Private decisions are more likely to reinforce the achievement of central bank objectives if decisionmakers understand the goals of the central bank, its evaluation of the forces bearing on the economy, and its possible responses to economic shocks.

Good communication is a complement to good policy, not a substitute for it. Ultimately, central banks are judged on the outcomes for the economy – how well they meet their objectives. No amount of well-designed communication can counter the effects of consistently deficient analysis or poorly judged policy choices. But clear explanations and public frameworks can themselves help to promote good policy. Feedback from the market is more useful to central banks when the market understands the central bank's reasoning, strategy, and objectives, even if market participants don't agree with the central bank's outlook. And the discussions and decisions on how to frame the public presentation of policy can lead to improvements in internal deliberations.

Among the most important criteria for judging the effectiveness of communications and transparency, then, is whether or not they impede making the best possible policy decisions. Transparency should not be allowed to inhibit the free give and take and the testing of ideas at meetings that are so important to reaching good decisions. And communication must deal with the diversity of views on the policy committee; that diversity is a strength of policy committees, but it can make it challenging to arrive at a clear, consistent public explanation of a policy decision, because policymakers can arrive at the same policy position based on different rationales. Good communication must also take into account uncertainty. Understandably, market participants want to know what is going to happen next – to the economy and to policy. But we cannot say more than we know, and we should strive to avoid giving people the impression that we know more than we do.

I'll touch on a number of these themes as I review recent Federal Reserve communications. Before I do, I have one last comment: Our communication strategy is a work in process – we are constantly looking for additional steps that could reasonably be expected to improve public understanding and policy effectiveness. However, we move slowly in changing what

[1] These views are my own and not necessarily those of my colleagues on the Federal Open Market Committee.

we say in part because ill-conceived communication policy has the power to harm the economy, and, even if that harm were to be realized, the policy could be difficult to alter.

Enhanced economic projections

As already noted, I believe that the additional information in the enhanced projections the FOMC announced in November should be a substantial step forward in increasing public understanding of monetary policy decisions.[2] The enhanced projections give more information about the FOMC's medium-term outlook for the economy. That's particularly important, because the lags in the effect of policy on economic activity and prices mean that policy decisions are necessarily based on a view of the likely path for the economy over several years, relative to the Federal Reserve's legislated objectives of maximum employment and stable prices.

In that regard, one of the most significant aspects of the initiative is the lengthening of the forecast horizon from 1-1/2 to 2 years previously to about 3 years. Shorter-term forecasts tend to be dominated by the interpretation of how recent shocks to the economy will play out. By lengthening the projection horizon, FOMC members will also be giving a sense of their assessment of a number of important structural characteristics of the economy that influence the conduct of policy. For example, given the starting point for the outlook, the forecasts will trace out a path for the economy to preserve or reestablish maximum employment and price stability that will reflect FOMC participants' views of the relative variation in output and inflation that is possible in the short run.

In addition, FOMC participants' projections of growth and unemployment in the third year of their forecasts will be influenced significantly by their interpretation of maximum sustainable growth and resource utilization, given their understanding of the likely growth of productivity and structure of labor markets. And our projections for inflation in year three will depend importantly on our sense of what inflation rate is consistent with our mandates for employment and price stability. That projection, along with the path to year-three inflation, should help the public differentiate short-term shocks to price stability from the longer-term price trends it should use for planning purposes. Over time, as actual inflation tends toward the year-three forecasts, inflation expectations may well become even more firmly anchored than they are today.

In another change, the Committee included total consumer inflation in its forecasts along with the core measure it had been using. We have always recognized that "price stability" was not intended to apply to a subset of prices that people paid. However, we have also found that excluding volatile food and energy prices generally gives a better sense of underlying inflation pressures that are likely to persist and dominate total inflation over time. Hence, core inflation has been the most useful guide to the factors affecting policy when our forecast horizon was relatively short. Because the final year or so of the longer horizon is heavily influenced by our longer-term objectives, a more comprehensive measure is now also useful and appropriate.

FOMC members will be making their forecasts quarterly, thereby adding two rounds to the semiannual forecasts keyed to our monetary policy reports and Chairman Bernanke's testimonies. Economic circumstances, and thus the appropriate path for policy, can change rapidly, and we will continue to address those changes in our policy announcements and the

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[2] The policy regarding enhanced projections was announced in Board of Governors of the Federal Reserve System (2007), press release, Nov. 14. Also, the new policy was discussed in a speech given by Chairman Bernanke that day (Ben S. Bernanke, 2007, "Federal Reserve Communications," speech delivered at the Cato Institute 25th Annual Monetary Conference, Washington, Nov. 14). And the first set of projections under the new policy was prepared in conjunction with the Oct. 30-31, 2007, FOMC meeting and released in the minutes of that meeting (Board of Governors of the Federal Reserve System, 2007, press release, Nov. 20).

minutes for our meetings. However, the increased frequency of forecasts will give us more opportunities to place such changes in the context of our medium-term outlook.

The forecasts themselves are each Committee member's assessment of the most likely outcome for the economy. From time to time, however, policy decisions must take account of less likely, but especially important, potential outcomes. A significant contribution of the enhanced forecasts is to report more regularly and systematically on Committee members' views on the degree of uncertainty in the medium-term outlook and whether the risks to the most likely forecasts are skewed in any particular direction. Both elements can influence Committee actions. Uncertainty arises not only from future economic shocks, but also from our incomplete knowledge of the structure of the economy and of the full characteristics of recent economic developments that had not been anticipated. When, as now, the FOMC believes that uncertainty is high, it may need to give greater weight to new information and be readier to revise its forecasts. Policy decisions may also take into account the substantial risk that the economy will turn out differently than the most likely forecast, especially when that alternative is seen as having unusually large costs in terms of public welfare.

The enhanced forecasts will be accompanied by a narrative derived from the forecast submissions and the discussion of those forecasts at the meeting. This narrative will give the Committee an opportunity to tell the story behind the forecast – the most important forces it sees as bearing on the outlook and on the risks around the outlook, extending and expanding on the discussion in the minutes. This explanation, as much as the forecasts themselves, may well be most useful to the public in interpreting new data and developments and their implications for the economy and policy. The narrative will regularly include Committee members' take on why reality has deviated from the expectations embodied in past forecasts – often a key to understanding and anticipating policy actions.

In the FOMC's discussion of communications, we considered, but did not adopt, a number of proposals at this time, and I thought it might be useful for me to briefly address a few of these, while keeping in mind my previous comment that we are constantly reviewing our communication strategy. As noted previously, our longer-term forecasts of inflation are presumably influenced by our individual assessments of what inflation rate would be acceptable and consistent with fulfilling our congressional mandates, but we chose not to ask each participant for an explicit numerical definition of price stability. We believed that the steps we were taking would provide additional information that could help clarify how we viewed price stability that at the same time would allow us to remain consistent with giving information about how we expected to fulfill our dual mandate. I expect that our new projections will provide some of the benefits of an explicit target in better anchoring inflation expectations while not giving up any flexibility to react to developments that threaten high employment. As we gain experience with the enhanced forecasts, we will continue to evaluate how best to promote stability of both prices and employment.

When FOMC participants make their forecasts, each individual assumes "appropriate" monetary policy – that is, the policy that is most likely to foster the achievement of our objectives. Forecasts made under such an assumption should better reveal the participants' views of the underlying structural parameters of the economy – the best possible tradeoffs between inflation and output stability in the short run and longer-term price and output trends – than would be made assuming an externally derived path for rates, such as the path implicit in market interest rates. If the markets' path for appropriate policy were at odds with my judgment about appropriate policy, I would have to write down a forecast whose path or end points were not consistent with what I believed were our best efforts to achieve our objectives.

The FOMC decided against reporting a range or histogram for participants' assumptions about appropriate policy, because it was concerned about the potential for unintended consequences of such a publication. Specifically, it worried about a tendency for the public to infer more of a commitment to following the implied path than would be appropriate for good policy. In that circumstance, deviating from the path would risk market instability, and concerns about such dynamic responses would complicate already difficult policy choices. To be sure, over time, market participants might learn how little weight they should give any published average of "appropriate" policies, but the learning process could take time and be costly, and we would not be assured of a successful outcome.

Recent FOMC communication

Communication in a period of market turmoil as we have experienced in the past several months poses special challenges. The situation has been changing rapidly, taking unexpected twists and turns. Every episode of financial turmoil is different, which greatly complicates the analysis of how the financial situation is likely to evolve in the current circumstances, how lenders and borrowers might react, and how spending and prices could be affected. Central bankers, like everyone else, necessarily are operating with incomplete information about the state of the financial system, and some of the day-to-day information they are getting is colored by the perspective of the people giving it. With everyone looking for clues as to underlying conditions, central bank communications will be scrutinized especially closely, with the risk of unanticipated and unwelcome reactions; a frequently debated question within the central bank is whether a given statement will reassure market participants or alarm them. At any given point, the FOMC must make judgments about an appropriate policy and its communication based on what it knows at the time and thinks, given that information, it can anticipate for the future. Because of the uncertainty and fluidity of the situation, the FOMC needs to be aware of the high odds of unanticipated developments as it formulates and discusses policy; however, market participants and other observers also must keep the same caveats in mind as they interpret what the FOMC is saying.

In many respects, our recent communication has been driven by the necessity to announce and explain unusual actions we have taken. Examples of this are the reduction in the penalty on the primary discount rate in August and the inauguration of a Term Auction Facility in December.

In addition, we've tried to adhere to certain principles in our communications over this period. First, we have tried to provide more information than usual to reduce uncertainty and clarify our intentions. This effort is particularly noticeable with respect to open market operations – beginning in August, we have been especially forthcoming about the operations we were undertaking to manage actual or potential disturbances in money markets. Second, we have attempted to let people know when our views of the macroeconomic situation had changed materially between FOMC meetings. For instance, we issued a FOMC statement about the changing balance of risks on August 17 and Chairman Bernanke delivered a speech in late November after market conditions had deteriorated again. And third, we have tried to be open in our balance-of-risks portion of our announcement about our perceptions of the shifting degree of uncertainty in the outlook caused by the recent turmoil. In both September and December we said that the uncertainty was so great that we couldn't usefully characterize the balance of risks; at the end of October, when markets looked as though they were settling down and spillovers beyond the housing sector might be limited, we thought we could characterize "rough balance."

Because the situation has been so fluid and so uncertain in its effects, the speeches of individual FOMC participants have given varied interpretations of the developments and their implications for policy. The resulting dispersion of messages has bothered market participants seeking clear, unambiguous guidance about the views of the central bank. The public should understand that the FOMC members do not coordinate schedules and messages, and that members' views are likely to be especially diverse when, as in the current situation, circumstances are changing quickly and are subject to many different analyses. The diversity of views on the Committee is one of its strengths and vital to arriving at sound decisions. As I noted in the introduction to this talk, sound decisions are the most important contributions we can make to further the accomplishment of our public policy objectives.

I'm sure that the communications of the Federal Reserve, like all human endeavors, can be improved. We will be learning from our own experiences and those of our sister central banks, as well as from discussions such as this one organized by the National Association for Business Economics.