Charles I Plosser: Communication and transparency in the conduct of monetary policy

Speech by Mr Charles I Plosser, President and Chief Executive Officer of the Federal Reserve Bank of Philadelphia, at the Council on Foreign Relations, New York City, 8 May 2014.

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The views expressed are my own and not necessarily those of the Federal Reserve System or the FOMC.

Highlights

1. President Plosser outlines his views that policy transparency and forward guidance could be enhanced if the central bank would be more explicit about its reaction function.
2. President Plosser notes that one way to be more explicit would be to indicate the likely behavior of the policy rate based on a few different Taylor-like rules that have been consistent with past conduct of monetary policy and are robust to our uncertainties regarding the true economic model.
3. President Plosser believes that the Federal Reserve Board staff's model, called FRB/US, seems to be a reasonable starting point for providing economic forecasts based on those rule-based policies.

Introduction

Thank you for the kind introduction. It's a pleasure to return to the Council on Foreign Relations. I know that the value of these sessions often arises during the discussion, so I will try to keep my opening remarks brief. Before I go any further, though, I should begin with the usual disclaimer that my views are my own and do not necessarily reflect those of the Federal Reserve System or my colleagues on the Federal Open Market Committee.

The topic I want to address today is communication and transparency in the conduct of monetary policy. Some of you can recall when it was taken for granted that the central bank was supposed to be secretive and mysterious. The guiding principle was simple: The less said about monetary policy, the better. Indeed, it was not until 1994 that the Federal Open Market Committee (FOMC) began to announce policy changes made at its meetings.

But times have changed. Transparency has replaced secrecy, and open communication has replaced mystery. The extent of this transformation is, in many ways, remarkable. Today, the issues of communication and transparency are front and center on the agenda of many meetings and conferences on central banking. A major reason for the focus on these issues is the recognition that the stance of monetary policy encompasses not just the current level of the short-term policy rate but its expected future path as well. More broadly, economists have come to understand that expectations, including expectations about monetary policy, play an important role in determining economic outcomes, such as real economic growth and inflation.

One element of communication that has received a good deal of attention is forward guidance. Forward guidance is central bankers' speak for communication about the future course of monetary policy, and particularly about the likely path of the short-term policy rate. One reason for this increased attention on the future path of policy is that short-term rates have been constrained by the zero lower bound. So when, or under what conditions, the nominal policy rate might eventually rise takes on greater significance.

However, forward guidance is not a separate or independent tool of policy. Its effectiveness is intimately related to other features of monetary policy. In particular, a credible, systematic approach to policy and the general openness and transparency of the policy process are essential elements in shaping expectations. Even with this recognition, there are various views about how best to communicate information about the intended path of policy and how to ensure that such information is credible. If it is not credible, then it will not shape expectations in a beneficial way.

More generally, a central bank can and often does communicate on a host of important issues, including its view of the current state of the economy, its assessment of risks, and its outlook for key economic variables. Perhaps most important, from my perspective, is communication about how the evolution of key economic variables systematically shapes current and future policy decisions.

In my remarks this morning, I want to stress the importance of the FOMC articulating such a systematic approach to policy. Doing so is likely to make forward guidance more effective, by helping the public to better interpret what that guidance means.

The benefits of systematic monetary policy

So what do I mean by a systematic approach to policy? Quite simply, I mean conducting policy in a more rule-like manner. The antithesis of such rule-like behavior, of course, is discretion; that is, policymaking conducted period by period with great latitude to take whatever actions seem best at the time.

The rules-versus-discretion debate in economics is an old one, dating back at least to Henry Simons in 1936.[1] Yet, following the Nobel Prize-winning work of Finn Kydland and Ed Prescott in 1977, most academic economists – but, unfortunately, far fewer policymakers – have come to accept the benefits of adhering to rule-like behavior in monetary policy.[2] These benefits arise, in part, because consumers and businesses are forward looking, and credible commitments concerning the determinants of the future path of policy can alter expectations in ways that make policy more effective and less uncertain. The ability to behave systematically and to align the public's expectations with that systematic behavior can allow the central bank to increase current economic activity, while simultaneously lowering inflation. But a credible commitment to honor past promises is an essential element of rule-like policy. Discretionary decision-making undermines such commitments.

The appropriate way to make policy systematic, or rule-like, is to base policy decisions on the state of the economy. That is, policymakers should describe the reaction function that determines how the current and future policy rate will be set depending on the state of the economy. Policymakers are, of course, no more certain about future economic conditions than anyone else is, and therefore cannot realistically commit to particular future values of the policy rate. Nonetheless, describing a reaction function or rule that explains how the policy rate will be determined in the future as a function of economic conditions can be highly informative.

Unfortunately, the science of monetary policy has not reached the point where we can specify a rule for setting policy and turn decision-making over to a computer. Judgment is still required. Nevertheless, I place a great deal of importance on systematic behavior both as prescription for good policy and in terms of my own policy deliberations.

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1 Henry C. Simons, "Rules versus Authorities in Monetary Policy," *Journal of Political Economy*, 44:1 (January 1936).

2 Finn E. Kydland and Edward C. Prescott, "Rules Rather than Discretion: The Inconsistency of Optimal Plans," *Journal of Political Economy*, 85 (June 1977), pp. 473–91.

Much study has been done on various rules, but the most well-known rule is attributable to John Taylor.[3] The Taylor rule is a reaction function that indicates how to set the policy rate as a function of deviations of inflation from the inflation target and some measure of economic slack.

The attractiveness of Taylor-like rules for monetary policy goes beyond their intuitive appeal or the fact that they seem to describe the actual behavior of monetary policy reasonably well. The reality is that Taylor-like rules yield very good results in a variety of theoretical settings. While this is surprising to some, it is of enormous practical importance. Given our uncertainty about the true model of the economy, knowing that systematic policy in the form of a Taylor-like rule delivers good outcomes in a variety of models means that these simple, robust rules can provide useful guidance for policy.

Systematic policies that provide important information about the policymakers' reaction function combined with other information, such as the policymakers' economic forecasts, can sharpen forward guidance in a way that reduces policy uncertainty and enhances economic performance. Thus, well-designed communications are valuable, and behaving systematically has the added advantage of making those communications easier for the public to understand.

Increasing transparency

But what else should the central bank convey? For example, should it publish forecasts of variables in its policy reaction function and should these forecasts be based on the most likely path that the policy rate will follow or on some other assumption?

While many central banks publish forecasts in detailed inflation or monetary policy reports, there is still debate about the nature of the forecasts and the assumptions that underlie them. For example, who owns the forecast? At some central banks, the forecast is that of the policy committee and thus represents a type of consensus forecast. In other cases, the forecast is that of the central bank staff. Individual policymakers who do not fully buy into the forecast are then free to express their own independent views about the outlook.

A critical piece of a forecast emanating from the central bank is the nature of the future path of the policy rate. Should a central bank's published forecast be based on its assessment of what the policy rate path is likely to be, perhaps based on its reaction function, a so-called unconditional forecast? Or should the forecast be based on an interest rate path that is more arbitrary, such as a constant interest rate path or one that is related to market expectations inferred from forward interest rates. Others question whether the central bank should reveal the forecast's assumed interest rate path at all.

Perhaps the greatest fear preventing most central banks from publishing the best assessment of its future interest rate path is that the public will assume the projections will be taken as a commitment to that path rather than a projection influenced by the evolution of the economy. In my view, such fears could be mitigated if policymakers would articulate the way they systematically expect to adjust policy in response to changes in economic conditions.

While I have suggested potential problems if the central bank publishes its assessment of the likely near-term path of policy rates, in conjunction with its economic forecast, there is also a major benefit; namely, the added discipline that it places on the policy process itself. As I alluded to in my introduction, monetary policy does not just affect the economy through the current setting of the interest rate, but also through the expected path that the policy rate will take over time. Providing information about how that path is likely to evolve forces policymakers to think more deeply and systematically about policy. Communication about

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3 John B. Taylor, "Discretion Versus Policy Rules in Practice," Carnegie-Rochester Series on Public Policy, North-Holland, 39, 1993, pp. 195–214.

that path, in turn, gives the public a much deeper understanding of the analytical approach that guides monetary policy. Again, my view is that policy transparency and forward guidance could be enhanced if the central bank was more explicit in articulating its systematic approach to policy.

Conclusions and going forward

I am fully aware that great care needs to be taken in providing more specific forms of forward guidance so that we avoid a false sense of certainty and a mistaken sense of commitment. Yet I believe systematic monetary policymaking can enhance economic performance, and therefore I favor clearer communication concerning the formulation of policy.

In a stylized world, where there is a single monetary policymaker who has considerable confidence in a model of the economy, effective communication would include a forecast derived from this model. This forecast would incorporate a policy path that yields the best economic outcomes based on that single policymaker's views.

However, we don't live in such a simple world. Monetary policymaking is often conducted by committee, and divergent views can and often do exist. While this can be clumsy at times, such governance mechanisms have great strength in preventing institutions from lapsing into groupthink by ensuring that various views are heard in an environment that promotes better decisions and outcomes and helps to preserve central bank independence and accountability.

Thus, it may be difficult for the FOMC to achieve a consensus forecast or policy path. One way to enhance its communication would be to indicate the likely behavior of interest rates based on a few different Taylor-like rules that have been consistent with the conduct of monetary policy. Doing so would require agreement on a particular model in order to produce the resulting rule-based behavior. For the Fed, the Board staff's economic model, called FRB/US, seems like a reasonable place to start. The FOMC could then articulate whether and why it anticipates policy to be somewhat more restrained or more accommodative relative to the projections given by the rules. A monetary policy report that might accompany such a forecast could include various views that may differ from the baseline summaries.

Performing this exercise would indicate the inherent uncertainty that policymakers face, yet it would also provide a better sense of the likely direction of policy and the variables most related systematically to that policy. Further, this type of communication would push the FOMC to conduct policy in a more systematic manner, which I believe will lead to better economic outcomes over the longer run.