Charles I Plosser: Communicating a systematic monetary policy

Speech by Mr Charles I Plosser, President and Chief Executive Officer of the Federal Reserve Bank of Philadelphia, to the Society of American Business Editors and Writers Fall Conference, City University of New York (CUNY) Graduate School of Journalism, New York, 10 October 2014.

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

Highlights

- President Plosser discusses how effective communications and a systematic, rule-like monetary policy lead to better economic outcomes.
- President Plosser believes the appropriate way to make policy systematic, or rule-like, is to base policy decisions on economic conditions. He thinks policymakers should describe the reaction function that determines how the current and future policy rates will be set depending on economic data. Monetary policy should be data dependent, not date dependent.
- President Plosser also believes the Fed should think of forward guidance as part of a systematic approach to decision-making and not an independent policy tool that attempts to bend expectations. As monetary policy becomes normalized, the Fed has the opportunity to ensure the public understands that forward guidance is an integrated part of a systematic approach to policy.

Introduction

Thank you. As you may know, this is the centennial year for the Federal Reserve. On December 23, 1913, President Woodrow Wilson signed into law the act that created the Federal Reserve System, and on November 16, 1914, the 12 Reserve Banks officially opened their doors as independently chartered banks. Oversight was assigned to a Board of Governors in Washington, D.C. That decentralized structure is one of our great strengths, but it requires that I begin by reminding you that the views I express this morning are my own and do not necessarily reflect those of the Federal Reserve System or my colleagues on the Federal Open Market Committee (FOMC).

Since this is a professional society of business editors and writers, I thought I would discuss the benefits of clear communications as part of a systematic, rule-like approach to setting monetary policy.

During the past eight years, I have spoken and written frequently about ways to improve the framework we use for making monetary policy decisions. In my view, the monetary policy framework is most effective when the central bank:

- Commits to a set of clearly articulated objectives that can be feasibly achieved by monetary policy;
- Conducts monetary policy in a systematic or rule-like manner;
- Communicates its policies and actions to the public in a clear and transparent way; and
- Protects its independence by maintaining a clear separation of monetary policy from fiscal policy.

These four principles are interrelated, and, as you will see, communication is a key ingredient for a sound policy framework. To its credit, the Federal Reserve has sought to strengthen its communications and its monetary policy framework in recent years. I have described the process as like a journey, with each step contributing to a more informed public and a more transparent central bank. While we have made strides over the past several decades, I also recognize that the journey in recent years has taken us into unchartered territory. Extraordinary actions by the Fed in response to the Great Recession have presented unique communications challenges, which have made clarity more difficult. Yet, I believe we have nonetheless made progress.

The journey thus far

Just consider how far we have come. It was once 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 FOMC began to announce policy changes made at its meetings. Before then, the markets were left to infer the policy action from the Fed's behavior in the market.[1] Since then, the FOMC has issued statements at each meeting, which include a vote tally, along with the views of dissenters. The FOMC now expedites the release of the minutes, publishing them three weeks after each meeting. It also reports the economic projections of Committee participants four times a year. These meetings are followed by press conferences with the chair of the FOMC. In 2012, the FOMC issued a statement clarifying our longer-run goals and strategy, including an explicit 2 percent target for inflation. And the economic projections now include information about the policy path assumptions of participants.

These last two initiatives were based on the recommendations of a subcommittee on communications led by then Vice Chair Yellen, which included President Evans of Chicago, former Governor Raskin, and myself. This summer, Chair Yellen asked Vice Chair Fischer to lead a new subcommittee on communications, with Governor Powell, President Williams of San Francisco, and President Mester of Cleveland, to continue to find ways to improve communications.

Clearly articulating objectives

Let's consider how communications support each of the four principles of sound central banking, beginning with clearly articulating the objectives of monetary policy. But before doing so, it is useful to spell out exactly what the FOMC is supposed to do. The Federal Reserve Act specifies the Fed "shall maintain long run growth of the monetary and credit aggregates commensurate with the economy's long run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates." Since moderate long-term interest rates generally result when prices are stable, many have interpreted these goals as a dual mandate to manage fluctuations in employment in the short run while preserving price stability in the long run.

However, most economists are dubious of the ability of monetary policy to predictably and precisely control employment in the short run, and there is a strong consensus that monetary policy cannot determine employment in the long run. As the FOMC noted in its statement on longer-run goals adopted in 2012, the maximum level of employment is largely determined by nonmonetary factors, such as changing demographics, which affect the structure and dynamics of the labor market.

In my view, excessive focus on short-run control of employment weakens the credibility and effectiveness of the Fed in achieving its price stability objective. We learned this lesson most dramatically during the 1970s when, despite the extensive efforts to reduce unemployment,

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[1] See the Federal Reserve Bank of Philadelphia, "Timeline to Transparency," www.philadelphiafed.org/about-the-fed/transparency/ (accessed October 9, 2014).

the Fed essentially failed, and the nation experienced a prolonged period of high unemployment and high inflation. The economy paid the price in the form of a deep recession, as the Fed sought to restore the credibility of its commitment to price stability.

When establishing the longer-term goals and objectives for any organization, and particularly one that serves the public, it is important that the goals be achievable. Assigning unachievable goals to organizations is a recipe for failure. For the Fed, it could mean a loss of public confidence. I fear that the public has come to expect too much from its central bank and too much from monetary policy, in particular. We need to heed the words of Nobel Prize winner, Milton Friedman. In his 1967 presidential address to the American Economic Association, he said, "we are in danger of assigning to monetary policy a larger role than it can perform, in danger of asking it to accomplish tasks that it cannot achieve, and as a result, in danger of preventing it from making the contribution that it is capable of making."[2]

In my view, the dual mandate has contributed to a view that monetary policy can accomplish far more than it is, perhaps, capable of achieving. Even though the FOMC's 2012 statement of objectives acknowledged that it is inappropriate to set a fixed goal for employment and that maximum employment is influenced by many factors, the FOMC's recent policy statements have increasingly given the impression that it wants to achieve an employment goal as quickly as possible through aggressive monetary accommodation.

I believe that assigning multiple objectives for the central bank opens the door to highly discretionary policies, which can be justified by shifting the focus or rationale for action from goal to goal. That is why I have argued that Congress ought to redefine the Fed's monetary policy goals to focus solely, or at least primarily, on price stability. I base this on two facts: Monetary policy has a very limited ability to influence real variables, such as employment. And, in a regime with fiat currency, only the central bank can ensure price stability. Indeed, it is the one goal that the central bank can achieve over the longer run.

Setting clear, achievable objectives is part of the framework. Asking policymakers to pursue those objectives in a systematic, rule-like approach is the second key principle.

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. It is difficult for policymakers to choose a systematic rule-like approach that would tie their hands and thus limit their discretionary ability. Yet, economists have long been aware of the benefits of rule-like behavior. Dating as far back as 1936, Henry Simons discussed how rule-like behavior is preferable to pure discretion.[3] More recently, Finn Kydland and Ed Prescott in their Nobel Prize-winning work showed that a credible commitment by policymakers to behave in a systematic rule-like manner leads to better outcomes than discretion.[4] Since then, numerous papers using a variety of models have investigated the benefits of rule-like behavior in monetary policy and found that there are indeed significant benefits.

One of the reasons that rules work better than discretion is that they are transparent and therefore allow for simpler and more effective communication of policy decisions. Moreover, a large body of research over the last 40 years has emphasized the important role expectations play in determining economic outcomes. That means more effective

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2 See Milton Friedman, "The Role of Monetary Policy," *American Economic Review*, 58:1 (March 1968), pp. 1-17.

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

4 Finn E. Kydland and Edward C. Prescott, "Rules Rather Than Discretion: The Inconsistency of Optimal Plans," *Journal of Political Economy*, 85 (June 1977), pp. 473-491.

communication of the decision-making process leads to more accurate expectations. When policy is set systematically, the public and financial market participants can form more accurate expectations about policy. Policy is then less of a source of instability or uncertainty.

The appropriate way to make policy systematic, or rule-like, is to base policy decisions on observable economic conditions. That is, policymakers should describe the reaction function that determines how the current and future policy rate will be set depending on economic data. I want to emphasize that a reaction function does not mean a timetable or a threshold for action. Monetary policy should be data dependent, not date dependent. And the use of that data must recognize that policymakers are no more certain about future economic conditions than anyone else is. Thus, the future path of policy will always be highly uncertain. However, a reaction function should explain how the policy rate will be determined in the future as a function of economic conditions.

I also want to clear up some confusion about whether a reaction function is somehow mechanical. The science of monetary policy has not reached the point where we can specify a single optimal rule for setting policy and turn decision-making over to a computer. Judgment is still required. Because we do not know the true model of the economy, I would suggest the FOMC begin by considering and reporting on a set of robust policy rules designed to have good results in a variety of models and across various stages of the business cycle. Such robust rules recognize that data are measured imprecisely and are subject to revision.

By considering such robust rules, the FOMC might be able to move toward a consensus on a qualitative description of its reaction function as an important first step. For example, we would not have to specify the precise mathematical rule but would provide assessments of key variables and then communicate our policy decisions in terms of changes in these key variables. If policy were changed, then we would explain that change in terms of how the variables in our response function changed. If we choose a consistent set of variables and systematically use them to describe our policy choices, then the public will form more accurate judgments about the likely course of policy. That will reduce uncertainty, promote stability, and lead to greater transparency.

Increasing transparency

As I mentioned at the outset, communications has been the subject of considerable discussion in recent years. It took on heightened importance as the FOMC responded to the financial crisis and recession. Since December 2008, the federal funds rate target has been near zero. Since the nominal federal funds rate cannot go below zero, we had to develop alternative policy tools in an effort to provide further accommodation to support the recovery, such as the large-scale asset purchase program. We also had to figure out how and what to communicate about these new tools. The asset purchase program has had many dimensions, such as the overall volume of purchases, the pace of purchases, the kind of assets targeted for purchase, and the criteria for starting and stopping the purchases. Policymakers have tried to fine-tune the program along each dimension while assessing the tradeoffs among them and the tradeoffs with other policy tools, such as the traditional funds rate decision. With so many moving parts to our policy framework, it is not surprising that communication is very complicated and challenging.

The task was further complicated because one of the unconventional measures employed by the FOMC was so-called forward guidance. Forward guidance is the central banker's term for communications about the future path of policy. One way to think of forward guidance is that it is just another step toward increased transparency and effective communication of monetary policy. However, another rationale for forward guidance is that it is a way of increasing accommodation in a period when the policy rate is at or near the zero lower bound. Some models suggest that when you are at the zero lower bound, it can be desirable, or optimal, to indicate that future policy rates will be kept "lower for longer" than might otherwise be the case. In this approach, such a commitment would tend to raise inflation expectations and lower long-term nominal rates, thereby inducing households and businesses to spend more today.

This approach asks more of forward guidance than just articulating a reaction function. It takes more credibility and commitment because it requires policymakers to directly influence and manage the public's beliefs about the future policy path in ways that are different from how they may have behaved in the past. As I have indicated in previous speeches, this approach to forward guidance can backfire if the policy is misunderstood.[5] ***5*** For example, if the public hears that the policy rate will be lower for longer, it may interpret this news as policymakers saying that they expect the economy to be weaker for longer. If the message is interpreted in that way, then the forward guidance will not succeed and may even weaken current spending.

I believe we should think of forward guidance as part of systematic approach to decision-making and not an independent policy tool that attempts to bend expectations. As monetary policy becomes normalized, we have the opportunity to ensure the public understands that forward guidance is an integrated part of a systematic approach to policy.

So, what additional steps can we take to increase transparency? I think that the FOMC could improve communication and transparency by preparing a more comprehensive monetary policy report on a regular basis, perhaps quarterly. Currently, the Chair testifies before Congress twice a year and submits an accompanying written report. In addition, the Chair holds press briefings four times a year when participants present their economic projections. I think there is an opportunity to combine these efforts into a more comprehensive report on monetary policy as many other countries do. The report would offer an opportunity to reinforce the underlying policy framework and how it relates to current and expected economic conditions. Ideally, this report would incorporate a discussion of robust systematic rules I referred to a moment ago. Such a discussion would provide the opportunity to inform the public about the expected future path of policy conditioned on how the economy evolves.

Publishing a monetary policy report with an assessment of the likely near-term path of policy rates, in conjunction with its economic forecast, would also provide added discipline for policymakers to stick to a systematic, rule-like approach. Providing information about how that path is likely to evolve forces policymakers to think more deeply and systematically about policy. Communication about that path, in turn, gives the public a much deeper understanding of the analytical approach that guides monetary policy.

While I am discussing transparency, I also want to touch on another misconception. Some commentators express the view that dissent causes dissonance and therefore confuses the communications. In fact, letting the public know about our debates and differing views is more transparent than hiding behind false consensus.

Monetary policymaking is 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 they help to preserve the central bank's independence and accountability.

Open dialogue and diversity of views leads to better policy decisions and is the primary means by which new ideas are gradually incorporated into our monetary policy framework. Thus, I believe diversity of thought is a sign of thoughtful progress. I have often quoted the famous American journalist Walter Lippmann who said, "Where all men think alike, no one thinks very much." I think it is healthy for the American public to know that we debate some

[5] See Charles I. Plosser, "Forward Guidance," speech to the Stanford Institute for Economic Policy Research's (SIEPR) Associates Meeting, February 12, 2013, Stanford, CA.

of the same issues that those outside the Fed debate. Hiding such debate behind a unanimous vote does nothing to promote true transparency.

Preserving independence

Finally, I believe that the fundamental concept of a decentralized central bank has great merit, in part, because it helps to preserve the independence and maintain the public trust in the institution. Independence is essential if a central bank is to play its fundamental role in preserving the purchasing power of a fiat currency. History is replete with examples of governments using the power to print money as a substitute for making tough fiscal choices, and the results are almost always disastrous.

Central bank independence is a fundamental tenet of sound central banking and leads to better economic outcomes. But independence must be accompanied by accountability. And accountability is more easily achieved when there is transparency. The public can best hold a central bank accountable when its goals are clearly stated and achievable.

Transparent and clear communications of monetary policy goals and a decision-making framework help ensure accountability and preserve central bank independence. Transparency can also enhance a central bank's credibility. A central bank that is transparent will be less willing to make promises it cannot keep. When policy pronouncements are more credible, policy is more effective. Transparency can also make it easier to explain changes in policy without damaging the central bank's credibility.

Conclusion

To summarize, the FOMC is on a journey to improve communications and the transparency of its monetary policy decision-making process. The benefits of transparency are now accepted by policymakers across the globe. Transparency not only improves the effectiveness of monetary policy, it also improves the central bank's credibility and accountability with the public. The FOMC's recent moves to publish guidelines on its longer-run goals and policy strategy and the policy assumptions that underlie FOMC projections are great strides toward this goal. However, more can be done.

In particular, I believe the FOMC should continue to work toward increasing the public understanding of how policy will react systematically to changes in economic conditions. I believe the FOMC should move forward to describe a reaction function and then communicate our actions and decisions in terms of this reaction function. A detailed monetary policy report could be a useful vehicle for such enhanced communication.

Because systematic policy is easily communicated to the public, it will improve the transparency and predictability of monetary policy, which reduces policy surprises. Businesses and consumers are more informed about the course of monetary policy because they understand how policymakers are likely to react to changing economic circumstances even if they are not certain what those economic conditions might be. Equally important in my view is that greater clarity about policymakers' reaction function strengthens accountability. Thus, systematic policy, communicated transparently, strengthens accountability and serves to preserve the central bank's independence.