The Federal Reserve Board

Remarks by Vice Chairman Roger W. Ferguson, Jr.

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Why Central Banks Should Talk

It is my pleasure to address the Graduate Institute of International Studies. I would like to discuss the importance of transparency for central banks--in particular, why they should communicate clearly with markets and the public. I have been closely involved at the Federal Reserve with this interesting topic, and I believe it to be especially relevant for many central banks around the world. Of course, the usual disclaimer applies to my remarks: I will express my own views, and you should not interpret them as the position of the Federal Open Market Committee or of the Board of Governors.

As should be especially obvious to you, I intentionally chose the title for my talk today, "Why Central Banks Should Talk," to echo that of the influential pamphlet "How Do Central Banks Talk?," published just last year by the affiliated International Center for Monetary and Banking Studies (ICMB). The authors include my predecessor, Alan Blinder, together with Charles Goodhart, Philipp Hildebrand, David Lipton, and Charles Wyplosz. My presentation--and indeed my thinking in general about this topic--was significantly affected by their insights, even in places where I do not pause to acknowledge their work explicitly.

Any discussion of transparency must first define the concept. Most important, transparency relates to a central bank's openness in explaining the rationale behind its specific policy decisions. The rationale for policy actions cannot be fully understood unless the central bank is reasonably clear about its long-run objectives. That is, the monetary authority should be forthcoming about its strategic goals as well as about the short-term tactics that it uses to achieve them. Finally, the central bank needs to describe the economic environment in which it expects its actions to be felt.

I will explore three main topics on the subject of central bank transparency. First, I will briefly describe why the recent trend toward greater transparency is desirable. Second, I will discuss the general characteristics of openness in the context of the given goals and organization of central banks. Third, I will address various specific suggestions in a U.S. context for further increasing the transparency of monetary policy.

Reasons for Encouraging Transparency
Transparency is valuable and desirable for both political and economic reasons. As to the political consideration, it has become increasingly obvious over the years that a central bank needs a substantial insulation from political pressures to execute policy appropriately. Such an independent central bank is less likely to succumb to the short-run temptation to boost output or to finance national budgets at the expense of long-run objectives such as price stability. In part, this follows because independent central bankers can have a more-distant horizon than other policymakers, which is desirable given the lagged effects of monetary policy on output and prices. To be sure, the establishment of the goals of monetary policy

should take place within the democratic process, but experience teaches us that outcomes are better when the central bank has discretion to achieve those ends.

Thus, the elected representatives of the public should determine the goals of monetary policy, while a central bank should be granted independence to set its instruments. Central bank openness allows the public and its elected representatives to make informed judgments and constructive criticisms about policies made by its central bank and to assess economic outcomes relative to specified long-run objectives. In general, to hold policymakers accountable, the electorate needs to know what they have done and the reasoning behind their key decisions. Such democratic accountability is even more important for central bankers, because the voting populace does not directly elect them. In short, transparency is a quid pro quo for independence.

Clarity about policy decisions also can enhance monetary policy's economic effectiveness. Like other central banks, the Federal Reserve controls only a very short-term interest rate on borrowing reserve funds between depositories, the overnight federal funds rate. However, theory and empirical evidence indicate that longer-term interest rates and conditions in other financial markets matter most for the transmission of monetary policy to the economy. Those longer-term rates and other financial asset prices, in turn, reflect expectations of future short-term rates as well as premiums for uncertainty. If the monetary authority can be more open about what it is doing and why and about how it perceives the economic outlook, then market participants can improve their expectations of future short rates, bringing the interest rates and financial prices that matter most for the economy closer into alignment with the intentions of central bankers. Of course, those intentions are subject to uncertainty and to the constant flow of new information. But explaining decisions more fully allows market participants to better anticipate policy responses when unexpected developments take place. By accurately assessing the possible extent of policy reactions even before they occur, financial markets can speed needed economic adjustments. In sum, greater transparency allows policymakers to work with, and not against, the markets.

Recent Trends in Transparency

In the past and until recent years, central banks around the world operated largely in secrecy, which was mainly unquestioned. "Mystique" encapsulated much of the tradition and wisdom of the way central banks related to the public. But that was the past. The Federal Reserve and other central banks have become considerably more transparent recently.

For many years the FOMC published minutes of each meeting that gave the economic background and reasoning behind its policy decisions and the vote along with any dissenting statements. But these minutes were not released until shortly after the next FOMC meeting. Since 1993, the Federal Reserve has altered these practices in several ways. In February 1994, the FOMC began to disclose changes in its operating stance along with a brief rationale, though no formal announcement followed FOMC meetings in which no policy action had been taken. While this step immediately clarified the current stance of monetary policy, the Committee's views about prospective developments, especially its own "bias" or "tilt" concerning likely future policy actions, continued to be published only with a delay, as a part of the minutes after the next meeting. In 1999, the FOMC began to announce its "bias" immediately and subsequently worked toward further refining its disclosure practices. Under current procedures, which were announced in January 2000, the FOMC issues a statement to the public shortly after every meeting. The statement provides not only information and explanation regarding the policy stance adopted at the meeting but also the

Committee's view about prospective risks to the outlook.

That view is indicated by the Committee's sense of the balance of risks in the foreseeable future vis-à-vis its 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 the way, the Committee has made clear that economic weakness is not synonymous with economic contraction. The main risks can be weighted toward economic weakness if growth could fall notably below the economy's potential.

I wish to be clear that the balance-of-risks statement does not itself predict the future course of monetary policy but rather provides the FOMC's judgment about the risks going forward. Although this judgment may well have implications for policy should the risks be realized, it is investors who appropriately form their expected path of short-term interest rates from this and other parts of the announcement, along with a variety of other information. It is, to me, particularly important that policy decisions at each meeting of the FOMC be based on incoming data and the evolving outlook after the previous Committee meeting rather than on a commitment about future policy at the previous meeting. The distinction between a central bank's sense of risk in the outlook and its predilection regarding a future movement in the stance of policy is important. The first is appropriate, but the second leaves the erroneous impression that policy decisions are largely based on readings of the economy taken at the previous meeting.

These reforms to increase transparency originated from within the Federal Reserve System, as we looked for ways to reduce uncertainty and improve clarity. To be sure, congressional pressure was largely responsible for the release of verbatim transcripts of FOMC meetings, beginning in 1994. But to minimize the effects of such full disclosure on the deliberative process, the FOMC elected to delay the release of the transcripts for five years. More broadly, a critical aspect of our weighing of each incremental step toward greater transparency has been that it not impinge on free and open debate within the FOMC or otherwise detract from the Committee's responsibility to pursue its legislated mandate. During this period, the Federal Reserve's legal mandate has remained the same, and the basic operation of the FOMC has not changed. Also, none of these steps toward enhanced transparency has altered the FOMC's decisions about the appropriate course of policy.

This trend toward greater openness is clearly global but it has manifested itself in various ways. To briefly note just a few examples, the Bank of Japan has taken steps toward greater transparency, particularly after the revision of its governing law in 1998. It now issues press releases after all meetings, which are held twice a month. Also, the European Central Bank has incorporated transparency in its policy process and has emphasized the importance of communications. Otmar Issing, the Bank's chief economist and a member of its Executive Board, highlighted this issue with his characterization of communications as the "hidden pillar" of the ECB's monetary policy strategy. In the United Kingdom, the Bank of England Act of 1998 established the operational independence of the Bank and strengthened the transparency measures that had been implemented earlier in the 1990s, when the government formally announced a numerical inflation target.

In addition, the Reserve Bank of New Zealand now publishes forecasts for the future path of its short-term interest rate consistent with achieving its objective. Lately, some monetary authorities in emerging-market economies, namely the Bank of Mexico and the Central

Bank of Brazil, have announced both a long-run inflation target as well as an explicit "glide path" in the interim toward their respective goals.

General Issues Relating to Transparency
Greater transparency is a welcome development, but I would now like to note some general caveats. I will then address certain more recent specific suggestions to expand openness further, in many instances with explicit application to the Federal Reserve.

First, monetary policy effectiveness must be the top priority. Although I have just argued that transparency can indeed enhance the effectiveness of policy as well as a central bank's independence, transparency is not an overriding end in itself. Transparency should not determine the goals of monetary policy. Directly elected officials should choose monetary policy goals consistent with their view of what will best promote the nation's economic welfare. Transparency then should be designed to be consistent with the superceding purpose of meeting the macroeconomic objectives that the legislature or some other elected official has set.

Second, the organization of the central bank matters for the way transparency is carried out. For example, conveying monetary policy decisions and the central bank's views of the economic outlook depends on whether, at one extreme, a single decisionmaker determines policy or, at the other extreme, an "individualist" committee--that is, with each member taking primary responsibility for his or her vote--arrives at the decision. On the one hand, if a sole official determines policy, then the rationale for his or her decisions can readily be summarized. On the other hand, summarizing and communicating the opinions of the disparate participants on a committee are inherently more difficult. And one would not want pressure to come to an easily communicated common view to constrain the expression of individual opinions and to work against the diversity of opinion that is the strength of the committee structure.

Third, assuming that elected officials set the goals for monetary policy, the resulting regime affects how and what central banks communicate. For example, transparency with a currency board is less difficult than with a policy group with dual goals. With the former, the central bank or government merely needs to specify the currency to which local money is inflexibly pegged and publish its available reserves on a regular basis. The simplicity of the goal facilitates communication and provides a single focus for policy. However, in a regime with multiple objectives, central bank officials must try to be transparent with respect to more than one objective. In short, as others have noted, more-complicated mandates require more-intricate communication. In that case, clearly summarizing a balancing of the goals would be more difficult in a short announcement, requiring as well other vehicles for describing the basis for policy moves, such as the FOMC minutes and the semi-annual Report on Monetary Policy.

Recent Specific Suggestions about Central Bank Transparency
I would now like to turn to some recent specific recommendations for improved transparency, in some cases with respect to the Federal Reserve System. These include the quantification of the central bank's objectives, the publication of forecasts, and the earlier release of minutes.

First, a central bank, the argument goes, should adopt and explicitly reveal numerical goals for its objectives in order to facilitate holding the monetary authority accountable, to reduce uncertainty, and to anchor private expectations about such things as inflation trends and monetary policy decisions.

For example, many countries in recent years have set a single quantitative inflation goal. But, in my view, this approach has potential drawbacks. As I have noted on previous occasions, even in the case of a single inflation goal, the selection of a particular price index to guide policy is difficult, and the appropriate index and inflation value might change over time as the structure of the economy evolves and the pace and nature of technological advances vary. Inflation targets also present problems in the presence of supply shocks, such as large increases in oil prices, that may simultaneously increase the price level and decrease aggregate output. Most inflation-targeting central banks attempt to gain flexibility in such cases by focusing on core inflation, by having relatively wide target ranges, by stipulating "escape clauses" that allow inflation to diverge from the target for a while, or by aiming at inflation well in the future or at an average rate over the business cycle and thus allowing enough time for the effect of such shocks to have died down.

Despite such elements of flexibility, an inflation-targeting regime may still not typically attend sufficiently to output variation or financial stability. Furthermore, these elements of flexibility may not foster the credibility of the central bank any better than a system of multiple objectives. The longer the policy timeframe and the wider the band for an inflation-targeting regime, the lower credibility will tend to be. Similarly, the more often a central bank declares emergencies, uses escape clauses, or allows price increases to go unchecked, the less credibility it will engender. For both "flexible" inflation targeters and those central banks with multiple objectives, real credibility for achieving inflation or other goals must flow ultimately from performance, not from predetermined frameworks.

Certainly, numerical inflation targets have proven useful for several countries facing difficult situations--for example, providing a nominal anchor when inflation has been high or variable or when the countries are leaving a fixed exchange rate regime. In some cases, quantified inflation targeting has been a means of getting government agreement to allow the central bank to be more independent and to focus more intently on bringing inflation under control. Even so, credibility gains from inflation targeting, aside from those arising from actually achieving low inflation per se, have been hard to identify. Empirical evidence for industrial countries to date generally suggests that focusing policy on attaining an inflation target--or announcing numerically specified targets for multiple objectives, for that matter--does not lessen the short-run tradeoff between employment and inflation. Moreover, quantified objectives evidently are not a necessary condition for desirable economic outcomes. At least in countries that have already achieved reasonable price stability, I submit that the adoption of a numerical inflation target promises little, if any, incremental benefit.

When the central bank's mandate includes multiple goals, the quantification of objectives becomes even more problematic. For example, the Federal Reserve's mandate includes the long-run goal of maximum employment as well as price stability. How does one measure maximum sustainable employment? As several economists have noted, estimating the non-accelerating-inflation-rate of unemployment (NAIRU), one possible measure of a full-employment objective, is even more controversial than selecting a target for a specific price index. Associated estimates of an output or employment gap would have an uncomfortably wide confidence interval. Some economists doubt the validity of the concept of NAIRU altogether. Thus, the uncertainty involved with setting such a real-side target and the temptation to hold the central bank accountable for achieving any numerically specified unemployment goal at all times should discourage quantifying an unemployment target for those economies with that goal. In any event, historical evidence suggests that maximum employment is best attained in the long run by ensuring price stability and not by attempting

to achieve a pre-announced quantitative employment objective.

Of course, the central bank or government could quantify the inflation objective. But, under a dual mandate, quantifying one goal and not the other would present problems. I suspect that, if the inflation goal had a numerical target but employment did not, then a central bank would naturally tend to place more emphasis on the quantified goal at the expense of the non-quantified objective. In such a case, this particular suggestion to improve transparency--numerically pinning down only one objective--would end up driving the regime. The central bank indeed might want to place differing weights on particular goals, but ease of quantification should not be a determinant of those weights.

A second suggestion for improved transparency, distinct from quantified objectives, is that central banks should publish the forecasts that inform policy decisions. Historically, the Federal Reserve has recognized the importance of providing the public with background on its assessment of key underlying macroeconomic forces. Twice each year, the Federal Reserve provides to the U.S. Congress an extensive monetary policy report and accompanying testimony, which include the central tendencies of individual FOMC members' forecasts of key economic magnitudes over the next year or two.

Going beyond current practice to more frequent publication of further detailed forecasts has disadvantages that need to be recognized. Our understanding of the economy is inherently limited, and therefore central banks should not imply that they have more knowledge than they actually do. Markets might give too much credence to forecasts backed by central bank credibility, which would create noise and distort the signals from the markets back to the central bank. Point-estimate forecasts are especially susceptible to being quickly overcome by new information and becoming soon outdated. Besides, Committee members consult a wide range of forecasts in the process of reaching their monetary policy decisions. As I have already noted, we have succeeded in conveying after each FOMC meeting the main risks to satisfactory economic performance. The balance of risks is not a forecast but does add a forward-looking element to our statements.

Another challenge regards whether to release the staff's forecast. Monetary authorities do not necessarily agree with or act upon the forecasts of their staff. Therefore, publication of the staff forecast would give that outlook undue prominence and could potentially be misleading about policy intentions. Also, immediate public scrutiny could impinge upon the willingness of the staff to present forecasts that might prove controversial.

A third proposal that has been made is to accelerate the release of the minutes, specifically to publish them before the next FOMC meeting. Currently, the private reaction to the release of the minutes is muted, given that an intervening FOMC meeting and policy decision have occurred. If the release of the minutes, instead, came before the next meeting, then market participants would be more likely to react to two sources of information for each single meeting--first to the statement that immediately followed the policy action and then, some weeks later, to the minutes. The minutes should simply deepen and expand the rationale for a policy decision that was already given in the statement released immediately after the meeting. They might also indicate the existence and strength of contrary views. At the margin, some of this might be additional information. However, there is a risk that even such a marginal expansion of information could receive more weight than it warranted and foster misperceptions about the possible course of policy. Such misperceptions might result from a market misinterpretation of any one element of these minutes, which in turn could lead to an inappropriate reaction to incoming data. Additionally, minutes are not new information

about the performance of the economy. I believe that markets and policymakers are both best served if markets focus on, and react to, incoming data and the evolving outlook rather than the printed record of a past meeting released during the intermeeting period having limited, if any, predictive value for the upcoming meeting.

Conclusion

In conclusion, central bank transparency is obviously beneficial, and I strongly welcome the recent trend across the globe toward greater openness. Transparency supports central bank independence and helps markets formulate policy expectations that are more consistent with the monetary authority's intentions. I am pleased that the Federal Reserve has increased its transparency and am proud that I had the opportunity to contribute to some elements of that improvement. Central banks should continue to thoughtfully consider proposals to increase transparency.

Openness is intended to serve two goals--accountability and effectiveness of policy. Any proposal for greater transparency should be judged by how well those objectives are met. Our goal at the Federal Reserve regarding monetary policy transparency is to provide as much information as possible to understand the decisions that we have made. Some recent suggestions--including the quantification of objectives, the publication of forecasts, and the earlier release of minutes--present problems in that they could well detract from our ability to achieve our externally defined goals. While, on balance, I do not support some of the proposals made recently, certainly I believe that the Federal Reserve should be, and is, willing to consider ideas for greater transparency as they arise.