

# Transparency and Monetary Policy

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University of California, Santa Barbara Economic Forecast Project 2012

May 3, 2012

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

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**Introduction**

I am delighted to be here today and to participate in this event. I first met Peter Rupert nearly 30 years ago. He was a Ph.D. student at the University of Rochester when I was on the faculty there. We were both much younger then. So I was delighted to accept his invitation to come to Santa Barbara. It is also a pleasure to join my fellow presidents from the Atlanta District and from the home-team District of San Francisco. I guess that means I have to be nice to John so I will be allowed back into the District in the future.

I hope you will see that all three of us share many of the same perspectives even though we also have differing views at times. One of the important features of our nation's central bank is the strength that comes from the diverse views and experiences that the various presidents and Governors bring to the table as we grapple with sometimes very difficult and challenging decisions regarding monetary policy. The give and take of our discussions and the information we share regarding what is happening across our geographically and economically diverse nation lead to better informed and more thoughtful decisions. As we share these views with the public in the spirit of transparency, though, we must caution that we always speak for ourselves and not for the Federal Reserve System or our colleagues on the Federal Open Market Committee.

Today, I want to give you my outlook for the economy and then I want to spend time sharing some thoughts on the steps the Federal Open Market Committee, or FOMC, has taken to become more transparent about its goals and objectives.

Four times a year, each FOMC participant submits projections for real GDP growth, inflation, and unemployment. These projections are conditioned on the individual's views of what sort of monetary policy each believes is appropriate over the forecast horizon given current conditions. Last week, the Fed released the newest Summary of Economic Projections, or SEP. Obviously, with 17 different individuals, it is not surprising that there is a range of views.

So let me quickly summarize the projections offered for this year and next. The central tendency of annual real GDP growth in 2012 ranged from 2.4 percent to 2.9 percent and for 2013 the range was 2.7 to 3.1 percent. This suggests moderate growth this year, with some pick-up for 2013. The central tendency of the inflation projections was near 2 percent for 2012 and 2013. The projections for unemployment reflect some differences. Those projections have unemployment ranging from a low of 7.8 percent to a high of 8.0 percent by the end of 2012. Since the unemployment rate currently stands at 8.2 percent, having fallen nearly a percentage point since last August, the most pessimistic forecast says that we will not make much progress this year on further reducing unemployment. The more optimistic view seems to be that unemployment will continue to drift down gradually over the remainder of this year. As for the end of 2013, the central tendency widened somewhat from a low of 7.3 to a high of 7.7 percent. Again, some expect the unemployment rate to continue a moderate downward path while others are less sanguine. I think it is fair to say that the projections in April represented an upgrade in the near-term outlook compared to the January projections. Indeed, near-term output and inflation edged up and unemployment edged down.

My own views place me in the slightly more optimistic camp. My outlook is for about 3 percent growth in both 2012 and 2013. I predict that inflation will hover near or slightly above 2 percent over much of the period. My optimism is most evident in my

projections for the unemployment rate. I believe that it will continue to drift down gradually, reaching 7.8 percent by the end of this year and near 7 percent by the end of 2013.

But truth be told, as always, there remains a great deal of uncertainty in the outlook, despite all our models and talented economists. As physicist Niels Bohr once said: “Prediction is very difficult, especially if it is about the future.” Indeed, the Fed has no crystal ball that allows it to see into the future so we have to make policy decisions in the fog of uncertainty, just like everyone else. So I thought I would spend the rest of my time discussing steps the FOMC has taken to become more transparent in the way we conduct monetary policy in this uncertain world. While we cannot predict the future, we can and should clearly communicate our objectives and how we are likely to react to future events.

In January, the FOMC took two very important steps on its journey to improve transparency and, ultimately, accountability. The first step involves the information underlying our economic projections. Remember I told you that those projections were based on each policymaker’s view of the appropriate path for monetary policy. Prior to January, we did not reveal what those paths looked like. The Committee now summarizes the monetary policy assessments that underlie the economic projections of output, inflation, and unemployment. These assessments are what each individual policymaker views as the policy path that is appropriate in achieving the Fed’s longer-term goals. They are inputs into the policy deliberations that occur at FOMC meetings, but the ultimate policy decisions represent the collective judgment of the Committee members.

This addition of the policy assessments to the economic projections has two benefits. First, having more information on the underlying paths should help the public better understand the projections. For example, they will have a better understanding of

whether inflation is expected to return to the long-term goal as shocks work their way through the economy or whether policymakers anticipate that further monetary policy actions will be needed to achieve the Committee's objective.

Second, as views of appropriate policy in the SEP evolve over time as economic and financial conditions change, the public will be able to draw better inferences about the relation between current economic conditions, the economic outlook, and appropriate policy. This, then, informs the public about how policy is likely to react in the future to changes in the economy. For example, in April, the SEP indicated that only four participants now expect the first increase in the federal funds rate will occur after 2014, compared to six in the January projections. These projections of the policy path have changed as the central tendencies of the 2012 projections of growth and inflation were revised up and projections of unemployment were revised down, as I noted earlier.

We know that when monetary policy is conducted in a systematic way — with a systematic relationship between changes in economic conditions and the policy actions taken by the central bank — policy becomes more transparent and easier to communicate. And the better the public and the markets understand how policy is likely to be adjusted as the economy changes, the more predictable policy becomes, which promotes price stability and better economic outcomes. In addition, policy transparency can increase the public's ability to hold the central bank accountable for its policy decisions.

I have argued for some time that the FOMC should provide information about the factors that will influence its policy decisions. Some call this a policy rule or reaction function. This will not only enhance transparency but also impose an important discipline on policymaking. If policymakers choose to deviate from the guidelines, they are forced to explain why and when they anticipate returning to more normal operating

practices. Requiring this type of transparency raises the bar policymakers face to engage in discretionary policies in the first place.

Let me now turn to the FOMC's second, and perhaps more important, step toward clarity. In January, the Committee issued a statement of its long-term goals and strategy. The statement made four important points. First, the Committee reaffirmed its commitment to its mandated goals of maximum employment, price stability, and moderate long-term interest rates.

Second, the statement acknowledged what economists have known for over 200 years – that in the intermediate to longer run, inflation is a monetary phenomenon and is thus determined by monetary policy. Therefore, it is appropriate for the Fed to set an explicit long-run target for inflation. The target selected was 2 percent, as measured by the year-over-year change in the personal consumption expenditures chain-weighted price index. By being explicit about its numerical objective for inflation, the Fed enhances the credibility of its commitment to price stability. This helps anchor inflation expectations, thereby fostering price stability and moderate long-term interest rates. Another benefit of such an explicit objective is that it provides the public with a numerical metric by which it can, and should, hold the Fed accountable.

Of course, articulating an inflation target is now viewed as a best practice in central banking and is a key step in achieving the benefits of transparency.

The third important feature of the statement explained why it is not appropriate for the Fed to establish a numerical objective for the maximum employment part of its mandate. This is not because the employment part of the mandate is less important, but because the economic determinants of employment are different from those of inflation. Maximum employment is largely determined by factors that are beyond the control of monetary policy. These factors include such things as demographics,

technological innovations, and numerous government policies, including tax policy, minimum wage laws, unemployment benefits, and the like. All of these factors can and do vary over time. Thus, the maximum level of employment will vary. It is also difficult to measure and not directly observable. Moreover, different economic models often lead to different conceptual views of how to define maximum employment. Therefore, it is inappropriate for the central bank to set a numerical objective for something it does not control and cannot measure with any degree of certainty.

Finally, the statement pointed out that the goals of monetary policy are complementary over the longer run. Price stability promotes economic efficiency by giving households and businesses more confidence that the purchasing power of the dollar will not erode. This simplifies the decision-making of economic agents, allowing the economy to function more efficiently and more productively. Conversely, the failure to maintain price stability can often lead to greater instability in output and employment.

However, in the short term, it is possible that the maximum employment and price stability parts of the Fed's mandate could be in conflict. The statement makes clear that in such circumstances the Fed will pursue a balanced approach to promoting its objectives. Admittedly, this statement does not give much guidance as to how policy will be conducted, but I suggest that the public watch the assessments of the appropriate policy as viewed by policymakers in the SEP as an important source of information in this regard.

So the FOMC is taking important steps as it seeks to demystify monetary policy. Clarity and transparency are important for achieving our objectives, and I believe that the Committee will continue on this journey as it seeks to improve the clarity and effectiveness of its communications.