

Central Bank Transparency: Why and How?

“How Transparent Should a Central Bank Be?”

The Philadelphia Fed Policy Forum
Federal Reserve Bank of Philadelphia
Philadelphia, Pennsylvania
November 30, 2001

Since arriving at the St. Louis Fed, I’ve been asked a number of times what I found to be my biggest challenge. On the monetary policy side of my responsibilities, I reply without hesitation that my biggest challenge has been to explain policy to a number of different audiences. Given that experience, I believe that the transparency issue is not posed properly by the title of this session, “How Transparent Should a Central Bank Be?”; the issue for me is how in fact to be transparent and what being transparent really means.

I’ll divide my remarks into two sections. First, I’ll discuss why I think transparency is important. Second, I’ll consider the problem of deciding what actions and statements might improve transparency and how we might measure the success of steps to become more transparent. I must emphasize, however, that I do not have settled views on this subject and believe that there is much room for constructive development in this area. The topic is almost unexplored at an empirical level.

Before proceeding, I want to emphasize that the views I express here are mine and do not necessarily reflect official positions of the Federal Reserve System. I thank my colleagues at the Federal Reserve Bank of St. Louis, especially Bob Rasche, for their comments, but I retain full responsibility for errors.

WHY TRANSPARENCY?

Most discussions about transparency are conditioned by notions of accountability of public

officials in a political setting. Every democratic society struggles in the purgatory between the ideal of government responsive to citizen concerns and the practice of a messy process responsive to well-financed advocates. We are instinctively suspicious of secret deals because we fear that they will come at taxpayer expense or will benefit undeserving special interests. The experience of our democracy, and that of other democracies, demonstrates beyond any doubt that the fear of secret deals is justified. We believe that policy decisions in the public interest rather than in the private interest will lead to a healthier and fairer society.

I hasten to add, however, that as far as I know special interest motivations have not had an important bearing on U.S. monetary policy. Because monetary policy is a generalized policy instrument, it has inherently little scope for providing special benefits to narrow economic interests. I discussed some of these issues at greater length several years ago in a lecture entitled, “The Federal Reserve as a Democratic Institution.”

Transparency in a general sense simply means providing the fullest explanation possible of policy actions and the considerations underlying them, in as timely a manner as possible. An advantage of transparency in this sense, familiar to every teacher and researcher, is that the best way to be sure you understand an issue is to explain it to others in a class, a journal article, a lecture, or in meeting minutes. Transparency is a great spur to developing coherent views, and surely it is beneficial to policymakers to be coherent in their own thinking.

MONETARY POLICY AND INFLATION

I remember my concern in years past, before assuming my current position, that refusal of public officials to explain their actions often reflected their own sense that their views were not very well formed, rather than a need to hide unsavory motivations. I personally believe that my current sense of obligation to explain my views publicly is as much, or more, a benefit to me as to my listeners and readers. I regularly use my speeches as an opportunity to dig into a specific policy issue and to force myself to develop an opinion on a matter I really ought to understand thoroughly.

Most discussions of transparency do not seem to go much beyond a faith that “government in the sunshine” will yield the desired results. However, naive confidence in “sunshine” is surely inadequate. One issue is that policy meetings in the sunshine are simply different meetings than ones held confidentially. A different meeting in the sunshine is not necessarily a better meeting from the perspective of serving the public interest well.

Sunshine advocates expect sunshine meetings to differ from closed meetings in that policymakers are assumed not to cut deals contrary to the public interest when they meet in the sunshine. I do not know of a study of the subject, but my casual impression is that there is no evidence that there is less special interest legislation now than there used to be before enactment of various pieces of sunshine legislation, such as the Freedom of Information Act.

From an economist’s perspective, the issue of “Why transparency?” seems pretty straightforward. Put simply, policy actions affect the economy through expectations in the financial markets and in the economy more generally. What the FOMC does most directly is to set a target for the federal funds rate. Expectations about the level of that target in the future determine interest rates all along the yield curve. Expectations about how the Fed will respond to various possible events determine, among other things, the expected inflation rate. Assuming that the Fed has sound policy objectives, its success depends critically on market expectations and

market confidence. Those expectations will be more accurate and confidence more complete the more accurately the market understands what the Fed is doing.

I know of no finding in the macroeconomics literature that provides a theoretical case, or empirical support, for the view that confusion or uncertainty in the private sector about the direction of monetary policy serves to better achieve policy objectives. Indeed, in the rational expectations literature, inaccurate expectations about policy unambiguously create inefficiencies in the economy. I take this point seriously, and believe that it provides a compelling case for policymakers to provide as much information about policy as they possibly can. But I do want to reemphasize that a naive approach to disclosure can damage the deliberative process without providing information of genuine value to the markets.

HOW TO ACHIEVE TRANSPARENCY?

From what I’ve just said, the answer to “Why transparency?” is that we hope to achieve better policy results. But how to achieve greater transparency, or whether any particular step will be constructive, is far from simple.

Consider the possibility of televising FOMC meetings, so all can observe the proceedings. One issue is the mismatch between the technical level of the meeting and the knowledge of the audience. If I really want to convey information on a particular subject effectively, I’ll give a different lecture to a freshman economics class than to a graduate seminar. Monetary policy needs to be conducted at the highest possible technical level; a general audience is more likely to be confused than enlightened by watching an FOMC meeting live. Most viewers would get little out of watching a discussion of technical econometric issues—which do arise from time to time in FOMC meetings—and might well misinterpret such discussion. Perhaps we shouldn’t worry too much about this issue, as the audience for an FOMC meeting would probably be pretty small

after a few such episodes. I do not think we would compete very successfully with daytime television!

Of course, a televised FOMC meeting would not be the same meeting we hold today. For one thing, the deliberations could not include discussion of information obtained under pledge of confidentiality. Information from individual firms does play a useful role in policymaking, and the Fed could not obtain such information without maintaining its confidentiality. Moreover, there is ample evidence that people in televised meetings behave differently than those in closed meetings. Some participants might have a tendency to grandstand for the audience and to avoid discussing difficult or controversial issues. In a completely open meeting, it is hard for some participants to try out ideas and then admit that the arguments offered by others are better. It is particularly difficult to analyze unpleasant possibilities in public, such as that a particular policy action might have the effect of increasing the risk of recession.

Anyone who has held a policymaking position knows how important confidentiality issues are. The Federal Reserve faced a sudden and severe confrontation with this issue in October 1993, when information concerning the long-standing practice of taping FOMC meetings became public. Most FOMC members were unaware that the meetings were being taped; the published transcript of the FOMC conference call of October 15, 1993, demonstrates vividly the anguish and uncertainty about how to proceed. It is clear from that transcript that the members were unanimous in believing that quick release of meeting transcripts would severely inhibit free exchange of ideas and information and damage the deliberative process. Many members were concerned that release of transcripts even after a lag of three to five years would also be harmful.

I'm told—but have no firsthand knowledge—that after the taping of FOMC meetings became publicly known, the meetings changed significantly for a time. Members read from prepared statements and give-and-take discussion did not occur as readily as it had previously. During the time I've been in St. Louis, my impression is that

FOMC deliberations are extremely open and that issues are thoroughly explored. I do not think that disclosing the transcript with a five-year lag inhibits my discussion, and believe that to be the case for most other members as well. I also believe that the transcript provides a valuable record for scholars and I strongly support the current system of releasing lightly edited transcripts.

So, my answer to *why transparency* is that we expect better public policy outcomes from a transparent process, but the more I consider *how transparency*, the more difficult the issue seems. The current system of releasing the FOMC transcript with a five-year lag works well. I do not believe that monetary policy actions motivated by special interests were a problem in the first place, and so the transcripts have not had a bearing on that issue. But the transcripts have served to enhance knowledge of the policy decision process and that has been constructive.

Probably more important than the transcripts in recent years was the decision in February 1994 to release the policy decision promptly at the conclusion of each FOMC meeting. My colleagues in the St. Louis Fed research division and I have conducted some research on the effects of that step. The bottom line from this research is that prompt disclosure of policy actions significantly improved the accuracy of market forecasts of policy actions.

The FOMC began disclosing its so-called “bias” in 1999 and later revamped the language of that statement. Moreover, disclosure of the policy action is now accompanied by a short statement. I have not examined empirically the effectiveness of these steps and have an open mind as to whether they have in fact improved public understanding of policy actions or the accuracy of market forecasts of future policy actions. I think it important to maintain an empirical perspective on these issues, for there is no other way to decide whether a particular step in the name of transparency is in fact effective.

Differences in central bank disclosure practices offer a great opportunity to conduct research on how best to pursue an effort to increase transparency. Many policies and practices differ among

MONETARY POLICY AND INFLATION

the world's central banks. If we are to make genuine progress on determining what works and what doesn't with regard to disclosure, we need to dig into the research opportunity presented by these different disclosure practices.

I'll finish by mentioning two specific ideas for improving Fed transparency. One is that the Fed could announce an explicit inflation objective, expressed either as a point target or a target range. I have long believed that such a step would be useful, and I advocated an explicit inflation objective not too long after arriving in St. Louis. A number of other central banks have explicit inflation objectives; however, comparing U.S. and foreign inflation experience does not provide a convincing case that an announced objective is necessary to maintain a low rate of inflation. Thus, although I do favor an announced inflation objective, it is clear that an empirical case is not a decisive consideration; transparency issues can never be resolved entirely through empirical investigation.

A second specific suggestion is that the FOMC might consider reducing its end-of-meeting statement to relatively simple boilerplate language. This suggestion may appear to be a step backward, but the issue is that the current statement is open to a variety of market interpretations, and the uncertainty about exactly what the statement means may not be helpful to the cause of clear communication. Boilerplate language with a relatively few options might have, or come to have, a settled meaning that would reduce market uncertainty. This example is also interesting because it illustrates the general point I'm emphasizing that how transparency is not a simple issue.

In summary, the case for *why transparency* is clear. Transparency promotes accountability, improves market efficiency and probably improves the clarity of policymaking itself. *How transparency* is just plain hard. It is easy to find communications gaps, but not at all easy to fill them.