

THE FED'S ROAD TOWARD GREATER TRANSPARENCY

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The more fully the public understands what the function of the Federal Reserve System is, and on what grounds its policies and actions are based, the simpler and easier will be the problems of credit administration in the U.S.

—Federal Reserve Board, *Annual Report*, 1923 (p. 38)

The Making of Monetary Policy

Montagu Norman, the governor of the Bank of England from 1921 to 1944, reputedly took as his personal motto, “Never explain, never excuse.” Norman’s aphorism exemplified how he and many of his contemporaries viewed the making of monetary policy—as an arcane and esoteric art, best practiced out of public view. Many central bankers of Norman’s time (and, indeed, well into the postwar period) believed that a certain mystique attached to their activities and that allowing the public a glimpse of the inner workings would only usurp the prerogatives of insiders and reduce, if not grievously damage, the effectiveness of policy.

Norman’s perspective on central banking now seems decidedly quaint. Over the past few decades, central banks around the world

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have worked assiduously to become more open about their activities. In fact, Norman's own institution, the Bank of England, has in recent years been a leading exponent of increased transparency in central banking. Monetary policymakers have adopted a range of methods to improve their communication with the public, including timely announcements of policy actions, expanded testimony before members of the legislature, the release of minutes of policy meetings, frequent public speeches, and the regular publication of reports about the economy and monetary policy. This increased openness is a welcome development for several reasons. Most importantly, monetary policymakers are public servants whose decisions affect the life of every citizen. Consequently, in a democratic society, they have a responsibility to give the people and their elected representatives a full and compelling rationale for the decisions they make. Good communications are a prerequisite if central banks are to maintain the democratic legitimacy and independence that are essential to sound monetary policymaking.

In addition, a considerable amount of evidence indicates that central bank transparency increases the effectiveness of monetary policy and enhances economic and financial performance in several ways. First, improving the public's understanding of the central bank's objectives and policy strategies reduces economic and financial uncertainty and thereby allows businesses and households to make more-informed decisions. Second, if practitioners in financial markets gain a better understanding of how policy is likely to respond to incoming information, asset prices and bond yields will tend to respond to economic data in ways that further the central bank's policy objectives. For example, if market participants understand that arriving information about the economy increases the likelihood of certain policy actions, then market interest rates will tend to move in a way that reinforces the expected actions, effectively supporting the goals of the central bank. Third, clarity about the central bank's policy objectives and strategy may help anchor the public's long-term inflation expectations, which can substantially improve the efficacy of policy and the overall functioning of the economy. Finally, open discussion of the central bank's analyses and forecasts invites valuable input and feedback from the public.

The benefits of an open and accountable policymaking process have spurred the Federal Reserve, along with other major central

banks, to take a number of actions over the years to increase its transparency. Appropriately, given the unique position of the Federal Reserve and the sensitivity of financial markets to its communications, these steps have generally been incremental in nature; but, taken together, they have substantially increased the ability of the American public to understand and to anticipate monetary policy decisions.

The Congress has also long been aware of the importance of Federal Reserve transparency and accountability. In particular, a series of resolutions and laws passed in the 1970s set clear policy objectives for the Federal Reserve and required it to provide regular reports and testimony to the Congress.¹ Since 1975, the Federal Reserve has presented testimony twice each year to the Congress on the conduct of monetary policy. These semiannual presentations have become an important vehicle for the U.S. central bank to make known its views on the outlook and on the appropriate stance of policy. Other notable milestones in the Federal Reserve's progress toward greater openness include: in 1979, the first release of semiannual economic projections; in 1983, the first publication of the Beige Book, which summarizes information about economic conditions received from the Federal Reserve System's business contacts; in 1994, the decision to release a postmeeting statement when policy actions had been taken; in 2000, the beginning of the practice of issuing a statement after each meeting of the Federal Open Market Committee and including in the statement an assessment of the balance of risks to the Committee's objectives; in 2002, adding the FOMC roll call vote to the postmeeting statement; and in 2005, the speeding up of the release of the minutes of FOMC meetings, from a delay of some six or seven weeks to just three weeks.

In testimony to the Congress at the time of my nomination as chairman, in 2005, I pledged to continue the trend toward greater openness sustained under Chairman Greenspan. In so doing, I stressed the importance of continuity with the policies and strategies that have served the American economy well. Any further changes, I promised, would come only pursuant to a consensus within the FOMC that those changes would enhance the Committee's ability to

¹The key measures were the House Concurrent Resolution 133 in 1975, the Federal Reserve Reform Act of 1977, and the Full Employment and Balanced Growth Act of 1978 (the Humphrey-Hawkins Act).

pursue its dual mandate of achieving maximum employment and price stability.

Toward that end, the FOMC has engaged in extensive deliberations over the past year or so to consider further steps toward greater transparency. Guided by a subcommittee chaired by Board Vice Chairman Donald Kohn, the FOMC reviewed the full range of our communications with the public.² As indicated in a statement issued by the FOMC today, these discussions have led to a decision to increase the frequency and expand the content of the publicly released economic projections that are made by Federal Reserve Board members and Reserve Bank presidents. As I mentioned, the Federal Reserve has published economic projections for almost 30 years, and, indeed, the Federal Reserve was the first major central bank to release such projections.³ Today's announcement builds on that foundation. In the remainder of my remarks I will describe the changes that we plan to make, and then explain why I believe that, collectively, they represent an important further step toward greater transparency.

Toward More Informative Economic Projections

Because monetary policy affects spending and inflation with a lag, policy decisions must be based on an assessment of medium-term economic prospects. Thus, the Committee cannot fully explain its policy decisions without sharing its economic outlook with the public and the Congress. To provide more-timely information about the evolving outlook, the Federal Reserve will release FOMC participants' economic projections four times each year, rather than twice each year as we have done previously.

Projections will continue to be released in February and July of each year to coincide with the semiannual Monetary Policy Report and the associated testimony to the Congress. Two additional sets of projections will be published in conjunction with the minutes of the FOMC meetings held around the beginnings of the second quarter and the fourth quarter of the year (in 2008, the April and October

²Gary Stern, president of the Federal Reserve Bank of Minneapolis, and Janet Yellen, president of the Federal Reserve Bank of San Francisco, were the other members of the subcommittee.

³Economic projections were first published in 1979 to fulfill the Board's legislated requirement to report on "prospects for the future."

meetings). The first expanded set of projections will be released next week, on November 20, together with the minutes of the October FOMC meeting. The horizon of the projections will be extended from two years to three. The projections released next week will extend through 2010.⁴

Each of the participants in the FOMC meeting—including the Federal Reserve Board members and all the Reserve Bank presidents—will, as in the past, provide projections for the growth of real gross domestic product (GDP), the unemployment rate, and core inflation (that is, inflation excluding the prices of food and energy items). In addition, participants will now provide their projections for overall inflation. Both overall and core inflation will continue to be based on the price index for personal consumption expenditures (PCE).⁵

Projections will continue to be made independently by each FOMC participant under the assumption of “appropriate” monetary policy, that is, the future evolution of the federal funds rate judged by that participant to be the one most likely to foster economic outcomes that satisfy the Federal Reserve’s dual mandate. Following past practice, we will publish the central tendency and the range of the projections for each variable and each year.⁶ We will also publish a comparison with the previous set of quarterly projections, a chart showing central tendencies and ranges for each variable, and charts showing the distribution of participants’ projections and how that distribution has changed since the previous release.

Accompanying the numerical projections will be a discussion—a projections “narrative” if you will—that summarizes participants’ views of the major forces shaping the outlook, discusses the sources of risk to that outlook, and describes the dispersion of views among policymakers. By providing a medium-term perspective, the narrative will complement the discussion of shorter-term developments contained in the minutes. We will also provide qualitative information

⁴The projection period of the first three releases each year will cover the current year and the subsequent two years. The fourth release each year will add a year to the projection horizon. Thus, the first three sets of projections in 2008 will be for the period 2008 through 2010, whereas the fourth set of projections will extend to 2011.

⁵Participants will no longer provide projections for the growth of nominal GDP. These now seem relatively less useful to the public, given participants’ projections for real GDP growth and overall inflation.

⁶The range for each variable in a given year includes all participants’ projections, from lowest to highest, for that variable in the given year. The central tendencies exclude the three highest and three lowest projections for each variable in each year.

about participants' views on both the uncertainty and the balance of risks surrounding the outlook, together with quantitative historical information on the typical range of projection errors.⁷ Of course, the specific material provided and its form of presentation may change over time as we gain experience and receive feedback.

Benefits of the Enhanced Projections

The enhanced projections will provide the public with several types of useful information. In particular, I find it helpful to think of the projections as functioning in three different ways: as a forecast, as a provisional plan, and as an evaluation of certain long-run features of the economy.

Most obviously, the projections reflect the economic forecasts of FOMC participants and as such should provide the public with greater and more-timely insight into the Committee's views of the economic outlook and the risks to that outlook. Of course, because our knowledge of the structure of the economy is incomplete and future economic disturbances are often unforeseeable, economic forecasting is a highly uncertain enterprise.⁸ The only economic forecast in which I have complete confidence is that the economy will not evolve along the precise path implied by our projections. Nevertheless, as I have already noted, because policy affects spending and inflation with a lag, Committee members have no choice other than to make medium-term forecasts—provisional and subject to uncertainty though they may be. Providing more information about these forecasts, including discussions of the factors underlying the forecasts and of FOMC participants' assessments of the risks to the Committee's objectives, should improve the public's understanding of the rationale for the current stance of monetary policy and any changes to that stance. The public will also be better able to judge the extent to which the Committee's rationale is reasonable and persuasive.

The projections also function as a plan for policy—albeit as a rough and highly provisional one. As I mentioned earlier, FOMC participants will continue to base their projections on the assumption of “appropriate” monetary policy. Consequently, the extended

⁷A Board staff paper discussing the historical forecasting record of the Federal Reserve and other institutions will be released on November 20, simultaneously with the release of the expanded projections.

⁸The historical data we will provide on forecast errors will starkly illustrate this point.

projections will provide a sense of the economic trajectory that Committee participants see as best fulfilling the Federal Reserve's dual mandate, given the initial conditions and the constraints posed by the structure of the economy. To illustrate, consider the question of the length of time over which a central bank should aim to restore price stability following an unwanted increase in inflation. A central bank that places weight on both employment and price stability, like the Federal Reserve, would not attempt to disinflate immediately or establish a fixed time frame for the restoration of price stability. Rather, the optimal expected time required for completing the disinflation would depend on a host of factors, including the size of the initial deviation from price stability, the initial state of the real economy (for example, the level of unemployment), whether the rise in inflation resulted from transitory or more persistent sources, the extent to which inflation expectations are well anchored, and so on. In circumstances in which disinflationary policy is necessary, the extended economic projections would make clear that the Federal Reserve is committed to maintaining price stability, but they would also provide some indications about what the Committee views as the most appropriate pace of disinflation, given the state of the economy and the requirements of the dual mandate. In like fashion, the speed at which policy aims to return the economy to its sustainable rates of growth and employment following a period of resource slack should depend in part on the nature and extent of inflation risks, among other considerations. More generally, the extended projections will convey additional information about the Committee's policy strategies and thus help augment the Committee's transparency, predictability, and accountability.

Finally, the extended projections will embody information about FOMC participants' evaluations of certain long-run features of the economy, evaluations determined both by the economy's structure and by the Committee's policy objectives. Because of the extension of the projection horizon to three years, participants' inflation projections will convey more information regarding their views about the measured rate of inflation that, in the long run, is consistent with the Committee's dual objectives of maximum employment and price stability. Were price stability the only objective mandated for the Federal Reserve, the FOMC presumably would strive to achieve zero inflation, properly measured—that is, the optimal measured

inflation rate would deviate from zero on average only by the amount of the estimated measurement error in the preferred inflation index. But under the Federal Reserve's dual mandate, the determination of the appropriate long-run inflation rate must take account of factors that may affect the efficient functioning of the economy at very low rates of inflation, such as the risk that the zero lower bound on nominal interest rates might hinder the effectiveness of monetary policy. Thus, the (properly measured) long-run inflation rate that best promotes the dual mandate is likely to be low but not zero.

Ultimately, households and businesses care about the overall, or "headline," rate of inflation; therefore, the FOMC should refer to an overall inflation rate when evaluating whether the Committee has met its mandated objectives over the long run. For that reason, the Committee has decided to publish projections for overall inflation as well as core inflation. In its policy statements and elsewhere, the Committee makes frequent reference to core inflation because, in light of the volatility of food and energy prices, core inflation can be a useful short-run indicator of the underlying trend in inflation. However, at longer horizons, where monetary policy has the greatest control over inflation, the overall inflation rate is the appropriate gauge of whether inflation is at a rate consistent with the dual mandate.

FOMC participants will continue to couch their inflation projections in terms of PCE inflation, rather than, say, inflation as measured by the consumer price index, because the PCE index is generally thought to provide the single most comprehensive and theoretically compelling measure of consumer prices. That said, no single measure of inflation is perfect, and the Committee will continue to monitor a range of measures when forming its view about inflation prospects.

The lengthening of the projection horizon will also allow the public to infer more about FOMC participants' current judgments about the rate of GDP growth and the unemployment rate that the economy can sustain in the long run. Over time, effective monetary policies foster rates of growth and unemployment close to their long-run sustainable rates. However, in contrast to inflation, which in the long run is determined by monetary policy, the rates of economic growth and unemployment that can be sustained in the long run are determined by many factors outside the control of central banks. Among these factors are the advance of technology, entrepreneurial activities, the growth in the size of the labor force, the rate at which workers acquire new skills,

tax and regulatory policies, and the efficiency of labor markets in matching workers with positions. Consequently, the long-run sustainable rates of economic growth and unemployment should be viewed as constraints on what monetary policy can achieve and not as variables that policymakers can freely choose. In addition, estimates of sustainable rates of growth and unemployment have been shown to be highly uncertain at any point in time; and they may vary significantly over time in light of new information and changes in the structure of the economy. Thus, the longer-run projections of growth and unemployment should be treated with considerable caution.

Relationship to Inflation Targeting

As you may know, I have been an advocate of the monetary policy strategy known as inflation targeting, used in many countries around the world. Inflation targeting is characterized by two features: an explicit numerical target or target range for inflation and a high degree of transparency about forecasts and policy plans. The steps being taken by the Federal Reserve, I must emphasize, are intended only to improve our communication with the public; the conduct of policy itself will not change. Nonetheless, in light of the changes to communications we are undertaking, one might fairly ask how the Federal Reserve's approach relates to inflation targeting.

A superficial drawback of inflation targeting is its very name, which suggests a single-minded focus on inflation to the exclusion of other goals. In fact, the practice of monetary policy in an inflation-targeting regime is not necessarily inconsistent with a dual mandate such as that given to the Federal Reserve. Indeed, most if not all inflation-targeting central banks today practice "flexible" inflation targeting, meaning that they take account of other economic goals besides price stability—notably economic growth, employment, and financial stability—when making policy decisions. Moreover, a broad consensus exists among central banks, whether they have an explicit numerical target for inflation or not, that maintaining low and stable inflation over time is the best means by which monetary policy can promote economic efficiency and maximize the nation's economic welfare. Thus, at least since the stabilization of U.S. inflation in the 1980s, the Federal Reserve's approach to monetary policy has had much in common with that of central banks that describe themselves as inflation targeters.

Nevertheless, some aspects of inflation targeting may be less well suited to the Federal Reserve's mandate and policy practice. In particular, although inflation-targeting central banks certainly pay attention to economic growth and employment, their formal accountability is often largely couched only in terms of a price-stability objective. Likewise, the communication strategies of inflation-targeting central banks tend to be focused on the formal inflation objective and the horizon over which that objective will be achieved. As I have emphasized today, the Federal Reserve is legally accountable to the Congress for two objectives, maximum employment and price stability, on an equal footing. My colleagues and I strongly support the dual mandate and the equal weighting of objectives that it implies. Of course, as I have discussed, the Federal Reserve's influence over these objectives differs importantly in the long run: Monetary policy determines the long-run inflation rate, whereas the factors that influence the sustainable rates of growth and employment in the long run are largely outside the central bank's control. Still, over time, monetary policy must strive to foster rates of growth and employment close to their long-run sustainable rates. The Federal Reserve must thus be accountable for the effects of its policies on the real economy as well as on inflation. The enhanced projections that I have described today will provide additional information pertinent to both halves of the Federal Reserve's mandate.

At a more technical level, the Federal Reserve differs from most inflation-targeting central banks in that it provides information about the independent projections of Committee members rather than a single collective forecast. To some extent, that difference reflects the relatively large size of the FOMC and the geographic dispersion of Committee participants. Those factors would make the development of a detailed consensus forecast quite difficult as a practical matter. But, as I will discuss briefly, such a diversity of viewpoints can enhance the quality of policy decisions.

The Diversity of the Committee

An important strength of the Federal Open Market Committee is its diversity. The Board members and Reserve Bank presidents who sit around the table at each meeting of the FOMC bring a wide range of perspectives to the deliberations that reflect the par-

ticipants' professional backgrounds, the regions of the country with which they are most familiar, and their differing approaches to economic and policy analysis. The task participants face at each meeting is to forge a rough consensus regarding the outlook, the risks to the Committee's objectives, and the appropriate policy response. Of course, it is not always possible—indeed, it would be rather unusual—to come to a set of conclusions that fully represent the views of every participant. But the process of searching for common ground is itself an important aspect of how the Committee operates. Diversity of views drives the Committee to adopt an eclectic approach and thus serves to limit the risk that a single viewpoint or analytical framework might become unduly dominant.

The changes to the projections process announced today preserve the important role played by this diversity of perspectives. As I have noted, Committee participants will continue to produce individual projections that reflect their judgments about the state of the economy and their approaches to policy. From the internal perspective, I expect the more frequent sharing of projections and the additional information they contain will improve our discussions and policy debates. From the external perspective, the public will gain additional and more frequent information about both the central tendencies and diversity of participants' views. In particular, the additional narrative material that will accompany the numerical projections will illuminate both the consensus of opinion and the differences in judgments that may emerge.

Conclusion

The communications strategy of the Federal Reserve is a work in progress. I believe that the changes announced by the FOMC today are an important advance: The changes will provide a more-timely insight into the Committee's outlook, will help households and businesses better understand and anticipate how our policy decisions respond to incoming information, and enhance our accountability for the decisions we make. But the changes are also evolutionary, in that they build on long-established practices. In that respect, they represent just one more step on the road toward greater transparency at the Federal Reserve. The Committee will continue to look for ways to improve the accountability and public understanding of U.S. monetary policymaking.

Reference

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