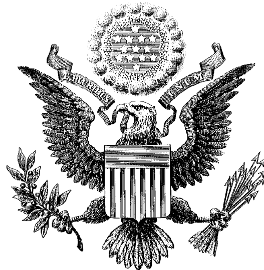
Transparency and Federal Reserve Monetary Policy



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Executive Summary

Today's changing financial environment requires more transparent Federal Reserve monetary policy. Such transparency would help to establish understandable rules and procedures, to eliminate unnecessary market uncertainties and volatility, and to minimize the costs of anti-inflation monetary policy.

Transparent monetary policy is characterized by openness and a lack of secrecy and ambiguity. Transparency is multi-dimensional and includes the clarification of policy goals, of policy procedures, and the timeliness in reporting policy decisions.

More transparent monetary policy has a number of advantages. It can work to (1) clarify policy objectives, (2) improve the workings of financial markets, (3) enhance central bank credibility, (4) reduce the chances of monetary policies manipulation for political purposes, (5) foster better monetary policymaking, and (6) complement congressional monetary policy oversight responsibilities.

Recently, many central banks have recognized these advantages and have moved toward making their monetary policies more transparent. The Federal Reserve has made some progress on this front but generally has lagged behind some other central banks. The Federal Reserve could move toward a more transparent policy by:

- adopting explicit inflation targets,
- reporting more frequently to the Congress,
- releasing information earlier, and
- providing more information to the public.

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TRANSPARENCY AND FEDERAL RESERVE MONETARY POLICY

INTRODUCTION

Today's changing financial environment demands more transparent Federal Reserve monetary policy. Such transparency would help to establish understandable rules and procedures, to eliminate unnecessary market uncertainties and volatility, and to minimize the costs of anti-inflation monetary policy. Two reasons underscore the need for greater transparency.

First, previous commodity-based monetary standards anchored the price system and established well-understood, automatic rules governing central bank actions.[1] Until the demise of the (Bretton Woods) commodity-linked international monetary system in the early 1970s, the actions of the central bank were predictable in given circumstances, obviating the need for explicit delineation of objectives and operating procedures.

Today, no monetary standard or price anchor has emerged to replace the previous system's rules. As a result, both the goals of monetary policy and the principles that govern policy remain unclear. This uncertainty makes financial markets more volatile and anti-inflation monetary policy more costly than necessary.

Second, monetary policy transparency can make financial markets less volatile and can help them better reflect relevant information for monetary policy. Milton Friedman recognized the relationship between the information revolution and the disciplinary role of financial markets:

> The information revolution has greatly reduced the cost of acquiring information and has enabled expectations to respond more promptly and accurately to economic disturbances, including changes in government [monetary] policy. As a result, both the public at large and financial markets have become far more sensitive to inflation and more sophisticated about it than in earlier times.[2]

Because of this phenomenon, central banks are increasingly obliged to pay more attention to, respond to, and in effect be disciplined by inflationary signals in the foreign exchange, commodity, and bond markets. Many central banks have found that increased transparency improves the efficiency of financial markets and, therefore, enhances their usefulness for market participants as well as for the central banks themselves. Recognizing transparency's benefits, these central banks

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[1]See J.M. Keynes, *Treatise on Money: The Applied Theory of Money*, MacMillan, London, 1971, p. 207.

[2]See Milton Friedman, "Monetary Policy in a Fiat World," in *Money Mischief*, Harcourt Brace Jovanovich, New York, 1992, pp. 254-5 [parenthesis added].

not only have adopted explicit goals in the form of inflation targets but have also improved their reporting of progress in achieving these targets, of procedures and indicators used in conducting policy, and of policy decisions. The Federal Reserve has also made some progress on this front but generally has lagged behind several other central banks.

The U.S. Congress, of course, has an inherent interest in and responsibility for increased Federal Reserve transparency because of its oversight responsibilities for monetary policy. By enforcing greater transparency in the form of mandated explicit policy goals and improved reporting requirements, Congress' oversight responsibilities would be simpler and less burdensome. Congress can learn from these developments and international experience, in effect delegating a portion of oversight responsibility to the financial markets and allowing them to play a larger disciplinary role.

After defining transparency and describing reasons for and consequences of traditional central bank secrecy, this paper presents the case for increased Federal Reserve transparency. Historical improve-ments in Federal Reserve transparency are documented, and comparisons to other central banks are made. Several forms of transparency are delineated and specific recommendations for improved transparency are described.

DEFINITION OF TRANSPARENCY

Dictionaries define "transparency" as easily seen through or detected; obvious, candid or open, clear; free from guile. A transparent monetary policy is characterized by lack of secrecy, obfuscation, or ambiguity, and should be understandable to those outside the policy process including both ordinary citizens as well as legislators responsible for policy oversight.

The concept of transparency for monetary policy has multiple dimensions. Transparency is relevant for policy goals as well as for policy procedures or "policy apparatus"; i.e., the instruments, indicators, and procedures used in conducting policy to attain given policy goals. Goal clarification, however, is the more important component of a transparent monetary policy since such clarification helps to identify which instruments, indicators, and procedures are best suited to achieve stated objectives. If price stability is identified as the proper goal of monetary policy, for example, then the policy instruments, indicators, and procedures chosen should maximize the probabilities of achieving this goal. Different goals may necessitate different variables for these purposes. Notably, one of the lessons of international inflation targeting experience is that successful central banks focus more on goal clarification than on explanation of policy procedures.[3] Nonetheless, markets work better when more information is available, when policy goals are well known, and when central bank reactions to indicator variables are understood.

[3] See Robert E. Keleher, *Lessons From Inflation Targeting Experience,* A Joint Economic Committee Report, February 1997.

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Timeliness is another dimension of transparency. Prompt disclosures of policy objectives, of progress in achieving these goals, and of procedures used in implementing policy are important elements of an open monetary policy. Transparent monetary policy, therefore, necessarily involves not only the clarification of objectives, but the timely and more complete disclosure of policy decisions and their underlying rationale.

CENTRAL BANK SECRECY

The historical reluctance of central banks to become open and transparent is well known. Many journalists, academics, and Members of Congress have recognized that secrecy and ambiguity are part of the culture of central banks.[4] Furthermore, recent research has demonstrated that the Federal Reserve has considerable information about important policy variables beyond what is known to commercial forecasters, suggesting that current policy is not transparent in nature.[5]

The Federal Reserve, for example, has explicitly defended secrecy, opposed full disclosure, and (historically) objected to inflation targets.[6] The argument has been that fuller disclosure would promote unnecessary volatility in financial markets, benefit certain speculators, and interfere with the execution of monetary policy. More fundamentally, historical central bank opposition to transparency seemingly relates to a distrust of market mechanisms stemming from the original lender-of-last-resort function of central banks, as well as to bureaucratic rent seeking behavior on the part of central bankers in order to protect their privileged monopolistic position while avoiding accountability.[7]

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[4]See Marvin Goodfriend, "Monetary Mystique: Secrecy and Central Banking," Journal of Monetary Economics 17, 1986, pp. 63-92, and references cited therein.

[5]See, for example, Christina D. Romer and David H. Romer, "Federal Reserve Private Information and Behavior of Interest Rates," NBER Working Paper 5692, July 1996.

[6]See Goodfriend, op. cit., for a review and analysis of the Federal Reserves' defense of secrecy. See also Robert E. Keleher, "The Pros and Cons of an Immediate Release of the FOMC Directive," unpublished memo, Federal Reserve Bank of Atlanta, June 1984. For documentation of Federal Reserves' historical opposition to inflation targets, see Irving Fisher, *Stable Money*, Aldephi Co., NY, 1934.

[7]For an analysis of bureaucratic incentives for covertness, see John F. Chant and Keith Acheson, "The Choice of Monetary Instruments and the Theory of Bureaucracy," Central Bankers, Bureaucratic Incentives, and Monetary Policy, edited by Eugenia Toma and Mark Toma, Kluwer Academic Publishers, Boston, 1986, pp. 107-128 (esp. pp. 109-11).

The original lender-of-last-resort (LOLR) function of central banks was premised on a belief in the inability of market mechanisms to prevent contagious bank runs causing contractions of the money supply and economic activity. Earlier provision of LOLR services involved the use of the discount window which necessarily involved proprietary information about individual bank loans and the individual portfolios of banks. Part of the responsibility of the LOLR was to maintain public confidence in the banking system while at the same time protecting the proprietary information of troubled banks. This function contributed to the culture of central bank secrecy which continues to this day.

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CONSEQUENCES OF SECRECY

Secrecy on the part of central banks such as the Federal Reserve has important consequences. The lack of an understandable price stability objective, for example, often results in multiple, alternating policy goals, producing unnecessary uncertainties and fostering volatility in financial markets. As a result, these markets react to any news suggesting the Federal Reserve is shifting policy objectives. Financial markets also respond to policy moves or statements of Federal Reserve officials since this information provides further clues as to Federal Reserve policy objectives as well as to its "economic model" or "policy apparatus." Therefore, uncertainty premiums build into interest rates causing them to be higher than would otherwise be the case. Furthermore, without a specific understandable policy objective, the central bank cannot be held accountable for its actions, and its credibility suffers. This deterioration of credibility raises the costs of disinflationary monetary policy.

Secrecy of the monetary policy process and policy indicators also promotes increased financial market uncertainty, unnecessary volatility, and, accordingly, larger uncertainty premiums in interest rates. Since markets are unsure as to what variables are used as policy indicators and what weights various data are accorded, markets react to any data releases they believe will influence Federal Reserve behavior.

Partly as a result of recognizing these consequences, much of the rationale for central bank secrecy recently has been discredited by the force of logical argument as well as by empirical evidence.[8] Some central banks themselves have recognized the value of transparency.

THE CASE FOR TRANSPARENT MONETARY POLICY

Establishing understandable monetary policy goals, informing the public about policy decisions in a timely fashion, and explaining how other variables are employed in the policy process have a number of advantages which work to improve monetary policy. Recognizing these advantages has prompted the central banks of several countries to adopt more transparent approaches to monetary policy. Specifically, a more transparent policy approach would make a number of contributions to Federal Reserve monetary policy, to the economy, and to financial markets. Improved transparency, for example, would:

- **Help to clarify the primary long-term policy objective.**
  A more open, forthright policy process would create powerful incentives for monetary policymakers to carefully outline the primary objectives of monetary policy. This process, in turn, would create incentives to keep attention focused on such goals as well as to adopt

[8]For evidence that increased central bank disclosure does not disrupt markets, see Michael T. Belongia and Kevin Kliesen, "Effects on Interest Rates of Immediately Releasing FOMC Directives," Contemporary Economic Policy, Vol XII, October 1994, pp. 79-91; and Daniel L. Thornton, "Does the Fed's New Policy of Immediate Disclosure Affect the Market?," Review, Federal Reserve Bank of St. Louis, November/December 1996, pp. 77-88.

procedures, indicators, and instruments that would maximize the chances of achieving these objectives.

- **Improve the workings and usefulness of financial markets.**
Contrary to assertions of the Federal Reserve, empirical evidence shows that central bank provision of more complete and timely information does not increase the volatility of financial markets. Instead, financial markets work better when inflation objectives are clarified and more timely and detailed information is readily available. A more open, transparent policy environment improves the workings of financial markets because unnecessary uncertainties and confusion are minimized and market volatility is reduced. More information enables private sector expectations to adjust faster to changes in monetary policy, allowing private sector agents to learn faster and minimize disruption of policy change. With a consequent reduction in uncertainty premiums, interest rates will be lower, bolstering bond and equity markets. The result is improvement of the information content of these financial market prices, and their increased usefulness as conveyers of market sensitive information.

- **Improve central bank credibility.**
A more transparent, open monetary policy also enhances central bank credibility. As monetary policy goals and procedures become well known and understood, the public more quickly learns about changes in policy, and central banks become more committed to achieving their publicly stated goals. As they begin to achieve these goals with greater regularity, central banks achieve enhanced credibility.

  This improved credibility, in turn, enables expectations to adjust faster to changes in monetary policy, fostering more flexibility in labor and other markets and lowering employment and output costs of disinflation. Goals such as price stability, therefore, can more easily be attained, managed, and maintained.

- **Minimize the chances policymakers would manipulate policy for political purposes.**
A more transparent monetary policy lessens the chances that policymakers will manipulate policy for political purposes.[9] Open, transparent and well-known policy goals and procedures would allow private analysts and financial markets to constantly monitor Federal Reserve actions and readily detect any manipulation of monetary policy for political purposes. Markets would quickly react to such manipulation by immediately revising inflationary expectations, and such action would readily be obvious to everyone. Consequently, the opportunity for central bankers to surprise the markets with stimulative policy would be severely constrained.[10]

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[9] In technical jargon, transparency would help to minimize the "time inconsistency problem."

[10] See Andrew G. Haldane, "Introduction," *Targeting Inflation*, edited by Andrew Haldane, Bank of England, 1995, pp. 10-11.

- **Work to improve monetary policy.**
  More transparent monetary policy would encourage and lead to more open debate and criticism; private sector analysts could more openly critique central bankers' actions, procedures, and rationale. Such criticism, in turn, would oblige the monetary authority to defend its policy objectives, decisions, and procedures. The Federal Reserve would be forced to openly confront and reconcile inconsistencies in its policy; incentives would be created for the central bank to get its analysis right. This resulting competition of ideas and more open dialogue would inevitably lead to improved, more informed policymaking.

- **Complement congressional oversight responsibilities.**
  A more transparent monetary policy would serve to complement responsibilities of the Congress for overseeing Federal Reserve policy. As suggested above, more timely, detailed Federal Reserve disclosure and a more open approach to monetary policymaking would help to improve the workings of financial markets and enable these markets, in effect, to better discipline monetary policy. As such, these markets could serve to complement congressional responsibilities for overseeing monetary policy. In particular, Congress could adopt a strategy to enhance transparency and thereby impose increased market discipline on Federal Reserve policy. Committees responsible for monetary policy oversight could closely monitor key market variables in assessing and evaluating the appropriateness of the stance of monetary policy. In effect, Congress could facilitate the delegation of some oversight responsibility to the market. Congressional oversight, therefore, would be simplified.

ADOPTION OF MORE TRANSPARENT CENTRAL BANK POLICIES

Recently, the Federal Reserve as well as several other central banks have adopted more transparent monetary policies. In the 1990s, for example, a number of central banks identified price stability as their primary policy goal and, accordingly, adopted explicit inflation targets.[11] But the commitment to transparency has taken these central banks far beyond the adoption of inflation targets. Many of these banks, for example, have consciously made improved transparency a goal of their respective institutions.[12] In implementing their strategies, for example, several of these banks immediately disclose policy decisions when they are made. These announcements are often accompanied by a detailed discussion as to the rationale for the policy move. More frequent and higher quality

[11] See Robert E. Keleher, *Lessons From Inflation Targeting Experience,* A Joint Economic Committee Report, February 1997.

[12] See, for example, Gordon G. Thiessen, Governor of the Bank of Canada, "Towards a More Transparent and More Credible Monetary Policy," Remarks, Montreal, Quebec, October 9, 1996; Andrew G. Haldane, op.cit, pp.10-11; and Frederic S. Mishkin and Adam S. Posen, "Inflation Targeting: Lessons from Four Countries," Economic Policy Review (Special Issue on Inflation Targeting), August 1997, Volume 3, number 3.

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published materials, testimony, and speeches also are elements of such strategies to improve transparency. Some of these banks publish inflation forecasts as part of their efforts.[13]

The Federal Reserve has also made moves to become more transparent in recent years. Such moves, for example, include:

- immediate notification of FOMC policy decisions,
- earlier release of the FOMC policy directive, and
- release of more information such as regional information contained in the so-called "Beige Book."[14]

In addition, the Federal Reserve provides a significant amount of information about its operations in various publications, reports, speeches, and testimony.

RECOMMENDATIONS FOR MORE TRANSPARENT FEDERAL RESERVE MONETARY POLICY

Although the Federal Reserve has come a long way from its earlier, more secretive approach to policy, its journey toward openness is still incomplete. Indeed, Federal Reserve policies still lag behind the more transparent policies of many of the world's more innovative central banks.

In view of its lackluster record on openness, the Federal Reserve should work to transform its historic secretive "culture" by adopting a number of changes to make U.S. monetary policy more transparent. In particular, the Federal Reserve should:

- **Adopt explicit inflation targets.**
  The most important step the Federal Reserve could take in moving to a more transparent policy would be to explicitly adopt price stability as the primary goal of monetary policy. As previous Joint Economic Committee studies have demonstrated, this can best be accomplished by adopting inflation targets as many other successful central banks have done.

[13] The Bank of England's Inflation Report is often cited to illustrate this point.

[14] For descriptions of the historical evolution of Federal Reserve disclosure policy, see, for example, Anna J. Schwartz, "Central Banking in a Democracy," unpublished manuscript presented at Western Economic Association meetings, Seattle, Washington, July 9-13, 1997; and Marvin Goodfriend, op.cit.

Before 1967, the record of policy action was published only in the Federal Reserve Board's Annual Report. Beginning in mid-1967, the Board began to release this record 90 days following an FOMC meeting. In March 1975, the Federal Reserve further reduced the delay from 90 days to 45 days. In May 1976, the release was further changed from 45 days to a few days after the next regularly scheduled FOMC meeting (a week or two earlier than previously). Recently, this report has been released on Thursday following the next regularly scheduled FOMC meeting. The "Beige Book" was formerly the "Red Book," which had (lower-level) confidential status until mid-1983.

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- **Report to the Congress more frequently on monetary policy.**
  The Federal Reserve could improve the transparency of monetary policy by reporting more frequently to the Congress than biannually as is now the practice. Reporting quarterly or every four months would be more appropriate.

- **Release information earlier to the public.**
  The transparency of policy could also be improved by earlier release of information to the public. With speedy modern information processing equipment, it no longer should take more than six weeks to prepare and release (edited) minutes of FOMC meetings. Furthermore, while some delay may be appropriate, there appears to be little reason for a five-year delay in releasing verbatim transcripts of FOMC meetings as well as "Greenbook" forecasts and "Bluebook" analyses.

- **Provide more useful information to the public.**
  The Federal Reserve can improve its information dissemination function in many ways. At the time FOMC decisions are announced, for example, more detailed explanations as to the rationale for policy change could be provided, perhaps involving a brief press conference. When the FOMC decides to leave policy unchanged, an explanation regarding why no action was taken can be just as important as providing rationale for an actual change in policy.[15]

  The Federal Reserve also could keep markets better informed about its current policy position. When market expectations appear to be at a variance with the Federal Reserve's internal expectation, for example, the Federal Reserve could make an effort to condition market expectations by providing more information about its policy intentions, goals, strategy, and "model of the economy." This would help foster predictability and promote financial market stability.

  More information about current inflation, Federal Reserve progress in reaching inflation targets and explanations as to how FOMC decisions and Federal Reserve policy instruments and indicators help to achieve price stability would also be useful. Such reporting might include the provision of "inflation reports" and inflation forecasts similar to some other central banks. Furthermore, advance identification of the form of FOMC action to be undertaken should inflation objectives not be reached also would be useful.

  A review of the Federal Reserve system's procedures for classifying the confidentiality of documents also would be helpful in moving the system to a more open, transparent central bank. The Federal Reserve, for example, could make available to the public more internal research, forecasts, memos, and internal briefings that are currently restricted unnecessarily. The taxpayers, after all, are the ultimate financiers of such efforts.

[15] The Federal Reserve's current practice is to issue a brief statement when it changes policy, but to give no explanation when it holds rates steady.

SUMMARY AND CONCLUSIONS

Transparent monetary policy is characterized by openness and a lack of secrecy and ambiguity. Monetary policy transparency involves a number of different dimensions including the clarification of policy goals and policy procedures as well as the timeliness in reporting policy decisions.

More transparent monetary policy has a number of advantages. It would, for example, (1) clarify policy objectives, (2) improve the workings of financial markets, (3) enhance central bank credibility, (4) reduce the chances of monetary policy manipulation for political purposes, (5) foster better monetary policymaking, and (6) complement congressional monetary policy oversight responsibilities.

Recently, many central banks have recognized these advantages and have moved toward making their monetary policies more transparent. The Federal Reserve has made some progress on this front but generally has lagged behind other central banks. The Federal Reserve could move toward a more transparent monetary policy by (1) adopting explicit inflation targets, (2) reporting more frequently to the Congress, (3) releasing information earlier, and (4) providing more information to the public.

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This study is the sixth in The Special Joint Economic Committee Series on Federal Reserve Monetary Policy. The studies in this series include:

(1) *Lessons From Inflation Targeting Experience*, February 1997
(2) *The Importance of the Federal Reserve*, March 1997
(3) *Establishing Federal Reserve Inflation Goals*, April 1997
(4) *The Roots of the Current Expansion*, April 1997
(5) *A Response to Criticisms of Price Stability*, September 1997
(6) Transparency and Federal Reserve Monetary Policy, November 1997

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