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Policymaking on the FOMC: Transparency and Continuity

This Economic Letter *is adapted from remarks by Janet L. Yellen, President and CEO of the Federal Reserve Bank of San Francisco, delivered at the Twelfth International Conference, "Incentive Mechanisms for Economic Policymakers," at the Institute for Monetary and Economic Studies at the Bank of Japan in Tokyo on May 31, 2005.*

It is a pleasure to take part in this conference. I thank the Bank of Japan for inviting me to share my views on incentive problems in monetary policy committees at central banks.

I thought I would organize my remarks around two issues discussed in the paper by Fujiki (2005) and in the sessions—transparency and continuity—and do so in the context of two issues the Federal Open Market Committee (FOMC) recently took up: (1) its decision to expedite the release of the minutes of its meetings; and (2) its discussion regarding the adoption of a numerical definition of price stability.

The Fed's recent steps towards transparency

Over the past decade, the FOMC has continually re-assessed the costs and benefits of various steps toward greater transparency and has made several significant increases in policy communication and openness. In February 1994, just months before I became a Federal Reserve Governor, the FOMC started to explicitly announce changes in the federal funds rate target. Later that year, the FOMC added descriptions of the state of the economy and the rationale for the policy action to the post-meeting press release. In January 2000, the FOMC introduced a statement describing the "balance of risks" to the outlook, and in March 2002 began releasing the votes of individual Committee members and the preferred policy choices of any dissenters. In August 2003, the Committee added explicit forward-looking language concerning future policy into its statement. Finally, in December 2004, it decided to release the minutes of its meetings with only a three-week delay. Previously, the minutes were made public with a five- to eight-week lag, just *after* the subsequent meeting and were, hence, less relevant to policy.

This decision to speed up the release of the minutes occurred several months after I returned to the FOMC table as President of the Federal Reserve Bank of San Francisco. I think it illustrates some of the important issues relating to transparency in monetary policy committees.

In considering whether to expedite the release of the minutes, potential costs were certainly recognized. Financial markets could misinterpret and overreact to the minutes. Greater emphasis on the minutes might also lead to less productive discussions at the meetings, because even speculative and off-the-cuff commentary would soon be out in the open and, hence, discouraged. On the benefit side, however, expedited release of the FOMC minutes provides more timely information to the public about the rationale for monetary policy actions and a more nuanced explanation of the reasons for the Committee's decisions. Such a move toward greater transparency facilitates accountability, which is essential for unelected central bankers in a democratic society, and might make monetary policy more effective by helping to align financial market expectations with policy objectives (see Swanson 2004).

One impact of expedited release of the minutes is that it results in the earlier airing of differences of opinion among members. A more subtle issue is whether the exposure of such differences might affect the degree of collegiality in the Committee. This issue is important because, in my view, cooperation is critical to the FOMC's success. My sense is that FOMC participants are highly motivated to cooperate in seeking, finding, and articulating a Committee consensus, and their ability to do so enhances the credibility, legitimacy, and likely effectiveness of monetary policy. In fact, I think FOMC members behave far less individualistically and strategically than assumed in some of the models summarized in Fujiki (2005). I do not find this terribly surprising. Sociologists find that in group situations, individuals are typically motivated to build on common ground to resolve differences of opinion and attain agreement (see Haslam 2004). Without such a sense of group solidarity, a 19-

member committee like the FOMC could find it so time-consuming as to be practically infeasible to craft even a short, post-meeting statement commanding majority agreement. Such sociological reasoning might also explain why FOMC dissents are so rare.

The jury is still out on whether the earlier exposure of differences of opinion will affect the sense of collegiality in the FOMC. Earlier release of the minutes affords greater flexibility for members to express their personal views publicly, for example, in speeches, without creating undue market confusion. My guess is that this will make it easier, not harder, to attain consensus, but time will tell.

Another step: quantifying a long-run price-stability objective?

A second issue relating to communication and transparency that the FOMC discussed in February 2005 is whether to adopt an explicit, numerical price-related objective for monetary policy. The Committee decided to hold off for now, but I am sure that, along with other issues in monetary policy communication, this topic will be on the table again in the future.

The Federal Reserve Act gives the FOMC a dual mandate—to pursue maximum sustainable employment and price stability—but does not define either objective. My personal view is that the quantification of the long-run price-stability objective could offer several benefits. In terms of Committee operations, it could help to focus and clarify our own discussions. It could also help to anchor the public's long-term inflation expectations from being pushed too far up or down. That is, a numerical long-run inflation objective may help avoid both destabilizing inflation scares and pernicious price deflations. Indeed, a credible inflation objective could enhance the flexibility of monetary policy to respond to the real effects of adverse shocks.

As with any move toward greater transparency, there are potential drawbacks. A main concern is the possibility that the enunciation of an inflation objective will be perceived as or result in a downweighting of the Committee's maximum employment mandate. To guard against miscommunication, the nature of this objective would have to be very clearly stated as a long-run goal only, with the path for attaining it dependent on the implications for other Fed objectives, especially employment and financial stability.

Continuity and the explicit, quantified price-stability objective

The adoption of an inflation objective also raises issues related to the continuity of FOMC behavior. The price-stability mandate is overarching because it is included in the Federal Reserve Act. But the interpretation of that mandate is left up to the Committee. Since one FOMC cannot bind future FOMCs, the potential for discontinuity could be large if individual views on the appropriate numerical objective were to change significantly over time or as a result of changes in the membership.

With respect to the likely stability of individual views over time, the evolution of my own thinking on this topic is perhaps instructive. When I was a Federal Reserve Governor, the FOMC discussed a numerical objective for inflation at its July 1996 meeting. At that meeting, there was some consensus among the participants, including myself, for a 2% long-run objective for consumer price index (CPI) inflation. From an economic standpoint, I believe the choice of an inflation objective should depend on an evaluation of the costs and benefits of very low inflation. Since then, there have been several important economic developments relevant to this choice. I argued in 1996 that the inflation objective should contain a cushion sufficient to grease the wheels of the labor market. The potential negative impact of downward nominal wage rigidity on real economic performance diminishes, however, with faster productivity growth, which raises average wage growth. As it turns out, high productivity growth in the U.S. during the past decade has made downward wage rigidity a non-issue, suggesting that a lower inflation buffer is sufficient. But, for me, this shift has been offset by the experience of very low inflation in the U.S. and deflation here in Japan, which has heightened my concern relating to the zero lower bound on the policy interest rate. Other relevant economic factors include the magnitude of the neutral real funds rate, the degree of macroeconomic volatility, and methodological changes affecting measurement biases.

Taking all of these factors into account, I find myself still pretty comfortable with the numerical objective I had recommended almost a decade ago. More specifically, I would now favor a 1.5% numerical objective for inflation as measured using the core personal consumption expenditures (PCE) price index, which, given the recent average differences in measurement bias, corresponds to a 2% objective

for the core CPI. If the stability of my own views on the appropriate numerical inflation objective is representative, it seems likely that the FOMC's numerical inflation objective would probably change fairly little over time due to *economic* factors.

The numerical inflation objective could also potentially evolve with changes in the membership of the FOMC, assuming some divergence in views among members. In fact, however, a number of Committee members have individually opined on this topic and the actual differences of opinion turn out to be rather small. I would characterize a long-run inflation objective centered on 1.5% for core PCE inflation as a "modal" view. Even if there were more significant differences of opinion, an advantage of a monetary policy *committee* is that a slow, continuous transition of new members is apt to produce greater continuity than might occur with a single central banker, where the replacement of the Governor could result in discrete policy shifts. In addition, the "sociological" considerations I discussed earlier, which foster cooperation and consensus, could encourage new members to support the goals endorsed by the prior committee. In practice, then, I think there would be ample continuity in the FOMC's inflation target.

Continuity is an especially important issue facing the FOMC now, as Chairman Greenspan's term as a Federal Reserve Governor comes to an end. The Chairman changes infrequently—we have had only two in the past quarter-century. But one of the strengths of the FOMC is the broad experience of its members and staff. During the transition to a new Chairman, this should help ensure continuity.

To conclude, I would like to stress that there are no final answers, and that transparency and continuity are important issues we face on the FOMC at almost every meeting.

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