
FRBSF ECONOMIC LETTER

Number 2001-26, September 7, 2001

Transparency in Monetary Policy

The title of a popular 1987 book by William Greider on the Federal Reserve said it all: *Secrets of the Temple* conjured up an image of the high priests of monetary policy hidden away behind marble walls in Washington, D. C., making mysterious decisions that affected the lives of all Americans. While the Fed's policymaking body, the Federal Open Market Committee (FOMC), would eventually release minutes of its meetings, and the Chairman did testify twice a year before Congress and would frequently give public speeches, that image of secrecy was one that central bankers often seemed to enjoy cultivating. At the time Greider wrote his book, the FOMC rarely provided timely public statements to explain why a policy action was taken. And the testimony of Federal Reserve Chairmen before Congressional committees was seldom designed for maximum clarity. In fact, *Newsweek* reported this quote from Alan Greenspan: "Since I have become a central banker, I have learned to mumble with great coherence" (July 25, 1988, p. 54).

Today, FOMC policy decisions are much more transparent. Immediately after each meeting, the FOMC issues a press release that explains any monetary policy action taken during the meeting. The FOMC also gives some indication of its future policy concerns and intentions. For example, after its June 27, 2001 meeting, at which the FOMC approved a 25-basis-point cut in its federal funds rate target to 3³/₄ percent, its press release noted that

Although continuing favorable trends bolster long-term prospects for productivity growth and the economy, the Committee continues to believe that against the background of its long-run goals of price stability and sustainable economic growth and of the information currently available, the risks are weighted mainly toward conditions that may generate economic weakness in the foreseeable future.

Commentators quickly interpreted this as a signal that future rate cuts might be in the offing.

The move towards greater transparency in monetary policy is not confined to the United States. In fact, central banks in several other countries have gone even further. This general trend reflects, in part,

research by academic economists that has stressed the potential benefits of making monetary policy easier to understand. In this *Letter*, I review the arguments for, and against, greater transparency. Economists have identified some clear benefits, but there may be potential costs as well.

What does transparency mean?

One difficulty in evaluating the potential costs and benefits of transparency is that the term has been used in several different ways. This is perhaps natural since transparency becomes an issue only when there is a problem of imperfect or incomplete information, and information can be imperfect or incomplete in many different ways. To understand the various aspects of policy transparency, it is helpful to focus on three key ingredients in the formulation and implementation of monetary policy—the central bank's objectives, the bank's assessment of the linkages between policy actions and the economy (the bank's "model" of the economy), and the bank's information about economic conditions. Each of these three factors—objectives, model, and information—can cause monetary policy to be opaque.

Transparency about objectives

Perhaps the most common notion of transparency in the economics literature is that associated with objectives. The public may be uncertain about the true objectives of monetary policy, or, while understanding that the central bank may desire low and stable inflation and full employment, the public may find it difficult to know how the central bank would trade off a bit more unemployment to gain lower inflation or how much increased inflation it might accept to prevent unemployment from rising. A policy is transparent about objectives if the public can accurately gauge the central bank's *intentions*.

It is natural to think of transparency in terms of intentions if policy objectives tend to shift over time. Faust and Svensson (2001) and Jensen (2000) provide recent analyses of transparency when objectives may change. When intentions are more transparent, the public is able to form more accurate forecasts of future policy actions and economic developments.

The emphasis on intentions arises from the view that the central bank's goals for employment or growth

may be unrealistic or unsustainable, or the central bank might be subject to “behind-the-scenes” political pressures to expand employment. Over the past twenty years, a large literature has analyzed the consequences for inflation when objectives for economic growth are too ambitious or when central banks face political pressures. In either case, the public will expect higher inflation. This boosts actual inflation, and the central bank is forced to accept either higher inflation or a slowdown and higher unemployment to bring inflation back down (for a survey, see Walsh 1998, Ch. 8).

Faust and Svensson (2001) argue that greater policy transparency is highly desirable because it leads to better economic outcomes. Transparency does so mainly by minimizing the central bank’s incentive to engage in overly expansionary policies. If the central bank’s objectives shift and it attempts to pursue an overly expansionary policy, the public quickly catches on when the policy framework is transparent. As a result, inflation expectations rise sharply. Because it is costly for the central bank to lower inflation expectations, the central bank is deterred from trying such a policy.

Jensen (2000) argues, on the contrary, that there can be a cost to greater transparency, particularly if the central bank already has a good reputation for maintaining low inflation. Increased transparency about any changes in the central bank’s objectives will cause the public’s inflation expectations to become more variable, which would cause *actual* inflation to become more variable. To reduce the undesirable variability in actual inflation, the central bank must focus relatively more on stabilizing inflation and less on stabilizing output and employment. This distorts stabilization policies and may lead to worse economic outcomes.

Transparency about economic models

Even if the public clearly understands the central bank’s objectives—perhaps because they are formalized in the bank’s charter, as is the case in New Zealand and the European Monetary Union, or because the government has publicly established policy objectives for the central bank, as is the case in the United Kingdom—monetary policy may be opaque because the public does not understand the economic model the central bank uses to evaluate alternative policies.

This uncertainty can be qualitative—does the central bank view its effects on the money supply, interest rates, or general credit conditions as the chief link between its actions and economic activity? Or the uncertainty can be quantitative—if the chief linkage involves interest rates, how big a rate cut is needed to offset a projected one percentage point rise in unemployment? In either case, the public may have

difficulty knowing whether the central bank is likely to change interest rates by 50 basis points or by 150 basis points to achieve its objectives.

Alex Cukierman (2000) has emphasized that, in practice, even the most transparent central banks have not been very transparent about the economic model they use. He notes that central banks can hardly be blamed for this—academic economists are themselves uncertain as to the true model of the economy. As a consequence, central banks are typically forced to employ several different economic models to evaluate policies. How these alternative models are then synthesized into a specific policy recommendation is part of the “art” of monetary policy (Walsh 2001) and may be difficult to convey to the public.

Transparency about economic conditions

Even if objectives are clearly stated and the central bank’s model is well understood, the public may not have the same information on current economic conditions that the central bank has. For example, in theory, the central bank may have preliminary data on the economy before it is widely available to the public. Thus, the central bank might cut interest rates because new data suggest an economic slowdown. But if these data are not publicly available, the public may be uncertain whether the rate cut is designed to offset a likely recession or to expand the economy, thereby risking an increase in inflation.

In this interpretation, a transparent policy regime is one in which the public is provided with the same information on economic conditions as is provided to the central bank. The argument for revealing all the information that the central bank has about the economy stresses that this information is critical for assessing how well the central bank is doing its job. Central banks cannot control inflation perfectly, so holding them accountable for achieving a specific target for the inflation rate is unrealistic. If inflation rises above target, it is important to know whether this was due to factors that the central bank could not have foreseen, or whether the central bank should have been able to predict the rise and adjusted policy to counteract it.

Transparency, in this view, is related to notions of accountability—if the public knows what the central bank knows, then it can assess whether the central bank made the right policy choices. The public needs good information to assess whether the central bank did what it should have done. If new information about the economy suggests that a rise in inflation is likely, the public can assess whether interest rates should be raised and, if so, by how much, and they can then judge whether the central bank implemented the correct policy.

Transparency about information helps make central banks accountable, but it may also come with a cost. Cukierman (2001) shows that inflationary expectations are more variable if the public has better information about current economic disturbances. As a consequence, interest rates become more variable as well. If interest rate volatility is costly, as is sometimes argued, then greater transparency is not a free lunch.

Transparency and inflation targeting

In recent years, several central banks have adopted inflation targeting as a framework for conducting policy. Under an inflation targeting regime, the central bank commits to achieving a target rate of inflation. This target may be set by the government (as is the case in the United Kingdom), or it may be set by the central bank itself (as is the case in Sweden). Proponents of inflation targeting have stressed that it is a very transparent means of implementing monetary policy. The inflation target is publicly announced, so the objectives of the central bank are made transparent.

However, even inflation targeting may not lead to complete transparency. Simply announcing a target for average inflation does not indicate how the central bank will respond if a recession threatens or if energy prices jump, and objectives are not the only aspects of policy that lead to uncertainty and opaqueness.

Proponents of inflation targeting also call on central banks to issue detailed reports on economic conditions and the outlook for inflation, as the Bank of England does in its *Inflation Reports* (<http://bankofengland.co.uk>). Such reports can go a long way towards giving the public better information on monetary policy as well as some insight into the bank's forecasts of future developments. These forecasts contribute to the overall transparency of policy, even though they do not allow the public to identify either the economic model or the information about economic conditions that were combined to produce the bank's forecast.

Conclusion

The economics literature has identified the potential costs of greater transparency about policy goals and intentions—an overemphasis on inflation sta-

bilization at the cost of employment fluctuations and excessive interest rate volatility. As yet, however, there are no quantitative estimates of either the gains or costs of transparency. Until there are, the general principles that (a) policymakers should strive for clarity and that (b) the public has a right to hold policymakers accountable suggest that recent moves by the Federal Reserve and other central banks to make monetary policy less opaque are positive developments.

Carl E. Walsh
Professor of Economics
University of California, Santa Cruz
and
Visiting Scholar
Federal Reserve Bank of San Francisco

References

- Cukierman, Alex. Forthcoming 2001 "Accountability, Credibility, Transparency and Stabilization Policies in the Eurosystem." In *The EMU and its Impact on Europe and the Developing Countries*, ed. C. Wyplosz. Oxford: Oxford University Press.
- Cukierman, Alex. 2000. "Are Contemporary Central Banks Transparent about Economic Models and Objectives and What Difference Does it Make?" Presented at the Bundesbank Conference on "Transparency in Monetary Policy" (October). <http://www.tau.ac.il/~alexcuk/pdf/transparency.pdf>
- Faust, Jon, and Lars E. O. Svensson. 2001. "Transparency and Credibility: Monetary Policy with Unobservable Goals." *International Economic Review* 2, pp.369-397.
- Jensen, Henrik. 2000. "Optimal Degrees of Transparency in Monetary Policymaking." University of Copenhagen (December).
- Walsh, Carl E. 1998. *Monetary Theory and Policy*. Cambridge, MA: MIT Press.
- Walsh, Carl E. 2001. "The Science (and Art) of Monetary Policy." *FRBSF Economic Letter* 2001-13 (May 4). <http://www.frbsf.org/publications/economics/letter/2001/el2001-13.html>

Research Department

Federal Reserve

Bank of

San Francisco

PRESORTED
STANDARD MAIL
U.S. POSTAGE
PAID
PERMIT NO. 752
San Francisco, Calif.

P.O. Box 7702
San Francisco, CA 94120
Address Service Requested

Printed on recycled paper
with soybean inks



Index to Recent Issues of *FRBSF Economic Letter*

DATE	NUMBER	TITLE	AUTHOR
1/26	01-02	Retail Sweeps and Reserves	Krainer
2/2	01-03	Inflation: The 2% Solution	Marquis
2/9	01-04	Economic Impact of Rising Natural Gas Prices	Daly
3/2	01-05	How Sluggish Is the Fed?	Rudebusch
3/9	01-06	The Return of the “Japan Premium”: Trouble Ahead for Japanese Banks?	Spiegel
3/23	01-07	Financial Crises in Emerging Markets	Glick/Moreno/Spiegel
3/30	01-08	How Costly Are IMF Stabilization Programs?	Hutchison
4/6	01-09	What’s Different about Banks—Still?	Marquis
4/13	01-10	Uncertainties in Projecting Federal Budget Surpluses	Lansing
4/20	01-11	Rising Price of Energy	Daly/Furlong
4/27	01-12	Modeling Credit Risk for Commercial Loans	Lopez
5/4	01-13	The Science (and Art) of Monetary Policy	Walsh
5/11	01-14	The Future of the New Economy	Jones
5/18	01-15	Japan’s New Prime Minister and the Postal Savings System	Cargill/Yoshino
5/25	01-16	Monetary Policy and Exchange Rates in Small Open Economies	Dennis
6/1	01-17	The Stock Market: What a Difference a Year Makes	Kwan
6/15	01-18	Asset Prices, Exchange Rates, and Monetary Policy	Rudebusch
7/6	01-19	Update on the Economy	Parry
7/13	01-20	Fiscal Policy and Inflation	Daniel
7/20	01-21	Capital Controls and Exchange Rate Stability in Developing Countries	Glick/Hutchison
7/27	01-22	Productivity in Banking	Furlong
8/10	01-23	Federal Reserve Banks’ Imputed Cost of Equity Capital	Lopez
8/24	01-24	Recent Research on Sticky Prices	Trehan
8/31	01-25	Capital Controls and Emerging Markets	Moreno