

# **The Governance, Communication, and Conduct of the Federal Reserve's Monetary Policy**

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## **Introduction**

Thank you for the invitation to speak at the second Monetary Policy Forum. This is a rare venue in the way that policy makers and market participants mingle. You can understand why the organizers might have the ambition to brand this as Jackson Hole East. Or Jackson Hole without the mountains. Or the rivers. Or Bill Poole in a cowboy hat. I advise pitching that as a virtue: At Jackson Hole East, there is no western-wear fringe to distract from a pure discussion of monetary policy making.

But first a little background. I left the staff at the Federal Reserve's Board of Governors at the end of September, although I had not participated in policy discussions in a meaningful way for the prior two months. Fifteen minutes of job search led me to the American Enterprise Institute, which offered the security of unconditional support for research and the lightest touch of the invisible hand of management that could be imagined. My intent was to work quietly on issues related to the intersection of finance, global macroeconomics, and the communication of monetary policy. Who knew that quiet contemplation was not in the cards?

What I have observed from my new position on the sidelines of monetary policy and markets is a failure to communicate. In all aspects of life, such a failure usually involves both parties. My central premise today is that market participants do not appreciate the extent to which the Federal Reserve has changed in the past year. Those changes reflect an ambitious attempt to apply the economic profession's understanding of the science of monetary policy to improve the governance of the policy process, the communication of policy intent, and the conduct of policy. At the same time, I will also argue that Federal Reserve officials have not always appreciated the difficulties in applying lessons from the textbook, in part because those economic models are incomplete and in part because the Federal Reserve's uneasy relationship with the Congress sometimes hampers plain speaking.

My discussion will follow the arc of these three ambitious changes in monetary policy, powered initially by good intentions, pulled down by the gravity of reality, and headed ultimately to orbit at a lower altitude than originally envisioned. I do not believe, however, that the U.S. Navy will need to be called in to shoot the debris out of the sky. Rather, the failure to communicate will be resolved over time as both sides adapt. The good news is that the necessary learning process is at work. The bad news is that this learning takes place while some of you in this room have open positions, which might explain why the commentary surrounding monetary policy making has gotten so heated at times.

## **Collaboration: Governing the Policy Process**

Doubtless, Alan Greenspan was a tough act to follow. But so too was Paul Volcker. We forget that investors were concerned about the inflation-fighting resolve of a man who was more associated with economic forecasting and corporate consulting than policy prescribing and committee negotiating. Alan Greenspan learned on the job. Or more accurately, market participants came to learn about how Alan Greenspan would do his job. And it is that deified version who retired two years ago that has been the benchmark of comparison.

Replicating that iconic figure would be difficult, to say the least, nor is it obvious that it would be in the best interest of the institution.<sup>1</sup> Concentrating authority in principle (and to be sure it was never in practice as concentrated as outsiders imagined) has its drawbacks. It does not develop bench strength in an institution, it poses continuity problems when so much of the world comes to view policy as the exercise of an individual's virtues rather than a group's common principles, and it does not tap into the resources available from other members.

I believe that Ben Bernanke began his chairmanship influenced by his own experience on the Board as a governor, by academic research that tended to show groups perform better than individuals, and by the foreign precedent of argumentative yet still successful monetary policy committees.<sup>2 3</sup> And he embarked on a fundamentally selfless act by attempting to make the Federal Open Market

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<sup>1</sup> Romer and Romer (2004) provide some historical background on the choice of Federal Reserve chairman, with particular emphasis on the multiple attributes required to be successful in the job.

<sup>2</sup> Blinder and Morgan (2005) present some laboratory experiments showing that decisions made by a group are better than by a single person. Lombardelli et al. (2005) also go to the laboratory in a complementary analysis.

<sup>3</sup> Ehrmann and Fratzscher (2005) review the different styles of the major monetary policy committees.

Committee more central to policy making. Eschewing the power and trappings of authority is not an everyday occurrence in Washington, DC.

There are four key pieces of evidence of enhanced collaboration within the FOMC. First, the meetings are longer. Do the arithmetic of the starting and ending times and note that four meetings a year now span two days. Second, Chairman Bernanke's testimonies and speeches about the economic outlook almost always have a role for the survey of the economic projections of Committee participants—that is, those opportunities to be alone on the public stage usually are taken to summarize the view of the whole and not the individual. Indeed, those testimonies and speeches are notable for what they do not include—they do not typically include personal speculations on unfolding macroeconomic trends. There are other opportunities to speak to those issues, and mixing the group's economic view with one person's interpretation of the channels of effects might risk confusing the public. Third, increasing the survey of economic projections to four times a year and using the minutes as platform for a more complete discussion of them also elevates the group's view. Fourth, changes in the guidance about the path of policy mostly always come from the group's official statements, not a personal statement. Indeed, the recent exception from this rule is instructive on that score: We now know from the most recently published minutes that Chairman Bernanke convened a conference call on January 9<sup>th</sup>, presumably so that he could be confident that his speech the next day conveyed a consensus view that additional policy easing would be forthcoming.

Increased collaboration within the FOMC is not, however, an unalloyed blessing and may be at the root of some of the displeasure about policy makers expressed by market participants. It is true that increasing the number of observations improves the standard error of a test statistic. It might follow that more voices in the deliberation of policy improves the average policy outcome. But the statistical result is the product of mathematical proof. The assertion about group dynamics is an expression of hope.<sup>4</sup> Larger groups are more prone to information cascades, especially when expertise and access to private information are seen to be distributed unevenly across the members.<sup>5</sup> The attempt to forge a consensus among a large group might slow the Committee's responsiveness to changed events or muddle the clarity of its statement. I cannot help but suspect when reading the FOMC's post-meeting statements that sometimes the role of the release is more to placate nineteen people sitting around the Board table in Washington and less to educate the public. And relying on official, joint statements may slow the flow of information. At a minimum, it makes the arrival of information more lumpy, and market participants more sensitive to specific events.

What should market participants do differently in this world of enhanced collaboration? I suggest that three changes are in order. First, emphasize the joint statements. If the Committee deliberates more as a group, then those group statements are a more precise summary of the group view, despite the unsanitary way

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<sup>4</sup> The review of the theory on the workings of committees in Gerlach-Kristen (2006) shows how complicated are the issues, depending, among other aspects, on the objective of the group versus the individual, the differences among group and individual information, and the degree of pre-meeting consultation.

<sup>5</sup> I address some of these issues in Reinhart (2003).

in which the sausage might be made and the mixed results on tasting. Second and as a consequence, remember that silence from the Chairman is just silence. That is, I believe that this is a chairman more willing to defer changes to an upcoming Committee statement than to make news on his own. And third, prepare for more dissents, both in numbers at a time and in the range of people who do so over time. Do not get me wrong, tradition and consensus holds such considerable sway at the Federal Reserve that I do not expect a swing to the Bank of England model of close votes.<sup>6</sup> But the enhanced opportunity to deliberate, the fact that they vote on the entire statement, and the importance of the statement make it likely there will be more nays in your future.

As I said earlier, progress usually is only made when both parties in a conversation make concessions. What should the Federal Reserve do differently? Most importantly, recognize that committees have one appointed among them as chairman for good reasons. Accept that there are times when quick action and a decisive voice are needed. Those are the times that the chairman has to step up to the plate.

### **Communication: Balancing risks**

I am a strong believer in listening to what policy makers say, but the problem is sometimes they shout and sometimes they whisper. Last year, even as policy action brought the policy rate down 1 percentage point, the FOMC was explicitly balancing risks to its dual objectives of sustainable economic growth and price stability. It

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<sup>6</sup> Blinder and Reis (2005) review the pattern of dissents.

cared both about potential slowing to spending, which was a threat that loomed larger and larger as financial markets frayed, and inflation, which was above the FOMC's informal goal.

But what was that informal goal? Here is where the Committee decided to whisper. From the end point to the October survey of economic projections, we can infer that the FOMC had an ECB-like goal for core PCE inflation of something less than 2 percent.<sup>7</sup> We can only infer it from a chart at the back of the minutes, of course, because otherwise the Committee did not explain its actions in light of its goal. That is, it was ECB-like in its goal and ECB-lite in explaining policy setting in terms of its goal. It was so, I suspect, because Congressional support of an inflation goal has always been weak. And that support weakened more with the change of political party in charge of the two houses of the Congress last year.

Because the FOMC was sensitive to both goals and the performance relative to those goals cut in opposite directions, it was slow in providing policy accommodation in 2007. But because the FOMC was reluctant to publicize its inflation goal, it had to rely on other reasons to protest the more substantial easing of policy built into money market futures rates. So it shouted about the fundamental strength of the economy and the resilience of markets and probably as a result appeared somewhat deaf to the multitude of messages from markets.

I am not arguing with having an inflation goal in principle or with the apparent range for that goal. Well, I might argue a bit with the apparent range. Why

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<sup>7</sup> For some cautionary evidence about taking those FOMC forecast too seriously, see Romer and Romer (2008), who show that the FOMC forecast performs poorly when compared to the forecast of the FOMC's staff.

did the center of the Committee settle on “somewhat less than 2 percent”? Probably in part because when they first talked individually in public a few years back about their working definitions of price stability, inflation was running comfortably in that neighborhood. Those public remarks framed the goal around the current level, which they continued to hold even as inflation drifted up and after we learned through the data revision process that inflation had never been that low in fact. But because the goal was settled on informally, we never had the chance to engage in the public discussion that would air those issues. I am arguing that if you have an inflation goal, you should use it. And an important part of its use should be to explain the prospects for policy.

Here I expect more of the movement to resolve the communications failure to come on the monetary policy side. Having a goal but not being forceful in using it as an explanatory device clearly falls short of best practice. But I would not expect a change any time soon. The political climate, accentuated by the current cyclical position of the economy, will be chilly toward explicit recognition of an inflation goal in the United States. That means market participants will have to be particularly attentive to both the shouts and the whispers of the Federal Reserve because volume does not always convey significance.

### **Post-Gradualism: Conducting Policy**

I must admit that there is a lot I do not understand about marketing in the economics profession. Sometimes when observed behavior is at variance with predictions from models, it is anointed as an anomaly and a cottage industry develops

to explore alternative explanations. Shortfalls in standard consumption theory, for instance, gave the profession two important anomalies. The equity premium puzzle tells us that the observed reward to risk taking in the equity market is too large relative to the smoothness of consumption.<sup>8</sup> And the excess-sensitivity problem tells us that this-self-same very smooth consumption path tends to vary more with income than the permanent-income hypothesis would predict.<sup>9</sup>

I bring this up because I fail to understand why the great beast that is the economics profession has never risen on its hind legs and growled in a menacing way about an obvious anomaly in policy rates. Over time and in many countries, policy interest rates tend to be very inertial, in that their current trajectory is extended far more often than reversed. In industrial economies over the last twenty years, policy continuations—that is, changes in the same direction as the previous change—tend to be observed five-to-ten times more than policy reversals—that is, changes in the opposite direction as the previous change. And the discrete change in the policy rate tends to be small, almost always and everywhere one-quarter percentage point.

Most sensible theoretical models, however, have the property that it is the level of the policy rate that matters for the level of economic activity. If that is the case and a forward-looking central bank is told to achieve a well-designed objective function focused on economic activity and inflation, then the policy rate should not be nearly so predictable. Why? As in textbooks, the level of the policy rate should be

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<sup>8</sup> Fama and French (2002) review the evidence on the equity premium. At this writing, Google Scholar reports approximately 127,000 academic items on the internet related to the equity premium.

<sup>9</sup> Flavin (1985) or the other approximately 147,000 related items on the web (again according to Google Scholar).

set to balance current risks to economic performance (both resource use and inflation to a national authority given dual objectives, as in the Federal Reserve Act). This assessment should incorporate a view about any exploitable (i.e., predictable) correlation in the shocks. But if the level of the policy rate reflects the response to all shocks known at the time, including the knowledge that some shocks are serially correlated, the decision on setting the level of rates the next time the policy committee meets will change only based on the arrival of new information. And that pertains only to genuinely new information, or that which could not have been predicted by the exploitable serial correlation in the data. New information—news—is unpredictable, and as a result so too should the next setting of the policy rate. Moreover, there is no reason in statistical theory to believe that the arrival of new information should conveniently round to one-quarter point on the policy rate so frequently.

That said, there is a strand of academic work holding that gradualism may be anomalous, but that it is a relatively innocuous violation. It is innocuous, this line of works holds, because if a central bank is relatively transparent in its intent ultimately to adjust the policy rate, even if it does so in small steps, the longer-term rates critical in shaping spending will be priced appropriately. That is, if there are a lot of paths of the overnight rate that can produce the same ten-year rate, why sweat the difference if policy makers chose one exhibiting a slow, measured, trajectory?

I always found the argument about shaping expectations to be compelling, especially as applied to the zero bound to nominal interest rates.<sup>10</sup> Even if the current policy rate was very low, policy stimulus could still be imparted by conveying the sense that the policy rate would stay lower for longer than currently expected. But believing that the mechanism is helpful around the zero bound to nominal interest rates does not logically imply that it renders gradualism innocuous.

In particular, gradualism creates inter-temporal bargains that are outside the settled order of many models. Arithmetic guarantees that you can get the same path for the ten-year yield with a multiplicity of paths of the policy rate, but those paths that have slow and small increases will provide sustained and predictable bargains to those who want to fund at the short end of the yield curve. I cannot help but think that the gradual tightening from 2004 to 2006 encouraged funding at the short end of the yield curve, including adjustable rate mortgages and their more exotic cousins, as well as any many carry-related trades.

The theoretical prediction—a random-walk policy rate—is so clean and stark and so at variance with the data outcomes of policy gradualism that I believe this anomaly should have been enshrined more prominently in the profession’s firmament.<sup>11</sup> But what do I know? Actually, what I do know is that it might be too late to do so, because the final significant change I want to highlight is the patent rejection of policy gradualism expressed through the FOMC’s behavior over the past six months.

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<sup>10</sup> As discussed in Bernanke and Reinhart (2004).

<sup>11</sup> Citations according to Google Scholar run about one-tenth those associated with the prior two anomalies I mentioned. Sack and Wieland (2000) examine the literature on policy gradualism.

A Committee that lowers the policy interest rate 125 basis points in nine days, as it did last month, is not acting gradually.<sup>12</sup> But even last year, the early efforts in this easing cycle, including a half-point move in September, were generally described as sufficient to balance the risks. Those statements sounded like they were written by a committee that believed it was frontloading policy accommodation. This assessment of the forces pressing down on aggregate demand and the resilience of financial markets were too optimistic in the event. But that does not change the intent behind the actions—bringing forward policy accommodation sufficient to the perceived problem.

Avoiding the gradualism of small and predictable changes in the policy rate brings policy practice more in accord to the textbooks. But I must admit to four main worries about how well it will work in fact.

First, front-loading policy changes can be difficult to calibrate as it requires an explicit judgment on the appropriate level of the policy rate. As a profession, we have a poor track record in getting the level of potential output right, among our failings, and we should correspondingly be bad at nailing the equilibrium real short-term interest rate. In contrast, a policy rule that says keep changing the rate in small amounts until the evidence tells otherwise may be inelegant but have the advantage of robustness.<sup>13</sup>

Second, some importance might accrue to changing the rate as well as getting the level right. In particular, changing the policy rate at a time of stress

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<sup>12</sup> This is an impressive accomplishment, even when not put at an annual rate.

<sup>13</sup> See the discussion in Orphanides and Williams (2007), for example.

(symmetrically either in response to a weakening in demand or a pick-up in inflation expectations) might have an important and helpful effect on confidence. If so, there is some value in reserving changes in policy for the right window when the public would view it receptively.

Third, and related, front-loading policy accommodation requires that the central bank be willing to keep to its plan. That is, it may be in a situation in which it pulls the level of the policy rate down on the expectation of weakness. If the data run in line with that forecast, the appropriate policy action is to do nothing subsequently—because it has already been done. The temptation for double counting—to act on the expectation and the realization—could be high if at least a portion of the public believes that changes in the rate have an independent effect on the economy. Entering the post-gradualist world might be the right move in theory, but it may take acts of courage in practice.

And fourth, speaking of courage, post-gradualist policy has to be symmetric so as not to impart a bias in policy. That is, the same Federal Reserve that eased aggressively to sustain economic expansion has to tighten aggressively should inflation expectations begin to creep up.

For their part, market participants should recognize that the federal funds rate will likely follow a different track than that of the past few decades. In particular, do not automatically extrapolate that large changes will be followed by large changes. That initial large change might be the front-loaded action substituting for smaller, gradual changes.

## Conclusion

These are interesting times for monetary policy. And mindful of the Chinese proverb, I am glad I am seeing them as a spectator. To be sure, there is ample scope for more progress, but do not let that blind you to the fact that there has been significant progress already. And progress has to be two sided. Market participants have to be more attentive to the messages from the Federal Reserve and less expectant of explicit guidance on the path of interest rates. And policy makers have to appreciate that there may have been good reasons why the textbook was not already put into direct application.

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