Making Monetary Policy and Talking about It

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The way we were

- **Volcker (1984)**
  “One danger in immediate release of the directive is that certain assumptions might be made that we are committed to certain operations that are, in fact, dependent on future events, and these interpretations and expectations would tend to **diminish our needed operational flexibility.**”

- **Greenspan (1989)**
  “It would be ill-advised and perhaps virtually impossible to announce short-run targets when markets were in flux” and even in normal times “a public announcement requirement also could **impede timely and appropriate adjustments to policy.**”

- June 1994 advice to Vice Chairman Blinder: “We don’t talk about the economy.”

- An absolute taboo on “forward-looking information”
The intellectual assault

- The democratic accountability argument
  - Democracy + CBI $\rightarrow$ accountability $\rightarrow$ transparency
  - Contrast Montagu Norman: “Never explain, never excuse.”

- The monetary-policy effectiveness argument
  - See next slide
The intellectual assault (cont’d)

- It’s not mainly the overnight rate that matters; it’s the rest of the yield curve.
- Forward-looking information helps condition (“manage”) expectations.
- Doing this right “tightens the gears” between the funds rate and the rates that matter.
- So *talking* about policy is part of *making* it.
- Near the zero lower bound, managing expectations may be the whole ball game.
The “quiet revolution” at the Fed

- Before February 1994: Say nothing and say it cryptically. ("Mumbling with great incoherence.") So markets often “got it wrong.”
- May 1999: fuller statements (even when $\Delta r=0$) and reveal the “bias”
  - May-Dec 1999: 135 substantive words/statement (6/6 statements)
  - 2000: 119 substantive words/statement (8/8 statements)
- March 2002: announce votes, with names
- August 2003: “considerable period” etc.
- February 2005: earlier release of the minutes
Attitudes today
(Bernanke speech in 2004)

- “As public servants whose policy actions affect the lives of every citizen, central bankers have a basic responsibility to give the public full and compelling explanations of the rationales for those actions.”

- “If effective communication can help financial markets develop more accurate expectations of the likely future course of the funds rate, policy will be more effective.”
The Fed is in “that awkward stage.”

• **Making policy:** The Fed is now practicing “inflation forecast targeting.”

• **Talking about it:** But it is not announcing either its forecast or its target.

• This is not very transparent!

• “Everyone knows” the target is 1-2% for core PCE.

• But is there a credible forecast that gets us into this range?
Next steps

- Adopt an official inflation target
- Announce the forecast: what sort? how often?
- Issue: what future monetary policy to embed in the forecast, and what to say about it
- Contrast: NZ/Norway/Sweden vs. “Humphrey-Hawkins” forecasts
- An easy first step: Use a mechanical reaction function.
Conclusion

- The Fed has come a long way since 1994.
- But it still has a long way to go.
- The Fed has never regretted any move toward greater transparency.
- Two easy next steps: announcing both the inflation target and (coherent) forecasts.
- A mechanical funds rate forecast is easy, too.
- Try it--you’ll like it!