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The Uncertainty of Making Monetary Policy: Do the New FOMC Statements Clarify Anything?

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Most uncertainty is unavoidable. For instance, we know that the current, extraordinary, boom in the U.S. will eventually come to end, we just don't know when. We know that the sustainable growth rate of the U.S. economy has increased over the past five years, we just don't know how much. The list goes on.

The job of central bankers is to conduct monetary policy in order to promote price stability, stable growth, and a stable financial system. They do this in an environment fraught with such unavoidable uncertainties. But in conducting policy, there is one uncertainty that policy makers can reduce: the uncertainty they themselves create. Everyone agrees that monetary policy makers should do their best to minimize the noise their actions add to the environment. **The essence of good, transparent, policy is that the economy and the markets respond to the data, not to the policy makers.** Does the U.S. Federal Reserve's Federal Open Market Committee (FOMC) meet this test? Or, do the current FOMC practices add noise to the economic environment?

Current practices were put in place on 22 December 1998, when the FOMC announced that it would periodically release statements explaining some of its policy actions, and clarifying the committee's thinking about likely future events. Beginning with the announcement on 18 May 1999, there have now been 5 such statements, one following each of the FOMC meetings between May and November. To understand the history of these statements, it is important to begin with the FOMC's policy directive. The directive has two parts, the first is a brief description of the current

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state of the economy, and the second sets the target for the federal funds rate and then describes the committee's consensus about the likely future course of interest rates. This last portion of the directive has become known as the "tilt" or "bias". The directive agreed to on 5 October 1999 contained an upward bias, stating that:

"In view of the evidence currently available, the Committee believes that prospective developments are more likely to warrant an increase than a decrease in the federal funds rate operating objective during the intermeeting period."

While the minutes of this meeting became publicly available only on 18 November 1999, and so the exact wording of the directive was only known 6 weeks plus two days later, a brief statement released the day of the meeting making it clear that this language had been adopted. Following a brief comment about how "a decreasing pool of available workers willing to take jobs" posed risks to the inflation outlook, the statement closed with the following remarks:

"Against this background, the Committee adopted a directive that was biased toward a possible firming of policy going forward. Committee members emphasized that such a directive did not signify a commitment to near-term action. The Committee will need to evaluate additional information on the balance of aggregate supply and demand and conditions in financial markets. "

Following the most recent meeting on 16 November, when the FOMC raised the federal funds rate target by 25 basis points, to 5 1/2 percent, the announcement of the interest rate change was accompanied by a comment that the bias had been returned to neutral. That is, the final sentence of the directive in place today reads:

"In view of the evidence currently available, the Committee believes that prospective developments are equally likely to warrant an increase or a decrease in the federal funds rate operating objective during the intermeeting period."

Does the FOMC's current announcement policy clarify policy maker's intentions, reducing the uncertainties in the environment? Or, does this scheme actually obfuscate the FOMC's intentions, making policies more opaque and increase risks surrounding future policy actions?

There are numerous difficulties with the current disclosure procedures. Primary among them is that the statements clearly mean different things to different people. A primary reason for this is that the FOMC is actually not clear about its own objectives. Unlike the European Central Bank, whose primary objective is price stability, defined as inflation in the Harmonized Index of Consumer Prices of less than two percent, or the Bank of England, where the Monetary Policy Committee is charged with maintaining inflation of 2 1/2 percent in the Retail Price Index, the Federal Reserve has no publicly stated objectives. The language of the Humphrey-Hawkins Act, which is very long on goals and very short on details, is all that we have. As a result, not even the members of the committee seem to agree on the specific goals they are striving to achieve. Is current policy targeting inflation? If so, at what level? Using what measure? Some articulation of these goals seems essential if we can every hope for clarity and transparency from the FOMC.

A second problem is that the bias in the directive has no agreed upon interpretation, even within the FOMC. Taken literally, the second sentence of the final paragraph of the directive is a statement about the intermeeting period. That is, about likely interest rate actions prior to the next formally scheduled FOMC meeting. Within this context, some people seem to think that the bias gives discretionary authority to Alan Greenspan, as the Chairman of the FOMC, to change interest rates on his own. This interpretation has it that if the bias is neutral, as it is today, then the Chairman can move the federal funds rate by 25 basis points in either direction. With a bias, he would be able to go 50 basis points in the direction of the tilt, but not the other way. Even if there were an understanding that this were the case, and there is not, it is inconceivable that any Chairman would use such power without extensive consultation with the members of the committee.

On a practical level, the tilt has been used as a consensus building device. The FOMC is unlike both the ECB council, whose votes are never published, and the Bank

of England's Monetary Policy Committee, who have a clear willingness to disagree publicly on the current stance of policy. In contrast, the FOMC both publishes its votes (in minutes released two days following the next meeting), and has a tradition of public consensus. For there to be more than two dissenting votes, out of the twelve voting members (when there is a full complement), is nearly unheard of. Dissents, particularly by the Governors or the President of the Federal Reserve Bank of New York, would be viewed by many observers as a revolt against the Chairman. The bias in the directive acts as mechanism whereby the Chairman insures that there is not significant dissent. When there is significant disagreement on the committee, the Chairman will offer those with only mild differences of views a biased directive as a way of expressing themselves without actually voting against his position.

The history of the statement is that, after a newspaper story disclosed the directive soon after the May 1998 meeting, triggering a sharp drop in stock prices, a number of the participants in the FOMC process expressed their dissatisfaction. While some people approved of the policy of disclosing the directive with a substantial lag, when it had become essentially irrelevant, others thought it best to announce the bias immediately after it was adopted. The current selective release of the bias and the statement is a result of the discussions that ensued during that year. The intention was to reduce the speculation about the committee's position, and increase the transparency of policy making.

My view is that the current strategy has been increasing the uncertainty created by the FOMC, not decreasing it, as had been hoped. There are several difficulties. First, the bias refers only to the intermeeting period, while the statements that have been released thus far use wording like "policy going forward," implying a longer horizon. Furthermore, by referring to selective concerns in the outlook, such as the recent focus on labor productivity and the pool of available workers, the statement suggests that future actions are predicated largely on the data that is in a small subset of what will become known before the next meeting. Finally, the statement gives the impression that the committee has been able to summarize its likely reaction to future events in a few sentences (the statements have been between 3 and 6 sentences). Surely none of these is either accurate or possible.

As for the tilt itself, it is important to ask whether it serves any useful purpose at all. In the absence of a more detailed description of the sense of the committee, the bias is very difficult to interpret. It is not, as some market participants seem to believe, a conditional vote about the next meeting. That is to say, when the committee sets a biased directive, it is not voting to change interest rates in the future. This would be very bad practice, and no one should be advocating it.

I have tried to argue that the current policy of including a bias in the FOMC directive, with selective public release of the bias and an accompanying statement on the day of the meeting, increases confusion. Where should we go from here? First, I propose the elimination of both the bias and the statement as they are currently constituted. The statement is too short to properly convey the sense of the committee, and the only purpose the bias serves is internal consensus building. If there is a bias, the market participants will speculate about it, and try to figure out what it is, and so there is little justification for not announcing it.

Looking to other central banks, we see several alternatives. The first is the ECB's approach, following that of the Bundesbank, where the President holds a press conference at the conclusion of each council meeting. This promotes transparency and enhances understanding. The give and take of a news conference allows for a description and justification of the decision that has been taken, and its accompanying subtleties. I am in favor of the Chairman holding a news conference following each FOMC meeting.

My preferred solution, however, is to accelerate the publication of the minutes of the meeting. The Bank of England publishes detailed minutes of the Monetary Policy Committee's deliberations two weeks following each meeting. This is an excellent communications device, as it contains details that make policy decisions much easier to understand, with the concluding section of the minutes would contain a clear synopsis of the committee's views on the future. The two week lag may seem like an eternity to financial market participants, where two minutes can be a long time, but it is the minimum that is physically possible. This short wait is likely to be worth the overall reduction in the uncertainty of monetary policy.