General Discussion: Monetary Policy Strategy and its Communication

Chair: Janice C. Eberly

Mr. Frenkel: I would like to make two points about the nature of the inflation target. First, countries that have used the inflation targeting strategy in order to move from a high inflation rate toward price stability, have invariably set their inflation target along the path in terms of a range within which the inflation should be. The logic of setting the target in terms of a range reflects the reality that the monetary authority is not certain about the economic model and about the response of the various variables to economic policy. That uncertainty reflects the fact that during the high inflation period, the economy has undergone significant dislocation which have rendered the economic model less certain. In contrast, the major industrial countries that have reached price stability, have set their target in terms of a *specific* rate of inflation rather than in terms of a *range* of possible rates of inflation. The question is whether it would not be prudent to also define the inflation target in the major industrial countries also in terms of a range? Second, most of the central banks in the major industrial countries have set their inflation target at the *level* of 2% per year (e.g., Bank of England, Federal Reserve, Bank of Japan, ECB). Since the economies governed by these central banks differ from each other, in many dimensions (structurally, institutionally, historically), what is the explanation that all have chosen the same inflation target? Finally, most central banks have recognized the importance of financial stability as a guide for policy. This of course, in addition to price stability. Yet, in many of the central banks this new focus on financial stability has not been formally incorporated into the language of the central bank law. Is this an important omission? Should we consider a wholesale revision of central bank laws?

Mr. Rehn: Many thanks for the excellent paper and very enlightening discussions. I have two concise questions. Athanasios, take the first as small talk, and second as the real beef. First, your key finding in your paper is that the shock to projections over inflation and growth matter most as the determinants of rate decisions rather than long-term considerations. In our research, the Bank of Finland has come to the same conclusion also as regards the ECB. So, it's not only the Fed; also, the ECB governing council seems to behave in a more terrestrial than a celestial manner. Yet, both the FOMC and the ECB publish also their long-term projections well beyond the near term. I'd like to ask what is your view on the basis of your research? What's the practical policy relevance of these long-term projections?

Second, a question related to the price stability target and symmetry or asymmetry. Compared to the Fed, the ECB has a single mandate as we know. It should be fairly clear and simple in principle. However, as it is defined as below but close to 2%, and this is not a very clear definition, it is obviously asymmetric and that's less clear than, for instance, the Fed's target. In light of your paper's findings, should the ECB's price stability target be changed and defined as an explicitly symmetric target like accepting a variation of inflation to both directions from 2% in the short term in order to converge to a 2% target in the medium term.

Mr. Eichengreen: Athanasios makes a compelling and suitably cautious case that leaves out something important, namely the difficulty of even incrementally changing a rule once you've embraced it. Consider the 2% inflation target and the debate around whether, with benefit of hindsight, we might have set it somewhere else, but that we have to live with it given that it's become a focal point for markets, and that there could be credibility costs from changing it. Relatedly, the gold standard, another example of a well-known monetary rule, lingered on for longer than it should have. Why is not hard to understand.

Exchange rate stabilizations are hard to abandon once they've been put in place. This raises a more general point: what is the exit strategy from the rule once it needs to be incrementally changed?

Mr. J. Taylor: One thing to add to what Athanasios said, is that it's really an international issue: the gains from a clearer policy or strategy just multiply internationally. A lot of the issues that the first two papers got into—spillovers, Jacob Frenkel mentioned inflation targeting reducing spillovers—all work better if there's a general view that all central banks to follow them as best they can. I would also say it's not just goodness of fit, which Frank Smets stressed to some extent, because you can have goodness of fit for policies that are terrible. And you want to have some independent assessment as best you can about what's good and what's not. Maybe that's based on models, and I think models are OK for this purpose. The other thing is that there is a lot of recent interest, resurging interest, in policy rules; this has to do with the zero bound. I've noticed it myself. And John Williams is a big part of that discussion. But how else would you analyze what to do in that situation than with some kind of strategy or rule? So that's why I think there's a resurgence.

And the last thing I'd say, I really enjoyed the op-ed by Janet Yellen and her colleagues in *The Wall Street Journal* stressing the importance of independence, and I think Athanasios' statement that strategy or rules helps independence is correct. But independence is not enough. You can have, in fact we have had, major fluctuations in policy in the United States without any real changes in the degree of independence. So, you need to have a strategy or rule in addition to independence because that provides the accountability in a very clear way. So, I would just say that in addition to independence you need a rule of strategy; independence is not enough. Rules will help independence, but you need to have an accountability to go along with the independence.

Mr. Orphanides: Thanks to both of the discussants. I fully agree with the characterization. I'm going to start with Valerie Ramey's characterization on Figure 2. That is exactly the problem, and the challenge is to find a simple way to communicate the systematic nature of policy. This is what I'm trying to propose. John Taylor has been trying to propose that, I have been trying to propose that, Allan Meltzer, Ben McCallum, over the decades to move incrementally in that direction.

With respect to what Frank said, yes this is indeed a way to get closer to a rule-like policy, constrain discretion, which is a problem for all central banks. But it's much less of a problem for inflation-targeting central banks, and much lesser of a problem for inflation-targeting central banks that have a clearly defined inflation objective that is provided by the authorities. That actually is a much simpler framework. You don't have to worry about interpreting what it means to achieve maximum employment at the same time you achieve price stability without having a clear definition of either one. This is why I think for situations like the Fed's situation with a mandate that is less clear than that associated with inflation targeting central banks, it's far more important to commit to a policy rule that gives the interpretation of then balancing of the alternative interpretations.

Jacob was asking why 2%. What is the optimal level of the long-term inflation rate that's consistent with price stability, but taking into account considerations such as the zero lower bound that we are facing now? Because in many central banks—the Fed, the ECB, and elsewhere—we were already doing work on how to deal with the zero lower bound before the crisis. And this was how we ended up ratcheting up from the zero inflation statements that were more common in the 1980s as a clear definition of price stability to this 2% levels to which I think we are globally converging to. It can be a continuous discussion whether 2 is the right number. I take it very seriously that if you are willing to deviate from 0%, you still have to stay within what Paul Volcker suggested, that if you're going to have positive inflation rate, it has to be low enough so that people will not be taking it into account in their decision making. I think to satisfy that definition, higher numbers would not satisfy that definition by my count, but this can be debated.

With respect to Olli Rehn's question, there are two things to respond to. One is, if it were possible for the ECB yesterday to adopt a 2% symmetric inflation goal, I think this would vastly improve the policy frameworks. And if yesterday is not possible, tomorrow would be good and I'd be waiting to see that. In terms of the forecasting, the point of looking at near-term projections is because they seem to be very good summary descriptions of the current state of the economy. As Frank pointed out, they're uncorking data. So, if you look at, say, GDP and growth starting at $t-1$ going to $t+3$, you're actually grounded in data, you are not really influenced by models. You don't have the model specification to worry about, and you incorporate the wonderful judgment that professional forecasters and central bank staff bring into the analysis, which forecasting status suggests is best for current quarter and one quarter ahead estimate of GDP for example. Far better than anything we can summarize in other ways. Looking at longer-term projections, let's say two-year projections, will actually be subject to the endogeneity problem of what are the models you are assuming, what is the policy in the background. So, you would have to deal with additional issues, and you would be moving away from a simple policy rule that is guided in data.

With respect to Barry Eichengreen's comment, I'm going to link this to John's comment. What's the exit strategy from 2%? Frankly, I hope there is no exit strategy from 2%. This is much more of an issue when we're discussing a simple policy rule. Should the Federal Reserve at the next meeting adopt the balance approach rule variation of the Taylor rule, or the first-difference rule or whatever. We have many, many alternatives and parameterizing these things does depend on what we know about the economy and what we know about the policy transmission mechanisms. So, we can expect that our best, simple policy rules will be evolving over time, much like our knowledge evolves over time. This is why in the proposal I make, and I think others have adopted and mentioned a lot of proposals as well, the issue is not to adopt *a* rule. The issue is to adopt a framework that will have the committee substitute its meeting by meeting discretion on setting the fed funds rate, substitute that to using its discretion to select a policy rule and every year re-evaluate the rule. What I would want to see ideally is an appendix of the January statement, an appendix providing an evaluation of the policy rule that had been adopted the previous year, with new results showing whether that rule is still close enough to be a reasonable rule or whether some other rule should be done. Central bank staff have the best research teams to do this, and in many cases, they're already doing this—inside the Fed, inside the ECB, and many other central banks. It's all about how one combines all of that knowledge to how policymakers translate it into systematic policy and communication.

Mr. Fischer: This has been extremely interesting. Let me deal with the 2% rate, which wasn't what I was going to talk about. The 2% rate happens to have become the global rate for what price stability means. We've never had a global agreement on what the rate of inflation is or should be. We've now got one. We take it away, we put the inflation rate's importance down because it's become a variable that we can set from time to time. So, I think we should understand that we will pay a price for changing the rate, whatever rate it is.

What I wanted to talk about was a question that occurs when you look at Valerie Ramey's really beautiful chart. The role of the Fed, we focus entirely on what is it that's good for the Fed when we're considering all this stuff. The Fed's role in providing information is much greater than the numbers it puts out. It's putting its judgment on the line at particular intervals. Question: How far apart should those intervals be? The Indian Central Bank apparently has only scheduled one meeting for every three months, but you can do it if X percent of the council calls for it, and the average that they actually have is about three a month. So, what is it we're after, and how frequently should these meetings be? I think it's a much bigger problem because we've got to look at what the economy needs, not what these guys, wherever the Fed is in here, or the central bank finds convenient. It matters what the Fed says and—I have some places go every two months. This will supposedly go every year, every three months and so forth. I don't think we've had a systematic look at that, and I think that is potentially a very important part of what should be fixed in conjunction with thinking about this whole chart that Valerie has provided. As for the risk, I think I thought I was hearing a lot of very sensible things, and that's all I have to say.

Ms. Lucas: Maybe this is a more direct way to ask a question that other people have alluded to. With policies like large scale asset purchases, and the corresponding balance sheet growth that came about because of the unconventional policies to get around the zero lower bound, there's a question about the credibility of characterizing policy in terms of a stable policy rate. A further complication on top of Valerie's points, is I that don't think the public really understands when there will be a switch between policy regimes, what the regime is during the switch, and when an unconventional regime will end. When I talk to my students, they don't even know that a short-term policy rate is the main target of the Federal Reserve, which suggests an important change in public perceptions. So, I just wanted you to comment on how you think about systematic rules when they must be extended to a policy regime that goes beyond the short-term rates?

A smaller issue is when you go to something like a survey of professional forecasters, a prediction of Fed policy is embedded in that forecast. In fiscal policy, we think of a baseline as being a function of taking a particular policy assumption and then projecting forward based on it. I think the Fed also needs to be more explicit about the policy assumptions in its forecasts. Most of the time, it might make little difference; but in times of heightened uncertainty, you do have to take into account what the market is thinking about policy versus your own expectation of what policy would accomplish.

Mr. Gorodnichenko: You emphasized the importance of communication to the general public. I was wondering if you could clarify who is the general public? Is it financial markets, members of the Congress, professional forecasters, or the household? I can imagine that it would be very hard to explain Figure 2 from the slides to the average American, and I assume that the average American doesn't know much about monetary policy rules such as the Taylor rule or the Orphanides rule.

Mr. Leahy: I'm looking at Frank's estimates, and I can't tell whether the glass is half empty or half full. On the one hand, it fits pretty well. But the R^2 is only 50%. So, if you adopted an Orphanides rule, you'd spend half your time explaining the deviations, or that's one possible outcome. But if you're explaining the deviations half the time, what's the purpose of the rule? Or, do you end up as Barry Eichengreen said, it becomes a straitjacket and you don't do the things you actually want to do? Which outcome would it be?

Ms. Vissing-Jorgensen: I'm sympathetic to moving toward a more rule-based approach, but it of course requires us to agree on the rule. I think that's not just about disagreement between policymakers at a given point in time, but also the whole issue of rotation on who votes on the FOMC. I wonder whether it's time to think about consolidating Reserve Bank Districts and ending rotation in order to sort of keep up the power balance between the governors and the presidency.

Mr. Walsh: Athanasios really stressed the value of rules as providing a way of implementing systematic policy, and he contrasted that with discretion and the potential cost of discretion. But at least the way I always think about discretion is that it is also a very systematic way of conducting policy. That's why we are able to analyze it in our models. And it's a systemic way of pursuing well-specified goals. It doesn't do as well as commitment, but it often does better than simple rules. As John Taylor emphasized, there are good rules and bad rules. And the only way you can compare whether a rule is good is by having clarity about the goals you're trying to pursue. So, I think either in defining what we mean by a good rule, or in analyzing discretion, we have to start by emphasizing what the goals are. I think the fundamental point comes back in some sense to where Athanasios started, and that is that the vagueness of the Fed's strategy for how it balances the dual mandate is really at the heart of all the issues involved in coming up with a more systematic approach to policy. So, I'd emphasize the importance of defining how you balance the trade-offs under the dual mandate; if that balance can't be clearly defined, you have to move to something like a single mandate. Otherwise I think it would be very difficult to gain the agreement and clarity to agree on a rule.

Ms. Boone: I'm very surprised; actually the approach from somebody coming from Europe where we have fiscal rules which have proven to eliminate any or near close to any discretion when it comes to addressing crisis or even the normal cycle. By contrast, we have central banks, not only in Europe, which have used their discretion of action to actually do extraordinary things and address most of the crisis. So, the fundamental idea of trying to bind the central bank with a rule is, to me, very, very surprising and I would like to hear why you decided to do that.

Perhaps the second thing is one of the arguments you mentioned in your paper is the lack of consensus that may exist within the members of the FOMC, which I guess is very similar in many central banks as well. I fail to see how having a rule would actually eliminate this type of discussion, or even whether we should wish or hope for that.

Mr. Orphanides: Let me start from the last point. Disagreement among members of the Committee is one of the reasons why it's difficult to adopt a common anything. But again, look at what the Fed managed to do in adopting a 2% target. Reading through the transcripts of late 2011 and early 2012, it is clear FOMC participants have very different views about what is best. But they also agree that it's more important for the committee as a whole to agree to something because that would make policy more systematic and it would benefit the economy overall. This is how they resolve their disagreement, by agreeing on something that is just satisfying and not ideal for anybody else. I think it's the responsibility of a well-functioning committee to do that, and to downplay individual differences when those differences inhibit the adoption of something that would result in something good for the committee overall.

There are a number of questions, so I will be selective. Who is the public? It's a very touchy question because there are different audiences clearly that central banks need to communicate. But frankly, being clearer in statements with a policy rule every January with a quarterly report that describes projections and links them to the rule actually is fairer for everybody. It reduces the role for Fed watchers and makes it feel more even-balanced for people who are less knowledgeable to be able to follow the rule.

How do we deal with the effective lower bound, which is an important issue. Here actually, I went and checked the 2012 transcript and the adoption of "QE infinity," as I remember John Taylor calling it. And none of the concerns about if the Fed has an open-ended asset purchase program, how do we know where this ends? The answer clearly could have been communicated with a rule in place. If you say, we will be purchasing X per month until inflation reaches some number, and then we will know it. This is much clearer in the context of a rule than the approach that was adopted at the time. I think it would have protected the Federal Reserve from some of the criticism that I think fairly was targeting the Fed at the time. We are uncertain about the economy and we are uncertain about monetary policy transmission at the zero lower bound, but we now have much better estimates than we had 10 years ago. All central banks that have engaged in QE actually have estimative and translating what is the equivalent with some uncertainty bounds of 25 basis points on the policy rate in terms of quantities and QE. So, if you have a simple interest rate rule, you could use that in those estimates as a benchmark that you would need to be adopting as you go along. You could adopt other procedures, you could move from a short-term policy instrument to longer-term interest rate instruments if you wanted to do that. As Frank said, these are some of the things that are worth studying going forward so that in case, just in case, we ever again need to do quantitative easing at zero lower bound elements, we have better approaches to adopt by then.