

## Can You Hear Me Now?

On November 14, 2007, the Federal Open Market Committee (FOMC) announced several changes designed to “improve the accountability and public understanding of monetary policy making.”<sup>1</sup> These changes included increasing the frequency of the economic projections of the FOMC participants (governors and Reserve Bank presidents) from two to four times per year; extending the maximum projection horizon from two to three years; and quantifying, to the extent possible, the degree of uncertainty policymakers attach to their economic projections.

Increased transparency is one way to reduce the uncertainty that households, firms, and financial markets have about the current stance of monetary policy and its implications for future economic outcomes. In his remarks describing these changes, Chairman Bernanke said that increased transparency benefits society and the economy in two important ways.<sup>2</sup> First, “good communications are a prerequisite if central banks are to maintain the democratic legitimacy and independence that are essential to sound monetary policy making.” Second, “central bank transparency increases the effectiveness of monetary policy and enhances economic and financial performance.”

When the FOMC released its new economic projections on November 20, 2007, economic and financial market participants tended to focus first on the revisions to the 2007-08 projections that were published July 18, 2007, in the *Monetary Policy Report to the Congress*. The new projections indicated that FOMC policymakers had become modestly less optimistic about real GDP growth in 2008 compared with three months earlier (the mid-point of the central tendency was reduced from 2.5 percent to 2.15 percent), but their expectation for core PCE inflation in 2008 was virtually unchanged from three months earlier (the mid-point of the central tendency is 1.8 percent).<sup>3</sup> In view of the recent turbulence associated with developments in the housing and mortgage finance sector, the market’s focus on the revisions to the near-term outlook is consistent with the FOMC’s risk management strategy. If, for example, the risk of weaker economic growth exceeds the risk of higher inflation (asymmetric risk), “the appropriate

policy gives more weight to a very damaging outcome that has a low probability than to a less damaging outcome with a greater probability.”<sup>4</sup>

Analysts then focused on the FOMC’s projections for overall and core PCE inflation in 2010. According to the central tendency, inflation—whether measured by the PCE or core PCE—is expected to be between 1.6 percent and 1.9 percent for the four quarters ending in 2010:Q4. From 2007 to 2009, though, overall inflation is projected to slightly exceed, on average, core inflation. Extending the projection horizon by one year is potentially an important innovation in the monetary policy communication process. For one thing, it reinforces the fact that monetary policy is the main determinant of inflation over longer horizons. Second, it also reinforces the fact that, over time, the overall inflation rate—which households and firms care most about—should be no different from the core inflation rate, which the FOMC uses as a measure of the underlying inflation rate. This is because food and energy price shocks tend to be temporary.

Some economic analysts appear to have interpreted the mid-point of the 2010 central tendency as the Committee’s long-term inflation preference—despite no explicit policy statement to that effect. Nevertheless, if this interpretation persists, and if expectations are crucial for ensuring good macroeconomic outcomes, then the FOMC’s longer-term inflation projection must be viewed as credible. One way to achieve credibility is by ensuring that the three-year-ahead projection errors are zero, on average. Attaining this outcome may be made more difficult because (i) the composition of the FOMC may change over time and (ii) each member may have a different view of what an “appropriate” policy stance is.

—Kevin L. Kliesen

<sup>1</sup> See [www.federalreserve.gov/newsevents/press/monetary/20071114a.htm](http://www.federalreserve.gov/newsevents/press/monetary/20071114a.htm).

<sup>2</sup> See “Federal Reserve Communications,” at [www.federalreserve.gov/newsevents/speech/bernanke20071114a.htm](http://www.federalreserve.gov/newsevents/speech/bernanke20071114a.htm).

<sup>3</sup> The central tendency removes the three highest and lowest projections.

<sup>4</sup> See Alan Greenspan, “Risk and Uncertainty in Monetary Policy,” at [www.federalreserve.gov/boarddocs/speeches/2004/20040103/default.htm](http://www.federalreserve.gov/boarddocs/speeches/2004/20040103/default.htm).