Commentary

Marvin Goodfriend

Back in 1984, I was invited by Bill Poole, then a member of the President's Council of Economic Advisors, to work as a senior staff economist for money and banking at the Council. When I arrived at the Old Executive Office Building that fall, I brought with me an early draft of a paper on central bank secrecy that I had just finished. I gave a copy to Bill, who I knew had a long-standing interest in central bank communications. I remember his reaction: Bill put the paper in an envelope, signed it, wrote on it "for my eyes only," and had his secretary put it in a safe. How appropriate, I thought! Later, Bill asked for a briefing and I described among other things the substance of the FOMC defense of monetary policy secrecy in a recently concluded Freedom of Information Act lawsuit.

My interest in the topic was initiated by a headline in the *American Banker* that read "Secrecy Primary Tool of Monetary Policy." How could that be? The assertion seemed at odds with everything Bill taught us in graduate school at Brown—that, according to rational expectations theory, more information should be better than less. Bill emphasized that private agents have an incentive to use to their advantage whatever information they have, whatever its source. I wrote the paper to explore under what circumstances, if any, central bank secrecy could be justified.

I would never have predicted that "information policy" would have generated so much interest among central bankers or as much research as it does today. The main difference is that today we speak of central bank "transparency" or "policy guidance" rather than central bank "secrecy." I remember thinking that it was unlikely that central bank secrecy would ever be debated openly, and if it ever were, then I thought the case for transparency would quickly win the day. I wasn't quite correct on either outcome.

In any case, it is useful to recall how far we've come. For the most part, central banks have moved away from secrecy toward transparency, partly by being more explicit about longer-run inflation objectives and partly by communicating short-term policy concerns and intentions more explicitly. Few would now claim that secrecy is a tool of monetary policy. Quite the contrary, communication is today widely recognized to play a central role in monetary policy. That said, we have come to the point where even those who favor transparency in principle worry that excessive forward guidance on monetary policy might be counterproductive. This is the thrust of the concern expressed by Bill that motivates Carl Walsh's (2008) paper.

The balance of my remarks addresses the limits of forward guidance by drawing a distinction between two dimensions of information policy: (i) transparency with regard to a long-run inflation objective and (ii) discretionary announcements used by central banks to substitute for transparency about a long-run inflation objective.

Transparency and communication help to implement interest rate policy in two ways—

Marvin Goodfriend is a professor of economics at the Tepper School of Business, Carnegie Mellon University.

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first, because a central bank uses a nominal interest rate policy instrument to manage real interest rates, and second, because a central bank uses a short-term interest rate to manage longer-term rates.

The primary role of transparency and communication must be to convey clearly the central bank's long-run inflation objective in order to anchor inflation expectations firmly, so that a central bank can manage short- and longer-term real interest rates reliably with its nominal interest rate policy instrument.

The secondary role of communication is to help exercise leverage over longer-term interest rates with a short-term interest rate policy instrument. This a central bank can do because financial markets price longer-term interest rates (up to a possibly time-varying term premium) as an average of expected future short rates. To manage expectations of future short rates, a central bank must take markets into its confidence by communicating its intentions based on its forecast of economic conditions, its structural view of the economy, and its medium-term objectives for employment, financial stability, and inflation.

Naturally, central banks are reluctant to reveal much of their current concerns or intentions because judgments about such things are necessarily imperfect, tentative, and subject to frequent revision. And some central banks are reluctant to announce explicitly their longer-run inflation objectives too. On the other hand, central banks recognize that interest rate policy benefits from transparency and communication, and central banks are inclined to be evermore revealing of their thinking in an effort to better manage longer-term interest rates.

The reluctance of central bankers to take markets systematically into their confidence creates a reliance on announcements to convey their concerns about the economy and their intentions for short-term interest rates. Discretionary announcements employed to guide markets in lieu of systematic transparency about underlying objectives and concerns would appear to provide a degree of flexibility in communication policy. The point I wish to make, however, is that it is an illusion to think that discretionary announcements can substitute reliably for systematic strategic transparency. Inevitably, the public will find it hard to interpret announcements made without strategic guidance and, therefore, a central bank will find it hard to predict the public's reaction to such announcements.

My point is nothing more than to apply rational expectations reasoning, made famous by Robert Lucas, to announcements. It is difficult for a central bank to predict how either a policy action or a discretionary announcement will be interpreted by markets when undertaken with insufficient strategic guidance, that is, when either is undertaken independently of a policy rule.

The Federal Reserve's experience in May and June 2003 is a case in point. The Fed famously accompanied a cut in its federal funds rate target at the May 2003 FOMC meeting with a surprise announcement that significant further disinflation would be "unwelcome." The statement was intended to alert the market to the fact that the Fed would act to deter deflation. The Fed was taken by surprise by what it considered an overreaction in the media and markets to its concern for deflation. The Fed rectified matters by dropping the federal funds rate by only 25 basis points at the June FOMC meeting instead of the expected 50 basis points.

The market reaction to the surprise May 2003 FOMC announcement was excessive relative to what the Fed expected, but it could have been just as easily insufficient relative to what the Fed intended. Either way, such misunderstandings are potentially costly for the implementation of interest rate policy because they whipsaw markets, create confusion, and weaken a central bank's ability to manage interest rates. Failing to convey a monetary policy message accurately in the first place can produce an extended period of policy-induced volatility as the mutual understanding between markets and the central bank on interest rate policy is gradually and painfully restored.

Arguably, the confusion in 2003 could have been avoided if an explicit numerical lower bound on the Fed's tolerance range for core personal consumption expenditures inflation had been in place. Markets would have been prepared for interest rate actions the Fed would take as inflation neared the 1 percent lower bound on its tolerance range. And longer-term interest rates would have drifted down as inflation drifted lower in early 2003 in anticipation of the Fed's reaction. In that context, announcements could have reinforced reliably the Fed's concern about further disinflation and the credibility of its commitment to prevent inflation from falling below 1 percent.

In conclusion, and returning to Bill Poole's concern about excessive forward guidance, we can say this: Forward guidance on interest rate policy is likely to be most effective when it reinforces a well-articulated monetary policy strategy anchored by an explicit numerical long-run inflation target. Otherwise, forward guidance should be undertaken with care and only with good reason given that discretionary announcements are difficult if not impossible to calibrate consistently to achieve their intended effect.

REFERENCE

Walsh, Carl E. "Announcements and the Role of Policy Guidance." Federal Reserve Bank of St. Louis *Review*, July/August 2008, *90*(4), pp. 421-42.