Monetary*Trends*

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Making Monetary Policy More Transparent

Not all changes in the Federal Open Market Committee's (FOMC's) target for the federal funds rate reflect a change in the stance of monetary policy. Hence, the FOMC could provide more information about its monetary policy objective by announcing whether specific target changes reflect a change in the stance of monetary policy or are responses to changing economic conditions intended to maintain the current policy.

Such a practice has precedent: Beginning in 1963, the Fed began announcing whether specific discount rate changes reflected a change in the stance of policy or merely realigned the discount rate with market interest rates. Prior to 1963, it was difficult for market analysts to distinguish between "policy" and "technical" discount rate changes and, consequently, the market reacted to all discount rate changes. When the Fed began announcing the extent to which discount rate changes were made for technical as opposed to policy reasons, the market no longer reacted to purely technical discount rate adjustments. The Fed's announcements appear to have eliminated uncertainty about why the discount rate was changed.[1]

An analogous problem exists for interpreting changes in the FOMC's funds rate target. Unlike the discount rate, the federal funds rate is determined by the market. The FOMC merely sets a target for the funds rate. In the absence of offsetting action by the Fed, the funds rate, like all market rates, responds to changing economic conditions. For example, an increase in expected inflation will tend to cause market interest rates, including the funds rate, to rise. Similarly, the onset of a recession or period of slow economic growth will cause the real rate of interest to fall and put pressure on the funds rate to decline as well. If the FOMC resists these pressures in order to maintain its target for the funds rate, it will, in effect, change the stance of monetary policy. For example, if changing inflation expectations put pressure on the funds rate to rise, the FOMC must ease policy if it desires to maintain its existing funds rate target. On the other hand, the stance of monetary policy is unchanged if the FOMC raises its target rate to correspond to the increase in expected inflation. Monetary policy becomes tighter only if the FOMC raises its target by more than enough to accommodate the increase in expected inflation. Similarly, if the FOMC does not wish to change the stance of monetary policy when economic forces are driving nominal interest rates down, it must reduce its funds rate target by precisely the amount of the effect of the changed economic circumstances.

The endogenous behavior of the funds rate under an unchanged monetary policy is illustrated by the so-called Taylor rule, shown on page 10. The Taylor rule can be derived from a model in which policymakers set a funds rate target in an attempt to minimize a specific weighted average of the deviations of inflation from a target and output (real GDP) from potential output. The funds rate target is changed in response to changes in the rate of inflation or output growth, relative to targeted inflation and potential output; however, the stance of monetary policy is unchanged so long as the policymaker does not change the weights he assigns to the inflation and output objectives. While the FOMC has never followed the Taylor rule, it illustrates the sense in which changes in the funds rate need not correspond to changes in monetary policy.

Because interest rates are affected by many of the same economic forces that cause policymakers to adjust their target for the funds rate, it is difficult to know whether a change in the target represents a change in stance of monetary policy or is merely an effort by the FOMC to maintain the existing stance of policy. In practice, it is difficult even for the FOMC to gauge how much the funds rate would move in the absence of actions to maintain it. Nevertheless, the FOMC could enhance the transparency of monetary policy by announcing whether target changes are intended to change the stance of monetary policy, maintain it, or reflect some of each.

—Daniel L. Thornton

[1]See Thornton: "Lifting the Veil of Secrecy from Monetary Policy: Evidence from the Fed's Early Discount Rate Policy." *Journal of Money, Credit, and Banking*, May 2000, *32*(2), pp. 155-67.