Chairman's Remarks

Alan Greenspan

TRANSPARENCY IN MONETARY POLICY

It is my pleasure to address this distinguished group that President Poole and his colleagues have assembled to consider the timely issue of transparency in monetary policy. We at the Federal Reserve are given two mandates that are not often spelled out explicitly. First, to implement an effective monetary policy to meet our legislated objectives. But, second, to do so in a most open and transparent manner in recognition that we, as unelected officials, are accountable both to the Congress from which we derive our monetary policy mission and, beyond, to the American people.

These twin goals do not always work in concert. In the extreme, we could achieve full transparency if our deliberations and actions occurred only in public fora. In principle, there is no reason this could not be done. And I do not doubt that there exists a select group of professionals who could deliberate in such open fora as effectively as behind doors. Milton Friedman—whose effect on monetary policy, especially here at the Federal Reserve Bank of St. Louis, is legendary—is one with such sharply refined skills. I might be able to name a few more, but I doubt that I would get much beyond counting the fingers on one hand.

Human nature being what it is, the vast majority of us are disinclined to offer half-thought-through, but potentially useful, policy notions only to have them embarrassingly dissected in front of a national television audience. When undertaken in such a medium, deliberations tend toward the less provocative and less useful. I do not say that such a system cannot function, but I do say that in my three decades in and out of government, I have never seen it function well. The undeniable, though regrettable, fact is that the most effective policymaking is done outside the immediate glare of the press. But that notion and others have been used too often in the past to justify a level of secrecy that turned out to be an unnecessary constraint on our obligation to be transparent in conducting the public's business.

We need to remember that in decades past it was believed that monetary policy was most effective when it was least transparent. The argument back in the 1950s, as I remember it, was that market uncertainty created significant differences of opinion in the direction of the prices of short-term debt instruments. The result was a "thick market" of bids and asks that increased the degree of liquidity. More recently, in the 1980s, policymakers, myself included, were concerned that being too explicit about short-run targets would make such targets more difficult to change, impeding necessary adjustments to evolving market and economic conditions. Not too many years ago, the world learned of decisions of the Federal Open Market Committee through minor variations in the minutia of daily open market operations—that is, effectively through faint signals that only informed market professionals knew how to read with accuracy. True, over time, those signals became increasingly clear, so that in the end, market participants never missed a policy decision or read into our open market operations a policy action when there was none.

As markets, experience, and the magnitude of outstanding financial instruments changed, the dead-weight loss created by such uncertainty—read: "risk"—became increasingly evident, as did the value of transparency. Simply put, financial markets work more efficiently when their participants do not have to waste effort inferring the stance of monetary policy from diffuse signals generated in the day-to-day implementation of policy. And being clear about that stance has not constrained our ability to adjust the stance of monetary policy in either direction.

Our current disclosure policy, one hopes, obviates such complexities. In recent years, we have achieved a far better balance, in my judgment, between transparency and effective monetary policy implementation than we thought appropriate in the past. Accordingly, as you know, we moved to the immediate disclosure of our policy actions and, over time, to explaining our decision and our sense of future risks directly after each meeting. In addition, we now publish full transcripts of our meetings after five years. Through these disclosures, together with congressional testimony, speeches by Board Governors and Reserve Bank Presidents, and the publication of the System's sizable research output, we endeavor to keep the public well informed. We

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have gotten to our present degree of transparency through an incremental process, and our disclosure policy will continue to evolve. At each step, we need to review whether in our judgment this new degree of openness optimizes the Federal Reserve's ability to implement effective monetary policy in the context of maximum feasible disclosure.

It is inherent in the complex and changeable nature of our economy that no one can forecast near-term outcomes with precision. However, it is also inherent in our economy that in the long run, the central bank has influence over only nominal magnitudes. As a result, the Federal Reserve can be quite explicit about its ultimate objectives—price stability and the maximum sustainable growth in output that is fostered when prices are stable. By price stability, however, I do not refer to a single number as measured by a particular price index. In fact, it has become increasingly difficult to pin down the notion of what constitutes a stable general price level.

When industrial product was the centerpiece of the economy during the first two-thirds of the twentieth century, our overall price indexes served us well. Pricing a pound of electrolytic copper presented few definitional problems. The price of a ton of cold rolled steel sheet, or a linear yard of cotton broad-woven fabrics, could be reasonably compared over a period of years. But in our new century, the simple notion of price has turned decidedly ambiguous. What is the price of a unit of software or a legal opinion? How does one evaluate change in the price of a cataract operation over a ten-year period when the nature of the procedure and its impact on the patient has changed so radically? Indeed, how will we measure inflation, and the associated financial and real implications, in the twenty-first century when our data—using current techniques—could become increasingly less adequate for tracing price trends over time?

So long as individuals make contractual arrangements for future payments valued in dollars however, there must be a presumption on the part of those involved in the transaction about the future purchasing power of money. No matter how complex individual products become, there will always be some general sense of the purchasing power of money both across time and across goods and services. Hence, we must assume that embodied in all products is some unit of output, and hence of price, that is recognizable to producers and consumers and upon which they will base their decisions. Doubtless, we will develop new techniques of price measurement to unearth those units as the years go on. It is crucial that we do, for inflation can destabilize an economy even if faulty price indexes fail to reveal it.

For all these conceptual uncertainties and measurement problems, a specific numerical inflation target would represent an unhelpful and false precision. Rather, price stability is best thought of as an environment in which inflation is so low and stable over time that it does not materially enter into the decisions of households and firms. Nonetheless, I cannot help but conclude that the progress that the Federal Reserve has achieved over the years in moving toward this old definition of price stability has contributed to the improvement in our nation's longer-term growth prospects that became evident in the latter part of the 1990s. So, for the time being, our conventional measures of the overall price level will remain useful.

President Poole has picked an appropriate topic for this group to consider. The historical record indicates that the increased transparency of the Federal Reserve has helped improve the functioning of markets and enhanced our credibility. But, to repeat, openness is more than just useful in shaping better economic performance. Openness is an obligation of a central bank in a free and democratic society. U.S. elected leaders chose to vest the responsibility for setting monetary policy in an independent entity, the Federal Reserve. Transparency of our activities is the means by which we make ourselves accountable to our fellow citizens to aid them in judging whether we are worthy of that task.