Whither Federal Reserve Communication

Frederic S. Mishkin

Member, Board of Governors of the Federal Reserve System

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Introduction

- Over the years, the Federal Reserve has made significant improvements in our communication.

- I will argue here that the Federal Reserve can go further in enhancing its communication strategy.

- My remarks today only reflect my own views and not necessarily those of anyone else on the Board of Governors or the FOMC.

Overview

- **Highlight key scientific principles regarding the objectives of monetary policy and the benefits of clear communication.**

- **Review the recent enhancements to Fed communication, and examine the conceptual considerations and empirical evidence which indicate that there is room for further improvement.**

- **Present a specific proposal for where the Fed should head in modifying its communication strategy.**

- **Address a few questions about whether these proposed changes would be feasible and desirable.**

The Objectives of Monetary Policy

- **Central bank's objective is to maximize the economic well-being of households.**
- **Broad consensus that maintaining low and stable inflation provides significant benefits to the economy.**
- **The rationale for maximizing employment is fairly obvious: recessions have adverse effects and periods of unemployment are particularly painful.**
- **However, long-run inflation is determined by the actions of the central bank, whereas the level of maximum sustainable employment is *not* something that can be chosen.**

The Benefits of Central Bank Communication

- **Commitment to a specific numerical inflation objective provides a firm anchor for long-run inflation expectations and can play a key role in promoting financial stability as well as the stability of employment and inflation:**
  - **Provides flexibility in responding to adverse demand shocks**
  - **Helps ensure that an aggressive policy easing is not misinterpreted as signaling a shift in the inflation objective**
  - **And may be especially valuable in periods of financial market stress when prompt and decisive policy action may be required**
- **More generally, central bank transparency contributes to democratic accountability and economic prosperity.**

Recent Enhancements to Federal Reserve Communication

- **The forecast horizon for FOMC projections has been extended to three years.**

- **Projections are now published four times a year.**

- **Projections now include a forecast of overall PCE inflation.**

- **A narrative provides additional context for these projections.**

How Has Federal Reserve Communication Been Enhanced?

- **The longer-run projections provide information regarding FOMC participant's assessments of the Federal Reserve's policy objectives:**
    - **The sustainable growth rate of output**
    - **The natural rate of unemployment**
    - **The "mandate-consistent inflation rate"** ***(that is, the long-run inflation rate which best promotes the Fed's dual mandate of price stability and maximum employment)***
- **The short-run projections provide information about FOMC participants' assessments of the current outlook and the rationale for the Federal Reserve's policy actions.**

Is There Room For Further Improvement? Conceptual Considerations

- **The three-year projection horizon may not be long enough to clarify the views of FOMC participants regarding:**
  - **The sustainable growth rate of output**
  - **The natural rate of unemployment**
  - **The mandate-consistent inflation rate**

- **The current projections do not provide a sufficiently firm nominal anchor, because these projections do not provide a transparent and credible commitment to a specific numerical inflation objective.**

Is There Room For Further Improvement? Empirical Evidence

- A number of countries have adopted explicit numerical inflation objectives, and the ECB has provided a fairly precise verbal description of its commitment to keeping inflation "below, but close to 2 percent over the medium term."

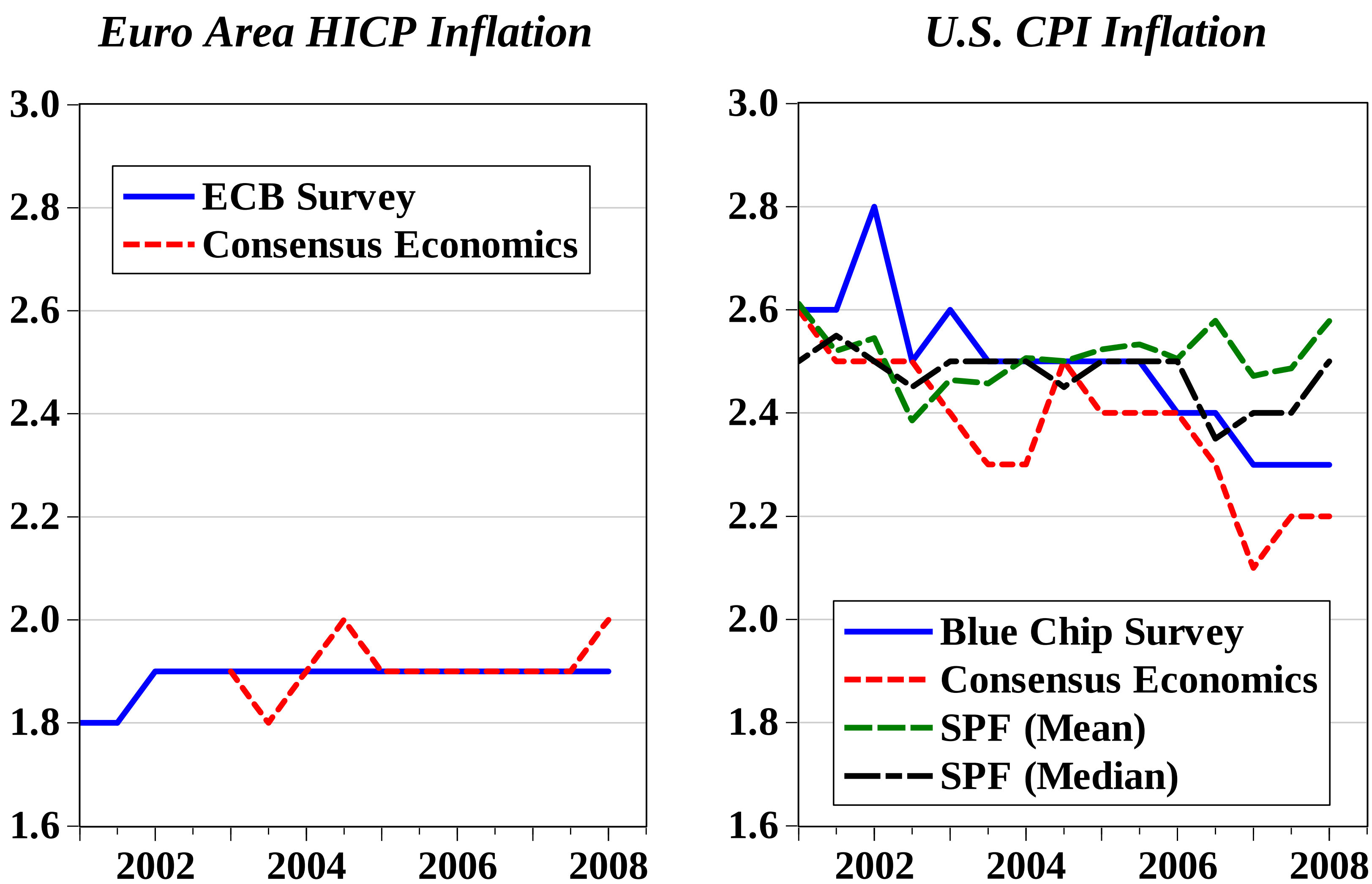
- Recent empirical work has found that an explicit inflation objective provides significant benefits in anchoring inflation expectations:

  - Greater stability and less cross-sectional dispersion in surveys of long-run inflation expectations

  - Greater stability and lower conditional and unconditional volatility of far-ahead forward inflation compensation

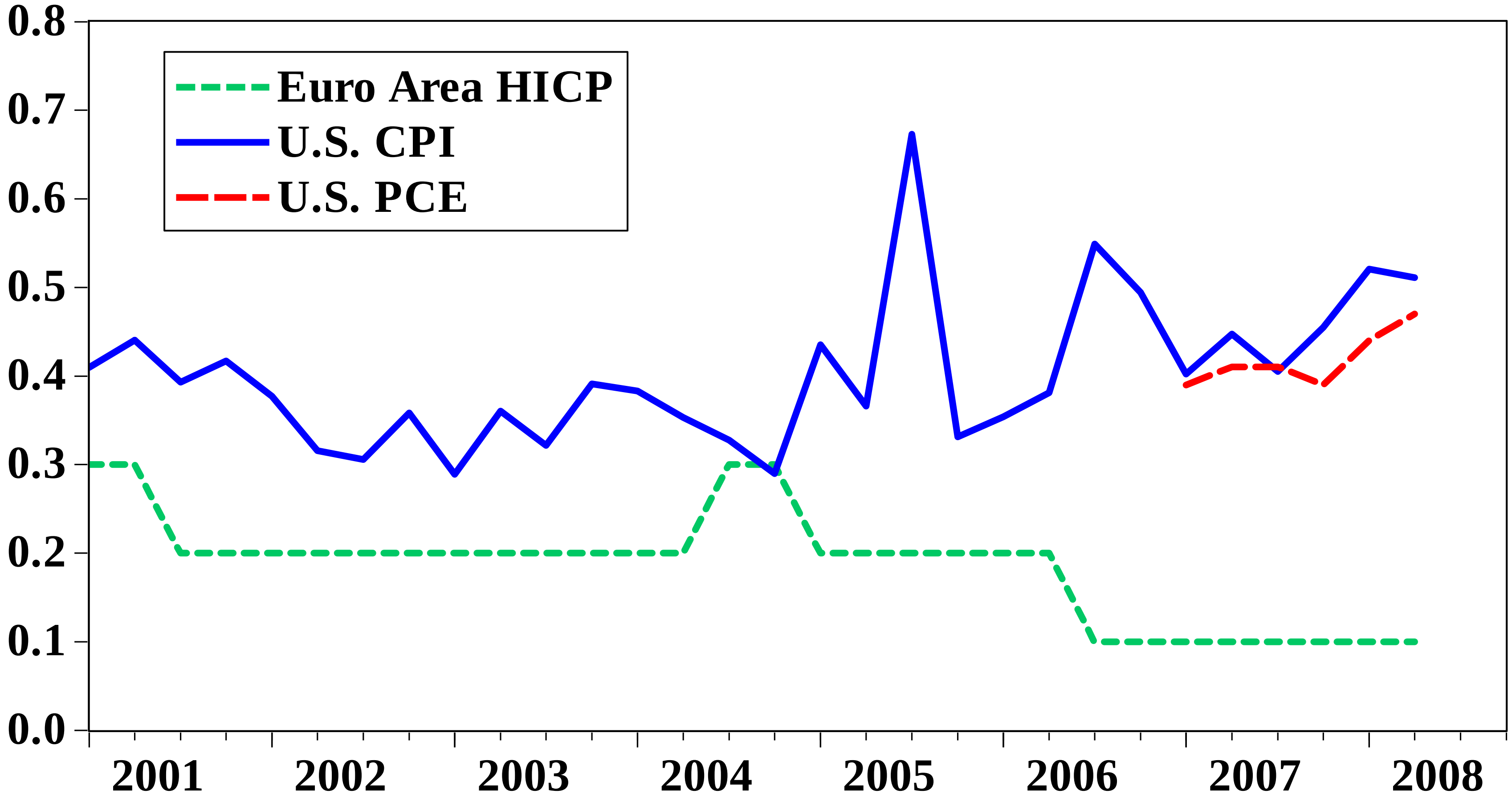
  - No increased volatility of real output and unemployment

Figure 1
Long-Run Inflation Expectations of Professional Forecasters



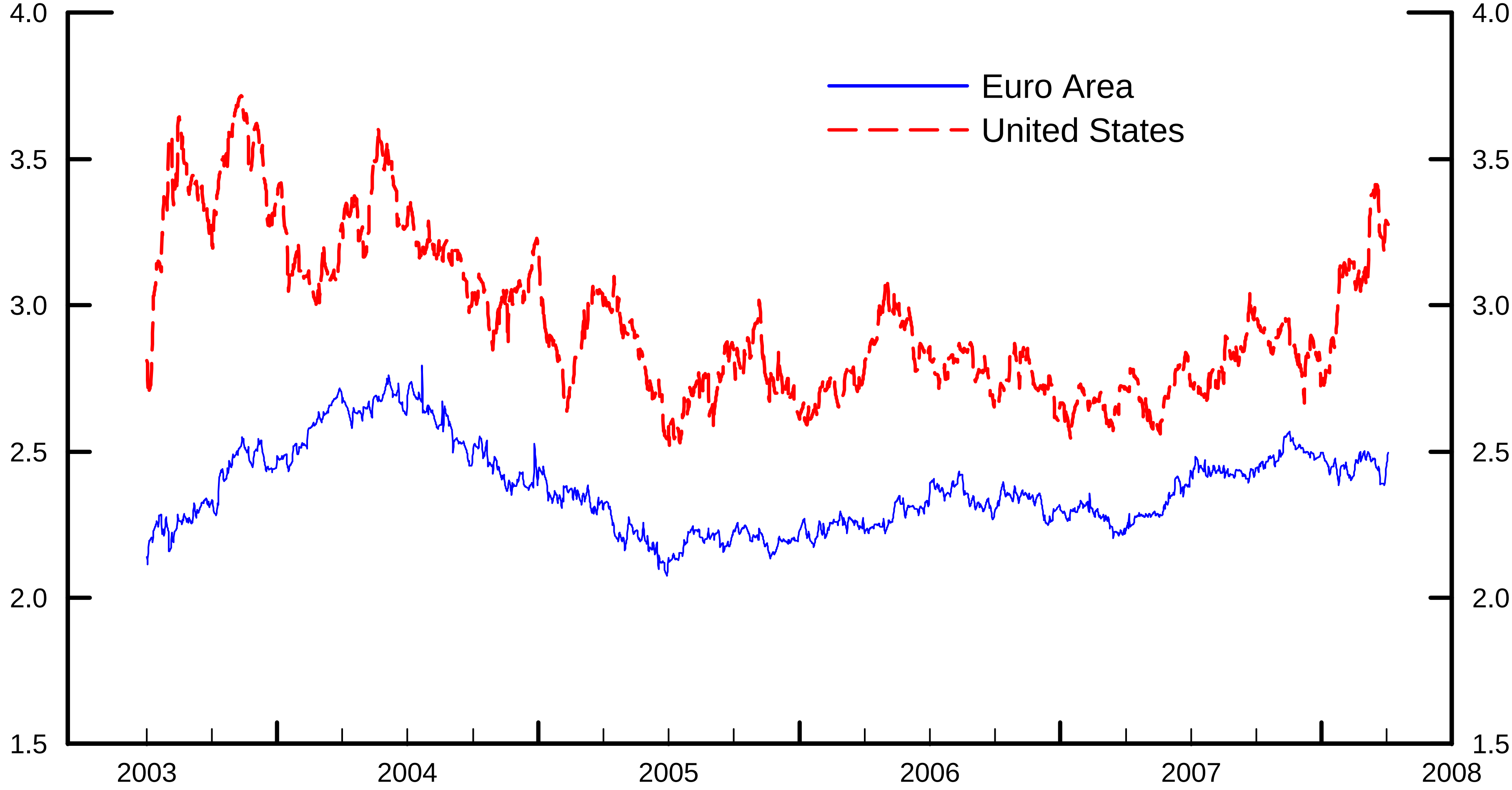
Source: Beechey, Johannsen, and Levin (2007)

Figure 2
Cross-Sectional Dispersion in Long-Run Inflation Expectations



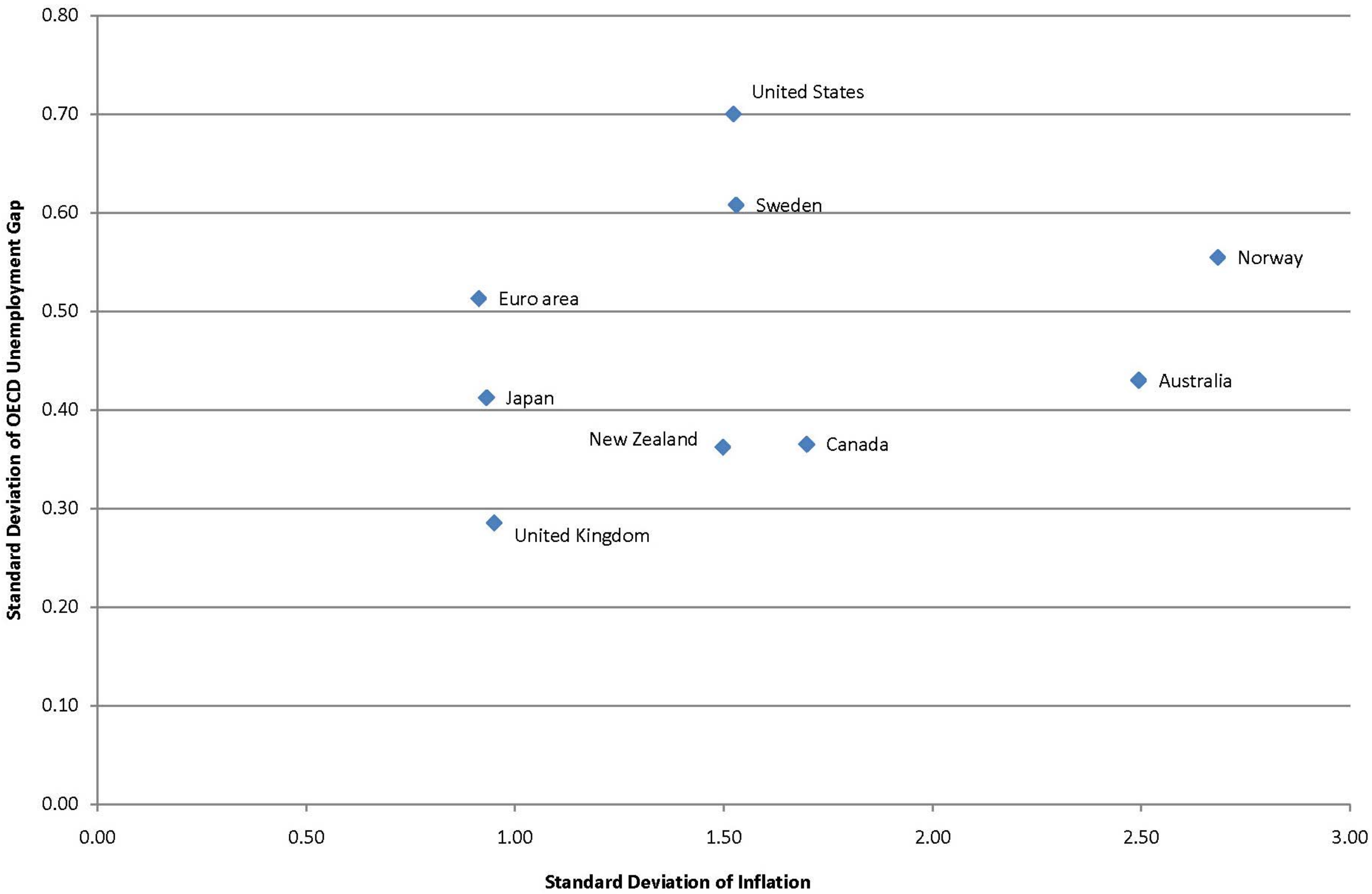
Source: Beechey, Johannsen, and Levin (2007)

Figure 3
Far-Forward Inflation Compensation



Source: Beechey, Johannsen, and Levin (2007)

Figure 4
Macroeconomic Stability in Industrialized Economies, 1999-2007



Source: OECD Economic Outlook

What Should be Done? A Proposal

- Lengthen the horizon of the projections even further.

- Reach a consensus on the value of the mandate-consistent inflation rate.

- Only modify the mandate-consistent inflation rate if there are sound economic reasons for doing so.

Would this Proposal Work?

- ***Would This Proposal Be Consistent with the Dual Mandate?***

  YES. This approach would help stabilize fluctuations in economic activity and would *not* be misinterpreted as a commitment to control inflation within a tight range.

- ***Should the Inflation Objective Be Stated as a Numerical Value Rather Than a Range?***

  YES. Specifying the inflation objective as a specific numerical value instead of a range or "comfort zone" is important for anchoring inflation expectations and avoiding perverse dynamics.

Would this Proposal Work?

- ***Would This Proposal Be Misinterpreted as Establishing a Goal for Maximum Employment?***

  NO. Dispersion of long-run projections for output growth and unemployment across FOMC participants would underscore that these projections are merely estimates of potential GDP growth and the natural rate of unemployment.

- ***Could the Numerical Inflation Objective Be Modified If Appropriate?***

  YES. The numerical inflation objective could subsequently be adjusted if such a modification was justified by sound economic considerations; cf. the technical adjustment in the Bank of England’s inflation objective in late 2003.

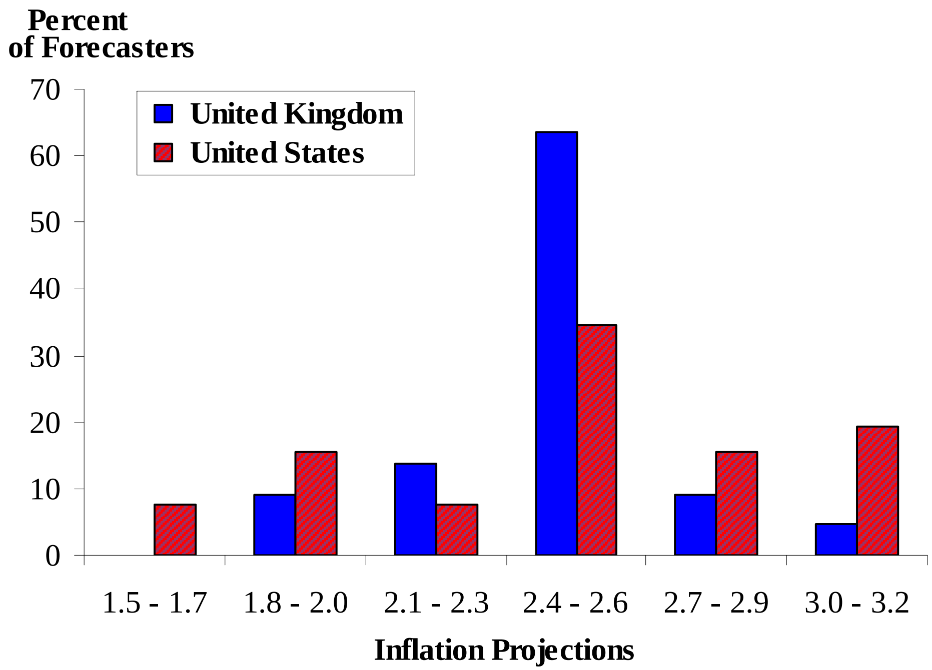
Would this Proposal Work?

- ***Would This Proposal Provide a Sufficient Degree of Commitment to the Nominal Anchor?***

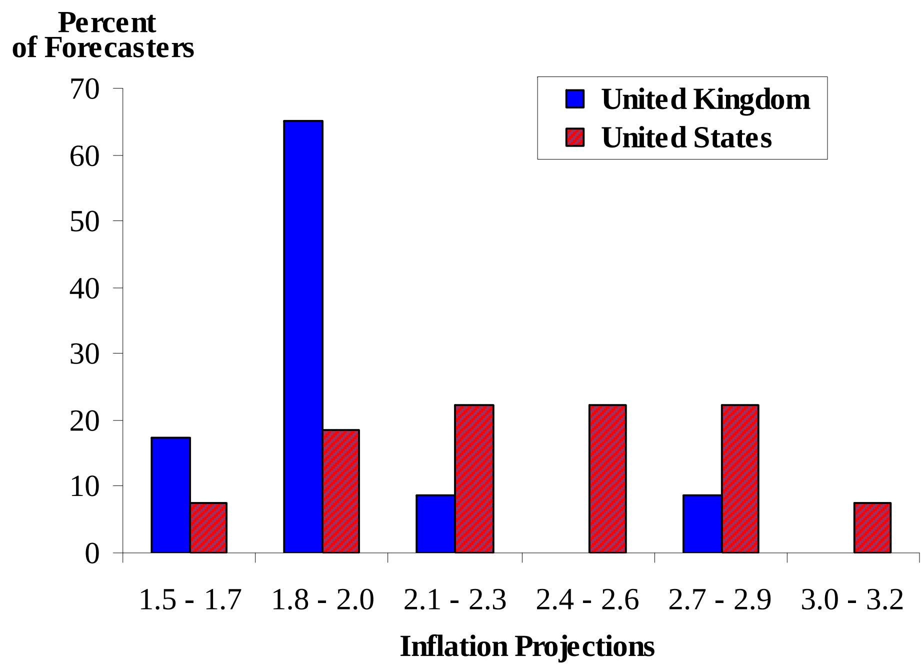
  YES. The transparency of the inflation objective would facilitate the commitment to this goal, analogous to the *stare decisis* principle in the U.S. legal system.

Figure 5
Comparing Medium-to-Long-Run Inflation Expectations in the United Kingdom and the United States

2001Q4

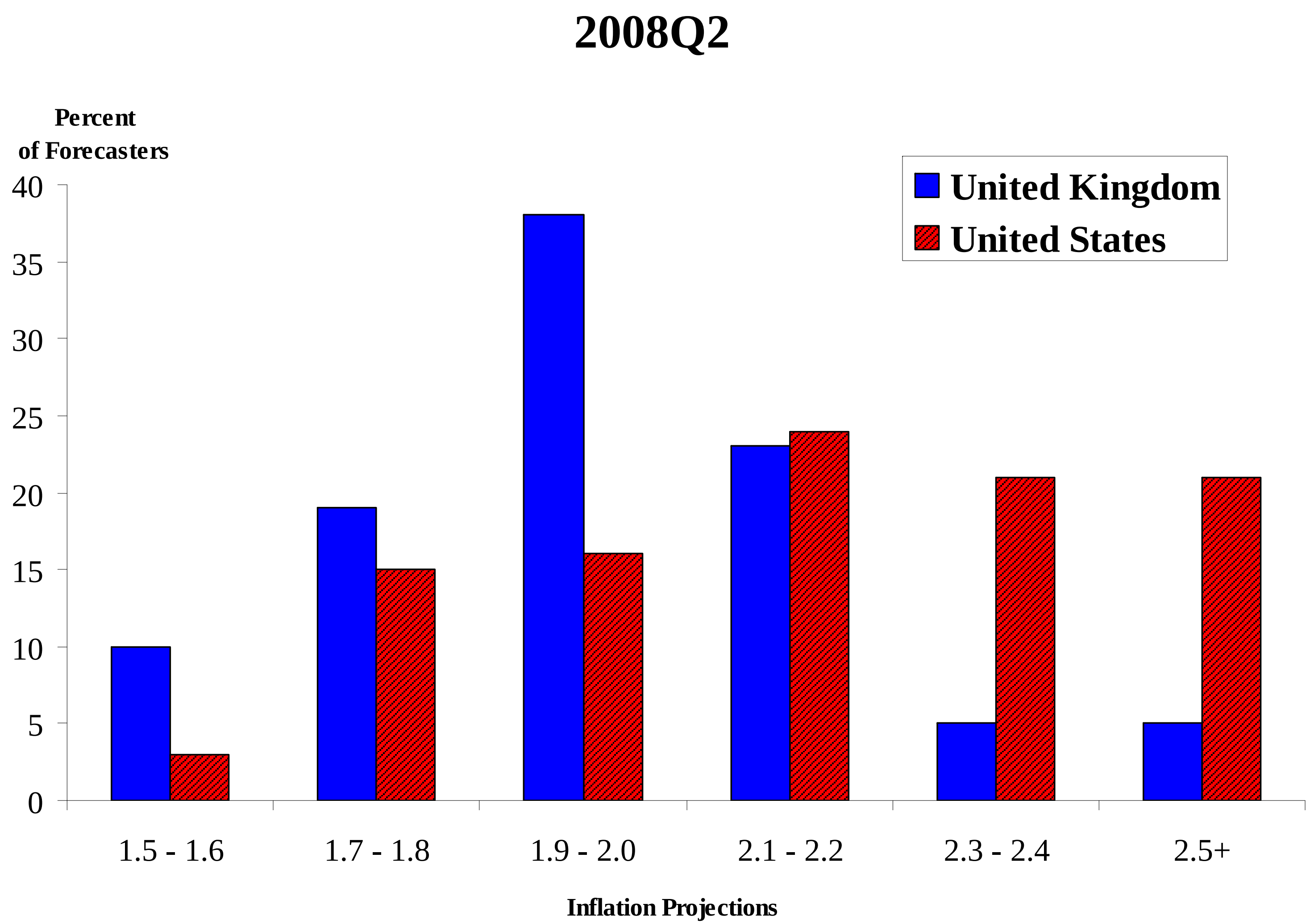


2004Q1



Source: Gürkaynak, Levin, and Swanson (2007)

Figure 5 (continued)



Source: Bank of England Inflation Report (May 2008) and Philadelphia FRB Survey of Professional Forecasters (05/13/08)

Conclusion

- **While recent enhancements in Federal Reserve communication have been beneficial, I believe that the science of monetary policy indicates that there is room for further improvement.**

- **Thus, I have suggested that the FOMC should:**

  - **lengthen the horizon of its projections**

  - **reach a consensus on a specific numerical value for the mandate-consistent inflation rate**

  - **indicate that this consensus value would only be modified for sound economic reasons**

- **I have argued that this proposal would improve economic outcomes by anchoring inflation expectations more firmly while continuing to provide sufficient flexibility for monetary stabilization policy.**