

Influences of the SOMC and Others Outside the Fed

Comments by

Roger W. Ferguson, Jr.

The topic we have been assigned—Influences of SOMC and Others Outside the Fed-- is in many ways an ironic one. If we have learned anything from the past 50 years, it is the importance of “independent central banks.” A simple definition of “independence” might be the freedom from outside influence. In fact, the Shadow Open Market Committee was founded at a time when the Fed had been freed from one form of outside influence--the need to support Treasury borrowing during World War II, which was ended by the 1951 Accord—but confronted other outside influences. The early 1970s were a time when the Fed faced immense political pressure—an outside influence applied successfully by the Nixon Administration on Arthur Burns, ultimately to the regret of the nation as inflation took hold. One of the goals of the Shadow Open Market Committee was to provide a framework that would guide monetary policy and, presumably, reduce the influence of external parties, such as Congress and the Executive Branch.

Adding to the irony, modern day central bankers are notoriously proud of their ability to avoid outside influences. Montague Norman, the iconic Governor of the Bank of England from 1920 to 1944, was fond of the phrase, “Never explain, never excuse.” I recall a situation during my tenure as Vice Chairman of the Board of Governors in which there was pressure on the relatively new European Central Bank to reduce rates. Wim Deussenberg came to the BIS and repeated a phrase that rings in my ears, “We hear, but we do not listen.”

In some ways, Paul Volcker, one of the most revered Fed Chairmen, embodied the high point of this disregard of outside influences. In the pursuit of price stability, the Fed was famously faced with

the strongest protest in its history. Indebted farmers demonstrated with their tractors, circling the Fed's Constitution Avenue headquarters, and home builders mailed pieces of 2-by-4s lumber with strong, in some cases scatological, messages addressed to Chairman Volcker. More substantively, and perhaps a victory for the SOMC, the Volcker Fed adopted a "monetarist-inspired" policy of targeting money supply resulting in the rates John Taylor highlighted yesterday and two deep recessions, all clearly creating public outrage. However, because the Fed was targeting the money supply, and not interest rates directly, they could argue that the rates that were the source of discomfort were simply the results of supply and demand forces beyond their control. The Volcker Fed was also famously comfortable with opacity and seemed to strongly believe that policy worked best when it surprised markets, and presumably other outsiders. Interestingly, the public, particularly journalists, also seemed to accept, however reluctantly, the notion that monetary policy should be literally and figuratively shrouded in a cigar smoke of opacity emanating from a "temple" not open to mere mortals.

So, I start by noting how much the thinking of sophisticated and sober-minded policy makers, such as those gathered here, has evolved over the last 50 years. Why has the concept of outside influence and more broadly outside interaction become an accepted concept at "bastions of orthodoxy" such as the Hoover Institution? To understand the answer to this apparent contradiction, I find it useful to segment "others outside the Fed" into three groupings: academics, other central bankers and financial markets.

Academic Influence and the Practice of Central Banking

Let me start with the influence of academics. The Shadow Open Market Committee might be considered "ground zero" for academics. However, there are other academic or quasi-academic groupings that focus on topics of importance to the Fed, such as the Group of Thirty, the Bretton

Woods Committee and the Global Interdependence Center's College of Central Bankers. These groupings and numerous individual academics have played a useful role in both attempting to influence Fed thinking and also in attempting to enhance Fed impact. The influencing part is embodied by the history of the SOMC itself. The intellectual rigor that the SOMC and the broader community of monetary scholars brought to the debate at the founding of the SOMC forced the Fed to recognize that non-monetary forces such as the power of labor unions and oil price shocks were not the proximate cause of the inflation being experienced in the 1970's.

Perhaps most fundamental to the functioning of central banking is the concept of "price stability" itself. This simple concept has evolved significantly due to the influence of academics and related groupings. Paul Volcker famously thought that the Fed's price stability mandate required zero inflation. However, thanks to seminal academic work, we have come to understand that price stability now means inflation somewhat above "zero." Academics, supported by experience, found that price stability defined by a small, positive level of inflation allows for more fluid wage setting (with the possibility of decreasing real wages without cutting nominal wages), avoids measurement errors, and avoids the zero lower bound (hopefully). In the euro area, where inflation is measured as a weighted average of the inflation of all member countries, the 2% target enables the implications of any differences between countries to be addressed. Having a target of 0% would mean there being some countries with negative inflation, i.e., deflation. In the U.S., a non-zero inflation target has allowed for goods disinflation even as we seem to have a bias toward persistently positive service inflation. I will return to the topic of price stability being defined as slightly positive inflation shortly.

Related to the concept of price stability at low, but positive inflation, is the concept of rules-based policy, as so powerfully expressed by John Taylor and the Taylor Rule. Variations of the Taylor Rule have been adopted as a framework both for driving policy discussion and for critiquing the actions

of policy makers. The debate around the FOMC table, which many in this room have experienced, has been strongly enriched by bringing a rules-based argumentation, even if policy itself is not guided exclusively by the Rule.

One must hasten to add explicit “inflation targeting” to these notable examples of academics driving Fed and other policy thinking. We think of inflation targeting as having emerged only in the 1990’s, but there were versions of “inflation targeting” from the early twentieth century. Irving Fisher proposed a “compensated dollar” system in which the gold content in paper money would vary with the price of goods in terms of gold, so that the price level in terms of paper money would stay fixed. In his Tract on Monetary Reform (1923), Keynes advocated what we might now call an inflation targeting scheme. In the context of sudden inflations and deflations, Keynes recommended a policy of exchange rate flexibility, appreciating the currency in response to inflation and depreciating it when there are deflationary forces, so that internal prices remained more or less stable. However, these early and rudimentary concepts of inflation target fell into disrepair during the Bretton Woods period, in large part because of the fixed exchange regime that prevailed. However, with the end of the Bretton Woods era, the need for a publicly recognized anchor became more pressing. Academics contributed importantly to this debate by demonstrating a link between an explicit inflation target and well-anchored inflation expectations. This has led to a much deeper understanding of the “expectations channel” as an independent and important channel of the transmission of monetary policy.

Of course, in addition to adding to our understanding of the theoretical underpinnings of monetary policy, academic economists have been central to recent debates on the correct stance of monetary policy. The debate that raged about the inflation that followed the COVID pandemic between those who saw the inflation as “transitory” and those who saw it as “permanent” is just the most recent example of how the Fed and academic economists are engaged with each other.

Before leaving the important role of academics in influencing the Fed, let me hasten to add that groupings of academics that I mentioned earlier, The Group of Thirty, Bretton Woods Committee and GIC's College of Central Bankers, have been willing supporters and amplifiers of the Fed and its policy efforts. Through reports with titles such as Central Banking and Monetary Policy: Principles and the Way Forward, Banking Conduct and Culture, and Enhancing Financial Stability and Resilience: Macroprudential Policy Tools and Systems for the Future, these groupings attempt to support and amplify the positive work of the Fed, other central banks, and regulators globally.

Central Bank Influences and Inflation Targeting

While academics have provided much of the raw material that has fed progress in Federal Reserve policy making, other central banks have played an important role. Everyone in this conference is well aware of the role of Reserve Bank of New Zealand, followed by the Bank of Canada, and the Bank of England. I will not relive that very important history. As you know, for more than a decade after many other central banks adopted a formal inflation target the Fed had not formally adopted such a target, even though for much of this time, the Fed seemed to settle implicitly on a 2% target. The Fed's official adoption of a 2% target only occurred in 2012. As a policymaker I was skeptical of adopting a point estimate inflation target. I believed that the FOMC could raise rates sufficiently to reduce inflation to the desired target, but that central bank tools, by themselves, could prove insufficient to raise inflation if it fell below that desired 2% level.

Financial Markets and the Need for Transparency

Financial markets are the third, and possibly most powerful, outside influence with which the Fed and other central banks must contend. The Federal Reserve was not founded to take responsibility for monetary policy. However, the Federal Reserve Act did allow the Reserve Banks to buy and sell government securities in the open market. By the early 1920's Fed officials recognized that these

purchases and sales influenced market interest rates and credit conditions. In 1923 the Fed's leaders formed the Open Market Investment Committee to determine open market operations for the entire System, and the Fed began to conduct monetary policy. The influence of the Fed on markets and vice versa has been well established for 100 years. What has changed is the attitude of central banks, particularly the Fed, in how they wish to "work" with financial markets. This is another way to discuss "transparency." I will dedicate the remainder of my remarks to this important topic.

As I said in opening, during the 50-year lifespan of the SOMC, the Fed and other central bankers gradually came to recognize that more transparency in policy making was inevitable and perhaps even a welcome development. If market participants understood the Fed's desired policy stance and likely moves, policy would be more effective. That effectiveness, emanating from influencing market expectations, gradually came to be seen as another tool of policy.

I have already mentioned Paul Volcker's preference for leaving markets in suspense, even after policy decisions were made. Far from being a nefarious action, Volcker and his colleagues probably believed that their internal discussions were more robust without the prospect of disclosure. They also worried about unintendedly strong impacts from disclosure. In a 1970s lawsuit, the Fed argues that immediate disclosure of its actions "would significantly harm the Government's monetary functions." The potential risks included unfair profits, outsized price changes and more costly open market operations. Instead of issuing a statement describing its policy actions, the FOMC expected markets to infer its intent by observing open market policy actions. During the early 1960's, the FOMC disclosed its monetary policy only once per year in Board's Annual Report. This disclosure was required by the Federal Reserve Act. The 1967 Freedom of Information Act required the FOMC to disclose its actions with a 90-day lag. In 1975,

the Committee decided to shorten the lag to 45 days, and again shortened the lag to 30 days in 1976.

Volcker's successor, Alan Greenspan, was also thought to be squeamish about the emerging trend toward central bank transparency. During Greenspan's tenure, journalists and market participants were rumored to analyze the size of his briefcase on FOMC meeting days for some sort of signal as to whether he would push for an interest rate cut. Greenspan facetiously claimed that he could "mumble with great incoherence." He observed in 1993 that "The Federal Reserve has a reputation, along with other central banks of being secretive."

I would assert that, contrary to this caricature of Greenspan's nearly two decades as chair as period of opacity, it was actually a period of experimentation and progress on the path to transparency. Greenspan certainly resisted the adoption of a formal 2% target, while supporting (or at least acquiescing in) an implicit 2% target. However, and importantly, Greenspan allowed several innovations that allowed markets to better understand Fed policy making. During Greenspan's tenure the Fed went from saying nothing on the outcomes of policy decisions to saying quite a bit on policy.

Before Greenspan, as discussed, changes in communication were gradual and often forced by legislative requirements. During Greenspan's tenure, the FOMC formed two working groups on transparency. The FOMC decided to issue increasingly detailed statements and issued them in a policy-relevant time frame, i.e., on the day of the FOMC meeting. Those statements started by simply stating the fed funds target, which was a major shift in policy framework from the money supply control that was the tool favored by the Volcker Fed, which had the advantage of allowing the Fed to disclaim any responsibility for the level of interest rates that causes so much pain. The practice of the FOMC disclosing its actions the same day of its meetings started in February 1994.

The now familiar practice of issuing a statement after every meeting, regardless of whether a change in policy had been agreed on, began with the February 2000 meeting. Additionally, the FOMC statements evolved during Greenspan's tenure to include disclosure of the FOMC votes and brief statements of the rationale for dissents, if any. Critically, the FOMC also experimented with differing phrasings of what future policy moves seemed most likely, while trying to avoid making commitments. These were initial, but critical, efforts toward official "forward guidance".

Of course, the FOMC has progressed on the journey toward transparency since 2006 but building on the base that the Greenspan Fed laid. Chairman Bernanke viewed the Fed as being behind other central banks in the move toward transparency. As mentioned, under Bernanke, the Fed adopted an explicit inflation target in 2012. Bernanke held the first post-FOMC press conference in 2011. While the FOMC had long used language that revealed the Committee's expectations of future policy, using phrases such as the "tilt" in the 1990's, the FOMC formally began using "forward guidance" after the 2007-2009 financial crisis. The persistent use of such "forward guidance" as a formal tool of policy had the desired effect of influencing longer-term rates in a direction that supported easing financial conditions.

If the Greenspan Fed has been misunderstood in terms of the degree of openness to transparency during normal policy making, Greenspan himself has certainly been credited with understanding the importance of transparency and working to control market expectations during periods of crisis. During the stock market crash of October 1987, Greenspan said, "The Federal Reserve, consistent with its responsibilities as the Nation's central bank, affirmed today its readiness to serve as a source of liquidity to support the economic and financial system." The value of these types of declarative statements during moments of crisis and dislocation has been well established by subsequent crises. Shortly after the terrorist attacks of September 11, 2001, the Fed issued a simple statement that is credited with calming markets; "The Federal Reserve is open

and operating. The discount window is available to meet liquidity needs.” In the summer of 2012, financial markets were concerned about the possibility of an imminent break-up of the euro. Mario Draghi, the President of the ECB, on the morning of July 12, 2012, uttered a few words that immediately defused the market concern. He said, “Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough.” In the aftermath of this statement, the spreads on government bond yields of Spain, Italy and Greece, the so-called peripheral countries, dropped back toward normal levels after a three year upward trend.

Conclusion

Central bank independence has become the norm for most modern economies. However, “independence” does not mean being free of all external influences. Academics, other central banks and financial markets have been implicated in both theory and practice of central banking. Whether it is understanding the nature of inflation itself, debating the current conjuncture, or pushing for greater transparency, outside forces have acted upon the Fed. The Shadow Open Market Committee is one of several institutions that have played a role in driving the Federal Reserve in both the understanding of the causes of inflation and in the practice of central banking.