



Making the Federal Reserve More Transparent and Accountable: Why the FOMC Should Explicitly State Its Monetary Policy Rule

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The new chairman of the Federal Open Market Committee (FOMC), Kevin Warsh, has announced the creation of a committee to study how the FOMC publicly communicates monetary policy. One of the cochairs of this new Communications Task Force will be Mervyn King, former governor of the Bank of England from 2003 to 2013.¹ The King appointment underscores Warsh's commitment to a fundamental review of FOMC communications. The opportunity, perhaps once in a lifetime, exists for fundamental reform.

The most important reform is straightforward: The FOMC should publicly state the reaction function or monetary rule that provides a consistent framework for monetary policy over time and use it as the benchmark for explaining, evaluating, and defending its policy decisions.

Improving FOMC communication therefore requires a broader understanding of transparency. This brief first explains why transparency requires more than forward guidance. It then shows why markets depend on a clear reaction function, why systematic rules outperform unconstrained discretion, and what monetary history teaches about those choices. The brief concludes by recommending that the FOMC explicitly state its policy framework and use it to explain and evaluate its decisions over time.

What the FOMC Should Communicate

The FOMC needs to communicate its monetary policy—not merely its current policy actions, but also the framework that gives those actions consistency over time. Spokespersons for the FOMC under former Federal Reserve Chair Jerome Powell would likely have averred that there is no need for reform. With the FOMC's congressional monetary policy reports and forward guidance—that is, indications of the likely near-term behavior of the funds rate given near-term economic

forecasts—surely, the nature of monetary policy is already transparent.² The contention in this brief is that, despite these communications, the FOMC’s monetary policy remains opaque.

The path forward will have to start with the definition of monetary policy, which concerns not just the implementation of monetary policy but also its design in terms of the consistency that disciplines the choice of individual policy actions over time. What is the optimal monetary policy, and how did the FOMC choose it? Its characterization must detail the transmission process. How does the behavior of the FOMC translate into the behavior of the public with its innumerable firms and households in a way that ensures achievement of the FOMC’s objectives? Answering that question begins with understanding how forward-looking financial markets interpret the FOMC’s policy framework.

Markets Need a Reaction Function

A basic issue is whether financial markets are forward looking. The answer is clearly yes. Markets do not move today based on information from a year ago. They move on new information. The FOMC’s forward guidance is based on current information. What is missing is the FOMC’s reaction function: how the FOMC adjusts the expected path of the funds rate in response to the arrival of new information. An FOMC reaction function is a critical constituent of a stabilizing monetary policy because it shapes how markets respond to new information, especially in moving the yield curve, or the pattern of interest rates from short- to long-term borrowing. Because the yield curve is part of the price system, for the transmission of monetary policy to stabilize the economy, the reaction function must allow the stabilizing properties of the price system to adjust to maintain equality between aggregate demand and potential output.

Current FOMC communications, however, convey a different message. They suggest that each period, the FOMC evaluates which part of its dual mandate—stable prices or maximum employment—is of more concern and then moves the funds rate in a commonsense way to make policy either stimulative or contractionary. Does this communication amount to a reaction function designed to stabilize the economy? It would, but only if the FOMC knew the structure of the economy so that it had the power to predict the impact over time of individual policy actions. If so, this kind of discretionary monetary policy would work, where “discretionary” means a policy in which policy actions are taken without the discipline of an underlying consistency over time.

That view of discretionary policymaking, however, assumes that the FOMC can accurately forecast the economy. In practice, the FOMC lacks that ability, as evidenced by the Summary of Economic Projections, or SEP, with its inability to predict inflation in recent years. For example, the December 2021 SEP forecast for core and headline Personal Consumption Expenditures inflation in 2022 was 2.6 percent and 2.7 percent, respectively.³ By the second quarter of 2022, however, the actual numbers had already risen to 5.3 percent and 6.9 percent. That is, the FOMC has no way of avoiding the long and variable lag critique of economist Milton Friedman, who emphasized

the FOMC's inability to forecast the impact of individual policy actions.⁴ That fact suggests that a stabilizing monetary policy does work with an unstated underlying consistency in the form of an understood but unarticulated rule of thumb. Note that economists characterize this consistency with some form of a Taylor rule—a systematic relationship between the FOMC's funds rate target and economic conditions—either the standard one in level form or the first-difference one, which does not require an assumption about slack in the economy.⁵ In either case, the FOMC must perform its usual task of judging the near-term behavior of the economy using many data sources. Implementation of a rule does involve judgment.

To make sense of what constitutes a stabilizing monetary policy, one must examine whether the FOMC's language of discretion masks an underlying consistency in policy. Forward-looking markets infer that consistency from the FOMC's behavior as an implicit reaction function, that is, a systematic pattern in how the FOMC responds to new economic information. For example, credibility for a policy of price stability requires that bond markets lower the yield on bonds in response to a weakening economy without incorporating a premium for a subsequent expected rise in inflation. By the end of the 1970s, monetary policy had lost such a stable nominal anchor. Expansionary monetary policy to deal with weakness in the economy perversely caused bond yields to rise.

Lessons from Monetary History

The history of monetary policy reveals episodes in which the FOMC has changed from one reaction function to another. That history usefully begins with the creation of the modern central bank by William McChesney Martin. Martin characterized policy as “lean against the wind” with preemption: a consistent moving of short-term interest rates to offset sustained changes in the economy's rate of resource utilization. In that way, policy stabilized the economy's rate of resource utilization, and the price system had full rein to maintain output growing at potential.⁶

Martin assumed the need for persistent changes in the FOMC's target for short-term interest rates (implicit in its free-reserves targets) to offset these “imbalances” in the form of sustained changes in the economy's rate of resource utilization, which indicated growth above or below potential growth in output. Such a policy would maintain price stability. Martin characterized these procedures as “taking away the punch bowl just as the party gets going,” that is, lean against the wind with preemptive changes in the funds rate to prevent the emergence of inflation.⁷ They impose a discipline that prevents the emergence of inflation, and in the process eliminate cyclical inertia in the funds rate.

The contrasting alternative that followed in the 1970s treated a socially desirable low rate of unemployment as a target coequal with price stability. Rather than using leaning-against-the-wind procedures to stabilize the economy around its market-determined rate of resource utilization, policymakers treated resource utilization as a lever for balancing inflation against unemployment. The common measure of this “slack” was measured by the unemployment rate relative

to a benchmark nonaccelerating inflation rate of unemployment, often called the NAIRU value, consistent with no change in inflation. In particular, in responding to weakness in the economy, the FOMC lowered the funds rate until inflation emerged. The emergence of inflation signaled to policymakers that monetary policy had achieved a desirably low rate of unemployment. Following the logic of the Phillips curve—that lower unemployment could be achieved at the cost of higher inflation—the FOMC traded off between its unemployment and inflation goals: lean against the wind with tradeoffs rather than lean against the wind with preemption. These contrasting procedures distinguished the inflationary Burns–Miller approach of the 1970s from the price-stability approach of the later Volcker–Greenspan policy.⁸

One can express the contrasting policies formally in terms of models. In the activist spirit of FOMC chairmen Arthur Burns and G. William Miller, inflation is a nonmonetary phenomenon driven by markup shocks (exogenous increases in firms' costs that they pass on in the form of price increases). As modeled by Blanchard and Galí, a policy of price stability then requires periodic increases in the unemployment rate.⁹ The Phillips curve captures the relevant tradeoffs between inflation and unemployment that the FOMC must balance off.

In the monetarist spirit of Paul Volcker and Alan Greenspan, inflation is a monetary phenomenon. The central idea in a monetarist model is the distinction between nominal and real variables, with nominal variables being inflation and money and real variables being relative prices and physical quantities. With a policy of price stability, there are no Phillips curve tradeoffs. The public adapts its expectations of inflation based on the systematic behavior of the FOMC. A credible rule that targets price stability causes firms setting prices for multiple periods (firms in the sticky-price sector) to do so based on the expectation of price stability. The FOMC is then free to follow procedures that cause the funds rate to track its natural rate counterpart. The experience in the post Treasury–Federal Reserve Accord period is consistent with the rule of lean against the wind with preemption.

As modeled by economists Marvin Goodfriend and Robert King, a policy of price stability turns the determination of real variables like the unemployment rate over to the operation of the price system. In an environment with a stable nominal anchor (the expectation of price stability), the price system works well to maintain full employment as modeled by the real business cycle core of the economy.¹⁰ Monetary control is achieved even if the theoretical counterpart of money (the liquidity in the public's asset portfolio) is not measured well by the empirical counterpart (M2). That control possesses two aspects. First, because money is demand determined by the public when the FOMC uses an interest rate as its instrument (the funds rate), the rule disciplines that demand to be consistent with price stability. Second, allowing the price system to determine real variables achieves equilibrium in the goods market. Equilibrium in the goods market maintains equilibrium in the bond market. The FOMC then is not in the position of monetizing an excess supply of bonds and creating monetary emissions that destabilize the price level. Procedures that

do not separate the determination of the price level from the operation of the price system are destabilizing.

Interference with the operation of the price system is the macroeconomic equivalent of price fixing. When the funds rate is set below the natural rate of interest, the resulting excess supply in the bond market, when monetized through bond purchases by the FOMC, creates inflation. Analogously, when the funds rate is set above the natural rate of interest, excess demand in the bond market requires bond sales by the FOMC and monetary contraction creates disinflation. That is, money creation or destruction is the counterpart of the excesses due to not letting the price system work.

Departures from the Rule End Badly

Traditionally, FOMC spokespersons have argued that taking policy actions within an explicit framework that imposes a consistency over time would undesirably limit the FOMC's ability to respond to unusual situations.¹¹ Yet, the FOMC never points to specific episodes in which departures from a systematic framework allowed it to stabilize the economy. Consider the two most recent departures from a policy of lean against the wind with preemption.

In summer and fall 2008, the FOMC was preoccupied by high commodity price inflation caused by the integration of the BRIC (Brazil, Russia, India, and China) economies into the world economy that pushed headline inflation above the much lower core inflation. Concerned that a reduction in the funds rate combined with high headline inflation would increase inflationary expectations, the FOMC failed to lower the funds rate after its April 2008 meeting even though the recession deepened. Later, it became clear that the world economy including the United States had entered a severe recession by August 2008. The decline in house values decreased the wealth of the public and likely lowered the natural rate of interest below the funds rate. The turmoil in credit markets following the Lehman bankruptcy in September 2008 made the natural rate of interest negative and exacerbated the contractionary nature of monetary policy. The subsequent combination of disinflation and rising unemployment meant that monetary policy was contractionary.¹²

The response to the pandemic provides a second example. The FOMC maintained the funds rate at the zero lower bound despite a rapid strengthening of the labor market starting in early 2021 and the emergence of above-target inflation starting in late 2021. The FOMC's monetization of a significant amount of the pandemic payments to households and firms amounted to a helicopter drop of money. The resulting inflation restored the desired real money balances of the public. These episodes illustrate the misleading argument often made against rules, namely, that unusual shocks require discretion.¹³

It is true that the structure of the economy changes regularly from a variety of sources, for example, changes in the openness to international trade and changes in immigration. Shocks can at times

be particularly intense, such as the COVID shock. Nevertheless, the basic logic of the price system does not change. The FOMC needs procedures that consistently cause the yield curve to move regularly in a way that adjusts intertemporal aggregate demand so as to remain equal to contemporaneous supply at the full employment of resources. For that to happen, financial markets need to understand how the FOMC itself responds routinely to the arrival of new information on the economy.

An Explicit Framework for FOMC Communication

The most fundamental change in FOMC culture would be a willingness to acknowledge past policy mistakes. Specifically, the FOMC should articulate the underlying consistency in its current policy and defend it by comparing it to past policies while asking whether those past policies were successful in stabilizing the economy. To do so would require investigating periods of historical instability and assessing whether the underlying consistency in policy in those periods contributed to the instability. On the basis of that historical analysis, the FOMC could then articulate the underlying consistency in its policy and defend it by acknowledging that policy has not always been stabilizing and that current policy has been changed to eliminate earlier problems. Only then can the FOMC and the public have confidence in the reliability of monetary policy.

Such explicitness would fortify the FOMC's institutional independence. One advantage would be protection from the vagaries of the appointments process. New appointees would have to make their views known on the rule and on the optimal monetary policy in general. Also, a rule would clarify how the behavior of the FOMC transmits to the behavior of the economy. Such clarity would encourage the FOMC to talk about monetary policy in terms of a conceptually simple model. At present, the implied message is that monetary policy is too complex to be understood by the public and must therefore be left to the experts. The resulting “trust me” approach makes the FOMC appear to be an unaccountable fourth branch of government.

The communications review initiated by Chair Warsh through the Communications Task Force especially offers an extraordinary opportunity—not merely to improve how the FOMC explains its decisions, but to make explicit the systematic framework that underlies them and thereby strengthen the stability of the monetary standard. The central reform is therefore straightforward: The FOMC should explicitly state the reaction function or monetary rule that disciplines monetary policy actions over time and use it to explain, evaluate, and defend its policy decisions. Doing so would make the FOMC more transparent and accountable while strengthening its institutional independence.

Author's Note

This brief is intended to encourage debate. Readers interested in the historical and theoretical foundations of these arguments can find a fuller treatment in chapters 22, 34, and 35 of my forthcoming manuscript, *Milton Friedman: Markets, Monetary Policy, and the Federal Reserve with Its History*.

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Notes

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2. On the Board of Governors website under Monetary Policy, see various FOMC Press Conferences by the chairman after FOMC meetings and various Minutes of the Federal Open Market Committee. Under Press Releases, see various speeches by members of the Board of Governors.
3. Board of Governors of the Federal Reserve System, “Summary of Economic Projections,” December 15, 2021.
4. Milton Friedman, “The Lag in Effect of Monetary Policy” in Milton Friedman, ed., *The Optimum Quantity of Money and Other Essays* (Aldine Publishing Company, 1969), 95–96, originally published in *Journal of Political Economy* 69, no. 5 (1961).
5. For a level-form Taylor rule, see John B. Taylor, “Discretion Versus Policy Rules in Practice,” *Carnegie-Rochester Conference Series on Public Policy* 39 (1993): 195–214. For a first-difference-form Taylor rule, see Athanasios Orphanides, “Monetary Policy Rules, Macroeconomic Stability and Inflation: A View from the Trenches,” *Journal of Money, Credit, and Banking* 36 (April 2004): 151–75.
6. William McChesney Martin Jr., “Address Before the New York Group of the Investment Bankers Association of America” (speech, New York, NY, October 19, 1955), *Statements and Speeches of William McChesney Martin Jr.*, Federal Reserve Bank of St. Louis FRASER, stlouisfed.org, 12; William McChesney Jr., “Statement of William McChesney Martin Jr., Chairman, Board of Governors of the Federal Reserve System, Before the Joint Economic Committee, February 6, 1958,” *Statements and Speeches of William McChesney Martin Jr.*, Federal Reserve Bank of St. Louis FRASER, stlouisfed.org.
7. McChesney Martin Jr., “Address Before the New York Group of the Investment Bankers Association of America,” 12.
8. Robert L. Hetzel, *The Federal Reserve: A New History* (University of Chicago Press, 2022), chaps. 17, 18, 19.
9. Olivier Blanchard and Jordi Galí, “Real Wage Rigidities and the New Keynesian Model,” *Journal of Money, Credit, and Banking* 39 (February 2007): 35–65.
10. Marvin Goodfriend and Robert King, “The New Neoclassical Synthesis,” *NBER Macroeconomics Annual 1997*, vol. 12, eds. Ben S. Bernanke and Julio Rotemberg (MIT Press, 1997), 231–96.
11. Board of Governors of the Federal Reserve System, “Challenges Associated with Using Rules to Make Monetary Policy,” Monetary Policy Principles and Practice, last modified March 8, 2018, <https://www.federalreserve.gov/monetarypolicy/challenges-associated-with-using-rules-to-make-monetary-policy.htm>.
12. Hetzel, *The Federal Reserve: A New History*, chap. 21.
13. Robert L. Hetzel, “COVID-19 and the Fed’s Monetary Policy: Flexible-Average-Inflation Targeting,” in *The Federal Reserve: A New History* (University of Chicago Press, 2022).