Babson Carpenter Panel

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Why Opacity is the Best Policy

"Would the region's currency be any less stable, if the leader of the central bank did card tricks and told hilarious jokes? Why should the chair of the central bank's mannerisms, personality and character matter in the conduct of monetary policy?"

I take the question to be about communication and transparency. The question is whether sober, deliberate speech—aided perhaps by props such as a suitably rumpled suit and cheap cigar—conveys the intended message better than, say, song and dance with bowler and cane.

The answer clearly depends on what the message is. If, like me, you were lucky enough to catch Bebe Neuworth and Ann Reinking in the Broadway revival of "Chicago," you will know what I mean, and you will agree that Paul Volcker and Alan Greenspan could not have done better. Song and dance can be extremely effective, and affecting.

In equal measure, I think you will agree that the Volcker and Greenspan performances at the Senate Banking Committee, which regrettably I have only seen in highlights on television, were masterful in their own way, and could not be equaled by Broadway's best. Given that Neuworth and Reinking aren't up to the task, I am inclined toward the preliminary conclusion that magic tricks and hilarious jokes won't help either, given the message that central bankers are trying to convey.

But what is the message that central bankers are trying to convey? And how is that message connected to the underlying goal of price stability? These are questions that go to the heart of our subject for today, because their answers will help us to understand why the stage personae of Volcker and Greenspan were so effective and affecting. They are also questions that go to the heart of monetary economics, since their answers depend on one's theory about how central bank actions are connected to aggregate price fluctuation.

There is a school of academic thought that conceives of central bank operations as following some version of a Taylor Rule, which is an equation describing how the central bank changes the Fed Funds rate depending on the realization of inflation and output relative to target inflation and target output. According to that school, the monetary policy Rule works mainly by influencing expectations about the future, and it follows that the central banker's communication job is simply to convey the Rule. If you're committed to a low inflation target for the future, and you signal that commitment credibly to the financial markets, then the result is low inflation today. It's not quite as easy as that, because expectations can be fickle when confronted with behavior that is contrary to announced commitment. So you have to follow through on your commitment, which means showing your true inflation fighting colors by raising the nominal rate of interest (more than one for one) whenever inflation rises, and by lowering it whenever inflation falls.

There is a related school of thought that emphasizes the temptation a central banker might feel, once having convinced the markets of his inflation-fighting credentials, to deviate a little bit from his announced intentions, in order to get a bit more output in the short run. Such a line of thought leads to the suggestion that it might be a good idea to hire central bankers whose <u>personal</u> commitment to fighting inflation is high, on the view that central bank policy will gain <u>credibility</u> from the personal credibility of the central banker himself. Thus the message conveyed by the central banker in his Senate testimony is not just the parameters of the current Taylor Rule, but also the likelihood that the current parameter choice will persist into the months and years to come.

For our purposes today, what is most notable about this academic theory is the contrast between the communication strategy it recommends and the actual communication strategy of central bankers in the past, not excluding the very same Volcker and Greenspan whose performance I have already characterized as masterful. It is true that the personae of both men involved notable qualities of personal credibility and personal commitment. But, contrary to the academic theory, both were also past masters of opacity and vagueness. Maybe they were in fact following some kind of monetary rule, but they both certainly refused to say so, much less to characterize that rule in simple algebraic terms.

From the point of view of academic monetary theory, this seems a strange state of affairs. How can you expect to influence expectations about your future behavior if you don't state any deliverables against which your performance can be evaluated? Or, to state the same question in reverse, if your commitment to price stability is genuine, what explains the reticence about communicating your strategy for achieving the stated goal? Surely such communication could only help matters? It's a puzzle, and the puzzle is not just an idiosyncratic quirk of Volcker and Greenspan. Historians tell us that such reticence is more the rule than the exception in the history of central banking. What explains that?

Central bankers themselves often say that they want to avoid disrupting the markets. But this explanation, viewed from the standpoint of academic theory, seems to beg more questions than it answers. How could it disrupt markets to tell them what exactly you are going to do? Shouldn't communication reduce uncertainty, about both the present and the future, and so reduce volatility of market prices? To be sure, you want to beware of problems of moral hazard that arise from, for example, the too-big-to-fail doctrine. If financial institutions know that the central bank will always be there to bail them out, then they are likely to take on more risk than otherwise, and so increase the probability that central bank bailout will be necessary. But that's a different matter from general interest rate policy where, academics seem to agree, clarity and transparency are practically a free lunch. The question thus remains, why are central bankers so notoriously shy of clarity and transparency?

The explanation, I suggest, has to do with the fact that the concrete behavior of central banks involves buying and selling assets in financial markets. The central bank plays many roles, but one of them surely is that of a trader, albeit a trader not motivated narrowly by profit. What is the classic discount window mechanism, after all, but a commitment to purchase a certain class of eligible assets at a definite price? From this point of view, the central bank is nothing more than the specialist whose assignment it is to make the market in money. The central bank's standing facilities to lend and accept deposits are nothing more than the bid-ask spread at which it is willing to deal in money. A modern theory of monetary policy could be built around this analogy.[1]

In classic 19th century central banking, much attention was focused on "keeping in contact with the market" which meant quoting prices sufficiently close to the market so as to attract some discount business, or conducting security trades in order to "make bank rate effective." Attention was focused on a single rate, the discount rate, rather than the full bid-ask spread, and the quantity of discounts was allowed to fluctuate according as the flow demand for discounts exceeded or fell short of the flow repayment of the bank's portfolio of discounted securities. Bank rate could be raised if it was desired to slow the demand for discounts, or lowered if it was desired to speed it up. This is the origin of modern monetary policy.

By contrast, in modern practice (as it is emerging) there is a standing deposit facility as well as a standing lending facility, so we have the full bid-ask spread. Moreover, the modern equivalent to bank rate is not the rate on

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[1] The following draws freely on Bindseil (2004) and Mehrling (2006).

either one of the standing facilities but rather a rate that lies somewhere in between the two bounds. Just so, in current practice (April 25, 2006), the Fed's discount rate of 5.75% lies 100 basis points above the Fed Funds target of 4.75%, and the Fed's deposit rate is fixed at zero. But this very wide spread (575 basis points!) only establishes the outermost bounds of the market, and most trading occurs in the open market at the much narrower spreads in the repo market, or the Eurodollar market, or the interbank Fed Funds market. The modern central bank, unlike the 19th century central bank, apparently does not <u>want</u> day to day contact with the market, and is more comfortable steering from a distance.

Why so? The whole point of this little digression on the central bank as a trader has been to shed light on the peculiar reticence of central bankers, and now we are coming to the point. They are not so much afraid of disturbing market expectations as they are afraid of being taken advantage of by other traders in the market. In money markets as in other asset markets, when you offer liquidity by standing ready to trade with all comers at a preannounced price, you open yourself up to trading at prices that conceivably deviate from true values. Central banks may not be profit-motivated, but their counterparties certainly are, and will jump at any chance to trade at disequilibrium prices.

In classic central banking, the central bank's inventory of discounts was supposed to provide a sensitive barometer on exactly this point. If discounts were rising, one reason might be that bank rate was too low and should be raised. If discounts were falling, one reason might be that bank rate was too high and should be lowered. Unfortunately, discounts might rise or fall for other reasons as well, such as an increase or decrease in economic activity. Even more problematic, discounts might rise simply because firms are unable to repay past loans on time, so that old discounts have to be rolled over. The history of monetary ideas can be viewed largely as an attempt to find indicators for interest rate policy that are more reliable than the quantity of discounts.

In modern central banking, the discount rate is away from the market, and commercial bill discounts are not a significant component of the central bank balance sheet. Absent intervention, we would expect to see the market rate fluctuating within the wide bounds set by the standing facilities. It is exactly this potential volatility that provides the incentive for profit-seeking dealers to spring up, offering a narrower bid ask spread inside the central bank's spread. It is the balance sheets of these profit-seeking dealers (including banks), not the balance sheet of the central bank itself, that provides the barometer in the modern system. Of course these quantities can also fluctuate for many reasons, so the problem of finding a reliable indicator for interest rate policy continues. The price level (Wicksell)? Aggregate output or employment (Modigliani)? Or some combination of the two (Taylor)?

Central bank standing facilities are trading options offered for free, but worth more or less depending <u>first</u> on how close they are to the market (not close, hence not worth much), and <u>second</u> on how long the options are good for. The longer the maturity of the option, the more valuable it is, and that is where the Taylor Rule comes in. If the central bank announces its interest rate Rule, and traders are convinced of its commitment to follow that Rule, then the standing facilities are options good not just until the next intervention, or the next FOMC meeting, but for much longer than that. True, the precise strike price will change over time, but we know exactly how it will change because the Fed has told us. That change makes valuation of the option more difficult, but knowing how it will change makes the option long term, and that makes it more valuable. Traders in a Taylor Rule world in effect <u>own</u> these complicated long term options, and <u>that can be expected to change their trading behavior today</u>.

About a year ago, my friend Al Wojnilower began warning of the consequences of the announced commitment to raise interest rates only gradually in measured steps, and not to deviate without advance warning. One consequence, he argued, was the failure of long rates to rise in step with short rates, a failure that puzzled many economists at the time. Writing last June, Wojnilower explained: "Not only has the Fed committed itself to restrain rate increases to the 'measured pace' of ¼% at a time, but also to give advance warning of any change in this policy. This virtually incites speculators to borrow short and lend long. The reduction in profit as the spread between long and short rates shrinks can be offset by borrowing and lending in larger amounts."[2] In the year since then we have seen how that all played out, as the Fed Funds target has continued to increase without any noticeable slowdown in credit expansion.

This recent experience shows, I think, why central bankers have historically been so reticent. It is not that they perversely want to increase uncertainty about future inflation, but that they quite reasonably want to increase uncertainty about the price at which they will be willing to support the money market in the future. When central bankers explain that they want to avoid disrupting financial markets, what they mean is that they want to avoid sparking an unsustainable expansion of speculative credit. Deviations of bank rate from the equilibrium rate of interest have

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[2] Albert M. Wojnilower, "Heading for Heavy Financial Seas and a Change of Command." (June 14, 2005) Craig Drill Capital, New York.

consequences for expected arbitrage profits immediately, but for expected inflation only in the longer term. The opacity and vagueness so characteristic of central bankers when they have the stage must be understood, I conclude, as a reaction to the magic tricks and hilarious jokes that profit seeking traders are only too ready to spring on an unsuspecting audience whenever they get their chance on the stage.

References

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