

“Faith-Based” Monetary Policy Frameworks

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Why adopt an explicit framework?

- From the January 25, 2012 Fed Statement:
- *“[F]acilitates well-informed decision making by households and businesses”*
- *“[I]ncreases the effectiveness of monetary policy”*
- *“[R]educes economic and financial uncertainty”*
- *“[E]nhances transparency and accountability”*

- *“Communicating this [2 percent] inflation goal clearly to the public helps keep longer-term inflation expectations firmly anchored, thereby fostering price stability and moderate long-term interest rates and enhancing the Committee’s ability to promote maximum employment in the face of significant economic disturbances.”*

Logic Relies on Three Assumptions

- 1) Fed statements and actions → expectations and beliefs of households, businesses, and markets
- 2) Expectations and beliefs → behavior
- 3) Behavior → macroeconomic outcomes, e.g., inflation and employment

Evidence for Assumptions #1 and #2?

- Do Fed statements and actions drive expectations and beliefs?
- Do those expectations and beliefs then drive behavior?
- Economists and central bankers take it on faith that the answers are YES but we have almost NO systematic evidence, as least in countries like the US, hence, *faith-based* monetary policy.

Criteria for Evaluating Alternatives

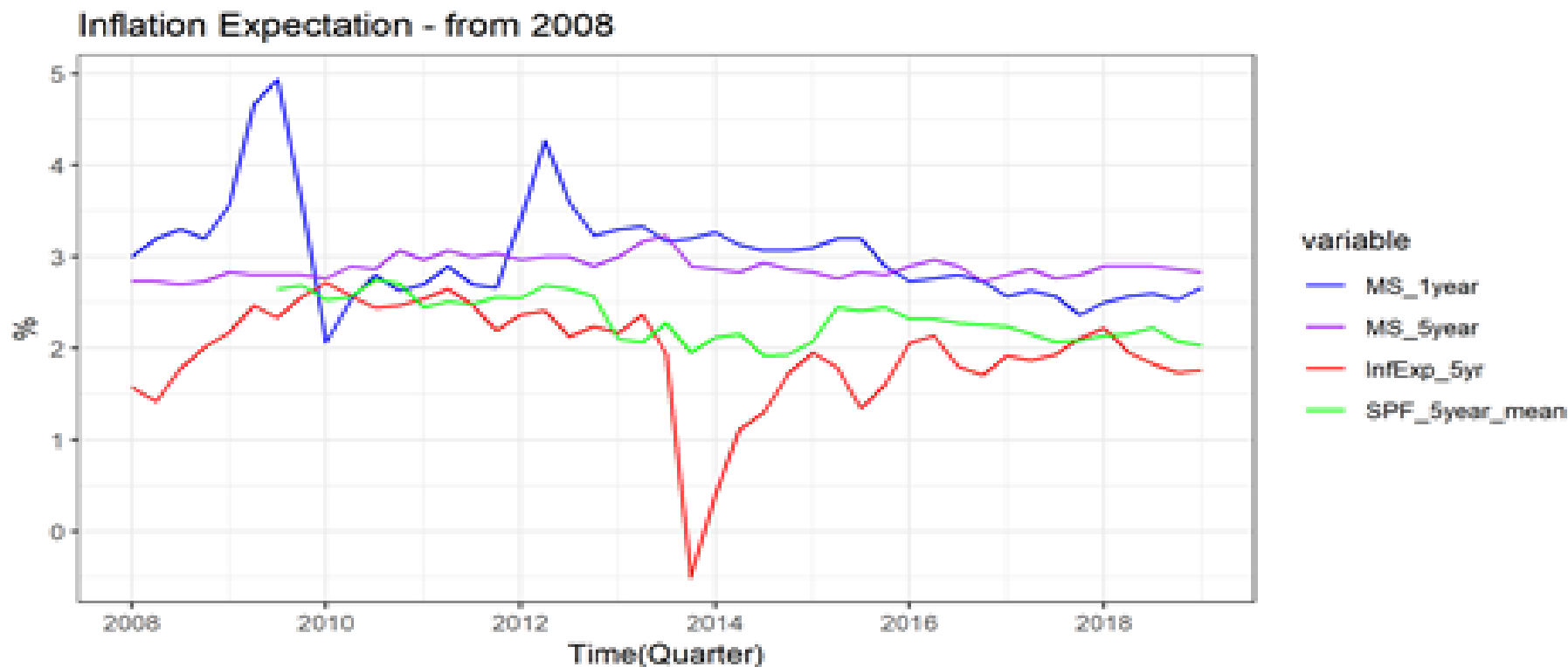
- While effectiveness in avoiding the zero lower bound, for example, is important, a crucial but neglected question is: *How effective are alternative frameworks, e.g., various forms of inflation, price level, or nominal GDP targeting, in allowing Fed communications and actions that drive expectations that then drive behavior?*
 - Expectations formation process? What anchors expectations? How do people learn and update?
 - Agent based models? Hachem (2016)
 - Will people change behavior?
 - Frequency of stubborn intuitions and “magical thinking” (Risen 2017 – and what follows draws from Risen)

Statements/Actions → Expectations/Beliefs

- 1) Are the relevant actors paying attention?
 - Fed watchers but households and businesses?
 - Attention check: What fraction of actors would know an announcement occurred and then get it right?
- 2) Can the information be presented in an understandable way?
 - For those who pass an “attention check,” what fraction could answer a question about how it *should* affect beliefs/behavior (separate from whether it does)?
 - What is the definition of inflation that households and businesses understand?

Whose expectation? Definition? Horizon?

- Michigan Survey (MS) systematically overestimates inflation in the last decade
 - Contrasting patterns for Professional Forecasters and Bond Market
- Do individuals only think of “prices that have changed” when asked to estimate “price changes”?



Statements/Actions → Expectations/Beliefs

- 3) Do people trust Fed statements and the relevant government data?
 - What is the Fed's objective? Dual or triple mandate?
 - Reliability? Fake news?
 - Alternative sources? Salience of gas prices?
- 4) Will people bring a strong prior?
 - Discount information if it contradicts a strong prior
 - Bygones?
- 5) Is the news considered positive or negative?
 - “Motivated reasoning” discounts negative information

Expectations/Beliefs → Behavior?

- “Magical Thinking” (Risen 2017)
 - Even after admitting a belief is “unfounded,” “irrational,” not based on data, etc., people often do not change their behavior accordingly
 - “A person may learn and agree that flying in an airplane is statistically much safer than driving but still refuse to fly.”
 - Decouple “error detection” from “error correction”
 - In what circumstances will households change wage demands and businesses change pricing plans even if they believe a Fed statement is credible?

Prevalence of “Magical Thinking”

(borrowed from Risen 2017)

“A friend was visiting the home of
Nobel Prize winner Niels Bohr...

The friend kept glancing at a horseshoe hanging over the door. Finally, unable to contain his curiosity any longer, he demanded: ‘Niels, it can’t possibly be that you, a brilliant scientist, believe that foolish horseshoe superstition!?!’ ‘Of course not,’ replied the scientist. ‘But I understand it’s lucky whether you believe in it or not.’”

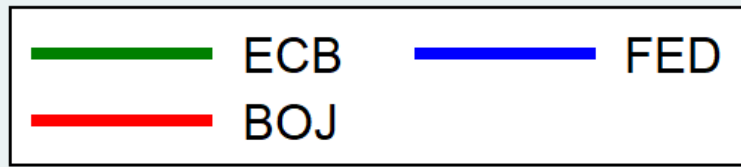
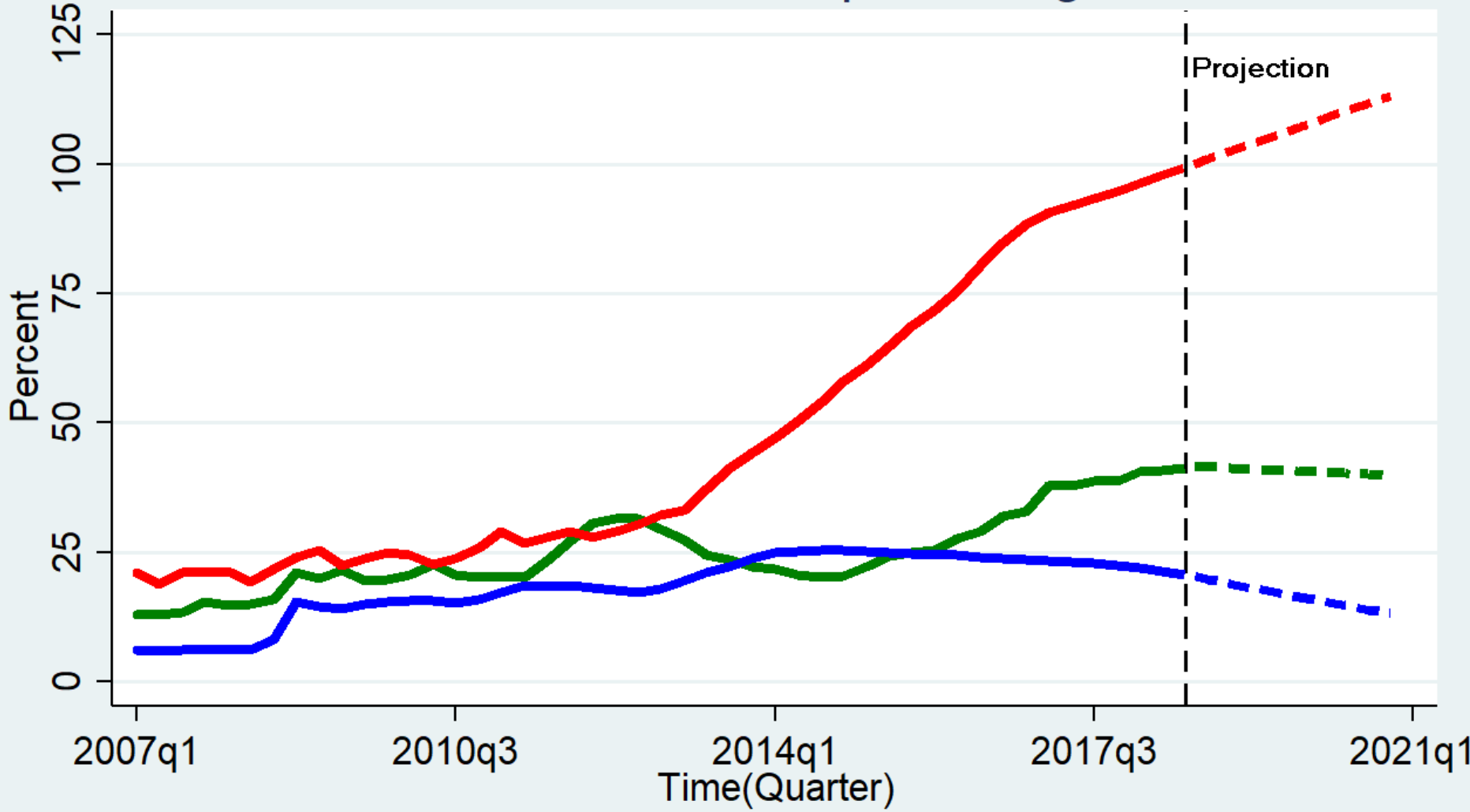
(Kenyon, 1956, pp.13)



Fed Actions/Behavior → Outcomes

- Does the central bank have the tools, in a moderate inflation environment, to be able to achieve a particular inflation outcome?
 - Obviously, some central banks in Latin America and Africa show they can still “unanchor” expectations, destroy credibility, and generate high inflation
 - But is a commitment to be within a narrow range of a low target feasible?
 - Could the adoption of an explicit framework eventually undermine “credibility” and the ability to achieve the outcome?

Central Bank Asset as a percentage of GDP



“Lose the faith” and gather data on which framework is most effective

- The ability of a framework to be helpful in changing expectations and behavior is at least as important as the ability of a framework to reduce the likelihood of hitting the zero lower bound. Many questions to address:
 - Credibility and clarity of targets? Price level vs Inflation vs GDP?
 - How are “price changes” interpreted?
 - Does “symmetry” help or cause confusion? “Bygones”?
 - What anchors expectations and affects behavior?
- The 2012 goal to “increase the effectiveness of monetary policy” is achieved only if we analyze these issues.
- This is a plea to “lose the faith” and gather data about the underlying behavioral assumptions.

Appendix: Textual Interpretation

- There is an established discipline of “semiotics,” the study of signs, communication, and interpretation.
- A crucial distinction emphasized by Leo Strauss, an influential U of Chicago political scientist, is between
 - *Exoteric* – what do the words appear to mean on their surface
 - *Esoteric* -- what is the coded meaning to those “in the know” or hidden below the surface because a group self-censored to avoid persecution; Do people always “say what they mean”?
- Do central bank officials ever “pull their punches”?
 - Consider what Greenspan said about his post 9/11 testimony (see the preface to Greenspan 2007)
 - How does that affect credibility especially in an “unusual and exigent” circumstances?