“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 $\rightarrow$ expectations and beliefs of households, businesses, and markets

2) Expectations and beliefs $\rightarrow$ behavior

3) Behavior $\rightarrow$ 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)
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”?

![Graph showing Inflation Expectation from 2008](image-url)
Statements/Actions $\rightarrow$ 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

- ECB
- FED
- BOJ
“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?