Reflections of a Monetary Policymaker

This is the last column in The Regional Economist *by William Poole. He retired at the end of March.*

Much of my thinking over the past 10 years as president of the St. Louis Fed has been devoted to monetary policy—both the strategy (the big-picture objectives of price stability and real economic growth) and the tactics (the specific actions taken by the FOMC to achieve those objectives). More specifically, I've concentrated on how the actions fit the strategy.

The study of these matters for central bankers (and many others) is important for two reasons. First, the central bank—just like any other public or private body that makes important decisions—must not act on the basis of whim. We must think ahead of time about the circumstances that would require any particular action. Second, for a central bank to achieve good outcomes for the economy, private decision-makers need not only understand monetary policy but need to form sensible expectations about future policy actions.

The formation of these expectations led to one of my first surprises as a monetary policymaker. As a longtime academic, I knew the professional literature in economics was full of insights into the importance of private-sector expectations about policy. But there was virtually nothing in the literature on how those expectations were formed. That became important to me as I started talking regularly with the press and other outsiders; it was clear that I needed to become part of the process of trying to establish correct expectations.

The expectations of the traders, journalists and others I was addressing were sometimes off-course because so often they were focusing on the "now"—what will affect them in the next few hours or days. They always wanted my prediction for what the FOMC would do at its next meeting, even if it were several weeks away. My standard answer was that I do not forecast policy decisions; rather, my job was to participate in making policy decisions. And those decisions—the specific actions—often had to be made at the FOMC meetings themselves because of late-breaking data or new arguments from fellow FOMC members at the meetings.

(Truth be told, over the years, I realized that even I had to be more flexible in my assessments of needed actions and not get stuck on

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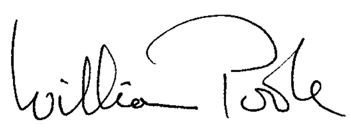

a policy action that I thought for sure was the right one only days ahead of a meeting.)

Because today's FOMC believes it's important not to surprise the markets, the committee started in 1999 at its regular rate-setting meetings to issue formal guidance to the public on the likely direction of future policy. I initially embraced this communication. If the committee were on the edge of raising the target, why not reveal that information? Then, the market could observe incoming information and decide whether strong data reports might complete the case for raising the target.

But several problems arose. It was harder than expected for the market to determine when incoming data made the case to change the funds rate target as suggested in the guidance. Sometimes, the data came in the other way, in which case the committee might want to change the target in the opposite direction to what was suggested earlier; this was awkward and could be interpreted incorrectly by the markets. Still another problem I had with such guidance: If the committee had a strong feeling as to what needed to be done at the next meeting, why not take care of it right away? Given lags in the effects of policy action, the current policy had to be based on the future outlook.

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If these reasons don't carry enough weight for critics, they need to know that the economy is shocked more often than most people realize, and those shocks can't be ignored because of policy guidance from a month earlier. I once thought that these shocks occurred only occasionally. But in my years at the Fed, I've found out that they are continual. Think of Long-term Capital Management, the dot-com bust, 9/11, the war in Iraq and now the subprime mortgage meltdown.

The shocks have become so normal that the markets are getting quite good at dealing with them on their own. Sometimes, the best thing the Fed can do is stay on the sidelines. When action is needed, however, the markets, the press and the public in general need to understand that the FOMC will move in accordance with its overall objectives … and not act on a whim.