The challenges of the Fed's bid for transparency

Thomas Sargent and William Silber

After the US Federal Reserve's Open Market Committee meeting in January Ben Bernanke, the chairman, announced it would begin publishing its views on future interest rates. He added a key caveat: the assessments "should not be viewed as unconditional pledges". Instead, they "are subject to future revision in light of evolving economic and financial conditions".

The costs of this move will, however, outweigh the benefits unless the public understands how the Fed is likely to respond to unexpected economic developments, even as it tells everyone more about what it expects. By publishing interest rate expectations, the Fed aims to impair its future flexibility – but not too much. The benefit of self-restraint is to come from the greater clarity that businessmen and other private sector decision makers will have about future Fed actions. Too often in the past, the Fed and other central banks succumbed to political pressure to deviate from pre-announced commitments.

The problem is that while some deviations from an announced "path" of future interest rates might be unwarranted, others would be entirely appropriate as new information appears and events unfold. The Fed's challenge is to distinguish between appropriate and inappropriate responses, and to convince the market and other branches of government it will behave accordingly.

That task would be easier if the Fed was truly independent, but it is not. Congress created the Fed and can abolish the central bank by a simple majority vote. Public pressures – as well as confrontations with presidents and Congress – to avoid high interest rates have derailed the Fed's best intentions throughout history.

Paul Volcker, who restored price stability during his term as Fed chairman, honoured Jimmy Carter's request to support the imposition of credit controls in 1980 to avoid still-higher interest rates. Mr Volcker considers this episode, which delayed his anti-inflation crusade, "a great mistake". While no president is known to have explicitly pressured Mr Bernanke's predecessor, Alan Greenspan, he found it easy to maintain low interest rates for too long, fuelling the credit boom and housing bubble that led to the financial crisis in 2008.

Mr Bernanke announced his new policy to disclose the committee members' assessments about interest rates immediately after the Fed announced the committee's conclusion that "economic conditions" would be "likely to warrant exceptionally low levels for the federal funds rate at least through 2014". Headlines trumpeted this likelihood as a "vow" to keep interest rates low. The Open Market Committee repeated its expectation of "exceptionally low levels for the federal funds rate at least through late 2014" in March.

Our fear is that the president and members of Congress will dismiss justifications in the future for higher interest rates that might be appropriate before the economy returns to full employment. With the memories of recession still fresh, Americans might not tolerate the pre-emptive restraint needed to maintain price stability.

Mr Bernanke could have deflected future complaints by saying: "We too know that financial forecasting is difficult; it is an exercise that becomes more uncertain the further into the future we go. While interest rates are close to zero now, we know they will not remain this low when the economy recovers, and we hope that recovery will occur faster than anticipated. The jumps in interest rates when recovery occurs will be smaller if Congress and the president balance the full employment budget, so that government borrowing contracts as corporations and individuals enter the credit markets." This is a message that would have made Congress and the president accountable as well.

Thomas Sargent, winner of the 2011 Nobel Prize in Economics, is a fellow at the Hoover Institution. William Silber is author of 'Volker: The Triumph of Persistence'. Both are professors at New York University

Financial Times March 21, 2012