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Communication in Monetary Policy

Remarks by

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Thank you for inviting me here and for offering me what I consider a perfect opportunity to speak on a topic at the heart of the Federal Reserve's efforts to promote a stronger economy--the vital role and growing use of communication in monetary policy.¹

Some of you cover the Federal Reserve and are familiar with how it sets monetary policy through the Federal Open Market Committee (FOMC). You know that the FOMC pays very close attention to what it says in the statements it issues after each meeting. This communication is supplemented by Chairman Bernanke's postmeeting press conferences and by providing detailed minutes of the Committee's meetings. Getting this message out to the public depends a good deal on the work you do in reporting on the FOMC, analyzing its statements and actions, and explaining its role and objectives. So let me begin by thanking you for those contributions.

But let me also say why I am particularly pleased to speak to you today. As writers and editors, all of you are prodigious consumers and producers of communication. At first glance, the FOMC's communication may not seem so different from what you've heard other government agencies say about their policies or businesses say about their products. I hope to show how communication plays a distinct and special role in monetary policymaking.

Let me offer a comparison that may highlight that difference. Suppose, instead of monetary policy, we were talking about an example of transportation policy--widening a road to ease traffic congestion. Whether this road project is announced at a televised press conference or in a low-key press release--or even if there is no announcement--the project is more or less the same. The benefit to drivers will come after the road is

¹ I am indebted to members of the Board staff--Jon Faust, Thomas Laubach, and John Maggs--who contributed to the preparation of these remarks.

widened and won't be affected by whether drivers knew about the project years in advance.

At the heart of everything I'll be explaining today is the fact that monetary policy is different. The effects of monetary policy depend critically on the public getting the message about what policy will do months or years in the future.²

To develop this idea, I will take you on a tour of past FOMC communication, the present, and what I foresee for the future. Until fairly recently, most central banks actively avoided communicating about monetary policy. Montagu Norman, governor of the Bank of England in the early 20th century, reputedly lived by the motto "never explain, never excuse," and that approach was still firmly in place at the Federal Reserve when I went to work there as a staff economist in 1977.

I'll begin by discussing how a growing understanding of the importance of transparency shaped FOMC communication in the years before the financial crisis. Next, I'll relate how the financial crisis brought unprecedented challenges for monetary policy that required the use of unconventional policy tools, including some barely contemplated before the crisis. Communication was a centerpiece of these efforts. Finally, I'll look ahead. I am encouraged by recent signs that the economy is improving and healing from the trauma of the crisis, and I expect that, at some point, the FOMC will return to a more normal approach to monetary policy. At the conclusion of my remarks, I'll discuss the communication challenges the FOMC will face when it comes time to make that transition.

² Like almost every government policy action, this hypothetical road project could affect expectations--it might influence decisions about where people live or commercial development, for example. The crucial difference is that these are not the primary and stated aim of this policy action, which is to reduce traffic congestion. As these remarks go on to explain, unlike most government policy actions, monetary policy is primarily concerned with affecting expectations of the future.

FOMC communication has long been a topic of great interest to me, and one I have worked on more directly since 2010, when Chairman Bernanke asked me to lead a new FOMC subcommittee on communications. This is probably a good moment to remind you that, as always, I speak for myself and not the FOMC or my colleagues in the Federal Reserve System.

From “Never Explain” to Transparency

Recently I used the word “revolution” to describe the change from “never explain” to the current embrace of transparency in the FOMC’s communication.³ That might sound surprising to an audience that knows very well what it feels like to be in the middle of a communications revolution. The speed and frequency of most communication, it seems, never stops growing, and I will admit that the FOMC’s changes to the pace and form of its communication seem rather modest in comparison. I’ve mentioned the Chairman’s quarterly postmeeting press conferences, which were initiated two years ago. While these events are televised and streamed live, the mode for most of the FOMC’s communication is decidedly old-school--the printed word. The Committee’s most watched piece of communication is the written statement issued after each of its meetings, which are held roughly every six weeks. It may seem quaint that my colleagues and I continue to spend many hours laboring over the few hundred words in this statement, which are then extensively analyzed only minutes after their release.

The revolution in the FOMC’s communication, however, isn’t about technology or speed. It’s a revolution in our understanding of how communication can influence the effectiveness of monetary policy.

³ See Janet L. Yellen (2012), “Revolution and Evolution in Central Bank Communications,” speech delivered at the Haas School of Business, University of California, Berkeley, November 13, www.federalreserve.gov/newsevents/speech/yellen20121113a.htm.

It will help if I start with some basics. The FOMC consists of the 7 members of the Federal Reserve Board in Washington and 5 of the 12 presidents of the regional Federal Reserve Banks. All 12 presidents participate in FOMC meetings but only 5 get a vote, a roster that rotates each year.

The FOMC's job, assigned by the Congress, is to use monetary policy to promote maximum employment and stable prices, objectives that together are known as the Federal Reserve's dual mandate. In normal times, the Committee pursues these goals by influencing the level of a short-term interest rate called the federal funds rate, which is what banks charge each other for overnight loans. When the FOMC pushes the federal funds rate up or down, other short-term interest rates normally move in tandem.

Medium- and longer-term interest rates, including auto loan rates and mortgage rates, generally adjust also, through a mechanism I will return to in a moment. By pushing the federal funds rate up or down, the FOMC seeks to influence a wide range of interest rates that matter to households and businesses.

Typically, the FOMC acts to lower the federal funds rate, with the intention of reducing interest rates generally, when the economy is weakening or inflation is declining below the Committee's longer-run objective. The FOMC raises the federal funds rate when inflation threatens to rise above its objective or when economic activity appears likely to rise above sustainable levels. Raising and lowering the federal funds rate was long the primary means by which the FOMC pursued its economic objectives.

It is hard to imagine now, but only two decades ago, the Federal Reserve and other central banks provided the public with very little information about such monetary policy moves--the spirit of "never explain" was very much alive. There were a number

of different justifications for this approach. One view was that less disclosure would reduce the risk and tamp down suspicions that some could take advantage of disclosures more readily than others. Some believed that markets would overreact to details about monetary policy decisions. And there was a widespread belief that communicating about how the FOMC might act in the future could limit the Committee's discretion to change policy in response to future developments. In sum, the conventional wisdom among central bankers was that transparency was of little benefit for monetary policy and, in some cases, could cause problems that would make policy less effective.

While communication and transparency steadily increased elsewhere in government and society, change came slowly to the FOMC. It wasn't until February 1994 that the Committee issued a postmeeting statement disclosing a change in monetary policy. Even then, it only alerted the public that the Committee had changed its policy stance, with scant explanation.⁴

Something big *was* changing, however, and it would soon be the force driving major enhancements in the FOMC's communication. By the early 1990s, a growing body of research challenged widespread assumptions about the how central banks, such as the Federal Reserve, affected the economy. The reevaluation starts with a question that puzzled many of my students when I was a professor: How is it that the Federal Reserve manages to move a vast economy just by raising or lowering the interest rate on overnight loans by 1/4 of a percentage point?

The question arises because significant spending decisions--expanding a business, buying a house, or choosing how much to spend on consumer goods over the year--

⁴ Previously, the public inferred policy changes by observing the Federal Reserve's behavior in securities markets.

depend on expectations of income, employment, and other economic conditions over the longer term, as well as longer-term interest rates. The crucial insight of that research was that what happens to the federal funds rate today or over the six weeks until the next FOMC meeting is relatively unimportant. What *is* important is the public's expectation of how the FOMC will use the federal funds rate to influence economic conditions over the next few years.⁵

For this reason, the Federal Reserve's ability to influence economic conditions today depends critically on its ability to shape expectations of the future, specifically by helping the public understand how it intends to conduct policy over time, and what the likely implications of those actions will be for economic conditions. To return to the example I used earlier, contrast this effect on expectations with that of a road project. Today's commute, alas, will not be improved or changed at all by the news that a road will be widened one day. But the effects of today's monetary policy actions are largely due to the effect they have on expectations about how policy will be set over the medium term.

Let me further illustrate this with some history. Starting in the mid-1960s, the Federal Reserve didn't act forcefully in the face of rising inflation, and the public grew less certain of the central bank's commitment to fighting inflation. This uncertainty led expectations of future inflation to become "unanchored" and more likely to react to economic developments. In 1973, an oil price shock led to a large increase in overall inflation. Expectations of higher inflation in the future affected the public's behavior--workers demanded raises, and businesses set prices and otherwise acted in anticipation of

⁵ Another factor that adds to the importance of expectations is that changes in monetary policy affect real activity and inflation with a substantial time lag.

higher costs--and this helped fuel actual inflation. The FOMC's occasional efforts to reduce inflation in the 1970s were ineffective partly due to the expectation that it ultimately wouldn't do enough.

By contrast, most of you probably know about the Federal Reserve's successful inflation fighting in the early 1980s. The FOMC raised the federal funds rate very high, causing a deep recession but also convincing the public that it was committed to low and stable inflation. Anchoring inflation expectations at low levels helped ensure that jumps in commodity prices or other supply shocks would not generate persistent inflation problems. This was illustrated by the effect of another escalation in oil prices starting in 2005. Unlike in the 1970s, these price shocks did not result in a broad and lasting increase in overall inflation because the public believed the Federal Reserve would keep inflation in check. The FOMC wasn't forced to raise interest rates--which softened the blow of higher fuel costs on households and businesses--because of the credibility the Federal Reserve had built since the 1980s.

If the public's expectations have always been important, you might wonder how monetary policy had any effect prior to the transparency revolution. As it turns out, with the notable exception of the late 1960s and 1970s, the FOMC usually responded in a systematic way to economic conditions. In 1993, economist John Taylor documented that FOMC policy changes since the mid-1980s had fairly reliably followed a simple rule based on inflation and output. Changes in the federal funds rate were usually made in several small steps over a number of months. In practice, the Federal Reserve's approach was "never explain, but behave predictably."

A close analysis of the FOMC's past behavior was a good guide to future policy, but it had two shortcomings as a substitute for transparency: First, it gave an advantage to sophisticated players who studied the FOMC's behavior--something that is arguably inappropriate for a government institution. Second, while a policy rule such as the one developed by John Taylor explained the course of the federal funds rate much of the time, there were cases when it didn't and when even the experts failed to correctly anticipate the FOMC's actions.

The trend toward greater transparency accelerated during the early 2000s. Starting in 2000, the FOMC issued information after every meeting about its economic outlook. It also provided an assessment of the balance of risks to the economy and whether it was leaning toward increasing or decreasing the federal funds rate in the future. Such information about intentions and expectations for the future, known as forward guidance, became crucial in 2003, when the Committee was faced with a stubbornly weak recovery from the 2001 recession. It had cut the federal funds rate to the very low level of 1 percent, but unemployment remained elevated, and the FOMC sought some further way to stimulate the economy. In this situation, it told the public that it intended to keep the federal funds rate low for longer than might have been expected by adding to its statement that “[i]n these circumstances, the Committee believes that policy accommodation can be maintained for a considerable period.”⁶

Let's pause here and note what this moment represented. For the first time, the Committee was using communication--mere words--as its primary monetary policy tool. Until then, it was probably common to think of communication about future policy as

⁶ See Board of Governors of the Federal Reserve System (2003), “FOMC Statement,” press release, August 12, www.federalreserve.gov/boarddocs/press/monetary/2003/20030812/default.htm.

something that supplemented the setting of the federal funds rate. In this case, communication was an independent and effective tool for influencing the economy. The FOMC had journeyed from “never explain” to a point where sometimes the explanation *is* the policy.

By the eve of the recent financial crisis, it was established that the FOMC could not simply rely on its record of systematic behavior as a substitute for communication--especially under unusual circumstances, for which history had little to teach. I think we're all fortunate that policymakers had learned this lesson, because the FOMC was about to encounter unprecedented economic conditions and policy challenges. The financial crisis and its aftermath demanded advances in FOMC communication as great as any that had come before.

Monetary Policy since the Onset of the Financial Crisis

The situation in 2008 and 2009 was like nothing the Federal Reserve had faced since the 1930s. In late 2008, the FOMC cut the federal funds rate nearly to zero--essentially, as low as it could go--where it has remained. With its traditional tool for expansionary monetary policy--lowering the federal funds rate--off the table, the FOMC turned to unconventional and, in some cases, newly invented policy options to try both to help stabilize the financial system and to arrest the plunge in economic activity. The public had grown accustomed to monetary policy that focused on changes to the federal funds rate target, with occasional, and at this point fairly limited, guidance that a particular policy stance would probably last for a while. Beyond the task of describing the new policies, extensive new communication was needed to justify these

unconventional policy actions and convincingly connect them to the Federal Reserve's employment and inflation objectives.

The best known of these unconventional policies is large-scale asset purchases, commonly known as quantitative easing. Starting in late 2008 and continuing through today, the Federal Reserve has purchased longer-term government agency debt securities, agency-guaranteed mortgage-backed securities, and longer-term Treasury securities that have added about \$2.5 trillion to its assets. These purchases were intended to, and I believe have, succeeded in significantly lowering longer-term interest rates and raising asset prices to help further the Federal Reserve's economic objectives. This is an easing of monetary policy, also known as accommodation, beyond what is provided by maintaining the federal funds rate close to zero.

It is important to emphasize that the effects of asset purchases also depend on expectations. If the FOMC buys, say, \$10 billion in longer-term securities today but is expected to sell them tomorrow or very shortly, there will be little effect on the economy. Current research suggests that the effects of asset purchases today depend on expectations of the total value of securities the FOMC intends to buy *and* on expectations of how long the FOMC intends to hold those securities. To make these asset purchases as effective as possible in adding accommodation, the FOMC, therefore, needs to communicate the intended path of Federal Reserve securities holdings years into the future. I will return in a moment to current and possible future ways in which the FOMC does and might communicate this information.

The other unconventional policy designed to contribute to monetary easing was almost purely communication--enhanced forward guidance about how long the

Committee expects to maintain the federal funds rate near zero. The situation in early 2009 was similar to 2003 but even more challenging, because in that earlier episode, the FOMC at least retained the option of a further reduction in the federal funds rate target. In 2009, communication about the future path of the federal funds rate was the only option.

Initially, the forward guidance was simple and familiar: The FOMC statement noted that “economic conditions are likely to warrant exceptionally low levels of the federal funds rate for an extended period.”⁷ The Committee enhanced its forward guidance in August 2011, when it substituted “at least through mid-2013” for the words “an extended period.”⁸ This date was moved into the future several times, most recently last September, when it was shifted to mid-2015.⁹

This “calendar guidance” was an advance over the indefinite “extended period,” but it suffered from an important limitation. The date failed to provide the public with a clear understanding of what conditions the FOMC was trying to achieve or the economic conditions that would warrant a continuation of the policy. As a consequence, it was hard for the public to tell whether a change in the calendar date reflected a shift in policy or a change in the Committee’s economic forecast.

To help provide greater clarity about the Committee’s objectives, in January 2012, the FOMC adopted and released a statement of its longer-run goals and monetary

⁷ See Board of Governors of the Federal Reserve System (2009), “FOMC Statement,” press release, March 18, www.federalreserve.gov/newsevents/press/monetary/20090318a.htm.

⁸ See Board of Governors of the Federal Reserve System (2011), “FOMC Statement,” press release, August 9, www.federalreserve.gov/newsevents/press/monetary/20110809a.htm.

⁹ See Board of Governors of the Federal Reserve System (2012), “Federal Reserve Issues FOMC Statement,” press release, September 13, www.federalreserve.gov/newsevents/press/monetary/20120913a.htm.

policy strategy.¹⁰ This statement laid out, for the first time, the rates of inflation and unemployment that the FOMC considers consistent with the dual mandate. Specifically, it stated that the longer-run inflation goal most consistent with the FOMC's price stability mandate is 2 percent, and that the central tendency of FOMC participants' estimates of the longer-run normal rate of unemployment ranged from 5.2 to 6 percent.

As the statement also made clear, economic developments may cause inflation and unemployment to temporarily move away from the objectives, and the Committee will use a balanced approach to return both, over time, to the longer-run goals. On the one hand, for example, the current rate of unemployment, at 7.7 percent, is far above the 5.2 to 6 percent range in the statement and is expected to decline only gradually. Inflation, on the other hand, has been running at or below 2 percent and is expected to remain at similar levels for several years. In this circumstance, both legs of the dual mandate call for a highly accommodative monetary policy. With unemployment so far from its longer-run normal level, I believe progress on reducing unemployment should take center stage for the FOMC, even if maintaining that progress might result in inflation slightly and temporarily exceeding 2 percent. The Committee reaffirmed this statement in January 2013, and I expect it to remain a valuable roadmap for many years to come, indicating how monetary policy will respond to changes in economic conditions.¹¹

¹⁰ See Board of Governors of the Federal Reserve System (2012), "Federal Reserve Issues FOMC Statement of Longer-Run Goals and Policy Strategy," press release, January 25, www.federalreserve.gov/newsevents/press/monetary/20120125c.htm.

¹¹ See "Statement on Longer-Run Goals and Monetary Policy Strategy," as amended effective January 29, 2013, on the Board's website at www.federalreserve.gov/monetarypolicy/files/FOMC_LongerRunGoals.pdf.

Meanwhile, the FOMC has continued to enhance its communication about how it would use the federal funds rate to return inflation and unemployment to its longer-run objectives. Last December, the Committee replaced its calendar guidance for the federal funds rate with quantitative measures of economic conditions that would warrant continuing that rate at its current very low level. Specifically, the Committee said it anticipates that exceptionally low levels for the federal funds rate will be appropriate “at least as long as the unemployment rate remains above 6-1/2 percent, inflation between one and two years ahead is projected to be no more than a half percentage point above the Committee’s 2 percent longer-run goal, and longer-term inflation expectations continue to be well anchored.”¹²

I consider these thresholds for possible action a major improvement in forward guidance. They provide much more information than before about the conditions that are likely to prevail when the FOMC decides to raise the federal funds rate. As for the date at which tightening of monetary policy is likely to occur, market participants, armed with this new information about the Committee’s “reaction function,” can form their own judgment and alter their expectations on timing as new information accrues over time.

These thresholds will, as a consequence, allow private-sector expectations of the federal funds rate to fulfill an important “automatic stabilizer” function for the economy. If the recovery is stronger than expected, the public should anticipate that one or both of the threshold values will be crossed sooner and, hence, that the federal funds rate could be raised earlier. Conversely, if the outlook for the economy unexpectedly worsens, the

¹² See Board of Governors of the Federal Reserve System (2012), “Federal Reserve Issues FOMC Statement,” press release, December 12, www.federalreserve.gov/newsevents/press/monetary/20121212a.htm.

public should expect a later “liftoff” in rates--an expectation that would reduce longer-term interest rates and thereby provide more-accommodative financial conditions.

Communication and Monetary Policy Challenges Ahead

The threshold guidance for the federal funds rate looks ahead to a time when the economy has healed from the worst effects of the financial crisis. Getting back to more normal economic conditions will allow for a more normal approach to monetary policy. I look forward to the day when we can put away our unconventional tools and return to what now seems like the relatively straightforward challenge of setting the federal funds rate.

At some point it will be appropriate to cease adding to accommodation and, later, to begin the process of withdrawing the significant accommodation required by the extraordinary conditions caused by the financial crisis. I believe that, once again, communication will play a central role in managing this transition.

Let me start with our current program of asset purchases, which was launched in September 2012 and revised in December. Notably, the FOMC has described this program in terms of a monthly pace of purchases rather than as a total amount of expected purchases. The Committee has indicated that it will continue purchases until the outlook for the labor market has improved substantially in a context of price stability. In its most recent statement, the FOMC also indicated that the pace and composition of the purchases may be adjusted based on the likely efficacy and costs of such purchases, as well as the extent of progress toward the Federal Reserve’s economic objectives.¹³ In my view, adjusting the pace of asset purchases in response to the evolution of the outlook

¹³ See Board of Governors of the Federal Reserve System (2013), “Federal Reserve Issues FOMC Statement,” press release, March 20, www.federalreserve.gov/newsevents/press/monetary/20130320a.htm.

for the labor market will provide the public with information regarding the Committee's intentions and should reduce the risk of misunderstanding and market disruption as the conclusion of the program draws closer.

The Federal Reserve's ongoing asset purchases continually add to the accommodation that the Federal Reserve is providing to help strengthen the economy. An end to those purchases means that the FOMC has ceased augmenting that support, not that it is withdrawing accommodation. When and how to begin actually removing the significant accommodation provided by the Federal Reserve's large holdings of longer-term securities is a separate matter. In its March statement, the FOMC reaffirmed its expectation that a highly accommodative stance of monetary policy will remain appropriate for a considerable time after the current asset purchase program ends and the economic recovery has strengthened.¹⁴ Accordingly, there will likely be a substantial period after asset purchases conclude but before the FOMC starts removing accommodation by reducing asset holdings or raising the federal funds rate.

To guide expectations concerning the process of normalizing the size and composition of the Federal Reserve's balance sheet, at its June 2011 meeting, the FOMC laid out what it called "exit principles." In these principles, the FOMC indicated that asset sales would likely follow liftoff of the federal funds rate. It also noted that, in order to minimize the risk of market disruption, the pace of asset sales during this process could be adjusted up or down in response to changes in either the economic outlook or financial conditions. For example, changes in the pace or timing of asset sales might be warranted by concerns over market functioning or excessive volatility in bond markets. While

¹⁴ See Board of Governors, "FOMC Statement," March 20, in note 13.

normalization of the Federal Reserve's portfolio is still well in the future, the FOMC is committed to clear communication about the likely path of the balance sheet.

There will come a time when the FOMC begins the process of returning the federal funds rate to a more normal level. In their individual projections submitted for the March FOMC meeting, 13 of the 19 FOMC participants saw the first increase in the target for the federal funds rate as most likely to occur in 2015, and another expected it to occur in 2016. But the course of the economy is uncertain, and the Committee added the thresholds for unemployment and inflation, in part, to help guide the public if economic developments warrant liftoff sooner or later than expected. As the time of the first increase in the federal funds rate moves closer, in my view it will be increasingly important for the Committee to clearly communicate about how the federal funds rate target will be adjusted.

I hope I've been able today to convey the vital role that communication plays in the Federal Reserve's efforts to promote maximum employment and stable prices. Communication became even more significant after the onset of the financial crisis when the FOMC turned to unconventional policy tools that relied heavily on communication. Better times and a transition away from unconventional policies may make monetary policy less reliant on communication. But I hope and trust that the days of "never explain, never excuse" are gone for good, and that the Federal Reserve continues to reap the benefits of clearly explaining its actions to the public. I believe further improvements in the FOMC's communication are possible, and I expect they will continue.

It has been my privilege to share these thoughts with you. Thank you for inviting me here today.