Forward Guidance in Extraordinary Times, in Normal Times, and Betwixt the Two

Loretta J. Mester
President and Chief Executive Officer
Federal Reserve Bank of Cleveland

Money Marketeers of New York University, Inc.
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Good evening and thank you very much for the invitation to speak to the Money Marketeers. I understand that a long line of Federal Reserve presidents and governors have addressed your distinguished group and I am very honored to follow in their footsteps. Tonight I will discuss the role of communications in Fed policymaking, focusing on the FOMC's forward guidance on the future path of policy. Of course, my remarks will reflect my own views and not necessarily those of the Federal Reserve System or my colleagues on the Federal Open Market Committee.

The Benefits of Clear Communication in Monetary Policymaking

Eleven years ago today, Alan Greenspan, then Chairman of the Federal Reserve, gave an economic outlook speech. The next day's headline in *The New York Times* read as follows: "Greenspan Hints at End to Low Rates," while the headline in *The Wall Street Journal* read: "Greenspan Suggests Continued Patience on Rates."[1] That one speech generated such contradictory messages illustrates the challenges monetary policymakers face when communicating with the public. Yet despite the challenges, over the past two decades the Federal Reserve has been on a journey to enhance its policy communications. That journey continues today because there are good reasons to believe that better communication will lead to better economic outcomes.

Clear communication and transparency can make monetary policy more effective by helping households and businesses make better economic and financial decisions. When policymakers are clear about the goals of monetary policy and the economic information that is important in their forecasts and policy decisions, the public will have a better idea of how monetary policy is likely to change as economic conditions evolve. Moreover, people will have a better sense of how policy will react not only to anticipated changes in conditions but also to unanticipated economic developments. Such knowledge helps households and firms make better saving, borrowing, investment, and employment decisions.

[1]These were the original headlines in the November 7, 2003 print editions.

Transparency about monetary policy plays another important role: it gives the public the information it needs to hold the central bank accountable for its policies. After all, in order to evaluate the central bank's policy decisions, the public has to know the basis for those decisions. Accountability is essential in a democracy, and it can also promote better policymaking. In the U.S., Congress has given the Fed a mandate to promote price stability and maximum employment, and it has given the Fed independence in making monetary policy decisions in pursuit of those goals. A body of research both here and abroad shows that when central banks formulate monetary policy free from government interference and are held accountable for their decisions, better economic outcomes result.

Of course, it has taken some time for central banks, including the Fed, to recognize the benefits of increased transparency. Twenty years ago the FOMC relied on open market operations rather than policy statements to signal shifts in the stance of monetary policy. It wasn't until 1994 that the FOMC began to explicitly announce changes in its fed funds rate target and added more description about the state of the economy and the rationale for its decisions. Since then, the Fed has taken a number of additional steps to improve the public's understanding of monetary policy. The FOMC now releases the votes of individual members and the preferred policy choices of any dissenters in its post-meeting statement, and it has expedited the release of the minutes of its meetings. And I think anyone who has looked at the minutes over time will notice that they have grown meatier, discussing in more detail the consensus view of policymakers, the perceived risks to the outlook, and also the range of views expressed around the table.

Over time, the FOMC has increased the information it provides on its economic outlook. Economic projections, which are now contained in the Summary of Economic Projections, or SEP, are released four times a year instead of twice a year. The projections include more economic variables and a longer forecast horizon, as well as the policy paths that underlay participants' projections.

Another important step toward enhanced communications came in 2012 when, for the first time, the FOMC laid out the guiding principles it follows in setting monetary policy. A key part of those principles was the establishment of an explicit numerical goal for inflation over the longer run. The goal is 2 percent inflation, as measured by the year-over-year change in the price index for personal consumption expenditures, or PCE inflation. Being explicit about the inflation objective reflects the FOMC's desire to be transparent and communicate clearly to the public. But it also underscores the FOMC's commitment to price stability and thereby helps anchor the inflation expectations of households and businesses at the target. Inflation expectations are an important determinant of actual inflation. So having an explicit target helps promote price stability.

Perhaps one of the most valuable additions to the FOMC's communications arsenal is the press briefing the Chair of the Committee holds four times a year to present the FOMC's economic projections. The briefings, which started in 2011, provide a vehicle for the Chair to expand on the information contained in the FOMC's post-meeting statement. She can highlight things that are too complex to discuss in the relatively short FOMC statement, and she can give a sense of alternative views as well. Indeed, the Chair did that at her September press briefing when she discussed various members' views on forward guidance, to which I now turn.

Forward Guidance in Extraordinary Times

The FOMC's forward policy guidance has received considerable attention. During the unusual economic circumstances of the past six years, the FOMC has provided forward guidance to help the public better understand the anticipated future path of interest rates. The formulation of the forward guidance has changed over time, from qualitative guidance, to calendar dates, to economic thresholds, and to a blend of state-contingent and date-based guidance. Let's walk through those changes.

In December 2008, the FOMC began with qualitative guidance indicating that it anticipated that weak economic conditions were likely to warrant exceptionally low levels of the fed funds rate for "some time." In March 2009, "some time" became "extended period." In August 2011, the FOMC changed its qualitative forward guidance to a calendar date when it said that it anticipated an exceptionally low fed funds rate at least through mid-2013. That date was later extended to late 2014, and then to mid-2015.

The FOMC changed the formulation of its forward guidance from calendar dates to thresholds in December 2012. The Committee said that it anticipated that the 0-to-¼ percent target range for the fed funds rate would be appropriate at least as long as the unemployment rate remained above 6½ percent, inflation between one and two years ahead was projected to be no more than a half percentage point above the Committee's 2 percent longer-run goal, and longer-term inflation expectations continued to be well anchored.

A year later, in December 2013, the FOMC blended state-contingent forward guidance with an element of calendar-date forward guidance. First, the FOMC indicated that in determining how long to maintain highly accommodative monetary policy, it would consider information in addition to the unemployment rate and PCE inflation, including additional measures of labor market conditions, indicators of inflation pressures and inflation expectations, and readings on financial developments. The FOMC then translated this into time, saying that based on its assessment of these factors, the 0-to-¼ percent target range for the funds rate would likely be appropriate "well past the time that the unemployment rate declines below 6½ percent, especially if projected inflation continues to run below the Committee's 2 percent longer-run goal."

In March of this year, the thresholds were replaced with guidance that linked the path of policy to the Committee's assessment of both realized and expected progress toward its dual-mandate objectives. The guidance continued to provide a time element by indicating that based on the FOMC's assessment, the

funds rate target will likely remain 0-to-¼ percent for "a considerable time after the asset purchase program ends, especially if projected inflation continues to run below the Committee's 2 percent longer-run goal, and provided that longer-term inflation expectations remain well anchored."

I note that the recent business cycle was not the first time the FOMC has used forward guidance. In August 2003, in the midst of elevated perceived risks of deflation, the Committee indicated that it believed policy accommodation could be maintained for a "considerable period." As deflation risks eased and economic conditions changed during that cycle, the forward guidance evolved as well, eventually indicating that the FOMC would be firming policy.

The common element in both of these forward guidance episodes is that they happened during periods of unusual economic circumstances: in the earlier instance, a deflation scare; in the later instance, the financial crisis, ensuing very deep recession, and subsequent slow recovery.

In extraordinary economic times, forward guidance can be thought of as more than a communications device. It is a tool of monetary policy that has the potential to increase the degree of monetary policy accommodation, especially when interest rates are essentially at their zero lower bound. By reducing uncertainty about the future path of policy, forward guidance helps lower interest rates by reducing the premiums investors demand to compensate them for interest-rate uncertainty.

In addition, in theory, if the central bank indicates that the future path of short-term interest rates will be low for a long time – perhaps lower and for longer than would have been consistent with the central bank's past behavior – this can also put downward pressure on longer-term interest rates, thereby spurring current economic activity. According to the theory, if people believe that the central bank will keep rates very low, they will expect higher economic activity and higher inflation in the future. When households, businesses, and market participants are assured of better economic prospects in the future, they should be

more willing to make investments in capital and labor today rather than delaying them, and this will help the current economy.

Note, though, that for forward guidance to have this effect, the public must believe that the central bank is setting policy differently than it has in the past and also that the central bank is committed to implementing this particular policy. If, instead, the public believes that the central bank is behaving as usual, it could misinterpret a very low policy rate as suggesting a gloomier outlook, and this would work to depress current activity – the exact opposite of the intended effect. In addition, before they will change their behavior and start spending today, households and firms have to believe that the central bank is committed to behaving in this unusual way. How to increase the credibility of such a commitment continues to be a subject of economic research.[2]

Forward Guidance in Normal Times

So, in extraordinary economic times, forward guidance can be viewed as an additional monetary policy tool. But in more normal times, away from the zero lower bound, I view forward guidance more as a communications device that conveys to the public how policy is likely to respond to changes in economic conditions. In other words, in normal times, forward guidance will focus less on when policy will be changed or even the particular path of future policy, and more on the rationale for policy decisions. To the extent that households and businesses understand how policymakers are likely to react to economic developments – whether anticipated or unanticipated – their policy expectations will better align with those of policymakers. As I discussed earlier, this alignment can make policy more effective.

[2] The literature has suggested different mechanisms for increasing the credibility of this commitment, including temporarily increasing the inflation target, targeting nominal GDP instead of inflation, and targeting the price level instead of inflation. For an excellent discussion of forward guidance, as well as other policies at the zero lower bound, see Michael Woodford, "Methods of Policy Accommodation at the Interest-Rate Lower Bound," Federal Reserve Bank of Kansas City Economic Symposium, Jackson Hole, WY, 2012 (www.kc.frb.org/publicat/sympos/2012/Woodford_final.pdf).

In the late 1980s and 1990s, the public had a pretty good sense of how the FOMC's policy would respond to economic developments, the so-called reaction function. They were able to get a handle on the FOMC's reaction function because after the great inflation of the 1970s, the FOMC became more predictable and systematic in how it reacted to changes in economic activity and inflation.[3] As a result, forward guidance was rarely used.

But the Great Recession required the Fed to behave in a way quite distinct from its past behavior, and consequently, there is less understanding about how policymakers are likely to react to incoming economic information than there was earlier. So in my view taking steps to enhance the public's ability to understand the rationale behind the FOMC's decisions has value. As our economy returns to normal, I would like the forward guidance used during the extraordinary times of the past six years to evolve into our offering a clearer sense of the FOMC's reaction function.

I believe the FOMC's Summary of Economic Projections, with suitable amendments, could play a central role in helping the public better understand how policy is likely to respond to economic developments. Before I offer three possible avenues for consideration, let me again note that these are my own views and do not necessarily represent the views of my colleagues on the FOMC, including those who serve with me on the FOMC's subcommittee on communications.

Right now, the SEP provides information on the range of projections of real output growth, the unemployment rate, and inflation across participants, as well as the policy paths that individual participants view as appropriate for achieving those projections. But there is no linkage across the variables. For example, there is no way to see whether a person low in the range of unemployment rate

[3] For a discussion, see John B. Taylor, "Monetary Policy During the Past 30 Years with Lessons for the Next 30 Years," luncheon address at the Cato Institute's 30th Annual Monetary Conference on Money, Markets and Government: The Next 30 Years, Washington, D.C., November 15, 2012.

forecasts is high in the range of inflation projections. Rather than presenting ranges, the SEP could be enhanced by linking the variables for each participant's projection so that the public could see what each policymaker is projecting for growth, unemployment, and inflation, and what policy path he or she believes will achieve those outcomes. This could be done without revealing the identities of the participants and would convey information on each individual policymaker's reaction function.

A second enhancement would be to more plainly communicate the degree of uncertainty around the projections. Currently, the divergence of views among participants is presented in the SEP. But the divergence across projections is different from the uncertainty any one individual would put around his or her outlook. Even if there were no divergence, so that each participant was projecting the same economic outcome and policy path, it would be incorrect to assume that the participants were therefore certain about that outcome or policy path. The SEP does give a sense of the number of participants who see balanced risks around their projections and whether the degree of uncertainty is higher or lower than average. But giving the public a better sense of the probabilities associated with the projections would be valuable.

That brings me to a third potential avenue to help clarify communications. While the SEP provides important information on the diversity of views among participants, trying to increase the information we provide on the consensus view would be worthwhile. It is the consensus view that is reflected in the policy statement after FOMC meetings. Presenting more information on the consensus economic outlook that underlies the Committee's policy decisions would help clarify the statement. I realize this will not be an easy task. The Committee experimented with developing a consensus forecast in 2012.[4] It turned out not to be the right time because policy comprised several elements, including the funds rate path, asset purchases, and forward guidance, as well as the fact that there was considerable diversity of views about the economy's structure and dynamics during those extraordinary economic times. However, we will

[4] See the minutes from the July, September, and October 2012 FOMC meetings (www.federalreserve.gov/monetarypolicy/fomccalendars.htm#11655).

eventually return to a more normal policy-setting environment, and in such an environment, the Committee might be more successful in developing such a consensus forecast, which could form a basis for explaining policy decisions and alternative views.

Forward Guidance Betwixt and Between Extraordinary and Normal Times

Of course, we are not there yet. So perhaps the more immediate question is what should forward guidance look like during the transition from extraordinary times to normal times? After several years of nontraditional monetary policy, the transition toward a more normal economy is likely to entail some uncertainty about monetary policy setting. I believe clear policy communications can and should play a key role in reducing that uncertainty. To that end, I favor the Committee being as clear as it can be that monetary policy will be contingent on the state of the economy. I favor putting less focus on a particular calendar date for liftoff. This is why I believe the FOMC's addition to its forward guidance last week was an important step in the right direction. It was a clear statement that if incoming information indicates faster than anticipated progress toward the Committee's employment and inflation objectives, then increases in the target range for the fed funds rate are likely to occur sooner than the FOMC currently anticipates. And if progress is disappointing, then increases are likely to be later. I think this is an important message to convey to the public.

I believe it would also be helpful over time to provide more information in our statement and other communications about the conditions we systematically assess in calibrating the stance of policy to the economy's actual progress and anticipated progress toward our dual-mandate goals, and to the speed with which that progress is being made. That is, the FOMC should explain how and why we came to our assessment that realized and expected progress toward our goals is pointing to a particular policy path.

I realize that there is a plethora of incoming economic data and information, and they can send confusing signals. Our communications should help the public to better understand policymakers' consensus

assessment of what is signal versus noise in the data. What changes in the data and other economic information do we view as material enough to change our medium-run economic outlook or the risks around that outlook? Systematically providing the public with such information will allow people to anticipate how policy is likely to change in response to economic developments that affect the outlook.

Conclusion

In summary, I have laid out some possible improvements to the Federal Reserve's policy communications. Such improvements cannot happen overnight – after all, we have been on a journey toward better communication for quite some time and I expect us to continue on that journey. Although there is a diversity of views on the Committee, I believe there is enough common ground to encourage us to seek progress along the lines I am suggesting. I believe our efforts will be rewarded because clear communications will lead to better economic outcomes and help make the trip back to normal a smoother ride.