

How Should the Fed Communicate?

"The Future of the Federal Reserve"

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Central bank communication is a topic of increasing interest. There is a burgeoning literature in both the United States and Europe, but I'll confine my comments to the U.S. context.¹

Perhaps ironically, one reason for the heightened interest in Federal Reserve communication policy is the Fed's success in making its policy decisions on the target federal funds rate highly predictable. As has been documented in a number of papers, the federal funds futures market quote the day before an FOMC meeting has, with only a few exceptions over the past decade, predicted accurately the Committee's decision on the target federal funds rate. What captures the market's attention now is the Committee's statement and not its action on the target funds rate.

Because I've developed some pretty definite views on the subject of Federal Reserve communication policy, it is especially important that I issue the usual disclaimer before proceeding further. The views I express here are mine and do not necessarily reflect official positions of the Federal Reserve System. I thank my colleagues at the Federal Reserve Bank of St. Louis for their comments, but retain full responsibility for errors.

A FRAMEWORK

The word "transparency" is often used in the context of an agency's or firm's communications,

but that concept does not take us very far. For the Federal Reserve, some might put the issue this way: At the time of each policy decision, the Fed needs to explain what it did and why. If "the what" refers to the target federal funds rate, then clear disclosure of the policy action has been in place since 1994. If "the what" refers to statements or hints about future policy actions, then it seems that the Fed does not have a settled policy on such disclosure. Moreover, disclosing or explaining "the why" of policy actions is obviously complex.

I'll confine my analysis to the economics of Fed communication policy. Disclosure issues in the context of political accountability overlap with the economics issues, but are not exactly the same. The economics issue is this: How can Fed communications make monetary policy more effective? That question requires a view about how the economy works.

My starting point is the concept of a full rational expectations macroeconomic equilibrium. The basic idea is that the private sector makes decisions in the context of its expectations about how the government will set policies of all kinds—fiscal policies determining taxes and spending, regulatory policies and monetary policies. I'll confine my discussion to monetary policies.

The baseline assumption is that the private economy and the central bank have the same information. I've discussed elsewhere what might happen when information is asymmetric, but will not take up that topic today.

¹ See especially *Geneva Reports on the World Economy* 3, "How Do Central Banks Talk?" I've developed my own thinking in a series of speeches and papers; see Poole and Rasche (2000) and Poole (2003).

MONETARY POLICY AND INFLATION

A critical feature of the rational expectations framework is that the central bank needs to be clear about its objectives. Moreover, the fundamental objectives of monetary policy should be stable over time, to provide a consistent basis for efficient planning in the private sector. For example, an inflation objective randomly chosen to be 5 percent one year and 1 percent another year will not yield a good equilibrium because the private sector will make mistakes in planning its activities, and will expend resources unnecessarily in trying to insure itself against the uncertain inflation outcome. If and when circumstances arise requiring fundamental policy objectives be changed, it is imperative that the new objectives be communicated to the market. Although there has been an ongoing discussion in the Fed about the advantages and disadvantages of a formal, numerical inflation objective, I think the ambiguity with respect to the Fed's inflation and employment objectives is not large and is not the main problem the Fed faces with its communication policies.

In the world of a rational expectations macroeconomic equilibrium, clarity with respect to both goals and strategy in pursuing goals is a virtue. This is an important point because the older monetary policy literature, from a tradition that predates the rational expectations revolution in macroeconomics, argued at times that monetary policy effectiveness depends on taking markets by surprise and creating uncertainty. Some observers still make this argument today. I reject this view; I know of no convincing models where policy-induced uncertainty yields superior economic outcomes.

One requirement, then, for an efficient rational expectations macroeconomic equilibrium is that the central bank have clear policy goals. Another requirement is that the private sector and the central bank have a common, and correct, understanding of the economy's structure—of how the economy works. The central bank must have a view as to how the economy works to know how to forecast the effects of policy actions, which I'll measure by adjustments in the target

federal funds rate. The private sector must have the same view, for otherwise it will make forecasts of the effects of policy actions that differ from the central bank's forecasts. A stable, efficient equilibrium is unlikely to prevail when the private sector and the central bank have substantially different views as to how the economy works. The strategy of monetary policy depends critically on the central bank's view as to how the economy works; thus, the central bank needs to convey its views in this regard to the maximum possible extent. Of course, reducing uncertainty is not the only important feature of monetary policy design—the systematic part of policy also needs to be well designed to achieve policy objectives in the most efficient possible way.

Given all the uncertainties and controversies in macroeconomics, it may seem that any attempt to construct a communication framework around the assumption of a common understanding of how the economy works must fail. In fact, the situation is much more hopeful. I believe there is a common understanding about many features of macroeconomic behavior and that we can sweep areas of uncertainty into an analytical uncertainty basket. There is agreement about most macroeconomic relationships at a qualitative and directional level, at least in the context of monetary policy conducted for stabilization purposes. Appreciating the uncertainty that macroeconomists share is an essential element of crafting a good communication strategy. That is, the central bank and the private sector can have a common understanding of the nature of the uncertainty basket and understand the significance of that fact for the conduct of monetary policy.

The third essential element of the framework is that economic change and economic outcomes that differ from forecasts are a consequence of the arrival of new information that is inherently unforecastable, at least at the current level of economic science. As new information arrives—often called “shocks” to emphasize the unforecastable or surprise nature that is inherent in new information—the private sector and the central bank have a common understanding of the impli-

cations of the new information, especially the implications for adjustments in the monetary policy instrument. There is an extensive literature showing how interest rates respond to surprises in the routine flow of economic data on employment, inflation, housing starts, industrial production and so forth.

The response to new information in the federal funds futures market is a direct bet on how the Federal Reserve will respond to the new information in setting the target federal funds rate. Given the accuracy of the fed funds futures market in predicting Fed decisions on the target fed funds rate, this literature supports the view that the rational expectations framework is useful for understanding actual market behavior as it relates to monetary policy decisions.

APPROACHING NIRVANA

The abstraction of the full rational expectations macroeconomic equilibrium provides a framework for a communication agenda. How can Fed communications help move the economy closer to the nirvana of the full and efficient rational expectations equilibrium?

To provide a very specific focus for my remarks, I'll concentrate on the short statement released at the conclusion of every FOMC meeting. That statement is the first step of an extensive process of explaining policy through minutes of FOMC meetings, speeches and testimony.

An important feature of the policy statement is an explanation of the reasons for the FOMC's decision on the target federal funds rate. The most recent statement, issued the afternoon of March 22, is a good example. The statement emphasized the FOMC's increased concern over inflation, as evidence is accumulating that firms perceive an increase in their pricing power. From my perspective, the market reaction to that statement made a lot of sense and reflected my own assessment of a changing inflation environment. The changed language in the statement not only explained the 25-basis-points increase in the target federal funds rate but also the renewal of the

"measured pace" phrase that indicates that the FOMC anticipates further increases in the target rate at future meetings.

The situation prevailing for about a year now, in which it has been reasonable to expect future increases in the target federal funds rate, is highly unusual. In my experience, most of the time it is not especially clear what the future pace of policy adjustments will be. This fact flows from the observation I offered earlier, that change in the economy and policy adjustments in response to change flow from the arrival of new information. Ordinarily, policy adjustments cannot be predicted with much accuracy because shocks that create the need for policy adjustments are not forecastable.

This point is extremely important. I sometimes hear pleas from market participants that the Fed should make clear in advance what it is going to do, to reduce uncertainty and make planning easier. A little thought should lead market participants to stop thinking this way. Suppose the Fed had advertised an expectation of an unchanged target federal funds rate in early September 2001. Should the Fed not have responded to the 9/11 shock? Obviously, the Fed should respond to such a shock; more generally, the Fed needs always to be open to responding to new information when it is of such a magnitude to call for a policy response, or when smaller individual pieces of information accumulate to such a point.

Let me formalize this point. Consider both the target fed funds rate coming out of an FOMC meeting and the rate coming out of a meeting six months later. How much of the change in the target rate over the six-month interval is determined by information available at the first meeting and how much by unforecastable information arriving between the two meetings? I have not attempted a formal statistical investigation of this question, but am willing to assert that most of the time the change in the target rate over a six-month interval is driven by new information over the six months and not much by information in hand at the beginning of the interval.

MONETARY POLICY AND INFLATION

If my claim is correct, then most of the time the FOMC cannot provide accurate information to the market as to the probable course of the target fed funds rate, in terms of a specific path measured in basis points. The future path will be conditional on future information that cannot itself be predicted. Attempts to provide specific forward-looking guidance will prove inaccurate and even misleading to the market. Moreover, the Fed could create a credibility problem for itself if forward guidance is too specific. If the market acts on the guidance, and the Fed subsequently responds to new information in a way that departs from the guidance, then the market will naturally feel that it has been misled. But if the Fed fails to respond to new information that seems to demand a response, in the interest of doing what it said it was going to do, then failure to respond may also damage credibility.

In short, the Fed should only offer specific guidance for the fed funds target path in circumstances in which it is highly probable that the specified path will remain appropriate in the face of new information. Generally, commitments need to be carefully conditioned so that the market understands that new information may require a different policy course. The Fed needs to explain as clearly as possible the conditionality of a commitment, and how the nature of the commitment must depend on circumstances. Most of the time, the most likely fed funds target rate six months in the future will be close to the rate at the beginning of the period; the outcome will depend on shocks over the interval.

It is also true that most of the time the policy outlook is asymmetric. Asymmetry arises because it is ordinarily the case that the economy's performance points to the need for the federal funds target rate in coming months to either: a) stay the same or increase; or b) stay the same or decrease. It is rare for the situation to be such that the odds of tightening in the near future are the same as the odds of easing. The policy situation becomes asymmetric when the economic situation becomes asymmetric. As I speak right now, for example, the upward thrust to the economy appears quite substantial and the risk of higher inflation over

the next six months or so seems clearly greater than the risk that inflation will fall below a desirable range. The aim of monetary policy should be to counter inflation pressures with a less accommodative policy stance, so that higher actual inflation does not extend beyond unavoidable transitory effects. Put another way, monetary policy should ensure that inflation pressures do not get built into inflation expectations and a higher actual inflation rate over a medium-term horizon.

The Fed's communication issue is this: Can the policy statement provide an accurate view of the extent to which the Committee believes the policy outlook has become asymmetric without triggering firm market expectations of an adjustment of the federal funds target at the next meeting? Asymmetry does not necessarily imply a high probability of a rate change in a particular direction at the next FOMC meeting, or the several meetings after that. What asymmetry does imply is that if new information mostly comes in one way—positive surprises, for example—then a policy adjustment will probably be appropriate.

The communication challenge is to provide the market a correct sense of the probabilities and of the sort of new information that might justify policy action. I do not have a settled view on this issue, but lean toward the position that trying to convey an accurate sense of asymmetry is more likely to be misleading to the market than helpful. The problem is that the market may read a statement of asymmetry as a hint of expected policy action at the next FOMC meeting, when no hint is intended. My own preference is to discuss the issue in general, and let the market sense a developing asymmetry from observing the same information flow the FOMC observes. Then, when subsequent shocks create the case for future policy action, the market will respond to those shocks by changing its policy expectations, which will be recorded in the federal funds futures market.

I've emphasized the importance of clarity of policy goals. I've emphasized the importance of reducing uncertainty with respect to Fed policy wherever possible. I'll finish with one other comment. Policy statements need to be crafted care-

fully, with special attention to the possibility that language will be misunderstood. This task is much harder than it might seem, in part because economists' language contains words with identical spelling but different meanings than in ordinary English. It is important that the Fed avoid inadvertently misleading the market. For this reason, I have been an advocate of crafting the policy statement at the conclusion of each FOMC meeting from stock phrases that have been given clear meaning through discussion over time and sustained and repeated use over time. Anyone who has read FOMC meeting statements knows that continuity is an important feature of them, and that the market appropriately focuses on what has and has not changed from one meeting to the next.

Although statements in recent years reflect considerable continuity, changes usually come as a surprise to the market, and the initial meaning of new phrases has not always been clear. For that reason, I think the FOMC could improve clarity, especially when policy direction changes, by agreeing in advance on stock phrases to describe different situations. The stock phrases from which policy statements would be put together could be explained in advance of actual use. Some will regard resort to stock phrases as boilerplate that is the very opposite of transparency. My view is that a handful of standard options to describe the Committee's summary evaluation of the state of the economy and the stance of policy would promote clarity and therefore transparency. The purpose of transparency is not served when the market greets a new statement with multiple interpretations.

CONCLUDING COMMENT

Clear policy communication requires a policy framework. The abstraction of a rational expectations macroeconomic equilibrium provides such a framework. An essential feature of such an equilibrium is that the economy evolves in responses to shocks—new information that cannot be predicted in advance. Appropriate monetary policy must also evolve in response to the same shocks. I believe that this framework takes us a long way in thinking with precision about communication issues. We need to be as clear as we can be about what we know, and emphasize that monetary policy actions must be conditioned on new information. That's my message—I hope I've communicated clearly!

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