

Fed Communications

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Federal Reserve communications are much in the news recently, in part because the Fed's main policy body, the Federal Open Market Committee (FOMC) has discussed communications issues on several occasions in recent years. I've spoken several times on various aspects of communications policy and today want to extend my views, which are developing further every time I take up the subject.

Before proceeding, I want to emphasize that 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—especially Bob Rasche, director of Research at the St. Louis Fed—for their comments, but I retain full responsibility for errors.

TRANSPARENCY: WHAT DOES IT MEAN?

Fed communications issues are often discussed under the general term “transparency.” What, literally, does transparency mean? The idea is that we could throw open the curtains and allow the public to look in through clear windows. If the Fed were to throw open the curtains, what would the public observe?

Of course, what the public would observe would be different from what now takes place. Televising FOMC meetings on C-SPAN would dramatically change the nature of the meetings. Certainly, what we mean by transparency cannot mean that all Federal Reserve deliberations are public in real time. Transparency must mean dis-

closing as much as possible without damaging the integrity of policy deliberations. That integrity is essential both to be sure that all issues are fully debated and to ensure that information obtained under pledge of confidentiality remains confidential.

But there is another aspect to transparency that is incompletely understood. Let me illustrate by reading several passages from the FOMC transcript. The transcript of FOMC meetings is released to the public with a five-year lag and is available on the Federal Reserve Board of Governors' web site. All the quotes are my own—it would not be fair to pick on others!

“My overall assessment is that Asia is primarily a relative demand shock rather than an aggregate demand shock for the United States.”
(Transcript of FOMC meeting of March 31, 1998, p. 54.)

“Money growth, whether we use M2 or a narrower measure—I prefer MZM because I think it avoids the problem with sweeps...”
(Transcript of FOMC meeting of August 18, 1998, p. 50.)

“I have a question about the outlook for investment, which is driven importantly, as it should be, by acceleration considerations.”
(Transcript of FOMC meeting of May 18, 1999, p. 18.)

What do you make of passages such as the ones I just read? These passages are all taken out of context, but my guess is that the material surrounding these passages would not help much in understanding them, unless the reader knows a lot of economics. Much of the FOMC delibera-

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tion consists of fairly technical discussions. Without an advanced degree in economics, or extensive policy experience, much of this material is simply incomprehensible. Thus, although policy experts can understand undigested material, the message that they would convey to the general public would likely not be timely and might not closely match, in emphasis and tone, the consensus message the FOMC would want to convey.

Moreover, a certain amount of communication during an FOMC meeting is nonverbal. For people who have come to know each other pretty well over the course of many meetings, some references in a particular meeting have meaning only in the context of discussions in prior meetings or outside the formal FOMC meeting—during academic conferences for example.

The thrust of my argument is that the word “transparency” is misleading with respect to Federal Reserve communications challenges. Instead, the Fed needs a conscious communications strategy rather than a strategy of simply “opening up.” The purpose of a conscious strategy is not to hide anything but rather to have a clear transmission of information. Successful communication requires that the FOMC distill principal messages or themes from its deliberations and the vast amount of material considered.

As an aside, I note that the FOMC transcripts are little discussed in the press. The general assumption is that they are too old to be newsworthy, but I think they also require a substantial background in economics and the history of monetary policy to interpret correctly. Thus, even if the transcript were released promptly after a meeting—which wouldn’t be constructive because doing so would change the nature of the Committee’s deliberations—I doubt that the transcript would be a very satisfactory communications vehicle.

FED COMMUNICATIONS GOALS

Any strategy requires a clear conception of the goals. For Fed communications strategies

there are a number of possible goals; I will emphasize two.

The Federal Reserve, as an agency created by Congress, clearly has a responsibility to be politically accountable. The Fed needs to be responsive to questions and concerns from the Congress and, indeed, from the public at large. The Fed needs to be as clear as possible as to the goals of monetary policy and the standards to be applied to judge the degree of success in meeting the goals. The Employment Act of 1946 sets the goals in general terms as maximum employment and purchasing power. The Federal Reserve, in congressional testimony, Fed documents and speeches, provides its interpretation of these goals.

A second, somewhat different, goal of communications strategy is to make monetary policy more effective. This is a goal of great importance for achieving the congressional mandate provided to the Federal Reserve. To explain the importance of clear communications to effective policy I need to develop the argument starting with a theoretical framework.

THEORETICAL FRAMEWORK

The Federal Reserve relies heavily on economic theory developed over the span of many decades. The theoretical framework is complicated in its technical form and implementation but quite straight forward in its bare-bones abstract framework. The key element is the interaction between the Fed’s policy stance and the response of the economy to changes in the policy stance.

At each of its meetings, the FOMC sets the intended, or target, federal funds rate. The federal funds rate is the interest rate on interbank borrowing and lending. Most fed funds transactions are for one day—overnight loans in market parlance. If the federal funds rate in the market is tending above the target rate, the Open Market Desk at the Federal Reserve Bank of New York supplies additional funds to the market through purchases of Treasury securities, or transactions with similar effect. If the rate in the market is trading below

the intended rate, the Desk absorbs funds from the market by selling Treasury securities or equivalent transactions. These open market operations adjust the supply of bank reserves so that the market rate remains close to the intended rate.

The FOMC sets the intended rate so as to achieve as closely as possible the goals of low and stable inflation and maximum sustainable economic growth. To understand how the FOMC decides on the appropriate target funds rate, we need to fill in details about how policy actions affect the economy.

The only interest rate affected directly by Fed open market operations is the federal funds rate. The market determines longer-term interest rates, such as Treasury bond rates of all maturities, and mortgage rates. These rates depend critically on expectations about the future. In particular, the market's expectation of a one-week rate depends on the expected overnight federal funds rate over the next seven days. In general, the rate on any bond depends on expected short rates over the horizon of the bond. Thus, the ten-year Treasury bond rate depends on expectations of short-term interest rates over the ten-year horizon.

Market expectations about future interest rates depend on the interaction of two interrelated sources of influence. One, obviously, concerns Federal Reserve decisions on the intended federal funds rate. Also important are expectations as to the demands for and supplies of funds in the private market. For example, with a simultaneous investment and housing boom, credit demands will be high and interest rates will tend to be bid up. In pursuing its policy goals the FOMC will be adjusting the federal funds rate as needed to keep the inflation rate low and stable. Thus, the market forms expectations about the underlying state of the economy that will bear on Fed decisions.

The Federal Reserve is constantly evaluating the situation in the markets and trying to adjust the intended federal funds rate to produce a satisfactory equilibrium in the economy. When we put the Federal Reserve's and the market's decisions and expectations together, we have a macroeconomic equilibrium.

FULL RATIONAL EXPECTATIONS MACROECONOMIC EQUILIBRIUM

The interaction between the Federal Reserve and the markets may be confusing at first sight, and indeed was confusing to economists for generations until conceptual breakthroughs in the 1960s and 1970s clarified the issue. Market behavior depends on expectations as to what the Federal Reserve is going to do, and what the Federal Reserve is going to do depends on what the market and the economy are anticipated to do. The full rational expectations macroeconomic equilibrium occurs when the market behaves as the Federal Reserve expects and the Federal Reserve behaves as the market expects. In both cases we assume that the expectations are fully rational, by which we mean that the expectations are fully informed on the basis of all available information.

The paradigm of a full rational expectations macroeconomic equilibrium sets the framework for communications strategy. From the Federal Reserve's point of view, policy effectiveness will be enhanced when the market has a complete and accurate understanding of the Federal Reserve's goals and policy processes. Thus, to obtain good policy outcomes it is in the Fed's interest to provide as complete information as possible to the market.

The abstraction of a full rational expectations macroeconomic equilibrium provides a powerful starting point for analysis of communications issues. Nevertheless, it is obvious that in reality information is incomplete, in part because the future is unknowable with precision. Moreover at any given time some individuals inevitably have more information and more processing power than others.

Asymmetric Information

A feature of many market environments is that some agents in the market have more information than others do. In the monetary policy context, the Federal Reserve has the largest and most extensive economic information gathering

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system in the world. The Fed not only has a large staff but also has access to considerable confidential information from individual firms. To some extent this confidential information can be disclosed in summary form without identifying individual firms, but nevertheless the Fed's timely access to this information and knowledge of the firms involved does give the Fed an advantage over the market in general. However, the information asymmetry is not totally one-sided. Individual firms have enormous specialized market information that the Fed does not have. For example, large retail firms have day-by-day and even hour-by-hour information on the scale of retail transactions in the economy; large banks and credit card companies have information on day-by-day economic activity as they observe flows of transactions on their own books. The relevant economy-wide reports constructed by government statistical agencies come out with a lag measured in weeks to a month or more. These formal statistical reports are the primary source of Federal Reserve information, and they are available to everyone in the market. Although there certainly is an issue of asymmetric information, my own view is that asymmetric information is not a major issue for Fed communications policy.

Policy Decisions Versus Policy

An extremely important distinction in the policy literature is that between policy decisions and policies. A policy is the systematic behavior of the policy agency in determining individual policy actions. Thus, how satisfactory a policy is cannot be judged from any single policy action. It is the sequence of policy actions and their relation to the observable economic environment that define a policy. In principle, there should be a policy response rule, or regularity, or formula, or recipe, or whatever you want call it, that guides or determines the individual policy actions. In the absence of such a regularity, policy actions would be random and capricious. Good policy

aims to be systematic—certainly not random and capricious.

The difficulty is that in the monetary policy arena no one has yet been able to derive a thorough and complete statement of what the policy rule is or should be.¹ The reason for this situation is that policymakers must respond to a flow of information that differs in certain respects from prior experience. In principle, in a rational expectations equilibrium, the flow of new information triggers policy actions that are highly predictable in the market place. That is, as new and unpredicted information arises, the Fed's and the market's response to the information should be highly predictable.

This conception of monetary policy creates a communications challenge because many market participants seem not to understand the framework very well. What market participants want to know more than anything else is what the Fed's next policy action is going to be. But, under most circumstances the FOMC cannot predict its next policy action because the Committee cannot predict the new information that will drive the policy action. Thus, an important communications challenge is for the Fed to explain the essential difference between policy and policy actions and why this distinction is critical to the effectiveness of monetary policy.

Fed Disturbances

Rational expectations models are designed so that the Fed policy action is a predictable function of information as it arrives. These models do not have a constructive place for a random component to Fed policy. That is, in an abstract model in which the Fed policy rule is specified with precision up to a random term, the smaller is the variance of the random term the more effective the policy will be. Intuitively, it makes sense that in the monetary policy context added uncertainty from unpredictable policy should

¹ I discussed this issue at some length in a speech in October 2005: "The Fed's Monetary Policy Rule," published in *The Federal Reserve Bank of St. Louis Review*, January/February 2006, 88, pp. 1-12.

not be expected to be constructive for the economy as a whole.

As an aside, note that there are policy environments in which a random component to a policy is an essential feature for policy success. Transportation of large sums of cash in an armored truck is an example. The transportation schedule and route should be randomized as much as possible to reduce the probability of theft. To my knowledge, in models of macroeconomic policy no one has created a positive case for randomness.

It is sometimes argued that policy communications should be vague to retain policy flexibility. My own view is that communications should be clear about what is known and what is not. It is possible to be perfectly clear about why flexibility is necessary—why policy actions ordinarily cannot be specified long in advance. The reason, as I have already argued, is that policy actions ought to be responsive to new information that cannot itself be predicted.

COMMUNICATIONS CHALLENGES

The discussion so far has left implicit a number of communications challenges, which I will now take up more explicitly.

Where the Fed has specialized information that it can disclose without compromising confidentially or the integrity of the policy process, there is a strong argument for the Fed to make such disclosure. In fact, for many years the Fed has published the Beige Book several weeks before each FOMC meeting. The Beige Book is a compendium of anecdotal reports summarized district by district across the country. This anecdotal information supplements the formal statistical information and is an important input to the policy process. In other cases the Federal Reserve may obtain specialized information through its own research. Results of Federal Reserve research are usually made available quite promptly in the form of working papers on Federal Reserve web sites.

At the conclusion of each FOMC meeting the Committee releases a brief policy statement. Policy statements also appear in speeches and testimony of FOMC members. This public information is not always perfectly clear. Part of the difficulty lies in the inherent uncertainties in the economy and uncertainties faced by Committee members. It is also natural for different Committee members to have somewhat different views and for those views to evolve over time. From this plethora of information it may be difficult for the market to distill clear messages. For these reasons, the summary policy statement at the conclusion of each FOMC meeting and the FOMC minutes of meetings play a critically important role.

My own view on the policy statement, stated on a number of occasions in the past, is that the policy statement needs to be put together from relatively few standard elements. The way I have put this point is that the English language is incredibly rich, often with multiple meanings for a given word. The various meanings can be looked up in a good dictionary. However, there is no dictionary in which we can look up the meaning of a paragraph. In the past, market participants have sometimes come to somewhat different interpretations of FOMC policy statements. This fact indicates to me that the Committee has not communicated with as much clarity as desirable. I do not pretend that the goal is easy to reach but believe that progress will require greater standardization over time in the structure of the statement and in the options from which the statement is put together.

There is a natural tendency to try to write in an interesting and literate fashion. One way to do so is to use synonyms to avoid repetition. The practice can be tricky, however. Suppose one policy statement describes the outlook as “solid” and the next as “robust.” Is robust a shade higher growth than solid? How much higher? Rhetorical flourishes make for more interesting writing but do not necessarily enhance clarity when it comes to policy statements. Examples of this sort abound. What is the difference between “moderate growth” and “modest growth?”

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Each policy statement is read next to the preceding one. The market looks closely at changes in the adjectives used, the word order and every other aspect of a statement. Sometimes I think that a series of statements could evolve in such a way that the meaning would be relatively clear, given the evolution, even though the most recent statement might be quite confusing if considered on its own.

For these reasons, and others, I believe that clarity in FOMC statements could be improved by making them more stylized. A stylized statement may be dull, but the market will search for meaning whenever the statement changes. If we want changes to have clear meaning, we need to form the statement from stock phrases that have been explained before.

I earlier emphasized that, in the rational expectations equilibrium framework, random policy disturbances do not serve a constructive purpose. Avoiding random disturbances is not as easy as it might seem, given that communication is difficult and misunderstandings or incomplete understanding is relatively easy. There are, however, some specific things that could be done.

Although I've emphasized statements, it is also true that the market searches for meaning in the policy actions themselves. An increase in the intended rate of 25 basis points between scheduled meetings has a very different meaning than the same size increase at a scheduled meeting. To reduce uncertainty over the meaning of intermeeting policy actions, the FOMC could adopt an explicit policy of making all policy adjustments only at scheduled meetings unless there were a compelling circumstance to act between meetings. The compelling circumstance ordinarily could be easily explained; indeed, the event triggering a policy response would probably be highly visible and the policy response occasion no market surprise. An example would be the policy action following the 9/11 attacks. A standard procedure of confining policy actions to scheduled meetings would avoid market specu-

lation about the reasons for surprise policy adjustments when they occur, and speculation that such a surprise might occur. Given that there have been only five intermeeting policy actions since 1994, this change would formalize what is now customary practice.

Another explicit understanding could be that all policy adjustments will be in increments of 25 basis points, unless compelling reasons argue for larger moves. The possibility that market expectations of future rate changes might not match the FOMC's expectations is nicely illustrated by experience in the spring of 2004. At that time the market understood that the FOMC would be raising the funds rate target from the 1 percent level that had prevailed since June 2003, and many in the market were concerned that the pace of rate increases might be rapid, as they had been in 1994. After its meeting of May 4, 2004, the Committee issued a policy statement that referred to a "measured pace" of policy actions in an attempt to better align market expectations with its own expectations.² This concern would not have been present if the FOMC had adopted a policy of confining adjustments to 25 basis points in the absence of a compelling reason to act more forcefully. The measured pace language did exactly what was intended, as press coverage after the meeting noted.

Confining policy actions to 25 basis points as a normal matter is pretty close to standard practice. Of the 47 policy actions from 1994 to date, 33 have been 25-basis-points changes, 13 have been 50-basis-points changes and only one has been a 75-basis-points change. There have been no changes larger than 75 basis points.

I emphasized earlier the importance of the distinction between a policy and a policy action. In its communications, I believe that the FOMC should work harder to explain how individual policy actions fit into a comprehensive and systematic policy. When the market understands why the FOMC acts as it does, the market will be able to observe arriving information and judge

² The full sentence in the policy statement was: "At this juncture, with inflation low and resource use slack, the Committee believes that policy accommodation can be removed at a pace that is likely to be measured."

how the FOMC is likely to respond to the same information. Appropriate market responses to information will accelerate the economy's response to the information, improving the efficiency of those responses. And, of course, FOMC policy actions will not be a surprise under these circumstances.

THE BOTTOM LINE: MEASURABLE SUCCESS

With my colleague Bob Rasche, I've been able to study the effectiveness of FOMC communications. I've presented the results in some detail³; here I'll just report the bottom line. Over the past decade, the market has been able to predict FOMC policy adjustments with considerable accuracy. That fact indicates that policy has been systematic enough, and communications effective enough, that we've made major progress toward achieving the goal of a full rational expectations macroeconomic equilibrium. Relative to the progress already made, my suggestions are minor refinements. But that is the point we have reached, and there is every reason to pursue further gains.

In my view, part of the reason the economy has been so stable—indeed, increasingly stable—over the past two decades or so is that monetary policy has become much more predictable. Greater predictability is a consequence of FOMC success in adjusting the stance of monetary policy in a much more rule-like way and the Committee's success in enhancing its communications with the market and general public. I've suggested a general framework for understanding communications issues—the full rational expectations macroeconomic equilibrium. Perfecting that equilibrium by making policy adjustments increasingly regular and by reducing aspects of policy that appear random to the market is a worthy goal.

As I have argued, there are some further steps along this road that the FOMC might consider. I would welcome suggestions from market participants and academic experts. And, I would welcome thoughts on this subject from my audience today.

³ See "How Predictable is Fed Policy?" *Federal Reserve Bank of St. Louis Review*, November/December 2005, 87, pp. 659-68.