Central Bank Communication

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Outline

I. Federal Reserve communications today
II. Conceptual basis for CB communication policy
III. A short history of Fed communications
IV. Back to the present: The Fed's three issues
V. Some lessons and questions for the future

I. The present: The Fed's four main communication challenges today

1. The FOMC apparently confused markets by skipping September.
   - This is a little strange:
     - It's been "a close call" (September or December?) for months.
     - Futures were expecting December by the time of the September meeting.
   - My hypothesis (**not sanctioned by management!**): The reason was the peculiar emphasis on China *et al*. in the September statement: *"Recent global economic and financial developments may restrain economic activity somewhat and are likely to put further downward pressure on inflation in the near term."*
   - Chair Yellen may have fixed this in her Amherst speech on 9/24: "*… my colleagues and I anticipate that it will likely be appropriate to raise the target range for the federal funds rate* ***sometime later this year***."

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   - Chair Yellen may have fixed this in her Amherst speech on 9/24: "… *my colleagues and I anticipate that it will likely be appropriate to raise the target range for the federal funds rate* ***sometime later this year***."
2. The FOMC statement still says "even after employment and inflation are near mandate-consistent levels, economic conditions may, ***for some time***, warrant keeping the target federal funds rate below … normal…"
   - In other words: We're OK about some overshoot.
3. The cacophony problem: Too many voices → confusion
4. As "exit" proceeds, e.g., liftoff happens, communications must change. How?

II. The conceptual basis for CB communication policy

1. CBI implies *accountability*, which in turn requires *transparency*
   - No more Montagu Normans ("Never explain, never excuse.")
2. If the CB is more (successfully) transparent, it should be able to manage *expectations* better.
   - Who, after all, really cares about the overnight rate?
   - "*Greater openness might actually improve the efficiency of monetary policy… [because] expectations about future central bank behavior provide the essential link between short rates and long rates… By making itself more predictable to the markets, the central bank makes market reactions to monetary policy more predictable to itself. And that makes it possible to do a better job of managing the economy.*" -- Alan Blinder, 1996

III. A short history of CB communication (starting with the Dark Ages)

- which, for the Fed, means prior to February 1994!

- *"Central Banking… thrives on a pervasive impression that [it]… is an esoteric art. Access to this art and its proper execution is confined to the initiated elite. The esoteric nature of the art is moreover revealed by an inherent impossibility to articulate its insights in explicit and intelligible words and sentences."*--Karl Brunner, 1981

- Sounds silly? Here are three Federal Reserve quotes from Goodfriend (1986):

  - *"Such phrases are terms of art that have meaning when read by knowledgeable market participants."* [Holland, 1976]
  - *"Disclosure of the directive would be more misleading to the market than no information at all."* [Sternlight, 1980]
  - *"The FOMC's ability to formulate effective policy by accurately predicting market reactions… would be diminished."* [Partee, 1980]

Why Greenspan changed in Feb 1994

(the entire February 1994 FOMC statement)

"***Chairman Alan Greenspan announced*** today that the Federal Open Market Committee decided to increase slightly the degree of pressure on reserve positions. The action is expected to be associated with ***a small increase*** in short-term money market interest rates.

"The decision was taken to move toward a less accommodative stance in monetary policy ***in order to sustain and enhance the economic expansion***.

"Chairman Greenspan decided to announce this action immediately ***so as to avoid any misunderstanding*** of the Committee's purposes, given the fact that this is the first firming of reserve market conditions by the Committee since early 1989."

Landmark year: 1999

1. Ferguson Committee: (1) issue a statement even on a "no change"; (2) reveal the FOMC's "bias"
   - Was Greenspan intellectually converted by then?
2. The ECB opens for business
   - Though accused of being secretive, ECB actually started more open than the Fed (e.g., with press conferences).

Landmark year: 2006

- Ben Bernanke takes over
- With an academic background, Bernanke came in believing in CB communication and openness.
  - Also in less personalization of monetary policy
- Then crisis hit in 2007-2008.
  - This virtually *demanded* greater explanation and more openness.

Landmark years: 2011-2012

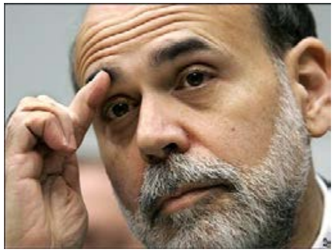
- April 2011: First press conference
- August 2011: More specific "forward guidance," starting with *dates*
  - Explicit forward guidance was the last frontier.
  - Fed did it to flatten the yield curve (same reason as QE in long Treasuries)
  - Started as "extended period," then went to "at least through mid-2013"
    - Was this a step forward? Fed later decided not.
- January 2012: the "dots" diagram started

Landmark years: 2011-2012

- January 2012: statement of longer-run goals and monetary policy strategy (2% inflation target, 5.6%±0.4 unemployment "target")
- December 2012: Changed forward guidance from *dates* to economic *conditions* (Evans-style formulation)

"the Committee decided to keep the target range for the federal funds rate at 0 to 1/4 percent and currently anticipates that this exceptionally low range 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,****"*

But "6.5%" subsequently became a "trap."

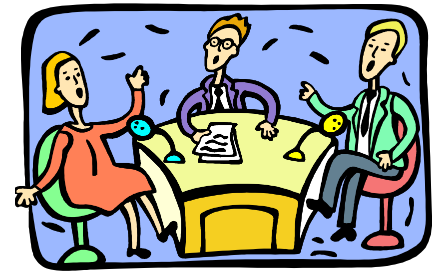



- Markets turned U=6.5% into a holy grail, looking upon it as a trigger for a rate hike.
- The words stayed in the FOMC statement through January 2014. (Bernanke's last meeting). The U rate in Jan. 2014 was 6.6%!
- Then 6.5% was removed amazingly smoothly in the March FOMC statement (Yellen's first): *"The Committee continues to anticipate, based on its assessment of these factors, that it likely will be appropriate to maintain the current target range for the federal funds rate* ***for a considerable time*** *after the asset purchase program ends."*
- Whoops—back to time again!

IV. Three challenges after "liftoff"
(each illustrates a generic problem)

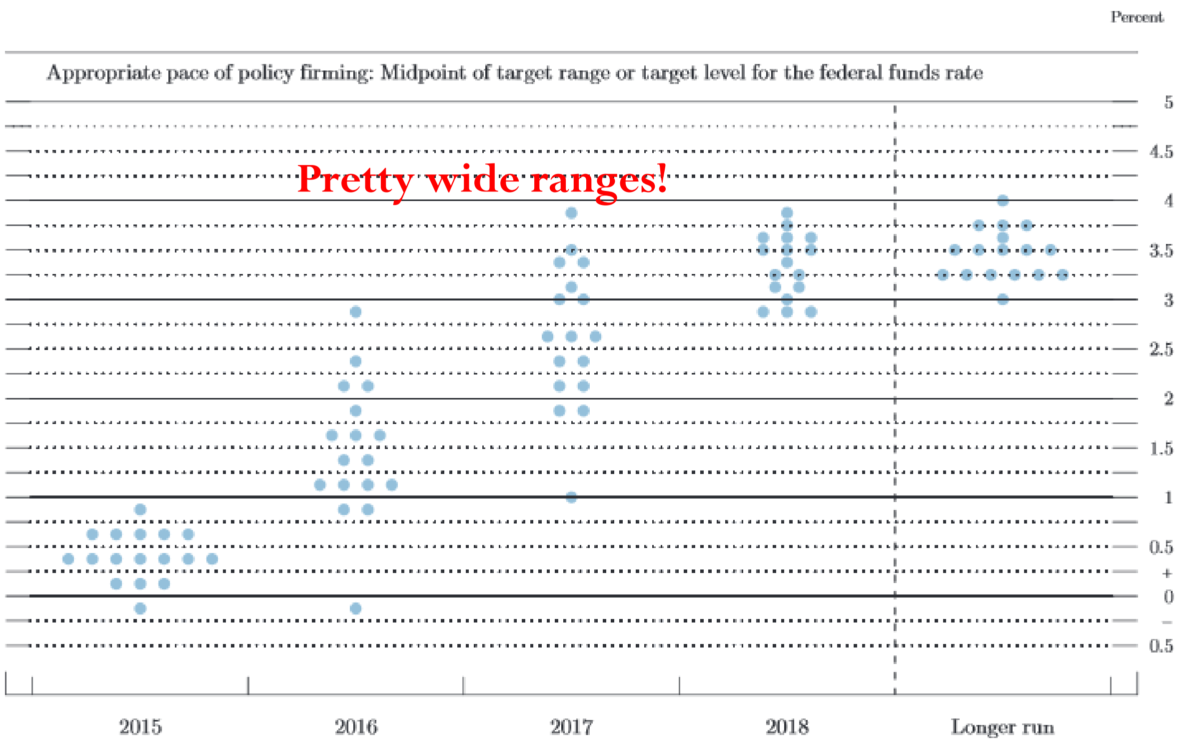
1. The cacophony problem
2. The over-reaction problem
3. New types of forward guidance during the exit?
   - What about after the exit?

1. The cacophony problem



- *"A central bank that speaks with a cacophony of voices may, in effect, have no voice at all."* -- Blinder, 2004
- Dissenting *vote* v. dissenting *talk*
- Markets can't/won't be convinced to listen *only* to the chair.
  - Maybe they are right!
- This problem may be impossible to fix when opinions vary so starkly. *(see diagram)*

The latest "dots diagram" (Sept. 2015)



2. The over-reaction problem

- Fed has been surprised several times by market "overreactions" (e.g., the "taper tantrum" in 2013, reactions to September meeting).
  - It shouldn't have been. Overreaction is generic.
- Blinder's Law of Speculative Markets: *"Markets generally get the direction right, but exaggerate the magnitude by a factor between three and ten."*
- Implication: Talk is policy. *(see quote)*

2. The over-reaction problem

"Greater openness might actually improve the efficiency of monetary policy… [because] expectations about future central bank behavior provide the essential link between short rates and long rates. ***A more open central bank… naturally conditions expectations by providing the markets with more information about its own view of the fundamental factors guiding monetary policy…, thereby creating a virtuous circle.*** *By making itself more predictable to the markets, the central bank makes market reactions to monetary policy more predictable to itself. And that makes it possible to do a better job of managing the economy."*

-- Alan Blinder, 1996

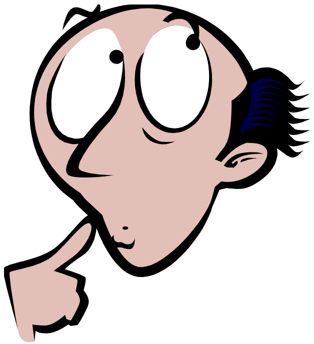
2. The over-reaction problem

- Fed has been surprised several times by market "overreactions"
  - It shouldn't have been. Overreaction is generic.
- Blinder's Law of Speculative Markets: *"Markets generally get the direction right, but exaggerate the magnitude by a factor between three and ten."*
- Implication: Talk is policy.
  - Markets will bring forward any future tightening--and magnify it.
  - CB must factor market overreaction into its plans.
  - Hard to get it right; I think the FOMC often underestimates; more talk can help.
  - September 2015 is a case in point.

3. After "liftoff"

- The FOMC has been communicating much more extensively since the crisis.
- Short-run question: How much forward guidance about rates will there be after "liftoff" (during normalization)?
- Long-run question: What sorts of communication after normalization? Will it go back to the old ways?
  - In normal times, there will be less to communicate about.
  - On the other hand, FOMC has learned that talk *is* policy.

V. Some lessons and questions



- Montague Norman is gone forever.
- It's hard to take back what has been "given."
  - Up to now, CBs have not wanted to. But maybe they will.
- There is no single template for all CBs.
- Proper communications policy is situational (e.g., *what* do you have to communicate about?)
- Will/should explicit forward guidance disappear once normalization is complete?