Forward Guidance and Communications in U.S. Monetary Policy

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Good evening and thank you very much for the invitation to speak in the Imperial Business Insights Series. I have learned that this successful series is now in its third year and it has brought speakers to the podium to discuss a wide range of topics in the major themes of finance, innovation, and entrepreneurship. Tonight I will speak about forward guidance and monetary policy communications. I think it is clear that this topic is related to finance, but I submit that it is also related to the two other themes of your series: innovation and entrepreneurship. Since the onset of the 2008 financial crisis, policymakers have had to be quite innovative in addressing the challenges facing the global economy. They have had to be entrepreneurial in developing new economic models and monetary policy tools to help navigate the uncharted waters of the past six years. Tonight, I'll give my views on one of those tools, forward guidance, and the role it plays as a part of the broader communications provided by monetary policymakers. 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.

Federal Reserve Structure and Governance

To understand the importance of monetary policy communications in the United States, it helps to understand a little about the structure of the institution responsible for setting monetary policy. That institution, the Federal Reserve System, was established by Congress in the Federal Reserve Act, which was signed into law in 1913. We like to say that the Federal Reserve is a decentralized central bank, which is independent *within* the government and not independent *from* the government. The structure is one of balance. Congress designed the Federal Reserve System to alleviate concerns that it would become dominated by financial interests in New York or political interests in Washington. The design includes representation from the rest of the nation, balancing public-sector and private-sector interests, and Wall Street and Main Street concerns.

The Federal Reserve System has 12 regional Reserve Banks and a seven-member Board of Governors in Washington that oversees those Banks. The governors, who serve the public, are appointed by the

president of the United States and confirmed by the Senate, the upper house of Congress. Governors serve staggered 14-year terms, which span several terms of the president and members of Congress. The length of the term is intended to insulate the governors from short-term political influence and allows them to take a longer-run perspective when setting monetary and financial regulatory policy. The chairman and vice chairman of the Board of Governors are chosen by the president and confirmed by the Senate from among the sitting governors for four-year terms. They can be reappointed until their terms as governors expire.

The 12 Reserve Banks operate in the public interest. They are distributed around the country in locations that were the centers of economic activity back when the Fed was established.[1] Each Reserve Bank has a nine-member board of directors. The directors of the Reserve Banks are chosen in a nonpolitical process. Three directors represent banks and six are nonbankers who represent business, agricultural, industrial, and public interests in the Districts they serve. The nonbank directors are responsible for choosing the Bank's president, who is subject to approval by the Fed's Board of Governors.

The body within the Federal Reserve System responsible for setting monetary policy is the Federal Open Market Committee, or FOMC, which was established in the Banking Act of 1935 and holds eight regularly scheduled meetings per year in Washington. This 12-member Committee is made up of the seven members of the Board of Governors, the president of the New York Fed, and four other Reserve Bank presidents, who serve on a rotating basis. As president of the Cleveland Fed, I vote every other year, as does the Chicago Fed president. The other presidents vote every third year. I note, though, that presidents who happen not to be voting members at the moment still participate in FOMC meetings. Thus, by design, the discussions at our meetings contain a mosaic of economic information and analysis from all parts of the country. I make it a point to bring in the information my staff and I have gleaned

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[1]Some Reserve Banks also have Branches. For example, the Cleveland Fed has a Branch in Pittsburgh, Pennsylvania, and a Branch in Cincinnati, Ohio. Each Branch of a Reserve Bank has a board of directors of five or seven members.

about economic and financial conditions from the businesses and banks in my District, as well as from our directors. This regional information, along with national data and analysis, plays an important part in our setting of national monetary policy in pursuit of our goals.

Those monetary policy goals were given to the Fed by Congress. The Federal Reserve Act says that the Fed should conduct monetary policy to "promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates." When prices are stable and the economy is at full employment, long-term interest rates are typically at moderate levels, so it is often said that the U.S. Congress has given the Fed a dual mandate. Note, this is in contrast to the Bank of England, which has a single mandate to deliver price stability, and subject to that, to support the government's economic objectives, including those for growth and employment.

While Congress has set the Fed's goals, it has also given the Fed independence in making monetary policy decisions in pursuit of those goals. That is, monetary policy decisions do not have to be approved by the president or Congress. It was the FOMC, rather than Congress, which established for the first time in 2012 a numerical goal for inflation over the longer run. This goal is 2 percent inflation, as measured by the year-over-year change in the price index for personal consumption expenditures, or PCE inflation, and it's the level the FOMC feels is most consistent with its congressional mandate.

The Bank of England also has independence. The 1998 Bank of England Act granted the bank independence in setting interest rates, although the government sets the inflation target, which is announced each year by the Chancellor of the Exchequer. There are many other examples of independent central banks, which is perhaps not too surprising, since a body of research both in the U.S. and elsewhere shows that when central banks formulate monetary policy free from government interference and are held accountable for their decisions, better economic outcomes result.

That is one reason that I believe clear communication about monetary policy is so important. Independence in setting monetary policy is worth preserving because it yields more effective policy. But accountability must go hand-in-hand with independence. A central bank cannot expect to remain independent from the political process unless it is transparent about the basis for its policy decisions. Because it takes time for monetary policy to affect the economy, the public won't be able to immediately see whether a policy action was a good one. So it is incumbent upon policymakers to explain the rationale for those decisions, including their evaluation of economic conditions as well as their outlook for the economy.

The Benefits of Clear Communication in Monetary Policymaking

But clear communication is not necessarily easy. Eleven years ago, 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."[2] 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. 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.

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

The Federal Reserve has been increasing the amount and type of information it provides to the public on its policy decisions. 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. Now that statement includes the votes of individual members and the preferred policy choices of any dissenters. The Committee provides minutes of its meetings three weeks after the meeting has concluded, and a full transcript with a five-year lag. The FOMC provides information on individual participants' economic outlook and policy paths in the Summary of Economic Projections, or SEP, which are released four times a year. Since 2011, the chair of the Committee has held press briefings four times a year to present these economic projections. The briefings allow 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, Chair Janet Yellen 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."

The Federal Reserve was not alone in using forward guidance. The Bank of Canada, the European Central Bank, the Bank of Japan, the Reserve Bank of New Zealand, the Swedish Riksbank, and the Bank of England have all provided some form of forward guidance on the anticipated future path of policy. Nor was the Fed alone in changing the formulation of its forward guidance over time. For example, when the Bank of England introduced forward guidance in August 2013, it was formulated in terms of economic thresholds. The Monetary Policy Committee (MPC) said that it intended not to raise the policy rate or reduce the size of its balance sheet at least until the unemployment rate had fallen to 7 percent unless any one of the following three conditions were breached: if inflation 18 to 24 months ahead was 0.5 percentage point or more above the 2 percent target, if medium-term inflation expectations were no longer sufficiently well anchored, or if the Financial Policy Committee judged that the stance of monetary policy posed a significant threat to financial stability that couldn't be mitigated with other tools.

In February of this year, as the unemployment rate approached 7 percent, the MPC replaced this threshold forward guidance with guidance indicating that, despite the sharp fall in unemployment, policymakers saw further scope to reduce spare capacity in the economy before raising the policy rate. The MPC provided more information in its Inflation Report on the factors that, in addition to the unemployment rate, would help determine the timing and pace with which policy accommodation would be removed. Thus, the evolution in guidance away from thresholds occurred both in the U.S. and in the U.K. as unemployment rates came down.

In extraordinary economic times, like the ones we've experienced in recent years, 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.[3]

Forward Guidance in Normal Times

[3] 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).

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.

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.[4] 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 U.S. monetary policy is likely to respond to economic

[4] 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.

developments. I will offer three possible avenues for consideration, and let me note again that my views are not necessarily shared by others on the FOMC, including those who serve with me on the FOMC's subcommittee on communications.

First, the FOMC's Summary of Economic Projections could link the variables across each participant's forecast. Currently, the SEP provides information on the range of projections of real output growth, the unemployment rate, and inflation across FOMC 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 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.

Second, the SEP could more plainly communicate the degree of uncertainty around the projections. Currently, the divergence of views among participants is presented, but the divergence across projections is different from the uncertainty any one individual would put around his or her outlook. Giving the public a better sense of the probabilities associated with the projections would be valuable.

Third, 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. After all, 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. Indeed, the Committee experimented

with developing a consensus forecast in 2012.[5] However, the Bank of England's Inflation Report shows that such a consensus forecast with confidence bands around the projections can be done in a way that enhances policy communications. As we return to a more normal policy-setting environment, the FOMC might be successful in developing its own 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. So let me offer three suggestions to improve our communications.

First, I favor the FOMC being as clear as it can be that monetary policy will be contingent on the state of the economy. This is why I believe the FOMC's addition to its forward guidance at its October meeting 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's policy 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.

Second, I believe it would 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

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

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.

Third, because there is a plethora of incoming economic data and information, which can send confusing signals, our communications, rather than merely providing an accounting of the changes in economic conditions, 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.