

# **The Federal Reserve and Monetary Policy Communications**



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## **Introduction**

I thank Tom Prusa, chair of the economics department, and Professor Joe Hughes for inviting me to present the Tangri Lecture. It is an honor for me to be with you today. I'd also like to take the opportunity to thank Joe for our research collaboration, which has spanned many years – probably more than we care to admit. Joe is a wonderful co-author, and he often tells me of the innovative techniques he is bringing to the classroom, so I would venture to say he is a dedicated and highly effective teacher as well.

This afternoon I will speak about the structure of the Federal Reserve System and the value of clear monetary policy communications. I'll summarize some of the improvements the Fed has made to its communications, and then offer my recommendation for potential next steps. 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.

## **Fed Structure, Monetary Policy Independence, and Accountability**

Before we can discuss monetary policy communications, it's important to have a sense of the structure of the Federal Reserve System.

After a period of financial instability, Congress established the Fed in 1913 to promote the health of the U.S. economy and financial system. Congress designed the Fed to operate in the public interest as a decentralized central bank: the Fed is independent *within* the government but not independent *from* the government. At the time, there were concerns that the central bank would become dominated by financial interests in New York or political interests in Washington. So the design includes representation from across the country and balances 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, D.C. that oversees those Banks. The governors are appointed by the president of the United States and confirmed by the Senate. Governors serve staggered terms of up to 14 years. These terms span several terms of the president and members of Congress, which 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 chair and vice chair of the Board of Governors, and the governor who serves as vice chair of supervision, a position created by the Dodd-Frank Act of 2010, are chosen by the president and confirmed by the Senate from among the sitting governors for four-year terms. The chair and vice chairs can be reappointed until their terms as governors expire.

The 12 Reserve Banks are distributed around the country in locations that were the centers of economic activity back when the Fed was established.<sup>1</sup> Each Reserve Bank has a board of directors whose nine members are chosen in a nonpolitical process, with three representing banks and six representing business, agricultural, industrial, and public interests in the Districts they serve. The nonbank directors are responsible for choosing a Reserve Bank's president, who is subject to approval of the Fed's Board of Governors.

This regional structure has served the country well for more than 100 years. It allows monetary policy decisions to take into account the diversity of the American economy and its people, and also helps us to carry out our other responsibilities. These include supervising and regulating banks and other important financial institutions, promoting the stability of the financial system, playing a major role in overseeing the nation's payments system, providing certain financial services to the U.S. government, and identifying

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<sup>1</sup>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 with five or seven members.

effective community development policies and best practices for promoting economic progress and access to credit in low- and moderate-income neighborhoods.

The Federal Open Market Committee, or FOMC, is the body within the Fed that is responsible for setting monetary policy. It holds eight regularly scheduled meetings per year in Washington, D.C. The FOMC was established by the Banking Act of 1935 and has 12 members: 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, rotating my vote with the president of the Chicago Fed. Other than New York, Cleveland, and Chicago, the other presidents vote every third year. I am a voting member this year, but it's important to note that all presidents, whether voting or nonvoting, participate in FOMC meetings.

So the discussions at FOMC meetings contain a mosaic of economic information and analysis from all parts of the country. And this regional information, along with economic and financial data and analysis, plays an important part in the FOMC's 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 maximum employment, long-term interest rates are typically at moderate levels, so it is often said that Congress has given the Fed a dual mandate.

While Congress has set the Fed's goals, it has also wisely given the Fed independence in making monetary policy decisions in pursuit of those goals. This means monetary policy decisions do not have to be approved by the president or Congress. This is wise because a substantial body of research and actual

practice indicate that when a central bank formulates monetary policy free from short-run political interference and is held accountable for its decisions, better economic outcomes result.

But independence does not mean that the Fed should be unaccountable for its monetary policy decisions or that it shouldn't be transparent about the rationale for those decisions. In fact, accountability must go hand in hand with independence or else independence from the political process won't be sustainable. Because it takes some 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 their decisions, their assessment of economic conditions, and their outlook for the economy. In other words, clear communications play a crucial role in monetary policymaking.

### **The Benefits of Clear Communications in Monetary Policymaking**

One important benefit of clear communication is that it can actually make monetary policy more effective by helping households and businesses make better economic and financial decisions. The public will have a better understanding of monetary policy when policymakers are clear about their policy goals, those aspects of the economy monetary policy can and can't influence, and the economic information that influences their forecasts and policy decisions. And when policymakers strive to be systematic in their policy responses to changes in economic conditions that influence the outlook, the public will have a better idea of how monetary policy is likely to change as economic conditions evolve. They will have a better sense of how policy will react not only to anticipated changes in conditions but also to unanticipated economic developments. With such knowledge, households and firms can plan better; they can make better saving, borrowing, investment, and employment decisions. In addition, when the public has a clearer understanding of the strategy monetary policymakers follow in normal times, they will also understand when nonstandard monetary policy action is required in extraordinary circumstances.

Indeed, in extraordinary times, like the financial crisis and deep recession we've lived through, policy communications not only provide transparency but they can also serve as a monetary policy tool. In particular, once interest rates hit their effective zero lower bound, providing forward guidance about the path that policy will likely follow in the future has the potential to increase the current degree of monetary policy accommodation. 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 – 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 adding accommodation and spurring current economic activity. In theory, if people believe that the central bank is committed to keeping interest rates very low, they will expect higher economic activity and higher inflation in the future and that will induce them to make investments in capital and labor today, thereby helping the current economy.

The Fed and other central banks used forward guidance as a tool during the Great Recession. The Fed's forward guidance took several forms. First, it was qualitative: the FOMC indicated in December 2008 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 an "extended period." In August 2011, this qualitative forward guidance changed to calendar-date guidance when the FOMC said 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. In December 2012, calendar-date guidance was changed to state-contingent guidance when the FOMC 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. Some form of this threshold guidance was used until March 2014. Since then, as the

economy has returned to normal and policy is normalizing, the FOMC has been providing information about the factors that will influence the future path of policy, but this is in the realm of regular policy communication conveying a sense of how the FOMC is likely to react to economic developments rather than guidance as a policy tool.

### **Steps the FOMC Has Taken to Enhance Monetary Policy Communications**

Over the past couple of decades, as the benefits of enhanced transparency have become better appreciated, the Federal Reserve has taken several steps to enhance its regular policy communications. I believe we've made substantial progress, although I also believe that achieving clearer monetary policy communications is better viewed as a journey rather than as a destination and we should always be working to make our communications more effective.

Some commentators have criticized the Fed for being, perhaps, a bit too transparent – with a cacophony of Fed voices speaking too many times. So it might surprise you to know that it wasn't until 1994 that the FOMC began explicitly announcing changes in its targeted policy rate, the fed funds rate. Before 1994, there was no post-meeting FOMC statement; the public had to infer what the FOMC decided by looking at how it implemented policy through its open market operations in financial markets. Now, the post-meeting statement describes the FOMC's view of the state of the economy and the rationale for its decisions. Since 2002, the statement has also included the votes of individual members and the preferred policy choices of any dissenters. Further context for the decisions is provided in the meeting minutes. Before 2005, these minutes weren't released until after the subsequent FOMC meeting. Now they are released with only a three-week lag. Recently, the FOMC used the minutes to convey information about the strategies it was considering for normalizing the size and composition of the Fed's balance sheet.<sup>2</sup> By

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<sup>2</sup> See FOMC, "Addendum to the Policy Normalization Principles and Plans," as adopted effective June 13, 2017 ([https://www.federalreserve.gov/monetarypolicy/files/FOMC\\_PolicyNormalization.20170613.pdf](https://www.federalreserve.gov/monetarypolicy/files/FOMC_PolicyNormalization.20170613.pdf)), FOMC, "Minutes of the Federal Open Market Committee, March 14-15, 2017," April 2017 (<https://www.federalreserve.gov/monetarypolicy/files/fomcminutes20170315.pdf>), and FOMC, "Minutes of the

the time it was announced in June 2017, the plan was well understood by market participants. In addition to minutes, the FOMC publishes a full transcript of each meeting with a five-year lag.

An important enhancement to monetary policy communications was the FOMC's statement on longer-run goals and monetary policy strategy, adopted in January 2012 and reviewed and reaffirmed each year since.<sup>3</sup> This statement laid out for the first time the guiding principles the FOMC uses in setting monetary policy. It recognizes that over the longer run, monetary policy can influence only inflation and not the underlying real structural aspects of the economy such as the natural rate of unemployment or maximum employment, but that monetary policy can be used to help offset shorter-run fluctuations in employment from maximum employment. Importantly, the statement also established an explicit numerical goal for inflation over the longer run. This is a symmetric goal of 2 percent, as measured by the year-over-year change in the price index for personal consumption expenditures, or PCE inflation. The explicit target not only provides transparency to the public but it also underscores the FOMC's commitment to price stability, thereby helping to anchor expectations about inflation. Since inflation expectations are an important determinant of actual inflation, having an explicit target helps promote price stability.

Outside of the blackout period around FOMC meetings, many of the FOMC participants present speeches – like this one – in which they share their perspectives on the economy and monetary policy with the public. As I mentioned, sometimes this speaking is criticized, but as a public servant, I think it's one of my duties to explain my views. In addition to speeches, the chair testifies before subcommittees of both houses of Congress at two regularly scheduled monetary policy hearings a year, and at additional hearings when asked. And since 2011, the chair has held press briefings after four FOMC meetings per year.

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Federal Open Market Committee, May 2-3, 2017," May 2017  
(<https://www.federalreserve.gov/monetarypolicy/files/fomcminutes20170503.pdf>).

<sup>3</sup> See FOMC, "Statement on Longer-Run Goals and Monetary Policy Strategy," January 31, 2017  
([https://www.federalreserve.gov/monetarypolicy/files/FOMC\\_LongerRunGoals.pdf](https://www.federalreserve.gov/monetarypolicy/files/FOMC_LongerRunGoals.pdf)).



These briefings allow the chair to expand on things that are too complex to discuss in the FOMC's relatively short post-meeting statement and to respond to questions from the media. The four meetings followed by press briefings are also ones at which the FOMC releases its Summary of Economic Projections, or SEP.

These projections, which are now quarterly, began in 2007. In ensuing years, the projections have been enhanced in various ways and I would expect us to consider further enhancements to the SEP over time, as part of our ongoing efforts to make our communications even more effective. The SEP now includes more variables and a longer time horizon. The variables included are real output growth, the unemployment rate, inflation, and core inflation, that is, inflation excluding food and energy prices, which tend to be volatile. The projections also include participants' anticipated path of appropriate policy given their outlook and their assessment of risks around the outlook. The projections are for the current year and for up to three additional years, and also provide participants' longer-run estimates of key economic variables. Most recently, the FOMC added confidence bands around the median projections across the participants.

I view the addition of confidence bands as an important enhancement, because these bands illustrate in a simple way the reasonable amount of variation to expect in forecasts and in outcomes relative to projections. They remind us of the important message that the economy can evolve in unexpected ways. For example, as shown in the latest SEP projections,<sup>4</sup> the 70 percent confidence interval around the median forecast of real GDP growth is about  $\pm 1.7$  percentage points for this year and a little over  $\pm 2.0$  percentage points for each of the following two years; for inflation, it is about  $\pm 1.0$  percentage point for

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<sup>4</sup> See FOMC, "Minutes of the Federal Open Market Committee, December 12-13, 2017," January 2018 (<https://www.federalreserve.gov/monetarypolicy/files/fomcminutes20171213.pdf>).

each of the next three years, and for the fed funds rate, it is about 1-1/2 to 2-1/2 percentage points over the next three years.

### **The Communications Challenge**

According to Voltaire, “Uncertainty is an uncomfortable position, but certainty is an absurd one.” In our context, this means it is important to remember that monetary policymakers have to deal with uncertainty, which takes several forms. The economy is constantly being buffeted by shocks that can lead economic conditions to evolve differently than anticipated. In addition, our view of current economic conditions can be cloudy because many economic data are revised over time, and these data revisions complicate forecasting and setting monetary policy in real time. There is also model uncertainty: it isn’t clear which model will best predict the future path of the economy at any given time. One approach that I like is to average across various models to develop a forecast, or to look at the forecasts from several different models and to analyze different scenarios. In speaking about FOMC projections, former Fed Chair Ben Bernanke said, “The only economic forecast in which I have complete confidence is that the economy will not evolve along the precise path implied by our projections.”<sup>5</sup>

The FOMC is not prescient, nor should anyone expect it to be. Yet, because policy affects the economy with a lag, policymakers need to make medium-run forecasts and acknowledge the uncertainty. But this poses a fundamental communications challenge – how can policymakers be transparent about their current assessment of economic conditions, the economic outlook, and their anticipated appropriate policy path without being perceived as having made a promise they won’t necessarily keep should the economy evolve in an unanticipated way. Added to this is the tendency for market participants, among others, to prefer more explicit statements and less uncertainty, and the potential that they will interpret the forecasts

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<sup>5</sup> See Bernanke, Ben S., “Federal Reserve Communications,” Cato Institute 25th Annual Monetary Conference, Washington, D.C., November 14, 2007 (<https://www.federalreserve.gov/newsevents/speech/bernanke20071114a.htm>).

of the economy and the appropriate policy path as having more certitude than they actually do, which creates communication issues when the forecasts and policy path change.

I note that here I'm talking about normal times. In extraordinary times, for example, when interest rates have reached the zero lower bound and policymakers want to run a policy of keeping interest rates very low for longer than they otherwise would, the challenge is just the opposite – how can policymakers credibly commit to such a policy path that differs from normal policy?

### **Policy Communications Recommendations**

I believe that to meet these challenges, we should focus our policy communications on conveying a better sense of the FOMC's reaction function in normal times, that is, the relationship between changes in monetary policy and changes in the economic outlook. This takes us away from having to predict the various shocks that may hit the economy, shocks that can arise from many different sources. Instead, we should provide a better sense of how policy can be expected to react when there is a change in economic conditions and the medium-run outlook, whether those changes were anticipated or not. Of course, policymakers do not necessarily agree on the precise form of the policy reaction function. Still, there is consensus on some of the factors that should influence policy, including measures of the unemployment rate, employment growth, output growth, inflation, and longer-run inflation expectations.

From a practical viewpoint, let me offer three suggestions of what the FOMC can do to create a better understanding of our policy reaction function.

First, let's ensure that our post-meeting FOMC statement focuses less on short-term changes in the data released between FOMC meetings and more on accumulated changes in economic and financial conditions and their effect on the medium-run outlook and progress toward our monetary policy goals. The statement should help the public and financial market participants to better understand policymakers'

consensus assessment of what is signal versus noise in the data. While the statement has been evolving in this direction, I believe it could do more to dissuade people from thinking short term. The statement is a very important part of FOMC communications. We could improve the public's understanding of our monetary policy reaction function if the statement provided more of a narrative of our assessment of how changes in economic and financial data have or have not changed the medium-run outlook, the risks around that outlook, and therefore, the appropriate policy path. In addition to the narrative, the statement would describe the current stance of policy and any policy actions taken, and some information on the future path of policy. In extraordinary economic circumstances, this might be explicit forward guidance that serves as a policy tool, as it did during the Great Recession and early part of the recovery. But during normal times, the statement would, instead, provide a rationale for future policy decisions. It would articulate the considerations the Committee would take into account when determining future changes in policy. If we provided more consistency about the conditions we systematically assess in calibrating the stance of policy, I believe the public and market participants would get a better sense of the Committee's reaction function over time and their policy expectations will better align with those of policymakers, thereby making policy more effective and, at least to some extent, reducing market volatility. What I'm suggesting would likely not result in a shorter statement but, I believe, a more informative one.

Second, let's begin using simple monetary policy rules as benchmarks to explain our policy decisions.

You can find updates for a set of seven rules and their outcomes across several forecasts on the Cleveland Fed's website, and the Federal Reserve Board's Monetary Policy Report now includes a section on policy rules.<sup>6</sup> These types of rules describe policy reaction functions that have been shown to yield good economic outcomes in some models and in some economic circumstances. I am not advocating setting policy mechanically according to a simple policy rule; no rule works well enough across a variety of

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<sup>6</sup> See "Simple Monetary Policy Rules," Federal Reserve Bank of Cleveland (<https://www.clevelandfed.org/en/our-research/indicators-and-data/simple-monetary-policy-rules.aspx>) and Board of Governors of the Federal Reserve System, "Monetary Policy Report," July 7, 2017, pp. 24-28 ([https://www.federalreserve.gov/monetarypolicy/files/20170707\\_mprfullreport.pdf](https://www.federalreserve.gov/monetarypolicy/files/20170707_mprfullreport.pdf)).

economic models and circumstances. However, using the rules as reference points and discussing why our policy may differ from these policy descriptions could go some way in helping to explain our own policy reaction function to the public.

This doesn't go as far as having the FOMC present a forecast that could serve as the benchmark for understanding the FOMC's policy actions and post-meeting statements, a recommendation I've made in the past.<sup>7</sup> The median paths in the SEP are somewhat of a step in that direction, but because the variables are not linked across participants, the median paths don't really represent a coherent forecast. For example, there is no guarantee that someone projecting the median inflation path would necessarily be projecting the median output path. In 2012, the FOMC experimented with developing a forecast representing the consensus of the Committee, but it proved difficult to achieve.<sup>8</sup> In lieu of that, the FOMC should consider publishing the Board staff's forecast as a benchmark against which policymakers could explain how and why their forecasts may differ.

Third, let's link the variables in the SEP. As I just mentioned, right now, each variable in our projections is reported independently, so, 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. 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 is appropriate given those projections. This could be done without revealing the identities of the participants and would convey information on each individual policymaker's reaction function. We might also consider other enhancements to help the public understand that the policy paths in the SEP are

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<sup>7</sup> See Mester, Loretta J., "Acknowledging Uncertainty," Shadow Open Market Committee Fall Meeting, New York, NY, October 7, 2016 (<http://www.clevelandfed.org/en/newsroom-and-events/speeches/sp-20161007-acknowledging-uncertainty.aspx>).

<sup>8</sup> See the minutes and transcripts from the July, September, and October 2012 FOMC meetings (<https://www.federalreserve.gov/monetarypolicy/fomchistorical2012.htm>).

not necessarily commitments but depend on how the economy evolves. Although this message may already be understood because of the FOMC's actions: last year, the economy evolved in a way that resulted in the FOMC raising the fed funds rate three times. This was consistent with the median projection of FOMC participants in March 2017. However, in both 2015 and 2016, the FOMC raised the funds rate fewer times than the median projection made in March of those years, clearly demonstrating that when economic conditions evolve differently than anticipated, the FOMC will adjust policy accordingly.

## **Conclusion**

Let me end by noting that 14 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: "Greenspan Hints at End to Low Rates," while the headline in *The Wall Street Journal* read: "Greenspan Suggests Continued Patience on Rates."<sup>9</sup> That one speech generated such contradictory messages illustrates the challenges monetary policymakers face when communicating with the public. I suspect that monetary policy communication will likely always remain somewhat of a challenge, but over the past couple of decades, the FOMC has been taking significant steps on its journey toward increased transparency and better communication. It is important for the FOMC to continue on this journey because when the public has a better understanding of how monetary policy decisions are made, not only will the public have the information it needs to hold us accountable for our decisions but monetary policy itself will be more effective. I have offered some concrete suggestions on how we might improve our communications by conveying a better sense of our policy reaction function. I expect the FOMC will continue to make progress because the benefits of clearer communication are clearly worth the effort.

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<sup>9</sup>These were the original headlines in the November 7, 2003 print editions.