Remarks for the Session:
"Hall of Mirrors: Feedback Between Monetary Policy and Financial Markets"*

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Panel Remarks at the
2020 U.S. Monetary Policy Forum
Sponsored by the Initiative on Global Markets
at the University of Chicago Booth School of Business

New York, NY

February 21, 2020

* The views expressed here are those of the author and not necessarily those of the Federal Reserve System or the Federal Open Market Committee.

Introduction

Welcome to this session entitled "Hall of Mirrors: Feedback Between Monetary Policy and Financial Markets." I thank Anil Kashyap and Ric Mishkin for inviting me to moderate today's panel discussion. I have been attending the U.S. Monetary Policy Forum for many years, and I marvel at the organizers' prescience in anticipating the issues confronting monetary policymakers. This panel's topic is no exception. It ties together various aspects of modern monetary policymaking, including the information content in asset prices, the role of expectations in monetary policy transmission, policy communications, and the wisdom of crowds.

As most of you know, the title of the session harkens back to a 2004 speech made by former Fed Chair Ben Bernanke. Speaking about how monetary policymakers can gain insights from asset price movements, he pointed out that if policymakers are too concerned about meeting market expectations for fear of creating excess volatility, then this undermines the information content of asset prices. As he put it: "Such a strategy quickly degenerates into a hall of mirrors" in which the policymaker is at once sending signals to the market about future policy and trying to gain insights from the market.

However, if the market's expectations get too far out of alignment with those of the policymaker, the policymaker finds herself in a difficult situation. If financial markets expect easier policy than what the policymaker feels is appropriate and she chooses to accommodate the markets' belief, this suboptimal policy could lead to macroeconomic instability in the future. If, instead, the policymaker chooses to disappoint the markets, she risks increased volatility and an unwanted tightening of financial conditions. Even a policymaker who declares that surprising the markets won't deter her from following appropriate policy might find that this declaration is not time consistent when faced with such a choice.

At the same time, as Amato, Morris, and Shin (2002) point out, the policymaker's view of the world may not be correct. If policymakers are successful in getting agents to accept their view, then the

informational content one might glean from agents' decisions just reflects back the policymakers' view and not the agents' own private information. The potential is that asset prices could deviate far from fundamentals if the policymakers' view is wrong.

The question is: how can policymakers best avoid the "expectations trap" (Chari, Christiano, Eichenbaum, 1998), and utilize the information content in asset prices?

Bernanke emphasizes the role of communications. In his view, policymakers should pay attention to the market's expectations for policy because they are a check on how well the central bank is communicating. When expectations are not well aligned, either policymakers aren't communicating the rationale for their own policy views very well, or they are communicating, but market participants aren't buying it. Thus, market expectations speak directly to two factors that are paramount in effective monetary policymaking: transparency and credibility.

The Federal Reserve has been on a journey of increased transparency for some time now in order to better communicate the Committee participants' current views on the economic outlook and appropriate policy.[2] Nonetheless, the Committee's views and those of the market are not always in alignment.

In these cases, policymakers shouldn't just capitulate to the market.[3] But they should be open to reassessing their view of the economy based on all incoming information, including the views of participants in the financial markets. We have to be open to the possibility that the markets' view may be

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[2] The Summary of Economic Projections (SEP) was launched in October 2007. It summarizes information about the individual FOMC participants' views on the economic outlook based on their own individual assessments of the appropriate path of policy. In January 2012, the SEP began including information on the individual appropriate policy paths, summarized in the well-known dot plot. In September 2015, the FOMC began publishing the median SEP responses for each variable in the projections. And in March 2017, the SEP began including confidence bands around the median path for each variable.

[3] Jeremy Stein and Adi Sunderam (2018) present a model in which society is worse off if the central bank cares too much about bond market volatility and moves policy rates too gradually.

more in alignment with fundamentals than the policymakers' view. Significant misalignment between the central bank's views and market expectations should also prompt the chair to augment communications in intermeeting periods and to consider improvements in how the central bank explains the rationale for its outlook for the economy, the risks around the outlook, and its view of appropriate monetary policy based on the outlook and risks.

I don't want to underplay the challenges of formulating effective policy communications. Consider the FOMC's post-meeting statement. It is pretty sparse. The chair's press conference does give more context, but I'd like to see more of that information in the Committee's statement, to provide more of a sense of our outlook and why we think our anticipated policy path is appropriate. Our assessment of risks is an important part of the policy discussion. We should provide more information on risks in the statement and consider releasing the balance of risk graphs that are part of the SEP with the other charts released at the time of the press conference. Currently, these charts are released with the minutes three weeks later. What I'm advocating would result in a longer statement – which may not be fashionable in the age of Twitter. But I think it would help us escape the statement's "Hotel California" problem: words check in but they don't check out. The market hangs on each word in the statement, so there is a legitimate reluctance to change any word from one meeting to the next because of the signal it might send to the market. If we used more words to explain things, each word would carry less weight. The language would be less boilerplate. This would free us to explain our rationale and change the statement's language productively from meeting to meeting without fear of sending the wrong message.

One last comment before I introduce our speakers. I've been talking about the market's expectations as if there is one monolithic market. But, of course, that isn't correct. The market is made up of many individual participants. In liquid markets, asset prices aggregate these individual investors' beliefs about the current and future state of the economy, but the diversity of views can still matter. The so-called taper tantrum in mid-2013 comes to mind. Before the FOMC communicated that tapering its asset purchases

might soon be appropriate, it looked as if market expectations were in alignment. Nonetheless, financial markets reacted sharply when the communication actually came. Both Jeremy Stein (2014) and Stan Fischer (2017) have discussed the episode, pointing out that the distribution of views across market participants and how strongly they hold these views are important determinants of how asset prices might react to an announcement, even one that is aligned with the median view in the market. The point being that even the best policy communications won't be able to prevent market swings all the time and policymakers and markets need to understand that.

As you can see, there are many things to talk about in this session. Our panelists bring broad academic, market, and central bank experience. Their bios are in your booklet, but briefly:

Richard Clarida is vice chair of the Board of Governors of the Federal Reserve System. Prior to joining the Fed, he was a professor at Columbia University. He has served in the U.S. Treasury Department and on the Council of Economic Advisers, and was a managing director of PIMCO.

Rick Rieder is managing director of BlackRock, where he is global chief investment officer and co-head of global fixed income. Prior to this, he was president and CEO of R3 Capital Partners, and was an advisor to the U.S. Treasury and the NY Fed.

Silvana Tenreyro is professor of economics at the London School of Economics and serves as an external member of the Bank of England's Monetary Policy Committee. She is president-elect of the European Economic Association, and, I'm happy to say, a member of the advisory council of the Cleveland Fed's Center for Inflation Research.

We'll hear from our speakers in the order in the program and then open it up to participants for discussion and questions.

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