The Regional Fed System and Evolving FOMC Communications

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October 24, 2005

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Plan for today

- Providing some context: A Simple Framework for Monetary Policy Analysis

    - How do the Regional Banks contribute to the formation of monetary policy?

    - How do FOMC communications fit into the monetary policy transmission channel? How have they evolved over time?

- Some Recent Issues in Monetary Policy Formation

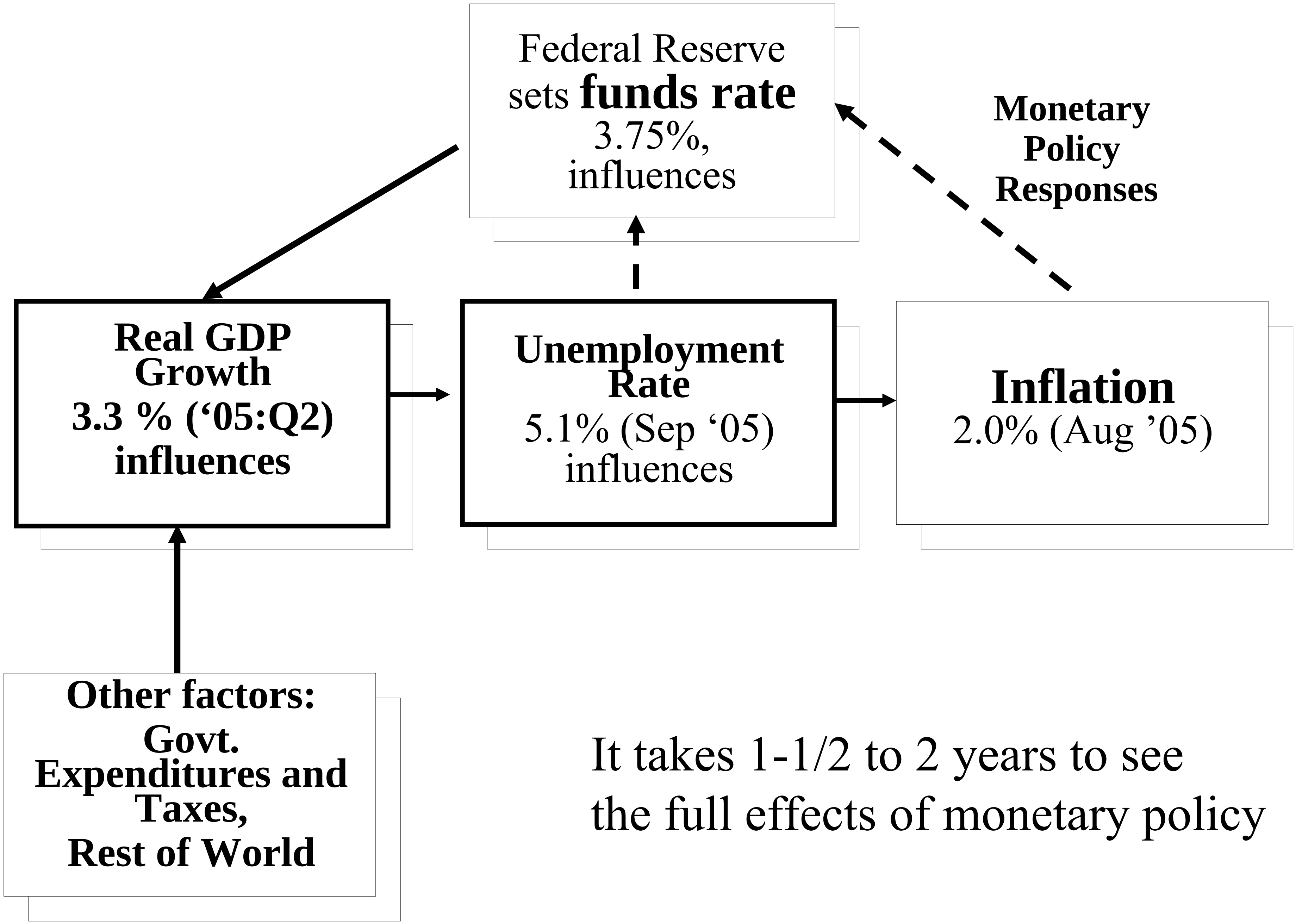
Disclaimer

The views in this talk represent my views alone, and not necessarily those of the Federal Reserve Bank of Boston or the Federal Reserve System

A Simple Framework for Monetary Policy Analysis

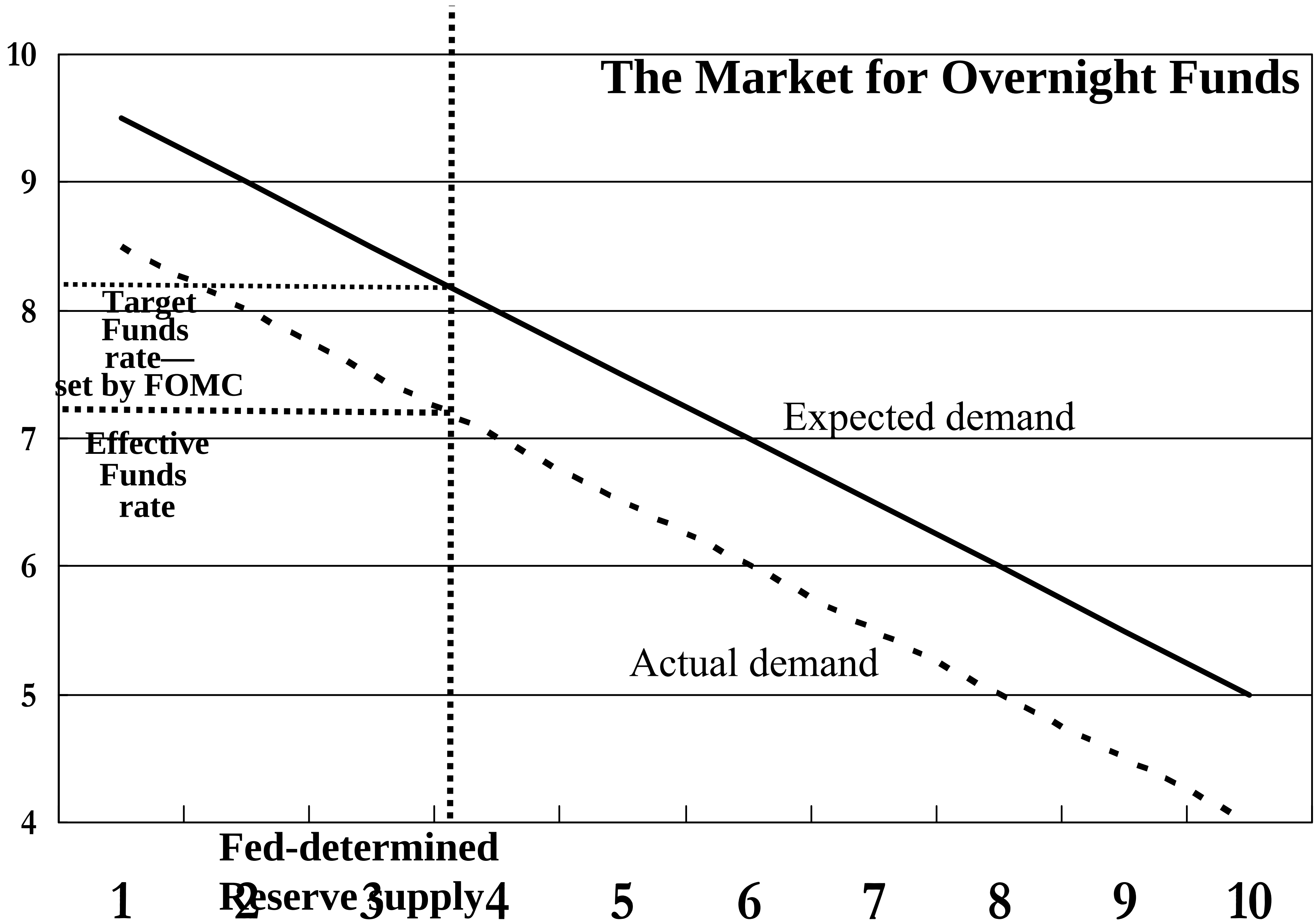
- What the Fed really controls—the funds rate
  - How well can it control it?
- Influences other credit market rates
- Which in turn affect real spending, employment, inflation
- Outcomes for spending, inflation influence Fed decisions, closing the loop

It takes 1 to 2 quarters for
(1) Interest rates to affect spending
(2) Spending to affect employment
(3) Employment to affect inflation

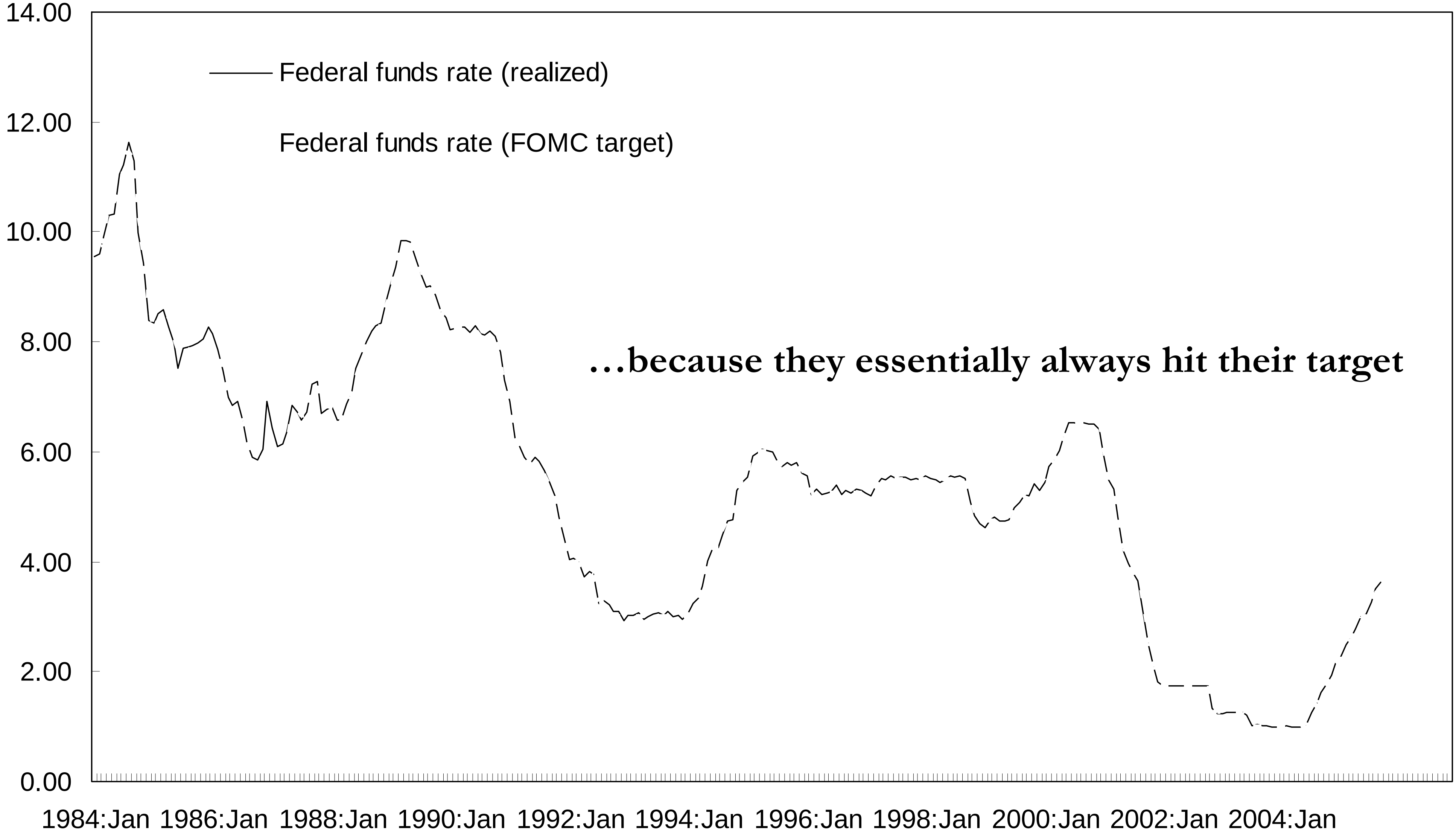


It takes 1-1/2 to 2 years to see the full effects of monetary policy

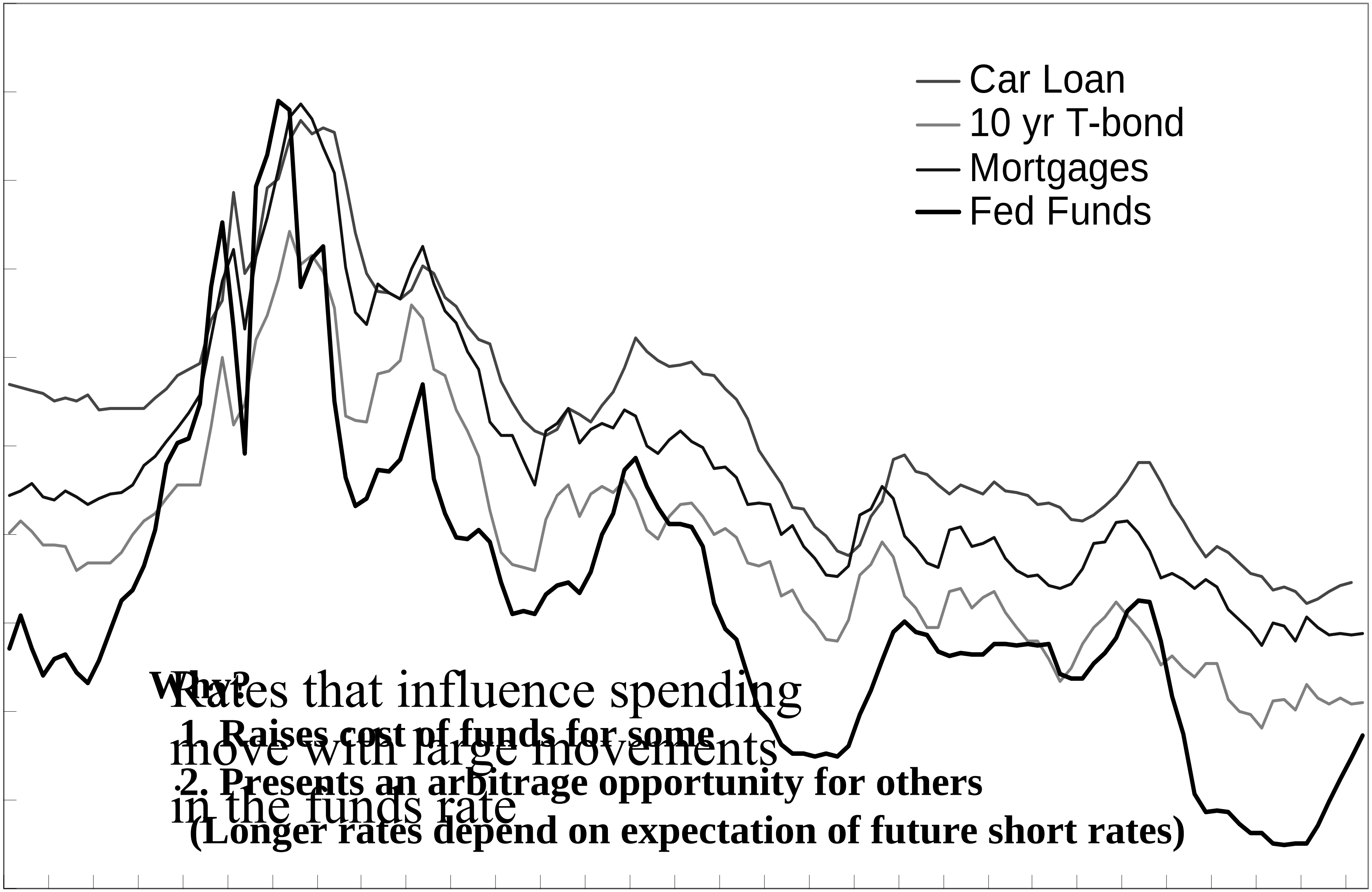
How the Fed Controls the Funds Rate



The Fed must be pretty good at estimating demand for fed funds



Other Prominent Interest Rates (and Asset Prices) Move with the Fed Funds Rate



Rates that influence spending move with large movements in the funds rate

Why?

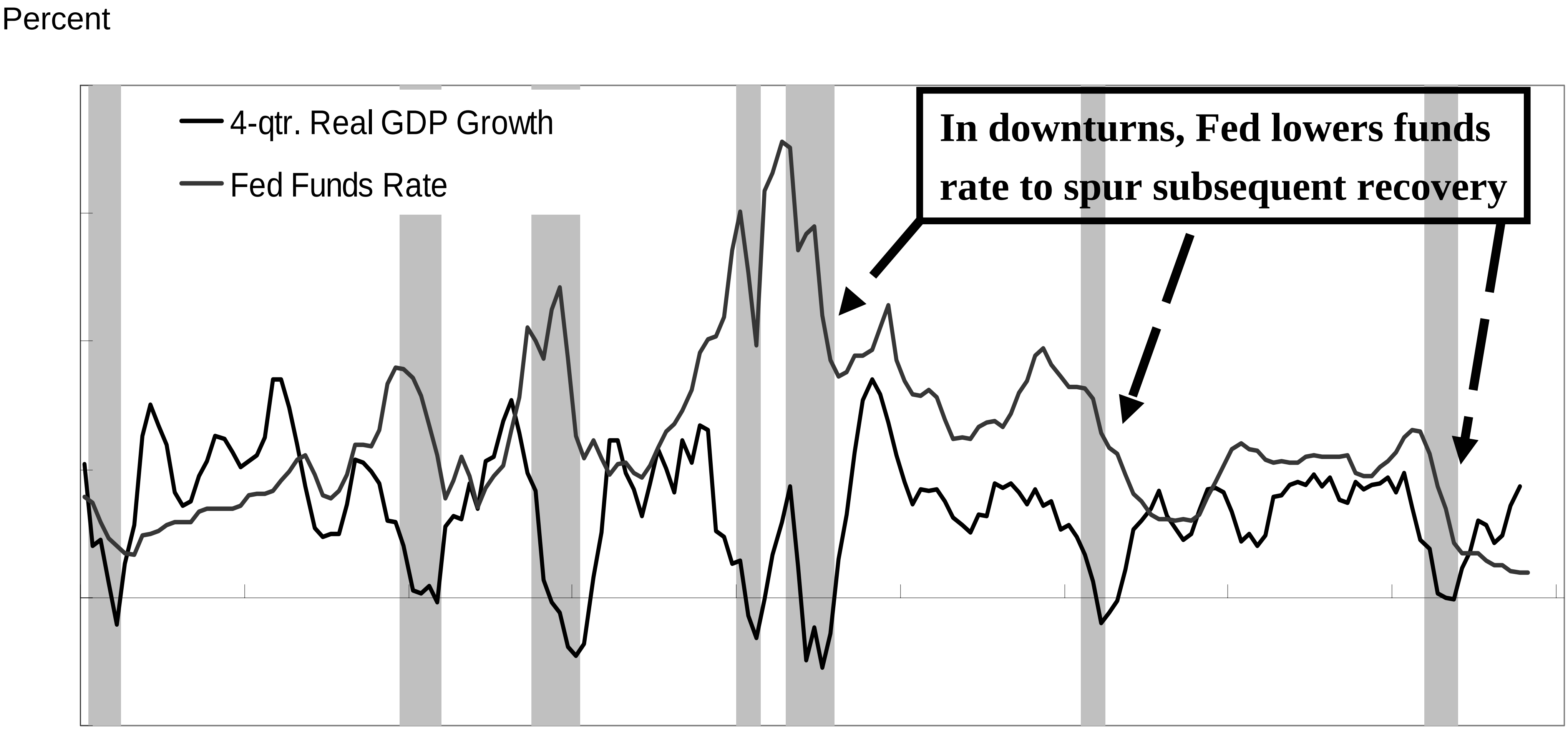
1. Raises cost of funds for some

2. Presents an arbitrage opportunity for others

(Longer rates depend on expectation of future short rates)

Source: Federal Reserve Board.

Real GDP Growth Responds to Interest Rate Actions of the Fed



Sources: Bureau of Economic Analysis, Federal Reserve Board.

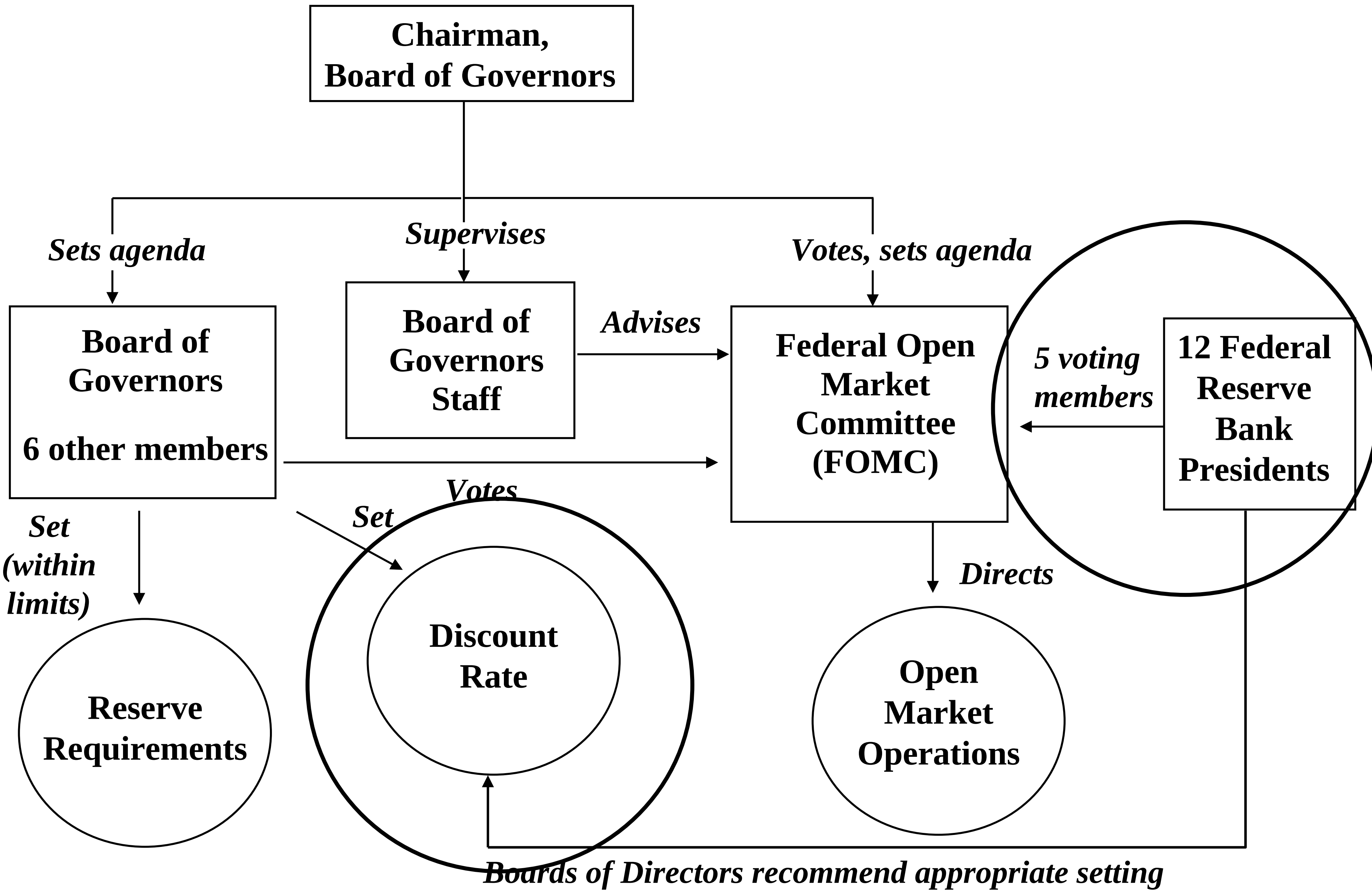
The Regional Feds and Communications in this Framework

- The chain starts with the setting of the funds rate—which is a Committee process (RB role)

- Keeping an unbroken chain depends critically on the link from fed funds to credit market rates

- For longer-maturity rates, this link depends on *expectations* of future funds rates—suggests <u>communications</u> may matter

1. Role of Regional Banks in Monetary Policy (MP): Organizational Structure



1. The Role of Regional Banks in MP

- <u>Formal structure</u>

  - 12 Reserve Banks (RBs), distributed somewhat oddly around the country (politics of 1913/14)

  - Presidents of RBs vote at and participate in FOMC meetings
    - NY votes all the time; others on a rotating basis, 2-year (Cleveland, Chicago) or 3-year rotations (all others)
    - All members discuss and participate at the FOMC meeting, whether voting or not

The Role of Regional Banks in MP

- Formal structure
  - Boards of Directors at each RB give a monthly recommendation on “discount rate” to Board of Governors
    - (No longer a “discount” relative to the funds rate)
    - **Really a signal from regional Boards to Board of Governors about desired federal funds setting**

The Role of Regional Banks in MP

- Practice
  - RBs are "face" of the Fed to the nation outside DC—not just a DC-centric institution
    - Information-gathering: Collect information from regional business contacts
    - Explain Fed policy to regional constituents—build Fed credibility
  - Bring important differences of perspective, both philosophical and geographic, to policy decisions

→ **More robust policymaking**: Better information, a variety of perspectives brought to process, no collapse into a monolithic DC view

How does Boston contribute to monetary policy?

- Each Bank has its own take on how the world works, the current state of the economy, and appropriate policy (part of "robustness")
  - Boston has a tradition that emphasizes an important stabilization role for monetary policy
  - We believe that "frictions" are quite important to business cycle evolution
    - The economy is not immediately self-equilibrating
  - We are not inflation "doves," but neither are we "inflation nutters" (output stabilization matters, too)

Structure of FRB Boston monetary policy involvement

- Staff of 20 economists, 12-15 research assistants, computer support staff
- Regularly meet among ourselves to discuss the economy and policy-related issues
  - Seminar-like environment to hash out issues
- Advise Cathy Minehan prior to each FOMC meeting to help prepare her to participate (two meetings)
- Other groups advise her as well
  - Academic, small business, financial institutions
- Occupies about 50% of our staff’s time

2. Communication and the Conduct of MP

- What the FOMC says can help to clarify the rationale behind a MP decision, *and* make MP more predictable
  - Where is the economy now, where is it going?
    - How much uncertainty is there about that outlook?
  - What do those expected outcomes imply about inflation and output relative to desired outcomes?
  - What does that in turn imply about appropriate policy, current and expected?

Communication and the Conduct of MP

- **To get a bit more specific**:

<u>Funds rate</u> *depends on*
Expected inflation relative to target
Expected output relative to potential

<u>Output</u> *depends in part on*
Medium- and longer-term interest rates

<u>Inflation</u> *depends in part on*
Output relative to potential

<u>Longer-term rates</u> *depend in part on*
Expectations of future policy actions

What public needs to know to <u>understand/anticipate our actions</u>

- Outlook (where inflation and output are going)
- Target (where we want them to go)
- Normal response to gaps between these two
- Uncertainty surrounding the outlook (especially if it's "asymmetric")

Communication and the Conduct of MP

- What does the FOMC communicate now?

- Regularly:
  - The target federal funds rate (after each meeting)
  - Qualitative sense of outlook (press statement after each meeting, minutes, speeches and testimony)
  - Qualitative sense of uncertainty around outlook
- Irregularly:
  - Qualitative sense of inflation goal (inflation does not materially affect business decisions)

Communication and the Conduct of MP

- Fed currently does *not* directly communicate
  - Its inflation goal
  - Its forecast for the economy
  - The path of policy rates that is consistent with the forecast
  - The uncertainty surrounding its forecast
- Some informal/fuzzy communication of these concepts through statement, speeches, minutes

Communication and the Conduct of MP

- Compare to other central banks around world
  - UK: Explicit inflation goal, explicit forecasts and uncertainty
  - ECB: Explicit inflation goal
  - Bank of Canada: Explicit inflation goal, forecasts and uncertainty
  - Reserve Bank of Australia: Explicit goal, forecasts
  - Relative to these, we are a bit tight-lipped
  - Is that a problem?
    - FOMC is continuously evaluating its communications strategy

How important is communication?

- Case in point: Spring 2003
  - Concern: economy looked weak, inflation was low, funds rate already very low (1%)
    - *Could* turn into a deflation
  - How to offset this with limited potential for funds rate cuts?
  - Try to "commit" to a low funds rate for the next year or so
    - Use language to accomplish this goal ("considerable period")
    - Hope to keep long rates low
    - Did it work?

More on Spring 2003

- Gov. Bernanke spoke about a "comfort zone"—an acceptable range for inflation
    - Below 1% was outside his comfort zone
    - Partial articulation of (one person's view of) inflation goal for FOMC
- Many spoke about "alternative monetary tools"
    - Provide a future promise of monetary stimulus, even if can't achieve by lowering the funds rate

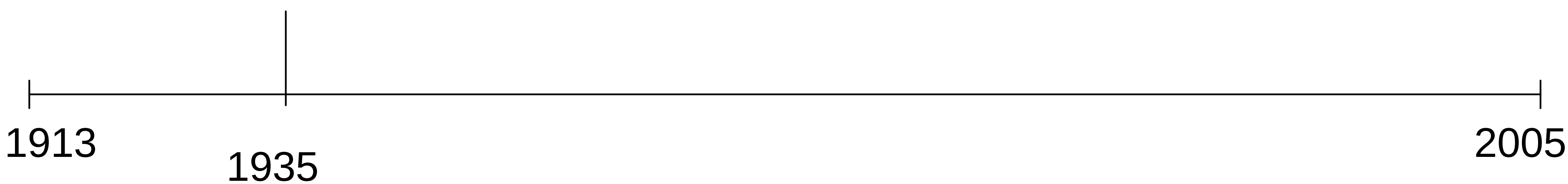
We’ve Come a Long Way, Baby

- Transparent communication has not always been the Fed standard
- Early on, the Fed released very little, and that with a substantial lag
- Look at the history of Fed communication

Communicating with the Public: A Brief History of Fed Time

Beginning in 1935, the FOMC released an official statement from its meetings entitled the "**Record of Policy Actions**," also known as the "**Policy Record**."

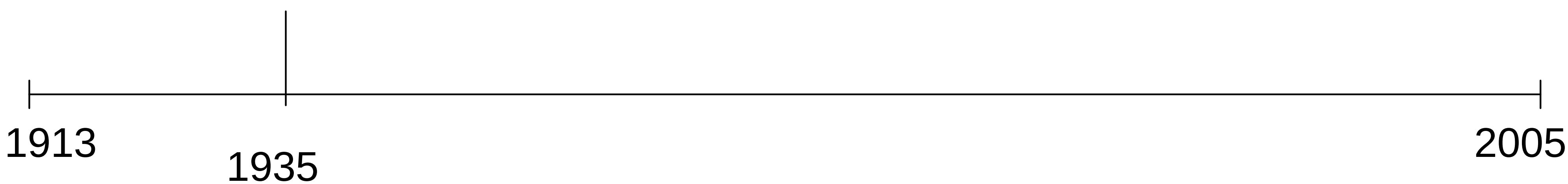
It was released once a year.



Communicating with the Public

The FOMC also collected “**minutes**,” which were detailed records of attendance, discussions and decisions from the meeting.

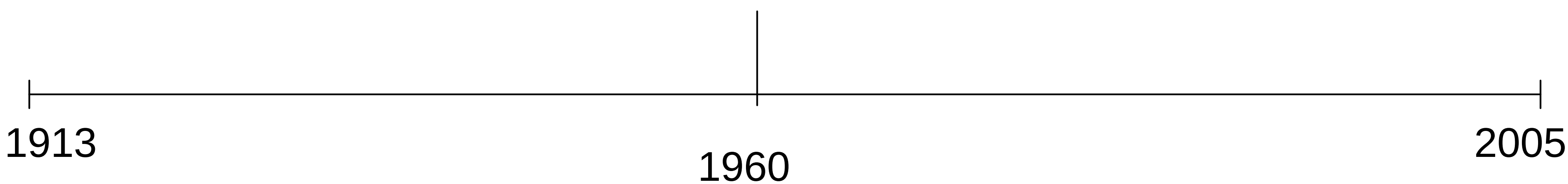
Minutes were maintained for the Committee’s private use and were <u>kept confidential</u>.



Communicating with the Public

The Policy Record, which was initially a page or two, grew to be an average of five pages by the 1960's.

It summarized **reasons** for the Committee's policy actions, as well as details of discussions held during the meetings.



Communicating with the Public

<u>EARLY RELEASE</u>: In June 1967, the FOMC decided that it would publish the Policy Record in the Federal Reserve Bulletin, **90 days** after each meeting.

The Committee would also issue an additional statement, the **"Minutes of Action,"** on this same schedule.

This document gave short **nonspecific** summaries of policy, organizational, and procedural actions held at the meeting.

1913 1967 2005

Communicating with the Public

Old "minutes"
(confidential)

Minutes of Action
(90 day release)

Memorandum of Discussion

Specific details of FOMC meeting

Released to the public five years after FOMC meeting

1913

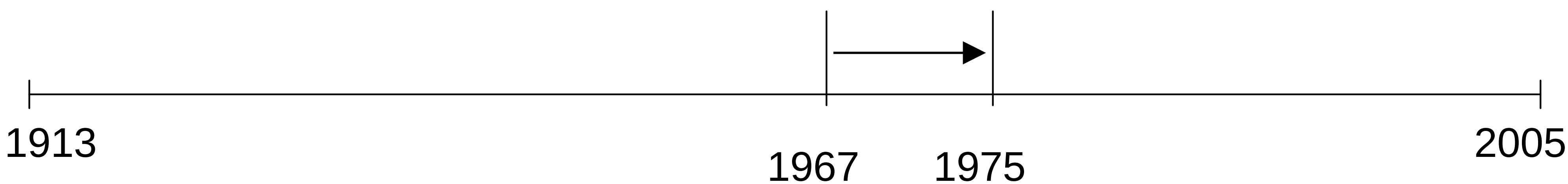
1967

2005

Communicating with the Public

By 1975, the 90 day lag of the release of the Policy Record was shortened to **45 days (i.e. after next FOMC meeting)**.

“…90 days was no longer necessary to avoid an unacceptable degree of risk that speculators would be able to take unfair advantage of the information or that market reactions would impair the effectiveness of the Committee's functions."



Communicating with the Public

In 1976, the Memorandum of Discussion is discontinued

1913

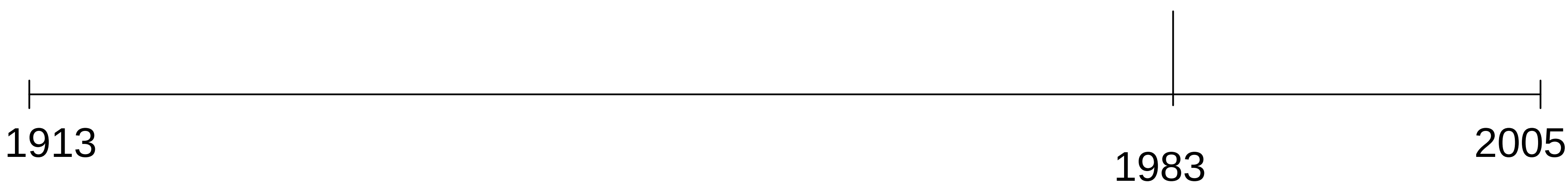
1976

2005

Communicating with the Public

In 1983 the FOMC adopts the practice of choosing the "**symmetry**" or "**bias**" of its policy stance. Not part of press statement, but in minutes (known after next meeting).

The stance was said to be **symmetric** or **unbiased** if there was an equal probability of either a tightening or an easing of the funds rate during the inter-meeting period.



And Then Along Came Alan

Alan Greenspan's Tenure

1987 2005

Communicating with the Public

Minutes of Action

Record of Policy Actions

"Minutes of the FOMC Meeting"

The Committee creates "lightly edited" transcripts of its previous meetings from unedited transcripts and tapes dating back to 1976. The transcripts are to be released to the public five years after each meeting.

1987

1993

2005

Communicating with the Public

<u>ANNOUNCING THE TARGET</u>: In February 1994, the FOMC adjusts its interest rate target (up) for the first time in two years.

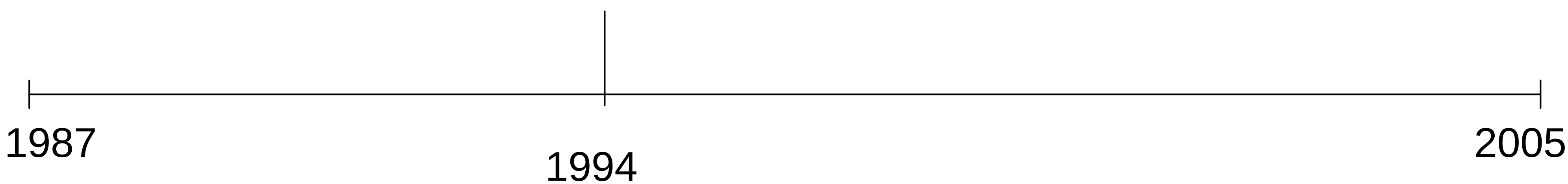
Worried that such a sudden adjustment would roil the markets, Greenspan decides to formally announce the decision.

1987 1994 2005

Communicating with the Public

The announcement was made in an effort to **<u>stabilize</u>** the markets.

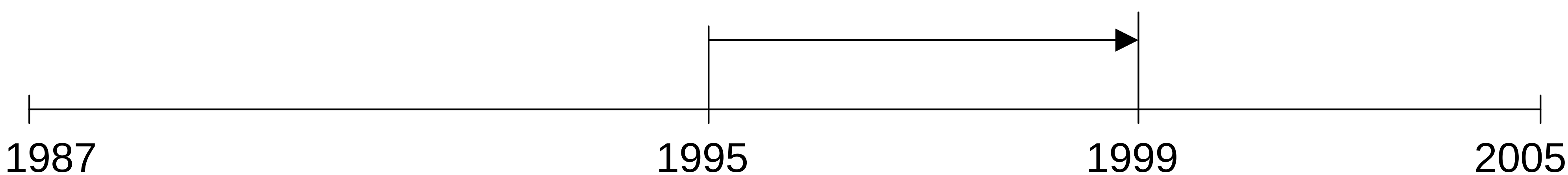
This reversed the FOMC's previous stance that announcing its decision would **<u>disturb</u>** the markets.



Communicating with the Public

One year later, the Fed officially adopted a policy to announce its funds rate decision immediately after each FOMC meeting.

Things did not change for four years.



Communicating with the Public

In May 1999, the FOMC began **announcing the bias** of its policy directive after each meeting.

This announcement was made **even if the funds rate was left unchanged.**

Communicating with the Public

The FOMC became concerned that the bias was creating excessive speculation about **future** policy actions.

In February 2000, the Committee decided to replace the bias with a **"balance of risks"** (BOR) statement.

BOR was intended to indicate the FOMC's assessment of the balance between **"heightened inflationary pressures"** and **"economic weakness"** over the "foreseeable future." Could be one or the other, or balanced. Can't be both. Balanced could mean no pressures on either side, or balanced pressures from both sides, large or small.

1987 2000 2005

Communicating with the Public

One aim was to make it clear that the time frame of its policy directive covered the period **beyond** the next FOMC meeting (“foreseeable future” versus “intermeeting period”).

Communicating with the Public

In March 2002, the Committee began immediate announcement of the vote, including the names of voting members on the committee.

Communicating with the Public

In May 2003, the BOR statement is altered to individually assess the importance of **“inflation risks”** and **“risks to real growth”**

The Committee also begins to use more forward-looking language in its statements.

“The Committee believes…for a considerable period”
…it can be patient”
…at a measured pace.”

1987 2003 2005

Communicating with the Public

Until December 2004, the Committee released the minutes of a meeting three days after the **next** meeting.

In December 2004, the FOMC announced that it would release the minutes three weeks after the meeting.

1987 2005

The Process continues …

- Will new Chairman take a more aggressive stance toward transparency?

- Will the FOMC move more in step with its foreign counterparts?

- Stay Tuned

Some recent monetary policy challenges

- Monetary policy in a low-inflation environment

- How to respond to energy price surges?

Monetary policy in a low-inflation environment

- What's the problem?
  - At low inflation rates, nominal interest rates will tend to be correspondingly low
    - Nominal rate = real rate + inflation premium
    - The latter will be low on average, perhaps 1-3%
  - Hard to push nominal interest rates below zero
    - Because currency always earns a zero return
    - Would like to push below zero to make short-term real rates negative
  - If a recession hits, will the Fed have enough room to lower interest rates?

M-policy in a low inflation environment

- What to do?
  - Keep inflation higher, providing cushion
  - Use something other than short-term interest rate policy
    - Depreciate the exchange rate (flood international markets with dollars)
    - Try to manipulate inflation expectations—raise them so as to lower real rates
    - Conduct open market operations in longer-term instruments
    - Pump reserves into the banking system, hoping that the quantity of reserves will spur demand, even if it won't lower rates

M-policy in a low inflation environment

- FOMC thought hard about all of these

- And, fortunately, didn't need most of them

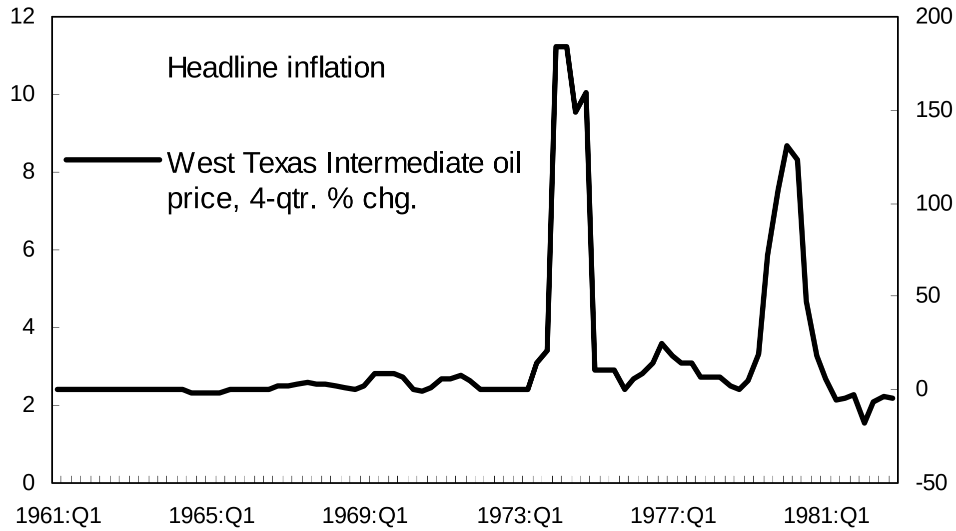
How to respond to energy price surges?

- May act as a "supply shock"
  - Defined as something that moves output and inflation in opposite directions
    - Oil price increases→lower output, higher inflation
  - Which may pose a more difficult trade-off for monetary policymakers
  - Demand shocks are easier—if output and inflation both rise, raise interest rates—no tough trade-off
- How much do energy prices pass through into non-energy inflation?
- How much do energy prices depress real activity?

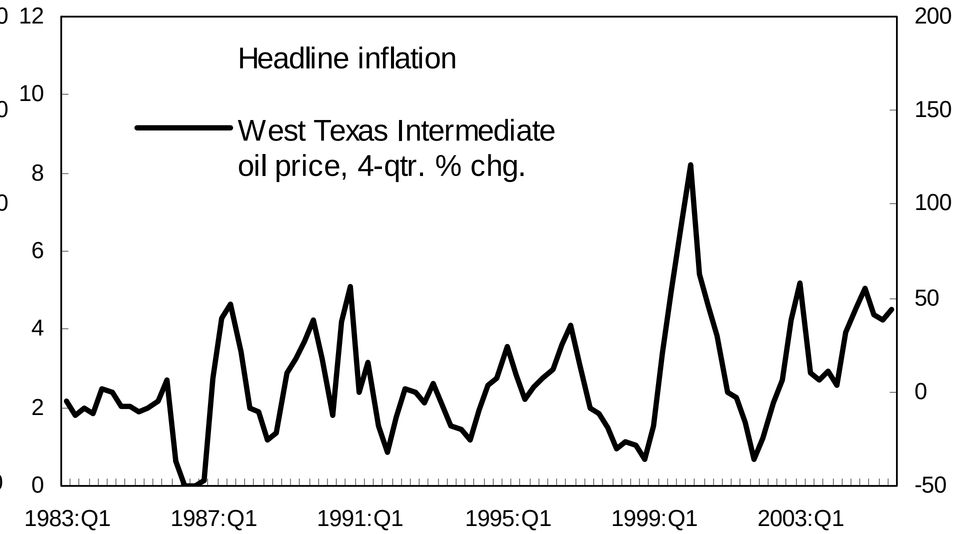
Pass-through of energy prices

to Headline

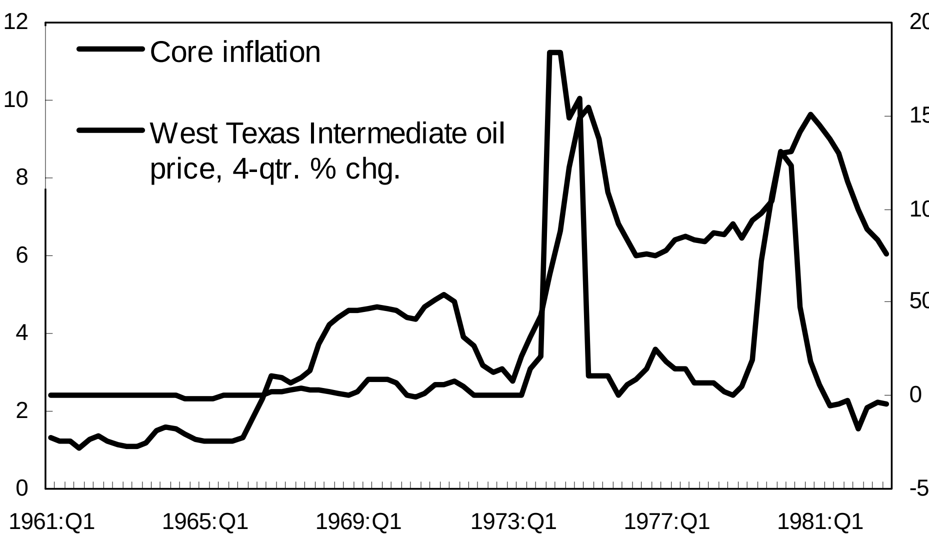
1961-1982

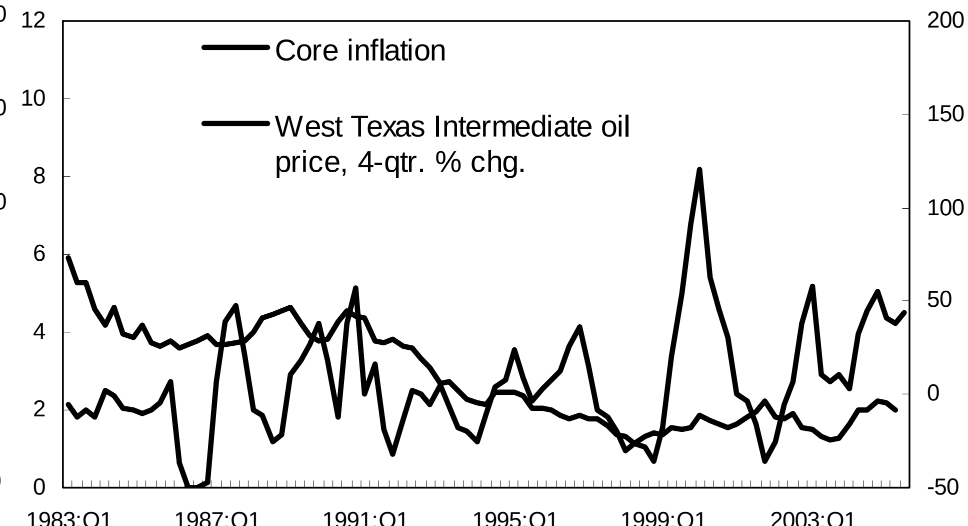


1983-2005



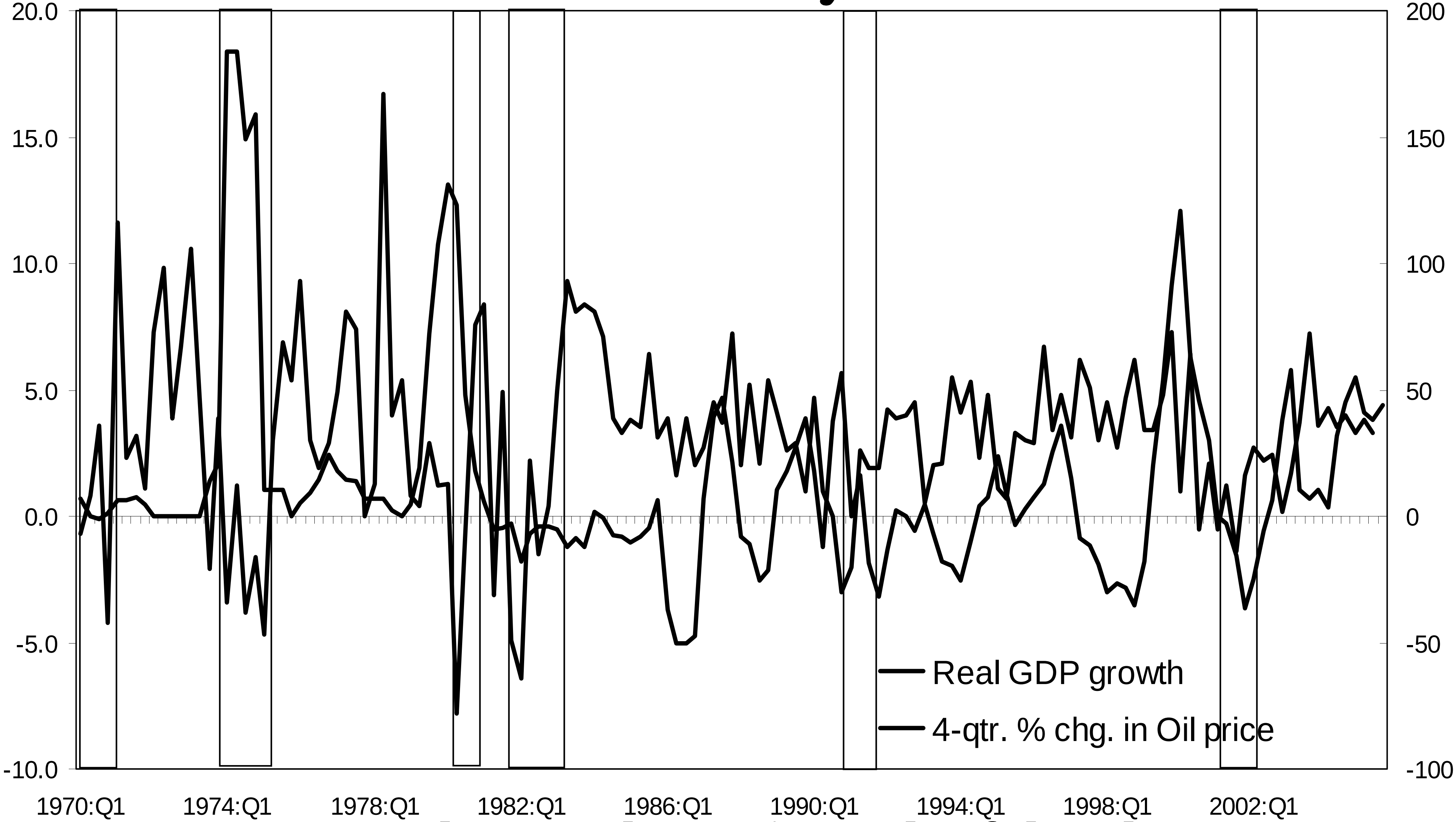
to Core





1. Not as big as it used to be
2. Currently pretty small for core inflation

Effect of energy prices on real activity



Some, but not dramatic—rule of thumb: 50% increase knocks off 0.5-1% consumption

How should monetary policy respond?

- Tougher call than a demand shock
- Often, energy price increases have been transitory
  - In this case, output and inflation effects are largely transitory
- If energy prices remain elevated
  - They tend to have only modest effects on trend inflation
    - But effect depends on sign of output gap
  - They have transitory and modest effects on real growth

→ Policy response depends on expected persistence of effect on inflation