

Charles I Plosser: Communication challenges

Speech by Mr Charles I Plosser, President and Chief Executive Officer of the Federal Reserve Bank of Philadelphia, before the 2014 US Monetary Policy Forum – “Initiative on Global Markets”, at the University of Chicago Booth School of Business, New York City, 28 February 2014.

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The views expressed are my own and not necessarily those of the Federal Reserve System or the FOMC.

Highlights

- President Plosser believes the Federal Open Market Committee has to revamp its current forward guidance regarding the future federal funds rate path because the 6.5 percent unemployment threshold has become irrelevant.
- President Plosser points out that before offering new forward guidance, the FOMC ought to be clear about its purpose. Is it purely a transparency device, or is it a way to commit to a more accommodative future policy stance to add more accommodation today?
- President Plosser notes that commitment is required to be successful in either approach to forward guidance. Policymakers cannot maintain discretion and simultaneously commit to forward guidance and expect that guidance to be effective.

Introduction

It is a pleasure to return to this event. The organizers have put together another great and timely program with distinguished participants. However, with Governor Stein and Presidents Kocherlakota, Evans, and myself all here, I am beginning to wonder if we are in Washington rather than in New York. Nevertheless, it is great to be on the program with so many of my fellow policymakers. If you listen carefully to each of us, you will understand why I start with the usual caveat that my remarks represent my own views and not necessarily those of the Federal Reserve System or my colleagues on the Federal Open Market Committee (FOMC).

Communication and transparency have been important themes in monetary policy discussions over the past decade or more. Indeed, in 2007 this Monetary Policy Forum began with Alan Blinder’s keynote address titled “Making Monetary Policy and Talking about It.” In part, this emphasis on communication and transparency reflects the steady evolution in the theory and science of monetary policy. Reflecting this emerging consensus, the Federal Reserve during the tenure of Chairman Bernanke has taken a number of actions to promote increased transparency about its actions and policies. In fact, President Evans and I served on a subcommittee led by current Chair Yellen specifically focused on improving communication.

Our efforts to improve communication took on heightened importance as the FOMC responded to the financial crisis and recession. Since December 2008, the federal funds rate target has been near zero. Since the nominal funds rate cannot go below zero, we had to develop alternative policy tools in an effort to provide further accommodation to support the recovery. We also had to figure out how and what to communicate about these new tools. Thus, well-understood communication practices about traditional policy tools gave way to untested ways to describe these new tools. The task was further complicated because one of the unconventional tools was so-called forward guidance. Forward guidance seeks to inform the public about the future path of policy rather than describing a policy action taken today.

Thus, effective forward guidance is all about communication and what it conveys or doesn't convey.

In my brief time today, I will focus on why I think communication is such a challenge and discuss some of the choices the Committee faces going forward.

Current state of affairs

First, communication is difficult because monetary policy is more complicated than it used to be. With the traditional policy tool at the zero lower bound, the Committee has focused on two unconventional tools. The first is the purchase of long-term assets, and the second, as I mentioned, is forward guidance. The asset purchase program has had many dimensions, such as the overall volume of purchases, the pace of purchases, the kinds of assets targeted for purchase, and the criteria for starting and stopping the purchases. Policymakers have tried to fine-tune the program along each dimension while assessing the trade-offs among them and the trade-offs with other policy tools, such as the traditional funds rate decision. With so many moving parts to our policy framework, it is not surprising that communication is very complicated.

We are now in the third round of asset purchases, or quantitative easing. Since September 2012, the FOMC has added some \$1.3 trillion in long-term Treasuries and mortgage-backed securities to its balance sheet through this program, buying at a pace of \$85 billion a month in 2013. This program, known as QE3, is already twice the size of the last round of asset purchases that was initiated in November 2010, known as QE2.

In December 2013, the Committee announced that it would reduce the pace of purchases from \$85 billion to \$75 billion per month. In January, it announced a further reduction to \$65 billion. The FOMC is now on a path of measured reductions, which, if continued, will end the purchase program late this year. If the economy continues to improve, we could find ourselves still trying to increase accommodation in an environment when history suggests that policy should perhaps be moving in the opposite direction.

Communication about the future path of asset purchases has, at times, been imprecise and confusing. Last June, the Committee suggested that it might begin to reduce the pace of purchases in the fall and perhaps end them when the unemployment rate reached 7 percent. However, the Committee did not even begin the tapering process until unemployment had reached 7 percent. It now seems unlikely that the program will end until the unemployment rate is below – or as indicated in the FOMC statement, perhaps “well below” – 6.5 percent.

Why is the 6.5 percent unemployment rate important? Because the Committee made it important. The Committee, in essence, told the markets that the 6.5 percent unemployment rate was an important quantitative marker. In December 2012, the FOMC indicated that it intended to keep the federal funds rate target near zero at least as long as the unemployment rate was above 6.5 percent, the inflation rate between one and two years ahead was projected to be no more than 2.5 percent, and inflation expectations remained well anchored. However, it is important to remember that these guideposts were thresholds, not triggers. The FOMC had not made a commitment to act once a threshold was reached, nor did it indicate how policy would evolve after a threshold was reached. It simply signaled that it would not act prior to crossing one of the thresholds.

Yet, the 6.5 percent threshold will soon become irrelevant, and it probably is already. So the Committee, at a minimum, has to revamp its communications regarding the future federal funds rate path. Given that we are still easing policy by buying assets, it is pretty clear that even though the threshold will soon come and go, the Committee is unlikely to contemplate raising rates as long as it is buying assets. Put another way, the practical constraint at this point for raising the policy rate is no longer the unemployment rate but the fact that we are still buying assets. Indeed, the Committee has acknowledged that it will likely be appropriate to keep rates at their current low rates well past the time unemployment falls below

6.5 percent. Therefore, in my view, the threshold has already lost its meaning as a guidepost. It needs to be replaced with something that is more relevant and informative.

This poses the challenge of how and what to communicate about policy going forward. Our actions and the data have made the current form of forward guidance outdated and mostly irrelevant. Indeed, one could reasonably wonder whether the inflation threshold has any meaning at this point. In other words, by allowing the unemployment threshold to pass without taking action, the public might conclude that the Committee could easily decide to let the inflation threshold pass without taking action as well.

Competing roles for forward guidance

Before we offer further forward guidance, it is important to be clear about what this forward guidance is intended to accomplish. As Yogi Berra is reported to have said, “You have to be careful if you don’t know where you’re going because you might end up somewhere else.”

One way to think of forward guidance is that it is just another step toward increased transparency and effective communication of monetary policy. This approach seeks to clarify how policymakers will alter policy as economic conditions change, that is, to describe a reaction function. By being more transparent about how policy will evolve as a function of economic conditions, this approach can help the public form more accurate expectations about the future path of monetary policy.

Economists have learned that expectations play an important role in determining economic outcomes. When businesses and households have a better understanding of how monetary policy is likely to evolve, they can make more informed spending and financial decisions. If monetary policymakers can reduce uncertainty about the course of monetary policy, the economy is likely to perform more efficiently.

Of course, in order to communicate something about the reaction function, you have to have one. That means in order to be successful with this approach to forward guidance, policymakers must be able to agree on how they will systematically respond to changes in economic conditions. To be useful, however, the reaction function need not be mechanistic. Qualitative information about such a function and how it will be implemented can also be useful and meaningful. Nevertheless, some degree of commitment to abide by the specified reaction function is necessary, if the communication is to achieve the desired result of reducing policy uncertainty and providing meaningful forward guidance. The excuse that “this time is different” undermines the commitment and the credibility of the information that the communication is seeking to provide. I would add that a committed and credible approach to such a systematic approach to policy is helpful and informative regardless of whether you are at the zero lower bound or not.

A somewhat different rationale or view of forward guidance is that it is a way of increasing accommodation in a period when the policy rate is at or near the zero lower bound. Some models suggest that when you are at the zero lower bound, it can be desirable, or optimal, to indicate that future policy rates will be kept “lower for longer” than might otherwise be the case. Thus, policymakers intentionally commit to deviating from what they would otherwise choose to do in normal times, such as following the Taylor rule. In these models, such a commitment would tend to raise inflation expectations and lower long-term nominal rates, thereby inducing households and businesses to spend more today.

This approach asks more of forward guidance than just articulating a reaction function. It takes more credibility and commitment because it requires policymakers to directly influence and manage the public’s beliefs about the future policy path in ways that are different from how they may have behaved in the past. As I have indicated in previous speeches, this

approach to forward guidance can backfire if the policy is misunderstood.¹ For example, if the public hears that the policy rate will be lower for longer, it may interpret this news as policymakers saying that they expect the economy to be weaker for longer. If that is the interpretation of the message, then the forward guidance will not succeed and may even weaken current spending.

The FOMC has not been clear about the purpose of its forward guidance. Is it purely a transparency device, or is it a way to commit to a more accommodative future policy stance to add more accommodation today? This lack of clarity makes it difficult to communicate the stance of policy and the conditionality of policy on the state of the economy.

Note that most formulations of standard, simple policy rules suggest that the federal funds rate should rise very soon – if not already. In other words, the zero lower bound no longer appears to be binding. However, the FOMC has provided forward guidance indicating that the federal funds rate will need to be low for some time to come.

How do we reconcile this apparent incongruity? It could be that the FOMC is using its forward guidance as a commitment device or signal for a more accommodative policy well into the future, as in the second approach I have discussed. Or, it could be the FOMC views forward guidance as a device for increased transparency but that it doesn't think the standard rules apply in the current environment. Then what rules do apply? If policymakers are not relying on a rule or a rule-like reaction function, policy is purely discretionary and forward guidance becomes ineffective. In either case, we have an opportunity and an obligation to provide more transparency and better communication.

This leads me to suggest that there is a more fundamental tension underlying our forward guidance and communication challenges. Forward guidance in either of the two approaches that I have discussed requires a degree of commitment to conduct future policy in some particular manner. That commitment is central to the success of either approach. Yet, I would suggest that the old “rules versus discretion” debate is alive and well. This, of course, is not a new tension within the FOMC, nor is it one that is likely to go away in the near term. But the heightened weight and prominence given to forward guidance as a policy tool has certainly shined a spotlight on this longstanding debate.

The desire to maintain flexibility to respond to “events on the ground” is a strong one. One can make the case that discretion is deeply ingrained in most policy institutions, particularly the Fed. Yet, the desire to maintain discretion is anathema to the commitment required for successful forward guidance. Policymakers cannot maintain discretion and simultaneously commit to forward guidance and expect that guidance to be effective.

So, I conclude as I began: Forward guidance and clear communications remain important challenges for monetary policymakers.

¹ See Charles I. Plosser, “Forward Guidance,” speech to the Stanford Institute for Economic Policy Research’s (SIEPR) Associates Meeting, February 12, 2013, Stanford, CA.