Discussion of Cieslak, McMahon, and Pang, "Did I Make Myself Clear? The Fed and the Market in the Post-2020 Framework Period"

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Review of the Federal Reserve's Monetary Policy Framework
Brookings Institution
June 14, 2024

Summary of Paper

- Thorough background on the 2020 FAIT framework
  - many examples, anecdotes
  - numerous quotes from FOMC members, news articles
- Discussion of successes and failures of FAIT framework
  - anecdotal and informal, but insightful
- High-frequency analysis of interest rate changes around macro announcements and FOMC announcements/communications
- Textual analysis of newspaper articles using ChatGPT
- Interest rate expectations vs. term premium responses

Summary of Paper's Conclusions

- The 2020 FAIT framework was a mistake I agree
  - designed to handle one specific problem I agree
  - difficult to communicate I agree
  - increased market uncertainty I agree
  - ended up constraining the FOMC I disagree
- Classic "risk management" approach better I agree
- Fed should be more explicit about bands around π^* I agree
  - shouldn't worry so much about small undershoots (or overshoots)
- Fed should give "scenario analysis"
- Fed should publish Tealbook forecast and/or SEP details I disagree

Comment 1: Point of Inflation Targeting was Clear Communication

- One of the main points of inflation targeting was clear communication with financial markets and the public:

“Inflation targeting is characterized by two features: an explicit numerical target or target range for inflation and a high degree of transparency about forecasts and policy plans.” (Bernanke, 11/14/2007)

“Among other important features of inflation targeting are vigorous efforts to communicate with the public about the plans and objectives of the monetary authorities and… strengthen the central bank’s accountability for attaining those objectives.” (Bernanke, Laubach, Mishkin, and Posen, 1999, p. 4)

“The use of inflation targeting increases public understanding of monetary policy, improves policy-maker accountability …” (BLMP, p. 6)

“We see the inflation-targeting framework as serving two important functions: (1) improving communication between policy-makers and the public, and, not unrelatedly, (2) providing discipline and accountability in the making of monetary policy.” (BLMP, p. 23)

“By making explicit the central bank’s medium-term policy intentions, inflation targets improve planning in the private sector , enhance the public debate about the direction of monetary policy, and increase the accountability of the central bank.” (BLMP, p. 23)

“Why spend so much effort on clarity and communication? The efforts by the inflation-targeting central banks to improve transparency and communication have been crucial to the success of the targeting regimes.” (BLMP, p. 296)

“Increased transparency would also reduce the financial and economic uncertainty associated with the Fed’s current procedures by giving the markets more information about what future monetary policies are likely to be. That would reduce substantially the costs incurred by financial analysts trying to guess what the Federal Reserve will do next and would make it easier for businesses and consumers to plan for the future, thus promoting economic efficiency.” (BLMP, p. 311)

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- In contrast, Cieslak, McMahon, and Pang provide extensive evidence that:
  - the 2020 FAIT framework was vague by design
  - policymakers themselves did not agree on details of the framework
  - markets and press sought more clarity and were rebuffed
  - term premia increased
  - FAIT seemed to create market uncertainty, confusion in 2021

- The 2020 FAIT framework was a giant step backward in communication and accountability

Comment 2: Communication Problems

Table IV:

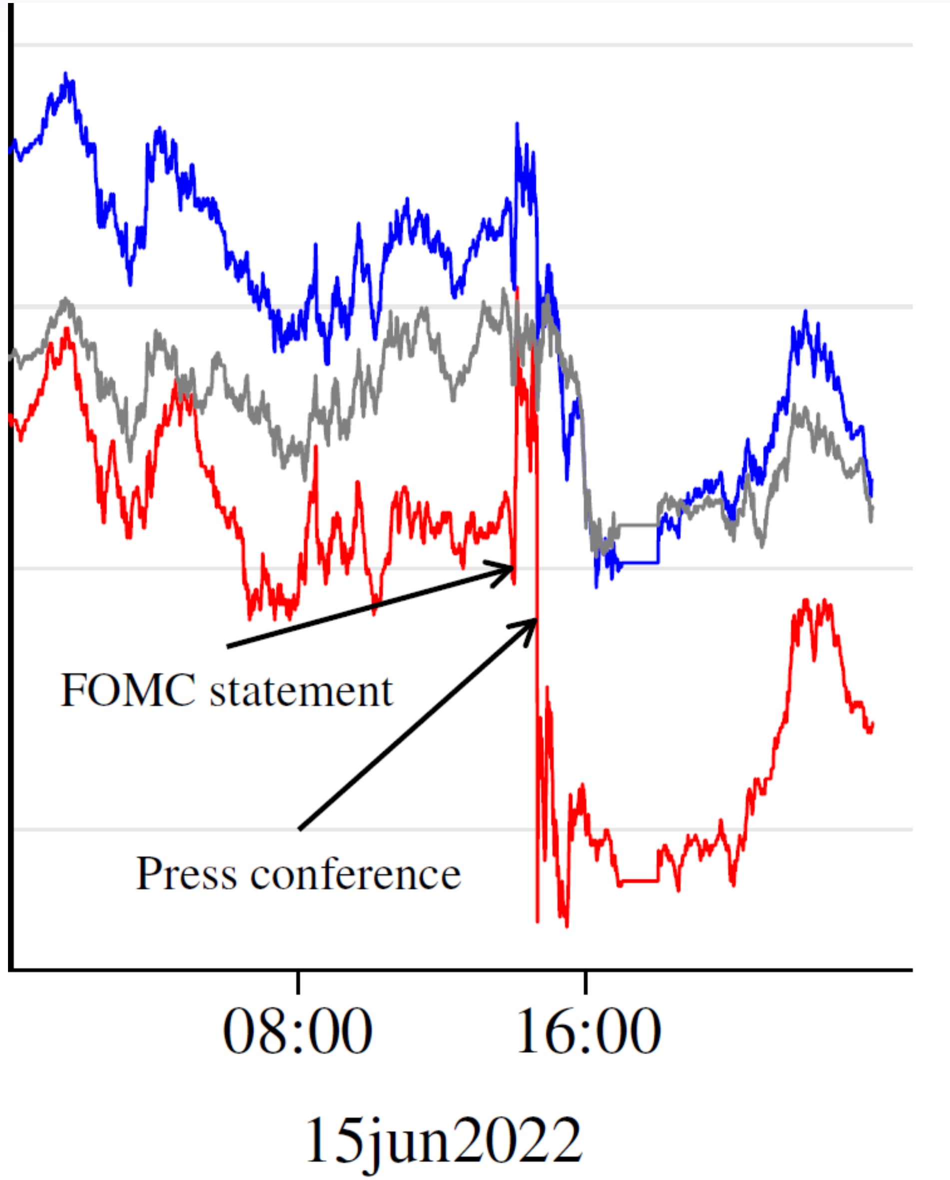
Sum of high-frequency market responses to: FOMC Announcements; Chair Press Conferences

Year	Asset	Total yld chng (bps)	MPD	PC
2020:8-2023:8	2y	422.9	31.0	-60.5
	10y	358.8	27.6	-49.1
	30y	325.4	24.4	-28.0

- This should not happen
  - with good communication, these columns should be uncorrelated
  - instead, Fed Chair systematically contradicted the FOMC
- Clear evidence of a communication problem
- Related to the 2020 FAIT framework? Not clear.

Comment 2: Communication Problems

Figure 11:



Comment 2: Communication Problems

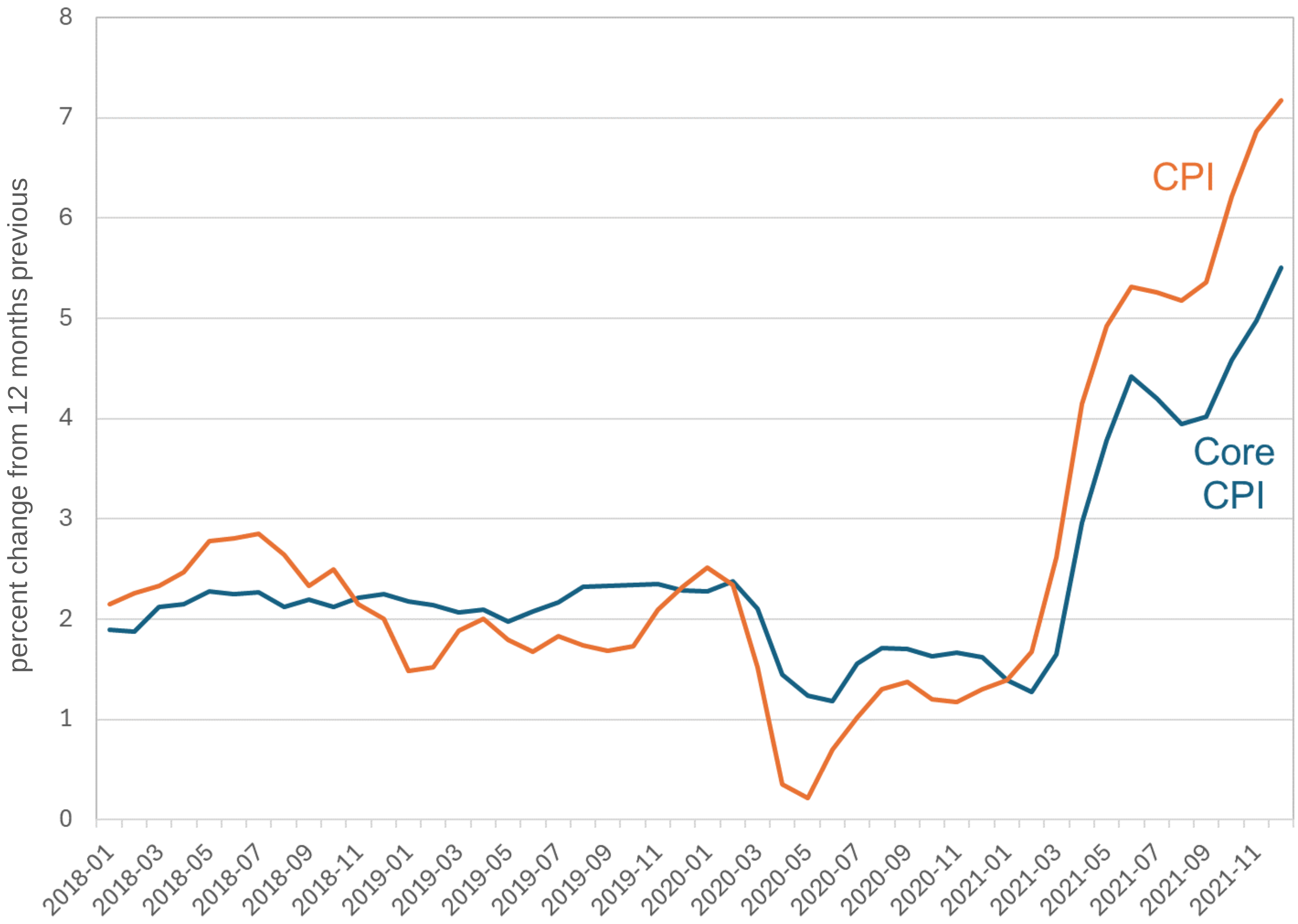
Swanson and Jayawickrema (2024):

	Eurodollar Futures				Treasury Yields				S&P500
	ED1	ED2	ED3	ED4	2yr	5yr	10yr	30yr	
(D) Explanatory R^2 for Monthly Interest Rate Changes and Stock Returns, 1988–2019									
FOMC Anncmts	**.123**	**.095**	**.065**	.046	.015	.022	.021	.018	.039
Chair Speeches	.030	.062	.064	**.071**	**.057**	**.053**	**.037**	**.039**	**.050**
Press Confs	.002	.001	.000	.001	.001	.005	.003	.001	.009
(E) Explanatory R^2 for Monthly Interest Rate Changes and Stock Returns, 2020–2023									
FOMC Anncmts	**.219**	**.207**	**.184**	**.169**	**.223**	**.171**	**.105**	**.052**	−.086
Chair Speeches	.003	−.010	−.011	−.009	.012	.016	.013	.016	−.001
Press Confs	−.137	−.137	−.087	−.062	−.063	−.053	−.028	−.016	**.040**

2020-2023 press conferences were, ex post, a serious communications failure

Comment 3: Fed Was Not Very Constrained by Its Fwd Guidance

Inflation in December 2021:



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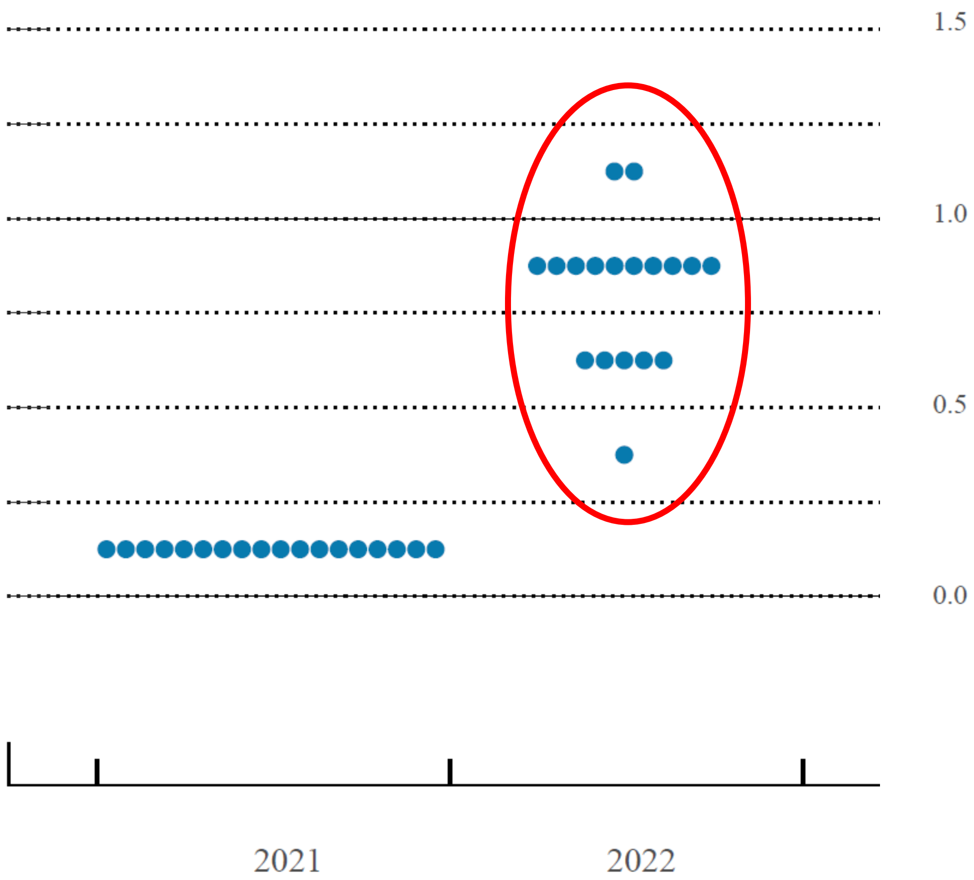
December 2021 Summary of Economic Projections:

Percent

Variable	2021	2022
Change in real GDP	5.5	4.0
September projection	5.9	3.8
Unemployment rate	4.3	3.5
September projection	4.8	3.8
PCE inflation	5.3	2.6
September projection	4.2	2.2
Core PCE inflation[4]	4.4	2.7
September projection	3.7	2.3



This does not look like the FOMC was constrained. It looks like they thought inflation would be transitory.

Comment 3: Fed Was Not Very Constrained by Its Fwd Guidance

If the Fed had been constrained in December 2021:

- SEP interest rate forecasts would have been hitting the constraint
  - instead, the FOMC soon set interest rates much higher
- SEP inflation forecasts would have been very high
  - instead, they were very low

Instead, it looks like monetary policy in late 2021 & early 2022 was set based on a bad assumption that inflation would be transitory.

Comment 4: Fed Should Publish SEP after Every Meeting

- Paper argues Fed should publish Tealbook, esp. staff forecast
  - puts political pressure on staff
  - creates significant risk of biasing staff forecast
  - e.g., there have been times when staff forecast changed dramatically
- Instead, publish the SEP after every meeting:
  - SEP is a fantastic resource
  - e.g., June 12, 2024 FOMC release
    and it would be very helpful to have SEP for July 30-31 meeting
  - avoids political pressure on staff forecast
  - minimal additional work
- Not necessary to connect dots to forecasts
  - SEP is extremely valuable as it is

Comment 5: Term Premium Fallacy

Changes in the term premium do not necessarily have the same effect on the economy as changes in expected path of short rates

- Rudebusch, Sack, and Swanson (2007 FRBSL ER)
- The term premium can change for many reasons. Different reasons imply different effects on the economy.

For example:

- Suppose a long-term real bond has no risk premium while comparable nominal bond has an inflation risk premium
- In equilibrium, firms & lenders are indifferent between the two rates
- If inflation risk premium goes up, in equilibrium, firms & lenders are still indifferent between the two rates
- Thus, higher term premium in this case does ***not*** imply lower investment

Summary

- Paper is an outstanding summary of Fed's post-2020 FAIT framework
  - well-written, thorough, informative, many good examples and quotes
- Authors are fair but ultimately critical of FAIT
- Suggest Fed should return to "risk management" oriented approach going forward

Some thoughts:

- 2020-2023 press conferences were a communications failure, not clearly related to FAIT
- Question the Fed story that it was constrained in late 2021 & early 2022
- Argue for publishing SEP every meeting rather than Tealbook forecasts
- Effects of term premia are not necessarily the same as effects of changes in short rate expectations