Fed's financial stability concerns and monetary policy[1]

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Even though the Fed does not have an explicit financial stability objective extending beyond its supervisory responsibilities, the public speeches of Fed officials, during the period 1997 to 2013, reveal that a higher speaking time or a higher negative tone on Financial Stability topics correlate with a more accommodative monetary policy stance. In contrast, communication on Housing topics correlates with a tighter policy stance. These results are mainly driven by the information in speeches of regional Fed presidents.

The Federal Reserve does not have an explicit financial stability objective that extends beyond its supervisory responsibilities. Nonetheless, a narrow interpretation of the dual mandate, i.e. ignoring any interactions between monetary policy and financial stability risks does not seem credible (see Kashyap and Siegert, 2020). Indeed, even in the absence of an institutionalised communication strategy, Federal Open Market Committee (FOMC) members do express their views on financial stability risks and policy consequences through informal public remarks.

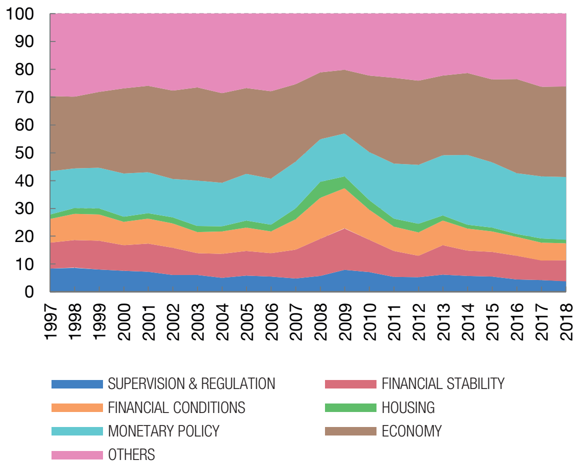
Therefore, we assess what Fed speeches reveal about financial stability concerns and whether there is a systematic relationship between higher proportion of time devoted to this topic and the Fed's monetary policy decisions (Istrefi, Odendahl and Sestieri, 2021). We focused on speeches because they give the speaker discretion over the content, and, to some extent, reflect debates and opinions expressed in FOMC meetings that have guided policy (Bernanke, 2015).

1 A similar version of this article was first published in Banque de France's Eco Notepad as blog post n°193 and as a SUERF Policy Note No. 80.

SPEECH-BASED FINANCIAL STABILITY INDICATOR

We computed speeches' topic proportions, using both a latent Dirichlet allocation (LDA) and a human refinement of the extracted LDA topics. Our dataset comprises around 3,850 public speeches given during the period 1997-2018 by Fed officials, i.e. the Chair of the Federal Reserve, the other members of the Board of Governors and the presidents of the 12 Federal Reserve Banks (FRB).

Chart 1
MAIN TOPICS COVERED IN FED SPEECHES



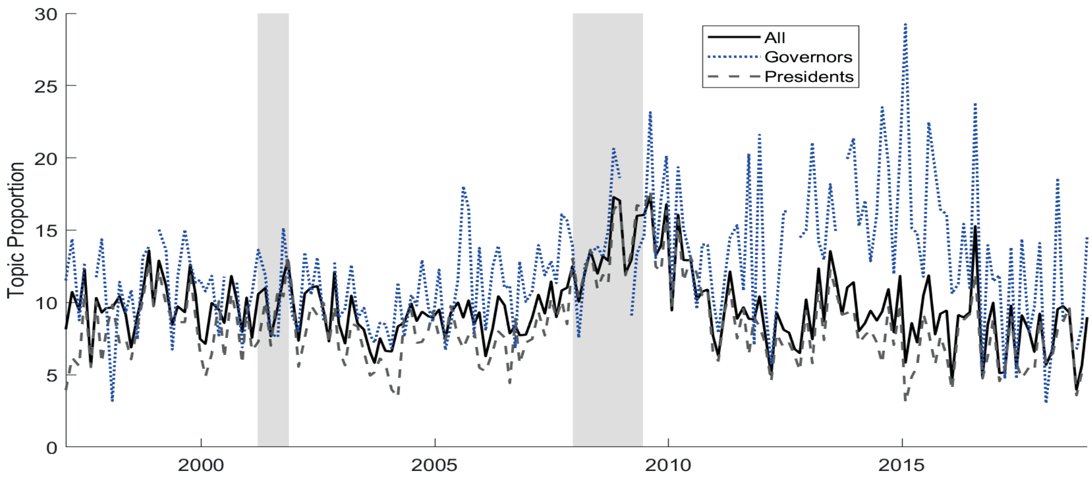
NOTE: The chart shows the proportion of six topics extracted from the Fed speeches for the period 1997 to 2018. The topic proportions displayed are annual averages.

Chart 1 shows the topic proportion of the six (of a total of 12) most important topics of Fed speeches at an annual frequency. We observe that, while Fed officials speak predominantly about issues related to the Economy and Monetary Policy (about 40-50%), in the period around the global financial crisis they dedicated a higher proportion of speaking time to Financial Stability and other financial-related topics.

Chart 2 zooms in on the financial stability topic, which relates mainly to communication about excessive behavior in financial markets or vulnerabilities in the financial system, showing the topic proportion at a FOMC meeting frequency. It becomes apparent that, for instance, members of the

Chart 2

FINANCIAL STABILITY TOPIC PROPORTION BY TYPE OF SPEAKER, 1997 TO 2018



NOTE: The chart shows the Financial Stability topic proportion at a FOMC meeting frequency by type of speaker: the Board members (Governors), the FRB presidents (Presidents) and both groups together (All). US recession periods are marked in grey.

Board of Governors devote, on average, a higher proportion of their speeches to Financial Stability than FRB presidents; especially after the global financial crisis (GFC). However, during the GFC, FRB presidents also significantly increased their speaking time on this topic.

DO SPEECHES CONTAIN A SIGNAL ABOUT MONETARY POLICY DECISIONS?

Next, we incorporate our speech-based indicator of financial stability into a Taylor-rule that contains a lag of the policy rate, the Fed's Greenbook forecasts of inflation and the output gap, and our financial stability speech-indicator. The policy rate is measured by the Federal Funds Rate (FFR) for the pre-Zero Lower Bound period (up to November 2008), and by the Shadow Rate (Wu and Xia, 2016) for the period after, to take into account the Fed's unconventional monetary policy. Results show that the proportion of financial stability communication prior to FOMC meetings is a relevant predictor for FFR changes, in particular for the period before the GFC. In other words, the intensity of speeches on financial stability provides additional information beyond what is captured by the Fed's internal forecasts of output and inflation. All other things being equal, an increase in the Financial Stability topic proportion is associated with a lower FFR, meaning an easing of monetary policy. This result is robust to different specifications of the Taylor rule and to the inclusion of standard financial indicators based on market data, such as the VIX.

These findings suggest that the Fed has rather acted to "clean" the damages than to "lean" against financial imbalances, internalising the negative impact of financial stability risks to the economy by setting a more accommodative monetary policy stance (see also Friedrich et al., 2019). Interestingly, we uncover a "leaning" stance when considering housing market concerns, i.e. when we include Housing topic in the Taylor-rule the coefficient is positive and significant.

DOES IT MATTER WHO THE SPEAKER IS?

The Taylor-rule coefficient associated with the financial stability speech-indicator have the same sign for speeches of the Fed Chair, the Governors and the FRB presidents.

However, we find that the FRB presidents' speeches contain a stronger signal for the likely direction of monetary policy (this result is not driven by speeches of New York Fed president). The fact that FRB presidents have less specialised positions than Governors, are more numerous and flexible in choosing the topics of their speeches, could rationalize this result.

Hence, even though FRB presidents are often criticised for cacophony by the financial press and market participants (e.g., see Olson and Wessels, 2016), our analysis suggests that their communication provides useful information for policy decisions according to a standard monetary policy reaction function.

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