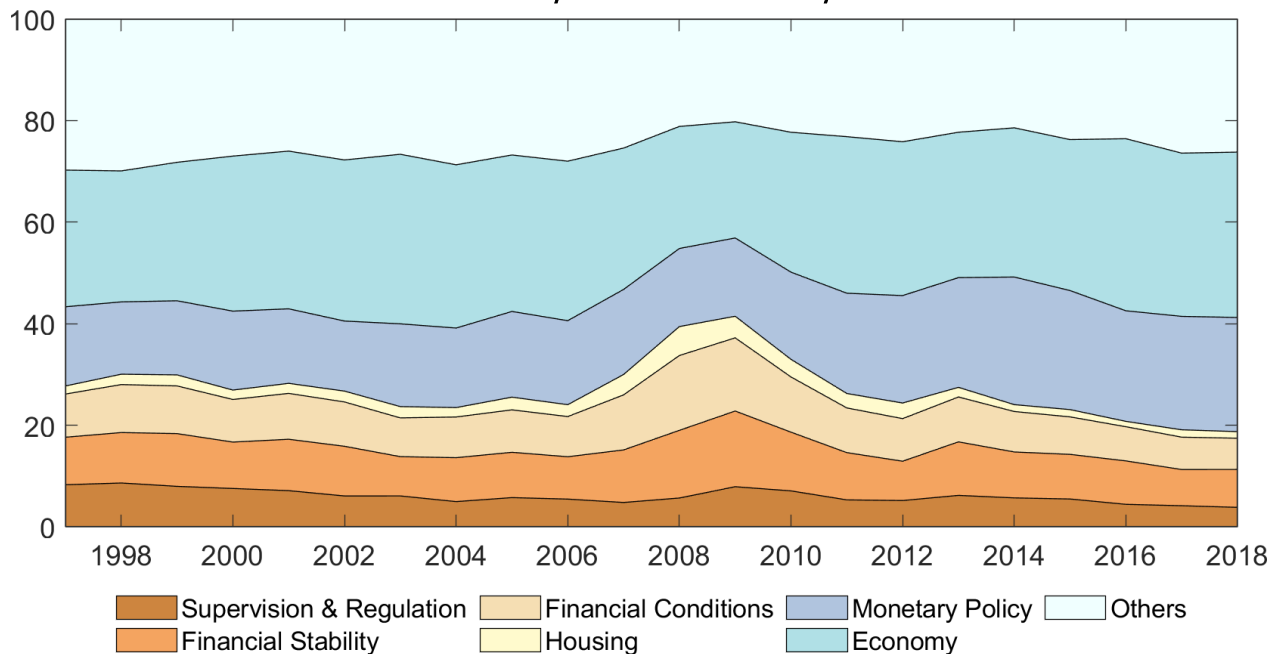


Fed's financial stability concerns and monetary policy

By [Klodiana Istrefi](#), [Florens Odendahl](#) and [Giulia Sestieri](#)

Even though the Fed does not have an explicit financial stability objective extending beyond its supervisory responsibilities, the public speeches of Fed officials reveal that there is a relationship between the higher proportion of speaking time on financial stability topics and more accommodative monetary policy. Financial stability became a topic of concern in Fed speeches especially around the global financial crisis.

Chart 1. Main topics covered in Fed speeches



Source: Istrefi, Odendahl, Sestieri (2020). 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.

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 would not be credible (see [Kashyap and Siegart, 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.

In a recent study, we assess what Fed speeches reveal about financial stability concerns and whether there is a relationship between higher proportion of time devoted to this topic systematically and the Fed's monetary policy decisions ([Istrefi, Odendahl and Sestieri, 2020](#)). We focused on speeches because they provide a more flexible form of communication compared to standard Fed communication through statements or reports. Moreover, speeches are likely to reflect the debates and opinions expressed in FOMC meetings that have guided policy ([Bernanke, 2015](#)).

Fed officials talked more about financial stability around the period of the global financial crisis

We analysed the main topics covered in Fed speeches, and consequently, their relative times in a speech, labelled as "topic proportion". To extract this information from speeches we employ textual analysis techniques, commonly used to extract information from text data. We looked at 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).

We identify 12 main topics covered in these speeches; for instance, Economy and Monetary Policy and several related to finance, such as Financial Conditions, Financial Stability, and Supervision and Regulation. Chart 1 shows changes in the topic proportions 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. Financial Stability, the topic at the centre of our analysis, relates mainly to communication about excessive behaviour in financial markets or vulnerabilities in the financial system that are likely to have major impacts on the economy. Thus, in our setup, this topic mainly reflects financial stability concerns.

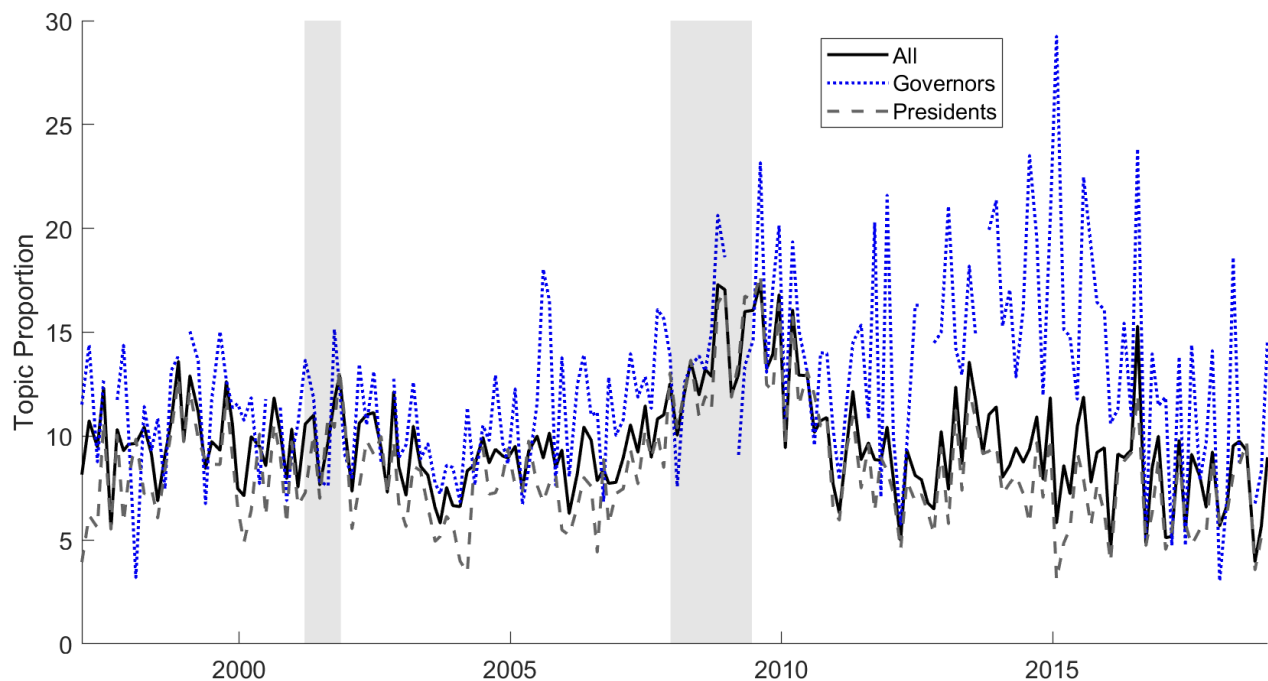
Governors and FRB presidents display differences in the intensity of communication on financial stability

While members of the Board of Governors and FRB presidents cover similar topics in their speeches, the intensity they assign to specific topics differs between them. This is the case for Financial Stability: 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 (see Chart 2). A similar pattern is observed for other financial-related topics, such as Supervision and Regulation.

These differences appear to reflect the Federal Reserve's institutional design and the specific

roles of these two groups. For instance, Governors and all the FRB presidents participate in the debate and decide on US monetary policy (the latter group is subject to a rotation of voting rights). Unsurprisingly, a large part of their speeches focuses on Economy and Monetary Policy. In addition, the Board of Governors writes regulations and creates supervisory policy for the Federal Reserve System. As part of their duties, Governors are assigned to several Board Committees, among them the Committee on Financial Stability and the Committee on Supervision and Regulation. This job "specialisation" of Governors could explain why in terms of public communication, they have more specialised speeches and therefore a higher average proportion of them in financial-related topics. The particular difference in intensity of speeches on financial stability between Governors and FRB presidents, especially during 2012-2016, corresponds to the implementation of new US banking and supervisory regulation over this period.

Chart 2. Financial Stability topic proportion by type of speaker, 1997 to 2018



Source: Istrefi, Odendahl, Sestieri (2020). 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.

Relationship between the higher proportion of speaking time devoted to financial stability by Fed officials and a more accommodative monetary policy

Do Fed speeches on financial stability concerns contain a signal about monetary policy decisions? To assess this, we incorporate our speech-based indicator of financial stability into a standard central bank reaction function. We regress the policy rate on the Fed's forecasts of

inflation and the output gap (a forward-looking Taylor rule), and on our financial stability speech-indicator. The policy rate is measured by the Fed 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 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 that which 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. We observe similar results for the Supervision and Regulation and the Financial Condition topics. However, for these two latter topics and unlike Financial Stability, an alternative text-based indicator that measures the degree of negative tone in speeches matters more than the intensity indicator. This might be because their corresponding topic words are not as negatively connoted as those for Financial Stability.

These findings suggest that the Fed acted rather to "mitigate" 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 [Wischnewsky et al. \(2019\)](#)). This Fed's attitude was observed at a time where effective macroprudential tools in the United States were lacking, especially before the GFC (see [Dudley, 2015](#)).

Does it matter who the speaker is? The speeches of the Fed Chair, the Governors and the FRB presidents on financial stability are all revealing. However, we find that the FRB presidents' speeches contain a particularly strong signal for the likely direction of monetary policy. While there might be other factors that matter, we conjecture that because FRB presidents have less specialised positions than Governors, are more numerous and flexible in choosing the topics of their speeches, there is more information in their speeches.. In addition, we find that the amount of FRB presidents' communication about financial stability is not driven by speeches of New York Fed presidents, despite of the central role of the New York Fed in the US financial system. 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 results suggest that there is valuable information in their public remarks.