The Term Structure of Monetary Policy Uncertainty

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FOMC announcements transmit to financial markets and the economy not only by changing the expected path of future interest rates but also by reshaping interest rate uncertainty across different horizons.

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This paper studies the transmission of Federal Reserve communication to financial markets and the economy using new measures of the term structure of policy rate uncertainty. High-frequency movements in the term structure of interest rate uncertainty around FOMC announcements cannot be summarized by a single measure but, instead, are two dimensional. We characterize these two dimensions as the Level and Slope factors of the term structure of interest rate uncertainty. These two monetary policy uncertainty factors help to explain changes in Treasury yields and forward real interest rates following FOMC announcements, even after accounting for changes in the expected path of policy rates. Finally, compared to high-frequency instruments derived from interest rate futures, our policy uncertainty factors provide stronger first-stage instruments and imply FOMC forward guidance has been more effective in stimulating economic activity in a standard proxy SVAR.

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