The Term Structure of Monetary Policy Uncertainty

by: Brent Bundick, Trenton Herriford and A. Lee Smith

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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.

JEL Classifications: E32, E52

Additional Files

Appendix

Article Citations

- Bundick, Brent, Trenton Herriford, and A. Lee Smith. 2022. "The Term Structure of Monetary Policy Uncertainty." Federal Reserve Bank of Kansas City, Research Working Paper no. 22-02, February. Available at https://doi.org/10.18651/RWP2022-02

Related Research

- Hanson, Samuel G., and Jeremy C. Stein. 2015. "Monetary Policy and Long-Term Real Rates." *Journal of Financial Economics*, vol.115, no. 3, pp. 429-448. Available at https://doi.org/10.1016/j.jfineco.2014.11.001

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Authors

Brent Bundick

Sr. Research and Policy Advisor

Brent Bundick is a Senior Research and Policy Advisor in the Economic Research Department of the Federal Reserve Bank of Kansas City. He rejoined the Department in 2014 after completing his Ph.D in Economics from Boston College. Prior to graduate school, Brent worked in the Department as a Research Associate and Assistant Economist. He also holds a M.S. in Mathematics and Statistics from the University of Missouri – Kansas City and a B.A. in Economics and Mathematics from the College of William and Mary. Brent's research interests are macroeconomics, monetary policy, and computational economics.

A. Lee Smith

Senior Vice President

Andrew Lee Smith is a Senior Vice President and Economist at the Federal Reserve Bank of Kansas City. In this role, Lee has oversight of macroeconomic research and serves as an advisor on monetary policy matters.Lee’s research has focused on the effects of expanding and unwinding the Federal Reserve’s balance sheet, the impact of forward guidance on financial markets and the economy, and, more generally, how central bank communication can influence expectations and economic conditions.Prior to joining the Bank in 2014, Lee received a Ph.D. in economics from the University of Kansas. He also holds a B.A. in economics and mathematics from Drury University in Springfield, Missouri.