Discussion of
"FCI-plot: Central Bank Communication through Financial Conditions" by Caballero-Simsek

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The FCI-Plot Proposal

- "Communicate" FCI_t (Financial Condition Index)
  to **enlist** financial arbitrageurs to lean more strongly against financial noise traders
  - future FCI_ts - a whole path (scenario-contingent) i.e. "**FCI-forward guidance**"
  - unlike interest rate rule (reaction function),
    FCI_t is **not** a policy **instrument** – pure communication

  - Expand the SEP projections

- Pure communication ("**Delphian**") CS25

- Communication and commitment ("**Odyssean**") CS24 (previous paper)
  (to overcome time-inconsistency problem)

Halls of Mirror Effect – A Warning Bernanke 2004

- A situation in which a CB's **reaction function** and **financial market prices interact** in economically suboptimal and potentially destabilizing ways
- Central bank policy choices and private sector beliefs about the economy are intertwined and lead to **unintended consequences**, like **self-reinforcing effects** that undermine the effectiveness of monetary policy.

- The central bank's expectations excessively reflect the private sector's expectations and vice-versa.
  - For example, the central bank cuts interest rates sharply in response to a recession.
  - Private agents mistakenly attribute it to Fed's views about the long-run real interest rate in the economy.
  - In response, the private sector lowers their own estimate of r-star, prompting output and inflation to fall.

“Whispering Effect” Jeremy Stein

- Central bank does not want to scare and erupt financial markets
- Speaks only “softly”
- Financial markets listen more carefully and interpret any micro-announcement
- Central bank speaks even more softly
- Financial markets interpret every nano-announcement
- ….

FCI – Which One? How to Design?

- One-dimensional or multi-dimensional index

- Big decision:
  - **Price of risk** / risk premium / spreads (portfolio choice/investment)
    - For which risk/market (if financial markets are segmented)
    - Tail risks (or normal risk)
  - Market **capitalization** to capture **wealth effects** (of consumption) CS24/25
    - In model p_t = market capitalization of all wealth (including government bonds)
    - Indirectly the price of risk through $Var(p_{t+1})$ to reduce arb's risk exposure

CS24/25: FCI vs. Output Gap Communication

- Consumption$_t$ = time preference rate $*$ $\mathbf{Net\ worth}_t$ (wealth) $= \rho * p_t$ (log-utility)
- Hence, FCI-communication of $\{\mathbb{E}_t p_s\}_{s \geq t}$ = communication of consumption
  = output-communication (since no investment)
- In CS25:
  Communication about output is as good as FCI-communication
  - Q: Why to add FCI-communication?
  - Q: What should one communicate if FCI and output are not 1:1-connected?

- In CS24: FCI and output are not 1:1-connected due to noise term δ_t
  - **actual** objective function has output gap (and inflation gap) as argument (not FCI gap)
  - **operational** objective function includes FCI gap (process) $\{p_s\}_{s \geq t}$ (with weight ψ)

  - **Odyssean Commitment (forward guidance)**…
    committing to "operational objective function" (with small ψ-weight) allows superior implementation than actual objective function (ψ=0) due to partial commitment.

Communication & Rule: Policy Instrument vs. Input

- **Single instrument: Only Interest rate**
  - **Taylor Rule** + Communication — Caballero-Simsek (2025)
  - $i_t = r_t^* + \pi_t + f(\pi_t - \pi^*, \underbrace{output_t - natural\ output_t^*}_{output\ gap\ (FCI_t - FCI_t^*)})$
    - FCI gap ⇔output gap (1:1-function)

- **Multiple Instruments + price of risk focus**
  - "Generalized/multi-dimensional Taylor Rule" — Alexandrov-Brunnermeier (2025)
  - Interest rates (excess, required reserves), price of risk, …
  - $\begin{pmatrix} i_t, \underline{i}_t \\ QE, QT, \text{price of risk} \end{pmatrix} = F(\pi_t - \pi^*, output\ gap, Financial\ Condition)$
    - FCI gap ⇏ output gap

Tantrums and FCI-Communication

- "Tantrum theory":
  - Abrupt believe changes about future monetary policy **PATH**
  - Tipping point – jump in equilibrium/incl. higher order beliefs
  - In CS25: financial market arbitrageurs' beliefs about Fed's "pstar" differs from Fed's suddenly released!
  - Q: Does discontinuous jump with FCI communication just occur earlier – when announcement occurs

- Gradual communication
  - Is FCI release sufficiently subtle?
  - Can FCI-communication be smoothed? What's the optimal frequency of revisions?

Financial Dominance

- Excessive volatility of price of risk
  due to imbalances in financial system

- **Financial Dominance**
  limits monetary policy space because it ruins financial stability
  (impairment monetary transmission mechanism)

- Q: Does FCI-communication limit or enhance financial dominance?

Political Economy: Fed is Seen as giving Investment Advice

- Predicting the value of all asset, market cap of S&P plus bond portfolio, p_t^* can be interpreted as **investment advice** from the FED
- SEP projections of GDP growth, unemployment, and inflation is not (despite hair diagram)
- Investors might make Fed responsible for losses from this "advice"
- E.g. Greenspan's "Irrational exuberance" statement is still controversial
- It might damage Fed's independence.

Wall Street vs. Main Street Communications

- Does FCI-communication simplify or complexify communication?
- Who will benefit primarily?
  - Wall Street or Main Street
  - Does it create asymmetric information between them?
- CS argue that Main street doesn’t need to know.

FCI communication, in sum

- Generally, I am sympathetic to more communication on Financial Conditions, but …
  - Halls of Mirror
  - Whispering Effect
- Communication (Delphian signaling only) vs. Commitment (Odyssean)
- What is a good FC Index?
  - Can it be reduced to a one-dimensional index?
  - What should it reflect? Market cap (incl. bonds) or price of risk/risk premia
  - SEP: Why not communicate in addition to GDP growth rate, if Market cap = consumption = output
- Multi-dimensional policy instruments: balance sheet measures (price of risk)
  - Communicating “Generalized Taylor Rule”
- Tamper Tantrum
- Investment advice problem: Threatens Fed Independence