DISCUSSION OF

"Did I make myself clear? The Fed and the market under the 2020 monetary policy framework"

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European Finance Association | August 2026

This paper

- Theory
  - Reaction function uncertainty is priced in asset markets
  - The price is higher when inflation is far away from target

- Empirics
  - Increase in risk premia following Powell's 2020 Jackson Hole speech, which signaled a new, complex, and unclear monetary policy framework
  - High-frequency evidence of common bond & stock risk premia (consistent with policy, inconsistent with demand shock fundamentals) around policymaker speeches
  - More pronounced when inflation took off

- An excellent, important, and timely paper!
  - You think 2020 increased monetary policy uncertainty?

This paper

- Theory
  - Reaction function uncertainty is priced in a
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- Empirics
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  - Increase really took off when inflation too
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When is policy uncertainty priced?

- Risk Premium: $\mathrm{RP} = -\mathrm{Cov}[M, R]$
- Let θ denote a vector of policy parameters [stochastic from investors' perspective],
  Z denote a vector of fundamental shocks

- Law of total covariance:
- $\mathrm{Cov}[M, R] = \mathrm{E}_\theta\left[\mathrm{Cov}_Z[M, R|\theta]\right] + \mathrm{Cov}_\theta\left[\mathrm{E}_Z[M|\theta], \mathrm{E}_Z[R|\theta]\right]$
  - $\mathrm{Cov}_Z[M, R|\theta]$: the "fundamental" risk premium for a given policy θ
  - $\mathrm{E}_\theta\left[\mathrm{Cov}_Z[M, R|\theta]\right]$: average "fundamental" premium across policies
  - $\mathrm{Cov}_\theta\left[\mathrm{E}_Z[M|\theta], \mathrm{E}_Z[R|\theta]\right]$: policy risk premium

INSIGHT policy risk premium will be nonzero only if
expected SDF **and** **expected returns** both depend on policy

When is reaction function uncertainty priced?

- Reaction functions are a particular kind of policy
- First order: they only matter when there is something to react to

Scenario	What to expect	Risk premium impact
At target	Nothing to react to — inflation and output gap at target, rate stays at r*, regardless of policy stance	None — outcome is invariant to the policy parameter
Above target	Rate hike expected; size increases with policy aggressiveness	More aggressive → larger hike: negative discount-rate news; lower consumption (higher MU) ⇒ + risk premium
Below target	Rate cut expected; size increases with policy aggressiveness	More aggressive → larger cut: positive discount-rate news; higher consumption (lower MU) ⇒ + risk premium

Positive policy premium either side of target, increasing in distance to target

When is reaction function uncertainty priced?

- Reaction functions are a particular kind of policy
- First order: they only matter when there is something to react to
- Second order: precautionary savings
  - Standard models: conditional consumption vol enters both M (and hence R)
  - If more aggressive inflation policy makes consumption more volatile, higher SDF and lower return → positive risk premium **at target**
  - In this model: miniscule force, linearized away
  - In any model that generates quantitatively plausible risk premia, it would matter
  - And could generate real effects…

Taking the framework to the 2020-2022 data

- Model comparative statics: mean-preserving spread in policy uncertainty
  - A useful pedagogical tool
  - Shows policy uncertainty is priced iff away from target
  - Puts a little bit of NK meat on the bones of the Law of total covariance

- Data: more complicated
  - Complex new policy framework
  - *"following periods when inflation has been running persistently below 2 percent, appropriate monetary policy will likely aim to achieve inflation moderately above 2 percent for some time"*
  - simultaneous change in first and second moments

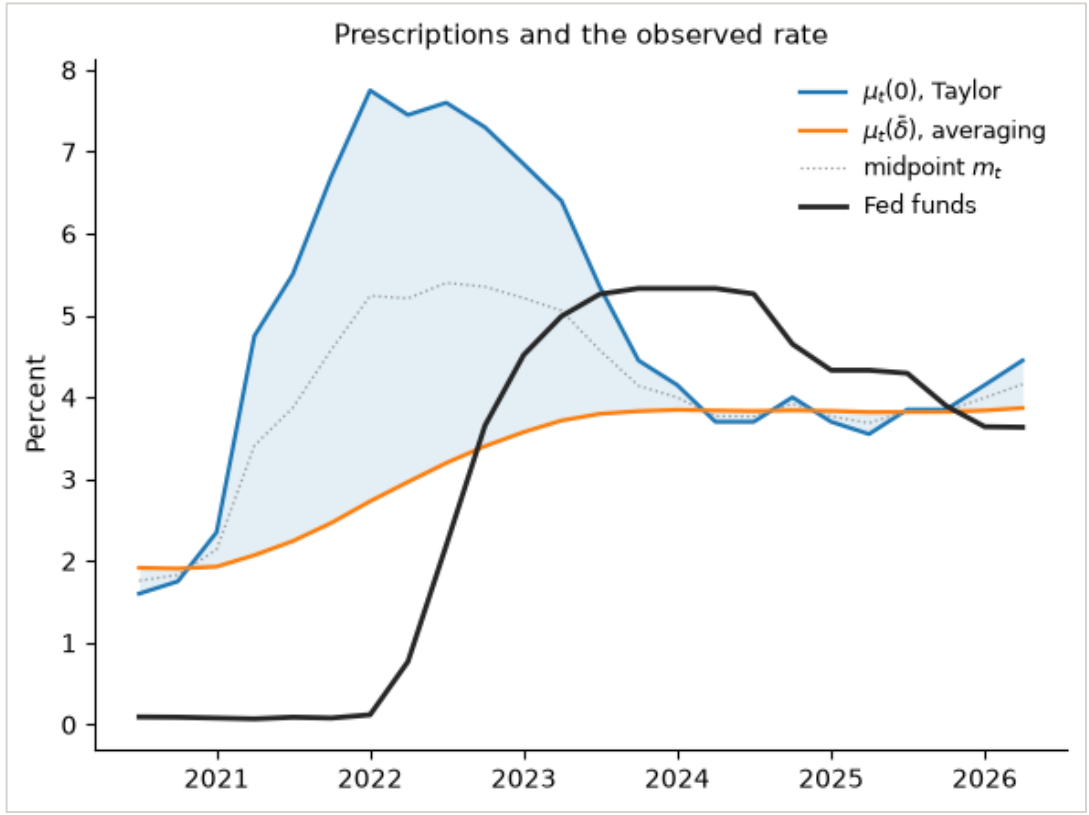
- To me, suggests a learning model

Markov-switching Monetary Rule

- A parsimonious implementation of FAIT:

- $\hat{\imath}_t = \phi\, \tilde{\pi}_t + \nu_t$ where
  - $\nu_t \sim N(0, \sigma^2)$
  - $\tilde{\pi}_t = (1 - \delta_t)\hat{\pi}_t + \delta_t\, \tilde{\pi}_{t-1}$

- $\delta_t \in \{0, \bar{\delta}\}$ indicates FAIT adherence
  - $\delta = 0$: standard rule
  - $\delta = \bar{\delta} = 0.95$: rule that would rationalize a neutral stance in Q4 2021 (when inflation was 4.8%)



Market Participants Must Learn δ_t

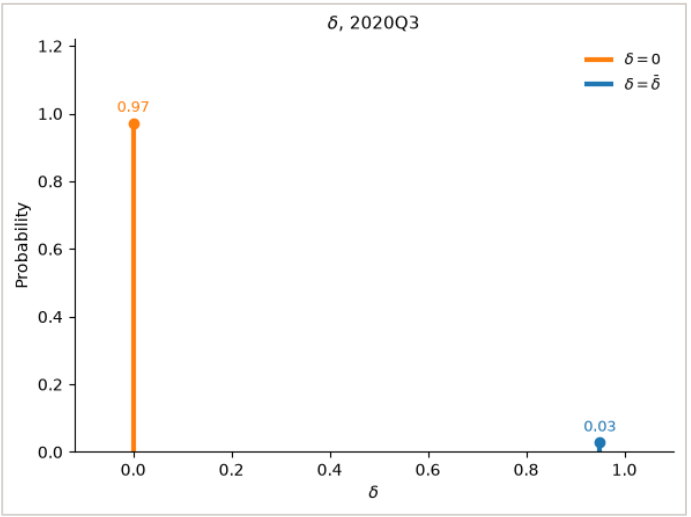
- 2020Q2: tight priors on the zero regime

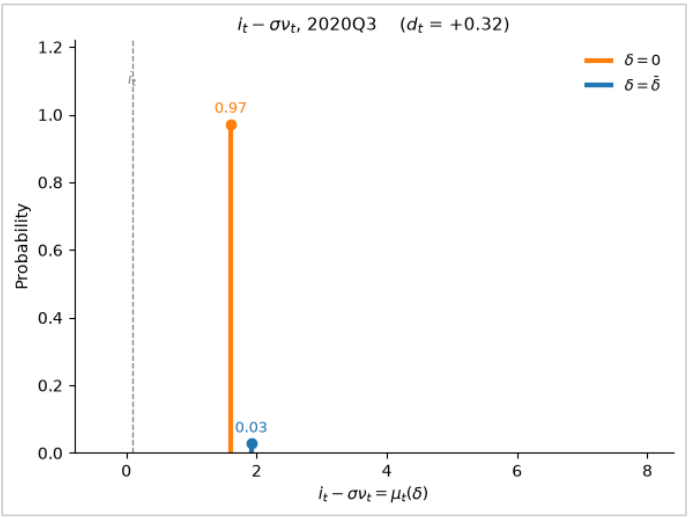
- Then, Bayesian learning from
  - Communication (extensively documented by this paper)
    - Powell's speech
    - subsequent policymaker speeches signaling $\bar{\delta}$ regime
    - then abrupt switch back to 0 regime
  - Action:
    - low $\hat{\imath}_t$ despite positive and rising $\hat{\pi}_t$
    - Then rapid hikes and much later gradual cuts even as $\hat{\pi}_t$ reverted close(ish) to target

- I don't have the text parsing abilities of this team…
  - And coding surprises in messaging from text alone is hard:
    - a hawkish message can be dovish relative to even more hawkish expectations…
  - So for illustration I'll stick to actions

An Illustrative Calibration

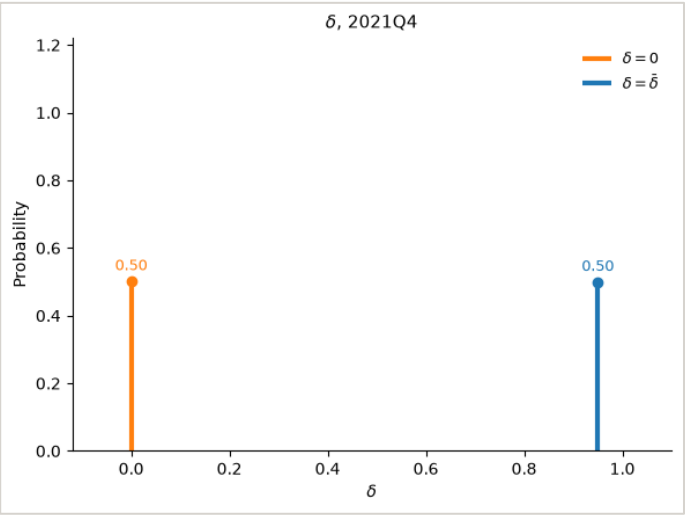
- Aug 2020: speech increases the probability of $\delta = \bar{\delta}$ regime
  - Higher uncertainty about δ regime
  - Not (yet) higher uncertainty about $\hat{\imath}_{t+1}$ because $\pi_t \approx \tilde{\pi}_t$
  - Rules close to observationally equivalent
    - d = difference btw the prescriptions

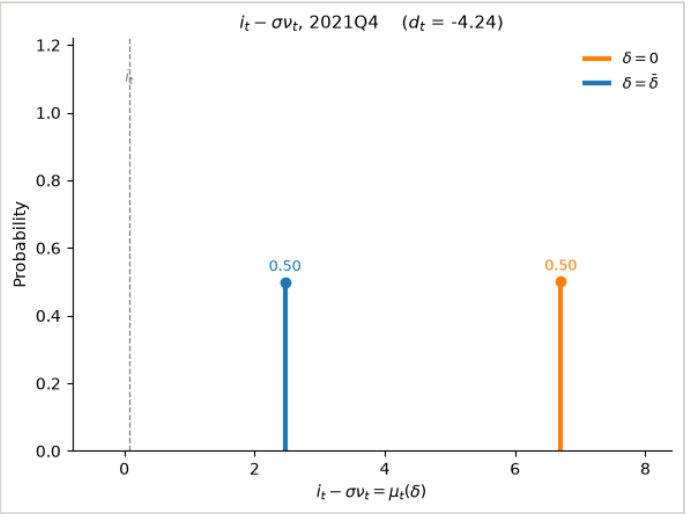




An Illustrative Calibration

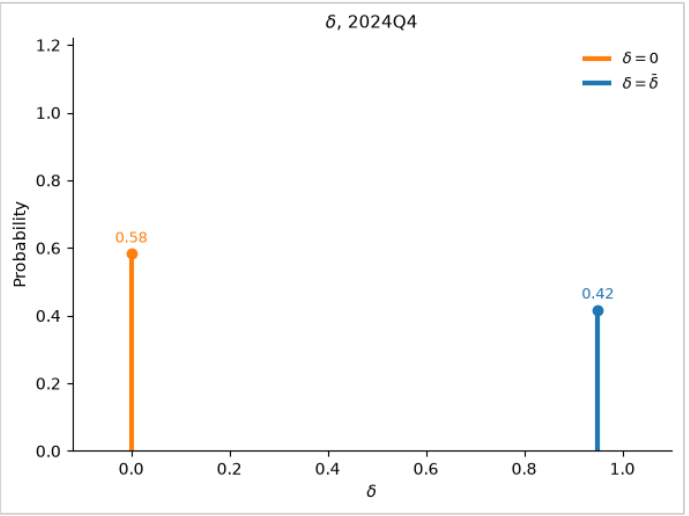
- Aug 2020: speech increases the probability of $\delta = \bar{\delta}$ regime
- 2020-2021: π_t rises
  - Even without updating
    - Uncertainty about δ now matters because $\pi_t > \tilde{\pi}_t$
    - so different rules prescribe different policies
    - Risk premia go up
    - $E_t[\hat{\imath}_{t+1}]$ also declines: suggests less aggressive rule
  - Further updating towards $\delta = \bar{\delta}$ b/c $\hat{\imath}_t$ is flat
    - Whether or not this increases δ uncertainty depends on $E_t[\delta_{t+1}] \lessgtr \bar{\delta}/2$

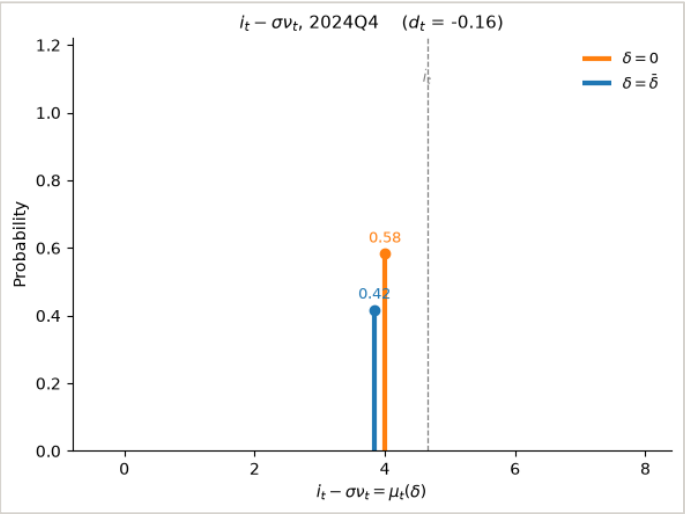




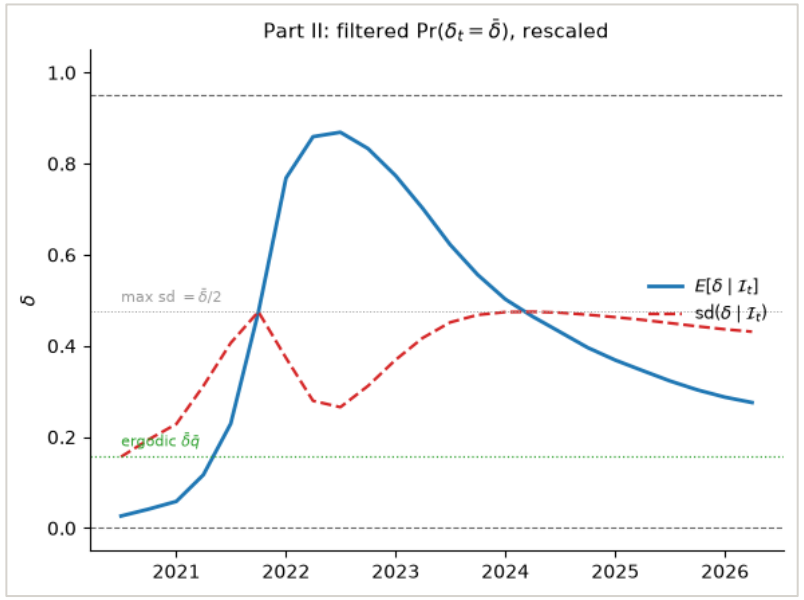
An Illustrative Calibration

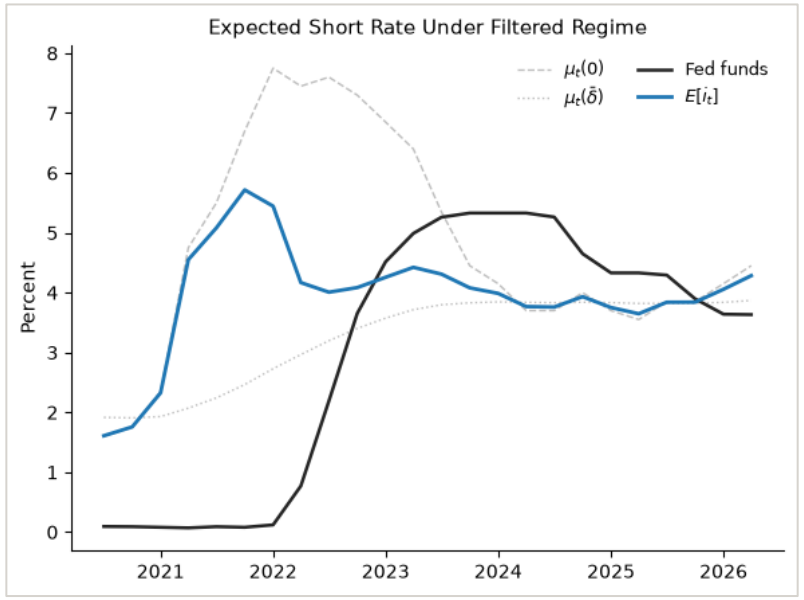
- Aug 2020: speech increases the probability of $\delta = \bar{\delta}$ regime
- 2020-2021: π_t rises
- 2022-2024: $\hat{\imath}_t$ rises, π_t falls
  - Aggressive response indicative of 0 regime
  - "Raw" uncertainty reduced if previous posterior was still closer to 0 than $\bar{\delta}$
  - Lower inflation is closer to target, so again policy matters less.
  - Rate uncertainty and risk premia lower

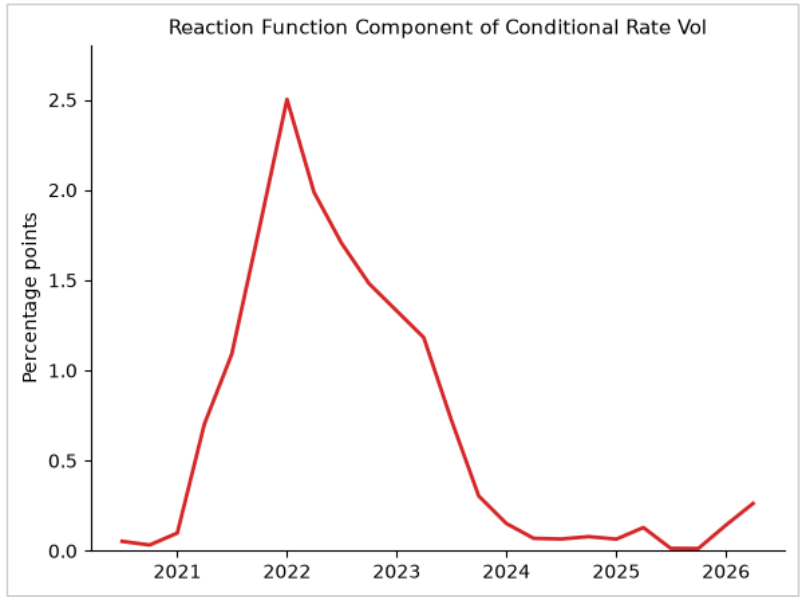




Brief Dalliance with FAIT➔ Uncertainty Spike







Uncertainty "tent" consistent with authors' empirical evidence

Why not deliberate time-varying uncertainty?

- Paper is quite adamant that policy uncertainty is bad
  - *"The Fed should strive to achieve outcomes with instruments it can control best, and controlling long-term rates is undoubtedly hard (Stein and Sunderam, 2018)"*

- But given that they do, why not through policy uncertainty?
  - Hard to vary second moment independently from the first: but maybe you don't need to
  - Damages credibility: where is this force in our models?
  - Huge rounds of asset purchases/balance sheet expansions aren't great either…

- Downside of attaching an asset pricing block to a textbook 3-equation linearized NK model: risk premia don't affect real quantities
  - So why do we care about them? Clearly, because we believe they do in the data