Policymakers' Uncertainty: The Risk-Management Channel

Anna Cieslak
Duke University, Fuqua School of Business

Abstract

How do monetary policymakers respond to risks, and why? Using FOMC private deliberations from 1982 to 2019, we construct individual-level measures of policymakers' perceptions of upside and downside risks to inflation and growth. Perceived upside inflation and downside growth risks significantly affect policy stance, both actions and forward-looking signals, even after controlling for policymakers' expected economic conditions. Risk management leads to systematic deviations from standard certainty-equivalent policy rules. We provide evidence that policymakers actively adjust policy to mitigate tail risks that are themselves endogenous to policy. Using textual evidence on policymakers' reasoning, we isolate an insurance channel and show that it accounts for up to a quarter of the variation in identified monetary policy shocks. Since the early 1990s, the Fed has successfully managed upper inflation tail risks to prevent expectations disanchoring, yet at the cost of weaker economic activity.