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Fed Thoughts: The End of History?

A new chapter in the history of Federal Reserve communications policies will open at the policy setting meeting on January 24th and 25th. All FOMC participants will now include their expectations for the appropriate level of the fed funds rate corresponding to their economic projections. They will also indicate the date at which they each expect to start raising the policy rate. In addition, news reports strongly suggest that the Fed will issue a statement of its longer-run goals and policy strategy.

Many market participants admit to being somewhat confused about the new disclosure policy. The exercise should be viewed as incremental in nature, limited by design flaws, and as likely to cloud as to clarify the public's understanding of policy intent, at least at the outset. And the mission statement, if one appears, may amount to little more than a strong commitment to motherhood and apple pie among central bankers — i.e., the importance of price stability in the long run — but provide no practical guidance as to near-term policy choices.

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A new chapter in the history of Federal Reserve communications policies will open at the policy setting meeting on January 24th and 25th. As promised in the minutes of the December meeting, all FOMC participants will now include their expectations for the appropriate level of the fed funds rate corresponding to their economic projections. They each will also indicate the date at which they expect to start raising the policy rate. In addition, news reports strongly suggest that the Fed will issue a statement of its longer-run goals and policy strategy.

The move to release more information about the path of interest rates is the compromise that we expected (see "Fed Thoughts for 2012: Into the Heart of Darkness," December 28, 2011). Fed officials are too disputatious to agree to a simple description of their policy setting, so they settled on reporting what they expect to do. By this logic, though, agreement on a mission statement would come as more of a surprise. If Fed officials agree on such a description of policy strategy at the upcoming meeting, then its drafters are likely to have pitched a very large tent to encompass the wide span of views on critical issues among FOMC participants.

The announcement of the new communications policy was initially met with an enthusiastic reception among analysts and market participants. Too enthusiastic, at the time, and now most market participants admit to being somewhat confused about the new disclosure policy.

To be sure, releasing the policy assumptions guiding their economic forecast will make the Summary of Economic Projections (SEP) more complete.[1] It will shed some light on the implied policy rule across Fed officials, as well as their view on the real short-term interest rate that prevails in the long run. It creates another policy instrument by giving the Fed a vehicle by which it can signal policy intent so as to shape market expectations. The exercise, however, should be viewed as incremental in nature, limited by design flaws, and as likely to cloud as to clarify the public's understanding of policy intent, at least at the outset. And the mission statement, if one appears, may amount to little more than a strong commitment to motherhood and apple pie among central bankers — i.e., the importance of price stability in the long run — but provide no practical guidance as to near-term policy choices.

We will deal first with the SEP and then with the mission statement.

Increased Disclosure about the Interest Rate Path
Thinking through the issue requires answering three questions.

- What will the Fed do?
- What does the Fed think it will accomplish?
- Why might there be less there than it seems?

Our advice is to prepare for a bumpy ride. The Fed and most people watching the Fed are not on the same page.

What Will the Fed Do?
Four times a year, FOMC participants submit their forecasts of real GDP growth, the unemployment rate, and headline and core PCE inflation for the current and next few years, along with their expectations of those variables in the long run. The full range of those responses is presented, along with the central tendency, which trims the sample by tossing out the three top and bottom responses.

Starting next week, the survey will include each participant's assumption about the appropriate stance of policy underlying their economic projections. Probably responding to increasing market angst about the new policy, the Fed published the template it will follow to release the information.[2] There are a couple of points of note about the general process and the Fed's specific template.

First, policy makers will not be reporting what they forecast the Committee will actually do, but rather what they personally think is the right policy path to follow. Individual recommendations may differ markedly from the consensus view. A participant on the fringe of the consensus might well believe that the Fed will make a mistake by not listening to them.

Second, in a world of unconventional policy action, measuring the stance of policy is not a simple exercise. FOMC

[1] An Acronym Obsessed Agency (AOA), the Fed has added SEP to their alphabet soup. Be prepared for news articles and newsletters with titles reporting a divided committee as "SEP-a-ration" or a particularly bad policy outcome as "SEP-tic". One hopes that Fed officials do not refer to the accumulation of reports over time as SEPs, because an African snake-like lizard with almost non-existent legs had the name first and might take offense.

[2] http://www.federalreserve.gov/newsevents/press/monetary/fomcchartstemplates20120120.pdf

participants will report three aspects of their economic outlook: What will the fed funds rate average in the final quarter of each year in the forecast period? When should the rate target be moved off its zero floor? And are any other policy actions — say, changes in the size or composition of the balance sheet or in the administered rate structure — called for over the forecast period?

The first two can be incorporated in the standard presentation of the SEP. The first, the appropriate funds rate, presumably can be a new row item, treated symmetrically to the already published real GDP and inflation forecasts. The second, the date of the first tightening, can be a memo item, presented in terms of the full range of responses and the trimmed central tendency.

The third item will be the equivalent of the essay portion of an exam, as quantitative easing is hard to quantify. The size of the Fed's balance sheet, for instance, rose by $600 billion under QE2 but is unaffected by Operation Twist. Both programs, however, removed about the same duration-equivalent value of Treasury securities from the hands of the public. Presumably, FOMC participants will be invited to specify any additional policy action that they deem necessary in an addendum to their outlook submission. Fed staff will then draft a few minutes-style paragraphs summarizing the range of preferred policies.

The Fed's clarification of its SEP disclosure on Friday was itself somewhat unclear. They intend to attach two figures to the standard table that give:

1. The distribution of responses for the *year* of first tightening; and

2. A scatterplot giving individual projections of the appropriate average fed funds rate in the fourth quarter of each of the next several years and in the longer run.

According to press reports, the narrative discussion of other potential policy actions will be released with the minutes, three weeks after the meeting.

This news was disappointing on a few levels. The clarification did not make clear whether the rate expectations will also be included in the SEP table. Not doing so would be a shame, because the Fed would miss the opportunity to emphasize that the interest-rate path is an integral part of the forecasting exercise. Also, the Fed will only report the year when tightening is expected to begin, which is mostly redundant given that it will also report participants' year-end funds rate.[3] Worse still, the narrative description of other preferred policy initiatives comes late in the process, leaving market participants to wonder for three weeks, "Is that all there is?"

What Does the Fed Want to Accomplish?

The financial dislocations of the past few years have shown that central banks do not run out of ammunition after they have pushed their nominal policy rate to zero. One focus has been to turn monetary policy makers into telegraph operators. In particular, the stance of policy can be eased (or tightened) by conveying to market participants that the policy rate will be kept lower for longer (or shorter) than previously expected. An attraction to central bank economists is that this sort of action can be analyzed in the formal models used to inform monetary policy decisions. In practical terms, the Fed hopes that a zero in the appropriate column of the SEP will signal that the Committee will not tighten that year. This will be underscored by the memo item giving the expected date of the first tightening.

The Fed, of course, already has a mechanism to send this message — the words of its statements released at the conclusion of policy meetings. The December statement held that:

> The Committee…currently anticipates that economic conditions — including low rates of resource utilization and a subdued outlook for inflation over the medium term — are likely to warrant exceptionally low levels for the federal funds rate at least through mid-2013.

By translating those words into numbers, the Fed's new policy updates the expected interest rate path automatically with each forecast round.

This buys some flexibility because the words of the statement have to be approved by a vote of the Committee, sometimes a daunting task that imparts inertia to the process. The new approach may also further comity within the Committee because even the hedged characterization of the rate path in the statement is a source of division. Indeed, Presidents Fisher, Kocherlakota, and Plosser all dissented on making the characterization of the policy path more specific in August 2011.

[3] The two figures will usually completely overlap, except when a participant expects policy tightening so late in a year that it does not pull up the fourth-quarter average above zero given the rounding rule.

The expansion of the SEP draws a line under the issue. The Fed is permanently in the business of shaping market interest-rate expectations. Two features of the change are likely to assuage any hurt feelings among members of the FOMC.

First, combining the rate assumption together with other forecasted economic variables underscores that it is not a promise. While the most recent FOMC statement explicitly held that the mid-2013 target for maintaining current policy rates was entirely conditioned on the economic outlook, market participants really paid little or no attention to that equivocation. After all, if it really was such weak tea, why would three FOMC members dissent on the issue?

Second, the rate path will be presented in a survey of all FOMC participants, not ratified by the smaller set of policy makers who vote.

Why There Is Less There Than it Seems

The Fed might not want the headache of aligning the words of the traditional statement with the new rate path in the SEP. If that proves to be the case, then they could excise the commitment language from the statement. At that point, what are seen as advantages of the new approach — underscoring the conditionality of the path and pushing it out of the voting process — will weaken its utility as a commitment device.

If the Fed opts to trim the statement in favor of signaling via the SEP at this meeting, then it will have to change its procedures and release both at the same time.[4] Even if it does that, do not rule out some confusion in markets as the realization sinks in that what had been seen as a promise has been shifted to an auxiliary table. The Fed more likely will opt for a belt-and-suspenders approach for the first release and include both the relevant words in the statement and the entries in the SEP, appropriately aligned. Then they can use the minutes to explain that the words will be excised at the next meeting.

There are, however, two drawbacks to ponder.

The zero bound. The Fed is betting that a row of zeroes will reassure market participants that tightening will be delayed. But zero is the lower bound of the central tendency and the full range of responses. What will draw the eye and raise the midpoint of the range is that some FOMC participants will see rates rising sooner, and perhaps by a noticeable amount. Indeed, the exhibit they intend to present will probably have some nonzero observations even in this year's entry. As for the date of first tightening, there will be several observations that violate the prevailing reassurance about no action until after mid-2013.

Orphan meetings. The SEP is collated at four of the eight scheduled annual meetings. If the SEP is to be the primary signaling device, does that mean that the other four meetings a year are orphans? If the Fed wants to send a message at one of those non-SEP meetings, it will have to improvise in the statement.

Bottom line: A More Flexible but Weaker Signaling Mechanism. The Fed has traded a policy of signaling commitment on rates through a formal vote for an arithmetic compilation of opinions about the path of policy. True, this will be an informed set of opinions coming from the highest Fed officials, but the Fed will now have a more flexible, but weaker, commitment device. To the extent that the new presentation draws attention to minority views, that commitment value will be weakened even more.

The Fed's Mission Statement

We have argued previously that most of the Fed's problems in communications stem from three obvious, but not always well understood, principles. Those roadblocks are structural to the design of the institution.

1. **Ambiguity.** The mission at the heart of Fed policymaking is ambiguous. In the Federal Reserve Act, the Congress tells the Fed to foster maximum employment and stable prices but is silent on how to weigh deviations from the two objectives or how quickly those deviations should be eliminated.

2. **Diversity.** Fed officials fundamentally do not agree among themselves on how to weigh relative deviations from the two goals.

3. **Democracy.** Chairman Bernanke entered office wanting to create a more democratic policymaking committee. This attitude was shaped by his experience as a governor and academic work indicating that a group makes better decisions than an individual does.

Together, these features explain why the Fed has previously had difficulty in being specific about its policy rule. Specifying the FOMC's policy rule butts against the core problem of the dual mandate. The Fed is assigned an ambiguous task

[4] Up to now the statement has been released at 12:30pm and the SEP table at 2:00pm. Taking the signaling language out of the statement in favor of the SEP would lead to 1-1/2 hours of confusion if the Fed stuck to the old schedule.

(Principle 1), and its leaders do not agree on its interpretation (Principle 2). Absent the imposition of order by the chairman (in violation of Principle 3) or a change in the legislated mandate (which is not in the cards in the near future), the FOMC is not be able to pre-commit on future contingencies.

This explains why Fed officials sent their colleagues on the communications subcommittee back to rework their proposed draft mission statement. Apparently, in the words of the minutes of the December meeting, the draft needed more "nuance." In Fed-speak, that means the next draft will be vaguer and more encompassing so as to accommodate the span of views among FOMC participants. Thus, do not hold out much hope for specific guidance if the Fed does roll out an agreed-upon specification of its policy direction.

The best case will be if they link the description of their policy goals to the SEP, which will have a column giving the range of their views of long-run values for key macroeconomic variables. All the building blocks of an implicit policy rule are there: where they want inflation to be in the long run and the attendant growth of real GDP and of the level of unemployment. The Fed could say something like this:

> The Federal Reserve fully supports the dual mandate of fostering maximum employment and stable prices given to it in the Federal Reserve Act. In the assessment of the Federal Open Market Committee, both goals are best achieved by maintaining consumer price inflation at a rate of [*INSERT central tendency range from table*] in the long run. In that circumstance, the FOMC anticipates real GDP to grow at a [*INSERT central tendency range from table*] percent annual rate and the unemployment to average [*INSERT central tendency range from table*] percent.

Even better, but less likely, would be another paragraph linking the appropriate stance of current policy to differences between those long-run assessments and the nearer-term entries in the SEP. The problem is that such explicit linkage would require crafting language agreeable to all and that is also consistent with each revision of the SEP over time. This defeats the purpose of creating an automatic mechanism that does not necessitate agreement among a fractious group of policy makers. It also raises the uncomfortable issue of governance: Who conducts monetary policy, those who vote on the FOMC or all participants at the meeting?

Bottom Line: Vagueness Rules on the Policy Rule

The group of people who run US monetary policy should be able to describe their view of its mission. However, Congress has given it an underspecified mandate and designed a policy committee that encompasses a range of views. Any mission statement is likely to be vague enough to encompass these differences.

Outlook for QE3. We think the use of additional unconventional policy initiatives will partly depend on the markets' reaction to the Fed's efforts to manage expectations through its traditional statement, the SEP, and perhaps a new mission statement. One factor in our call for QE3 in the first half of this year is our expectation that those communications initiatives will fall short of the mark.

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