The Fed's Communications *Struggle*

Forward guidance versus asset purchases in shaping market opinion.

By John M. Berry

For years, expectations about future Federal Reserve monetary policy changes have been almost as important a tool for central bank officials as actual changes in interest rates or the purchase of long-term assets such as Treasury and mortgage-backed securities. The key goal of Fed communications with the public has been to shape those expectations so as to leverage its actions, particularly when its target for overnight interest rates is pinned close to zero as it is now.

As Bill Dudley, president of the New York Federal Reserve Bank, put it in a speech on May 21, "First, and most importantly, managing expectations is critical in the execution of monetary policy at the zero bound. This includes expectations about the central bank's objectives for inflation and the economy, and expectations about how the central bank will use its tools in the future to achieve these goals.

"Second, in managing expectations, good communication is essential. Expectations will not be well anchored when communications are muddled or inconsistent, or when a central bank acts in ways that are not consistent with its guidance.

"Third, actions speak louder than words alone. Thus, there is an important role for asset purchases that ease financial conditions to support growth and keep inflation expectations well anchored," Dudley said, adding still other points.

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Ironically, expectations and Fed communications took a body blow the following day when Fed Chairman Ben S. Bernanke, to the surprise of many investors and analysts, told Congress that the central bank might begin reducing the $85 billion worth of asset purchases "in the next few meetings." Not end the purchases, but taper them.

The problem was that the policymakers on the Federal Open Market Committee were in disarray over this complicated issue, and trying to explain it coherently was not easy. Unfortunately, this breakdown in communications generated a jump in long-term interest rates as investors concluded the Fed was likely to tighten monetary policy more quickly than they had expected.

"Not since 1991 have we had such a large and rapid contractionary shift in the market's belief about what the Federal Reserve's reaction function is," said economist J. Bradford DeLong of the University of California at Berkeley.

Between mid-May and early August, yields on ten-year Treasury notes rose by about a percentage point, to 2.6 percent. At the same time, some measures of expected future inflation declined. The combination meant that real interest rates rose even more than nominal rates. As a result, current thirty-year home mortgage interest rates also jumped, rising from 3.35 percent on May 1 to 4.39 percent on August 1, according to Freddie Mac.

That in turn made it harder for some home buyers to obtain mortgages and some homeowners to refinance existing ones. Those were the last things Fed officials wanted to see happen at a time they are counting on a pickup in economic growth after a weak first half in which it ran at only a 1.4 percent annual rate.

The problems that began in May got worse in June and July. The unconventional—actually unprecedented—large-scale purchases of assets had ballooned the Fed's balance sheet to $3.5 trillion, compared to only $852 billion on the eve of the financial crisis in 2007. The asset purchases, known as quantitative easing, have been open-ended since last fall. The conventional part of policy, the overnight interest rate target, was essentially zero and most Fed officials had indicated they did not expect it to be raised until 2015. This pair of policies was seen by most analysts and investors as a package and it was assumed that a decision to slow the purchases would be a signal that the interest rate target might be raised much more quickly than they had expected. Officials, however, did not seek any such tight link and some of them were already uneasy about quantitative easing and ready to dump it. Several have consistently opposed it.

But it was still no small surprise that, the day after Dudley's speech, Fed Chairman Ben S. Bernanke told Congress that the central bank might begin reducing—"tapering" became the word of the day—the monthly asset purchases "in the next few meetings." Not end the purchases, mind you, but taper them soon. "A premature tightening of monetary policy could lead interest rates to rise temporarily but also would carry a substantial risk of slowing or ending the economic recovery," he said.

Later the same day, minutes from the FOMC meeting at the end of April were released. They said that "a few" participants were concerned that financial markets were becoming "too buoyant" and might be a risk to financial stability. "A number" expressed a willingness to begin to reduce the monthly purchases as soon as June. Others wanted to see more progress on bringing down joblessness first.

Continued on page 72

Adam Posen

Dr. Posen Takes on Tapering

Adam Posen, director of the Peterson Institute for International Economics, unloaded on Bernanke and the Fed. Posen, an unabashed advocate for quantitative easing, declared, "Bernanke and the Fed are going to be sticking to their guns and thereby shooting the economy in the foot. So essentially they have committed to tightening, in the next couple of meetings. There's a lot of jabber out there about, it's tapering, it's not tightening."

Markets, in contrast, had been expecting quantitative easing to go on either forever or run at an even greater pace, Posen said. "Cutting off that possibility, in market terms, is a tightening. And that's why we've seen interest rates rise, and now, mortgage applications fall.

"The reason they're doing this apparently is because they're scared of a bubble—a bubble in U.S. credit markets, a bubble in U.S. housing markets … You can tell that not just from what they say but the fact that this tightening doesn't make much sense given the economic forecast they have, which is for very low inflation and only a slow decrease in unemployment."

—J. Berry

Continued from page 41

The minutes and Bernanke's remarks rattled financial markets, particularly the bond market. If officials were that anxious to begin to cut back on the stimulus provided by the asset purchases—however much that might be—was it likely there would be no move to raise the overnight rate target until 2015? The market reaction spurred reassuring statements from a number of Fed officials other than Bernanke who tried with only partial success to calm things down.

According to the minutes of the FOMC meeting on June 18 and 19, participants spent a great deal of time discussing whether all the market volatility was, in a sense, their fault or were market expectations of faster economic growth the cause for the sharp rise in long-term rates. The views of the officials were all over the lot, both as to the cause of the run-up and whether it was a good or bad thing. They also spent time on "how best to communicate the committee's approach to decisions about its asset purchase program and how to reduce uncertainty about how the committee might adjust its purchases in response to economic developments."

Some wanted to say the outlook for the labor market had improved enough since the asset purchase program began last September that tapering "had or would likely soon become appropriate" and to make that clear to the markets. Others thought that might tie the committee's hands. Still others were concerned that stating such an intention "might be misinterpreted as signaling an end to the addition of policy accommodation or even be seen as the initial step toward exit from the committee's highly accommodative policy stance."

The minutes continued, "It was suggested that any statement about asset purchases make clear that decisions concerning the pace of purchases are distinct from decisions concerning the federal funds rate." In any event, there was agreement that some additional clarity about the asset purchase program was needed soon—even if there was no such clarity within the committee itself!

The true conclusion was that Bernanke, during his post-meeting press conference, "should describe a likely path for asset purchases in coming quarters that was conditional on economic outcomes broadly in line with the committee's expectations." In other words, Mr. Chairman, you figure out what to say because we can't.

That post-meeting press conference, a feature of Fed communications begun in the spring of 2011, is a marked departure from the past when chairmen avoided virtually all such events. They are now held four times a year after an FOMC meeting at which the forecasts of the participants are updated. (And James Bullard, president of the St. Louis Fed, said it makes no sense to skip meetings; each should be followed by a press conference. And some observers are saying that if tapering doesn't begin in September, when a press conference is scheduled, it won't happen until December because there is no press conference in October!)

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What Bernanke said on the afternoon of June 19 was this: if the economy moves as the FOMC participants expect—that is, if gains in employment continue, growth picks up, and inflation moves up toward 2 percent—"it would be appropriate to moderate the monthly pace of purchases later this year." And if the economy continues on track, "we would continue to reduce the pace of purchases in measured steps though the first half of next year, ending purchases around mid-year."

On the other hand, should conditions turn sour, the reductions in purchases could be temporarily halted or even reversed, Bernanke said. And even if additions to the Fed's balance sheet slow, "these large and growing holdings will continue to put downward pressure on longer-term interest rates," he said.

Before he took questions, the Fed chairman said that even if the Fed gradually reduces the asset purchases, "any need to consider applying the brakes by raising short-term rates is still far in the future."

In response to questions, Bernanke cast the whole thing as "no change in policy … there's simply a clarification, helping people to think about where policy will evolve."

The entire episode had a wide impact. In early July, Olivier Blanchard, the International Monetary Fund's director of research, said in discussing an update in the IMF's *World Economic Outlook* that one of the risks facing the world economy is the exit from quantitative easing.

"We attribute the high volatility of financial markets in the recent past, not so much to news from the Fed, but to the sudden realization by investors that quantitative easing would eventually come to an end," Blanchard told journalists. "As they tried simultaneously to rebalance their portfolios both in the United States and abroad, the result was some overshooting, isolated dislocations in some markets, and high volatility. Going forward, we expect volatility to decrease, maybe not back to the levels of a few months ago, but to decrease relative to the highs of the recent past, but one cannot rule further attacks of nerves along the way."

So what had gone wrong? asked a journalist.

"The Fed policy has two legs, the policy rate and quantitative easing," Blanchard explained. "I think on the first, there was fifteen years of refining communication so that when the policy rate was moved, it was well understood what it meant.

"We are now dealing with a new policy, and exit from that policy hasn't been tried before. So we're going to see the same initial learning about how best to communicate. I think the Fed is doing a relatively good job of it, but I'm sure that they'll improve their communication over time as they learn how markets react," he said, adding, "They probably learned something from the last three weeks."

Adam Posen, director of the Peterson Institute for International Economics and a former member of the Monetary Policy Committee of the Bank of England, unloaded on Bernanke and the Fed the following day during a media conference call organized by the Council on Foreign Affairs. Asked by a moderator what the Fed will be doing, Posen, an unabashed advocate for quantitative easing, declared, "Bernanke and the Fed are going to be sticking to their guns and thereby shooting the economy in the foot. So essentially they have committed to tightening, in the next couple of meetings. There's a lot of jabber out there about, it's tapering, it's not tightening."

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In mid-July, after the minutes were released on their usual schedule three weeks later and Bernanke had given his semi-annual monetary policy report to Congress, exactly what had happened and what may happen in coming months remained more than a little murky.

Economist Tim Duy of the University of Oregon, who follows the ins and outs of Fed policy extraordinarily closely, is confused.

"Some FOMC participants are not comfortable with asset purchases because they fear financial instability" and that makes "reaching consensus increasingly difficult as the last minutes suggest. As that discomfort grows, so too does the risk of premature policy withdrawal," Duy said.

"The trouble is that handing off policy from asset purchases to interest rates is not as simple as it seems," he continued. "One is a current action, the other is a promise about the future. As is often said, talk is cheap. Actions speak louder than words. Forward guidance is not as powerful as asset purchases in shaping expectations, thus investors, regardless of the promise of a longer period of low short-term rates, re-priced debt when asset purchases were clearly revealed as temporary."

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Of course, if the Fed did not have a dual mandate of maintaining price stability and maximizing sustainable employment, there would have been no need for quantitative easing. Inflation simply isn't a problem now and doesn't appear likely to be for quite a long time to come. St. Louis's Bullard, in fact, dissented at the June FOMC meeting because he feared inflation was running too low. But with Republicans generally blocking any effort to use fiscal policy to stimulate economic activity, and unemployment unacceptably high, Bernanke has sought to take up some of the slack.

That has not set well with those, including former Fed Chairman Paul Volcker, who want the Fed to focus only on price and financial market stability. As he wrote in a recent *New York Review of Books* piece, "Asked to do too much—for example, to accommodate misguided fiscal policies, to deal with structural imbalances, or to square continuously the hypothetical circles of stability, growth, and full employment—it will inevitably fall short."

In other words, the Fed should not take risks just because some other part of government isn't doing its job. Fortunately, Bernanke and a majority of the FOMC have tried to honor both of their mandates, though some like Adam Posen think they haven't done nearly enough to fight joblessness. ◆