

## **FOMC BIAS**

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At the December 1998 FOMC meeting members agreed to release, on a selective basis, any decision to tilt towards an interest rate change in the inter-meeting period. This information previously was released with a six-week lag. The committee felt that, on an infrequent basis, it was important to signal the markets that a bias (an asymmetric directive in FOMC terminology) towards a change in the federal funds rate was part of the FOMC's decision. When the committee deems it appropriate, the bias will be released at the end of the meeting along with any decision to change the federal funds rate target (standard practice since 1994). While this attempt at openness or transparency is laudable, in this particular attempt, the policy is most likely to be counterproductive. Selectively announcing the bias gives the impression of moving toward greater transparency without really doing so. Thus it deflects attention away from more serious and far-reaching changes that would bring real clarity to Fed policymaking such as setting multi-year inflation targets and making predictable responses to deviations from them. The FOMC should build in its hard-earning credibility by improving the predictability of its policy actions rather than attempting to signal its intentions on a selective basis.

The rationale is that, at times, it is important for the markets to know that the committee is leaning towards a rate change so that markets will not be surprised should a change occur. The idea is that keeping markets informed about possible future interest rate changes by the FOMC will reduce poor investment and consumption decisions by firms and individuals and thereby limit the costs to the economy caused by such changes.

But there is a real issue about whether selective release of the bias adds to market information about the monetary policy process or just adds noise that leads to volatility in markets. Experience to date seems to indicate the latter. For example, in June the FOMC took action to raise the funds rate target, yet the announced dropping of the bias towards

higher rates clearly dominated that action, causing the stock market to soar. The announcement of a non-biased directive was understandably taken by many to imply that the FOMC was no longer of the belief that the most probable direction of the next funds rate movement was up. Yet, the committee moved the funds rate up in August. By surprising the market, the FOMC defeated the primary purpose of transparency.

### **The Value of Transparency in the Policy Process**

The value of having markets understand the policy process is that they will make fewer mistakes in terms of investment decisions. Markets have incorporated all current information into asset prices and they carefully monitor new information in order to assess the probabilities of various future outcomes. They build these future outcomes into current asset prices. Potential FOMC policy actions that change the federal funds rate will impact current asset prices. Thus, the more the markets understand about FOMC policy objectives and the FOMC's ability and process for achieving them the fewer mistakes they will make in pricing current assets.

If markets fully understand FOMC decision-making, then they will react to incoming information in a manner consistent with the FOMC. This means that when the FOMC takes action to change rates there will be very little response in terms of market prices since market participants will have already factored the rate change into current market prices. Thus, there are fewer surprises, fewer investment mistakes and fewer costs to the economy. The FOMC apparently believes that selective release of the bias will aid this process.

A second rationale for releasing the bias is that a more open or transparent policy process is consistent with democratic traditions. One result could be reduced criticism of secrecy and the concomitant political pressures to meddle with fed independence in the monetary policy arena. It is doubtful that selective release of the bias will be a positive in this regard and it may well be a negative.

### **The Making of a Bias**

The origin and uses of the bias, as it is now called, would make for a useful and interesting research piece for a fed economist with access to internal reports and

transcripts. During the 1980's one intense internal debate about the bias was whether it gave the Chairman of the FOMC the right to change the funds rate by 25 or 50 basis points between meetings. There was no clear resolution to the debate.

An important function of the bias was (and perhaps still is) to aid the Chairman in reducing the number of dissenting votes and to allow members to have their views "count" without dissenting. For example, if the Chairman wanted to achieve a consensus on "no change" in the funds rates while limiting dissents he could offer a bias towards higher rates. Members who wanted a decision for higher rates might accept a bias instead of dissenting. In such cases, the bias had more to do with internal procedures than with policy intentions of the committee. Clearly, releasing a bias of this nature would mislead markets about intended policy action.

Another problem with a selectively released bias is that it could lead to gamesmanship. Some members may want to use the bias to cause markets to respond without having to actually change the funds rate. This is the exact opposite of an open or transparent policy process. Moreover, selective release adds more uncertainty to the process and consequently more volatility. A surprise release will cause abrupt adjustments in market prices because it presents new information that is not reflected in asset prices.

The value of signaling policy intentions versus taking policy action is also an issue. If the FOMC **always** follows its announced bias with policy action, then markets will immediately change asset prices to reflect the bias. So why not just take the policy action? If the FOMC **never** follows its announced bias with policy action, the markets would not adjust asset prices and the bias serves no external purpose while hindering fed credibility. If the FOMC **sometimes** follows its announced bias with policy action, then markets will only partially adjust asset prices to reflect the bias. If policy action then does not take place markets will again adjust asset prices. Only if action follows the bias will appropriate market responses take place. So why not take policy action in the first place?

The evidence indicates that the FOMC follows its bias with a policy action less than half the time. A review of the directives since October of 1992 indicates that there have been 26 decisions for a bias. Only 11 were eventually followed with a policy

action. That means policy action followed the bias just 42 percent of the time. A bias does increase the unconditional probability of a rate change but a **selective** announcement also creates uncertainty. The bias, had it been selectively announced during this period, likely would have provided markets with more noise than information. It is not clear that the committee, in announcing a bias, is using it as a substitute or a complement for a policy change. Some members use it as a weak substitute for a policy change while others use it to reinforce a policy change. How can the market learn anything from the announcement if the FOMC is not clear about what it announces? Credible and predictable policy actions provide transparency; signaling policy intentions with a selectively announced bias does not. Also, the current bias policy does not help overcome criticism of secrecy or lessen the likelihood of political pressures on fed independence.

### **Alternative Directions**

Instead of attempting to signal its intentions with a selectively released bias, the FOMC should build on its hard-earned credibility by improving the predictability of its policy actions. First, it should formally adopt a multi-year inflation target of 0-2 percent as its dominant objective. Doing so would take attention away from the latest numbers and the bias and force the FOMC to focus on policy actions that would impact inflation two years ahead, thereby recognizing the lag between policy actions and results. Better yet, the committee should seek a legislative mandate for such an objective.

Second, the committee should make clear its response function to deviations from the inflation target. Deviations could prompt predictable adjustments to the monetary base, for example. Controlling monetary growth with rules also should be given consideration.

Third, the committee should end its policy of selective release of the bias. Recent experience suggests the bias provides more noise than information. The committee also needs to consider whether the bias should even be part of the policy process at FOMC meetings. The Chairman has other methods for building a consensus for policy action at meetings and member should be afforded the opportunity of voting on policy actions without the encumbrance of a bias. After all, actions speak louder than words.

