Monetary Policy: Transparency and Clarity Require a Strategy

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It's one thing to be transparent and it's another to be clear. The Fed's efforts to be both transparent and clear have been thwarted by the lack of a consistent, understandable strategic guideline for conducting monetary policy. Its fragmented and fully discretionary approach--including constantly changing its near-term guidelines for when it may change policy, its excessive focus on high frequency data and its tendency to bounce from one short-run concern to another leaves everyone to guess and speculate about monetary policy. Its forward guidance tactics add confusion. This adversely affects economic and financial market performance, raises risks of policy mistakes and undercuts the Fed's credibility--in the public's eyes, in financial markets and in Congress.

Economic and financial performance would benefit if the Fed were to establish clear and understandable policy guidelines and stick to them. This would involve modifying the Fed's Policy Statement published following each FOMC meeting, toning down its excess emphasis on high frequency economic data and its overstated concerns about how financial markets may respond to monetary policy changes, and establishing new communications guidelines.

The Fed actually has a long-run strategy statement, but just doesn't follow it very well. In its "Statement on Longer-Run Goals and Monetary Policy Strategy" published in January 2012 and amended and approved each January, the Fed established its longer-run goals of 2 percent inflation and maximum employment, and stated that it seeks to mitigate deviations of inflation and employment from these long-run goals. This is a consistent interpretation of its dual mandate. In the strategy statement, the Fed states that "employment is largely determined by non-monetary factors that affect the structure and dynamics of the labor markets", thereby acknowledging the limitations of monetary policy in addressing some aspects of underperformance in labor markets. In its January 2012 Statement, the Fed noted that the FOMC's central tendency forecast for the normal rate of unemployment was 5.2 percent to 6.0 percent; in its January 2015 document, forecasts were 5.2 percent to 6.0 percent.

In practice, the Fed has consistently changed its policy guidelines and muddled up the implementation of this longer-run strategy, effectively transforming it to a fully discretionary approach driven by short-run concerns. The Fed shifted its forward guidance on ending its quantitative easing from a date-based strategy to an unemployment rate trigger. When the unemployment rate fell rapidly, the Fed lowered

its guideline; when the unemployment rate converged on the FOMC's estimate of the long-run natural rate, the Fed broadened its focus to various labor market measures, including the labor force participation rate that was obviously far outside the scope of monetary policy. Subsequently, the Fed shifted gears and led markets to focus on wage trends. Neither the Fed's Strategy Statement nor the Full Employment Act of 1977 that established the Fed's dual mandate includes wages or the labor force participation rate as Fed objectives.

Following its Strategy Statement in 2012, the Fed quickly blurred the interpretation of its inflation target by suggesting that 2 percent was the long-run *average* target and that temporarily higher inflation would be allowed—even welcomed—if it were associated with stronger real growth that reduced unemployment. Some Fed members expressed that they were open to a higher inflation target. These statements not only called into question the Fed's commitment to its inflation target, but they sounded very similar to the failed policy recommendations of the 1970s to exploit the tradeoff between inflation and unemployment, even though the illusory nature of a long-run Phillips Curve is well known.

More recently, while the Fed has forecast that inflation would rise to its 2 percent target, it has expressed concerns that the low inflation is harmful to economic performance. Such statements are misleading. There are no signs anywhere that low inflation or expectations of deflation are deterring spending. Moreover, lower oil prices that temporarily suppress inflation are positive for economic performance; the lower prices of imports resulting from the stronger US dollar boost consumer purchasing power; and the persistent decline in durable goods prices (the PCE deflator has fallen in each of the last 20 years) reflect technological innovations that are a hallmark of US progress and prosperity. In a practical sense, could it be that inflation is not too low, nor too high to influence private spending decisions—and in terms of economic performance, isn't it in a favorable range?

The Fed's monetary policy is heavily influenced by high frequency economic data, despite their well-known limitations, volatility and frequent revisions, of the monthly data. The media and financial markets follow the Fed's lead. Consider the Bureau of Labor Statistics' (BLS's) monthly employment report. The BLS estimates that the standard error of its establishment survey of monthly changes in nonfarm employment is 105,000. This may be small relative to the size and complexity of the US labor market, but it is large relative to the average monthly change in jobs and almost always larger

than deviations of the reported job changes from consensus estimates. Moreover, data revisions can be large. The BLS publishes detailed descriptions of its estimates (Bureau of Labor Statistics, "Employment Situation Technical Note", September 4, 2015). But the Fed seems to take each monthly point estimate of job changes at face value and leads financial markets to do the same. Fed members tell the public that the next jobs number will heavily influence the Fed's upcoming policy decision. Following each Employment Report, Fed members join financial market participants in commenting on its details. This is highly inappropriate, not just because the data are noisy but also because monetary policy has always affected the economy with a lag. The Fed's short-sighted focus increases the probability of a policy mistake and conveys the wrong image about what should be important in the conduct of monetary policy.

The Fed's focus on short-run concerns has clearly affected its monetary policy in 2015. Earlier this year the Fed indicated that it would likely raise rates in June, only to back off, partially in response to the disappointing economic performance in 2015Q1, even though the Fed itself acknowledged that Q1 had been depressed by temporary factors (bad weather in the West Coast port strike). Not surprisingly, the preliminary estimate of a negative real GDP in Q1 was revised to positive and growth in Q2 bounced to 3.9 percent.

Following its June FOMC meeting, the Fed indicated that it would likely hike rates in September, but did not do so because of concerns about China and emerging markets. China's economic slowdown has been unfolding for a long time and the associated lower prices of oil and commodities are positive for the US economy. Financial market volatility spiked, but there were no signs of disruption to global liquidity or capital flows. To delay its rate hike was wrong and the Fed harmed its credibility.

Each twist and turn of the Fed's focus on short-term concerns is reflected in the Fed's official policy statement and/or communicated by various Fed members who blanket the airways with their assessments of economic conditions. This reinforces the public's perceptions that the Fed responds to short-term fluctuations and takes its eye off its long-run strategy.

The Fed's efforts to manage market expectations through a formal policy of forward guidance has been less-than-successful and has generated unintended side effects. In fall 2012, the Fed's forward guidance strategy was formally implemented to complement its QEII and QEIII asset purchase programs to signal to markets the Fed's

intention to keep bond yields artificially low in order to stimulate aggregate demand. In fact, bond yields have remained low but nominal GDP growth has not risen above 4 percent (see Chart 1). ***Thus, in its ultimate goal – stimulating the economy – the Fed's forward guidance and QE have fallen short.***

This clearly shows the limitations of monetary policy and the strong influences of non-monetary policies and factors that constrain economic activity, including the oppressive impacts of tax and regulatory policies. While the Fed acknowledges the limited scope of monetary policy to achieve its mandate of maximum employment, it argues incorrectly that if it had not been for its QE and forward guidance, the economy would be much weaker, with millions of fewer jobs. This is based on *ex post* simulations of its macro model, which has an unreliable track record, and involves more self-defensive hubris than reality.

Following the conclusion of QEIII, as the unemployment rate has converged on estimates of its natural rate, the Fed's forward guidance has morphed into an evolving set of excuses to keep its policy rate anchored to zero, and has become increasingly inconsistent with its long-run strategy.

In its official forecasts, FOMC members project the economy will continue to grow at its recent pace and inflation will drift up to 2 percent even as the Fed raises rates along a path the FOMC members deem appropriate (the "dots"; see Table 1). These Fed forecasts are consistent with historical experiences: in past episodes when the Fed has raised interest rates, the economy has continued to grow, the US stock market has held prior gains and in general, the Fed rate increases have not been disruptive to financial markets (Table 2). Even aggressive rate increases that have resulted in very high real rates have not harmed economic expansion. Presently, with the Federal funds rate negative, a rate hike would barely be felt in the economy. Nor should China's slowdown deter a rate increase: the Fed raised rates aggressively in 1994 when Japan, then the world's second largest economy, was reeling and its big banks ere insolvent, and the Fed raised rates in 2004 when Europe was growing modestly.

Why, then, does the Fed continue to maintain its negative federal funds rate? Presumably, the Fed is worried about inflation being too low and/or about negative market responses to a rate increase. Neither worry is warranted. Financial markets are fully aware the Fed will raise rates and have priced it in. The market sell off in response to the Fed's September decision to not hike rates and to express new concerns about

international conditions highlights the Fed's poor instincts and the unintended consequences of its forward guidance. Witness the Bloomberg New headline of September 26: "Stocks Slump Toward Worst Quarter in Four Years on Fed Confusion."

The Fed should know that markets and the public take seriously the Fed's forecasts and its public statements about economic and financial conditions. Many in business and the financial markets believe that when the Fed says something, it knows something that the public may not know. The Fed's forward guidance strategy of guaranteeing artificially low rates conveys a negative economic view that may have adversely influenced spending and investment decisions. ***History suggests strongly that businesses would respond positively to a rate increase accompanied with a Fed expression of confidence in economic performance.***

What should the Fed do?

The Fed should reaffirm its Longer-Run Strategy Statement, announce publicly that these objectives take precedence over short-run considerations and implement the following tactical changes:

*Policy Statements. These official statements following each FOMC meeting should be streamlined to approximately one-half of their current length, with clear text that briefly relates economic conditions and monetary policy to the Fed's Strategic Statement and its forecasts. It should eliminate forward guidance such as "The Committee currently anticipates that, even after employment and inflation are near mandate-consistent levels, economic conditions may, for some time, warrant keeping the target federal funds rate below levels the Committee views as normal in the longer-run." Statements like this are confusing and reflect the over-extension of the Fed's monetary policy scope.

*The Fed should base its policies on longer-run trends, evaluate economic conditions on the basis of smoothed monthly and quarterly GDP data, and tone down its public commentary on high frequency data. Consistent with suggestions of the BLS and Bureau of Economic Analysis, monthly data on employment, retail sales, durable goods and international trade should be viewed through the lens of 3-month or longer moving averages. The Fed should not allow quarterly data that are clearly temporary in nature, like 2015Q1, influence monetary policy.

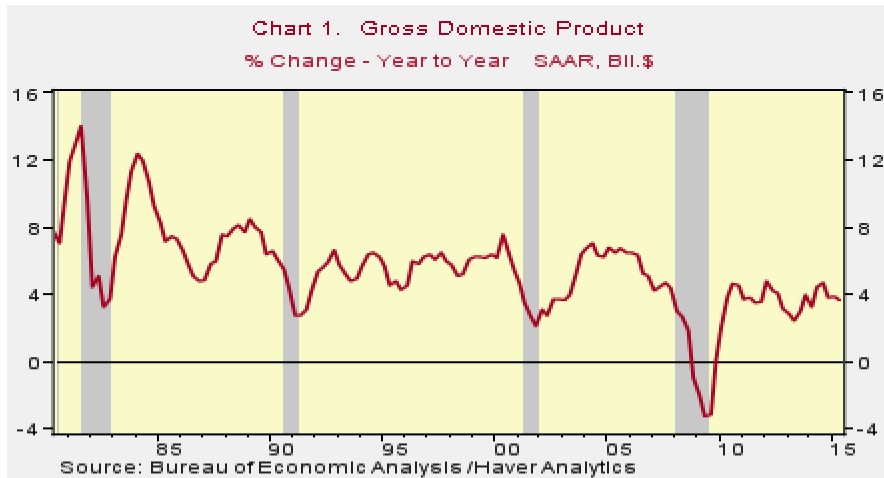
*The Fed should acknowledge historical experience that shows clearly that monetary policy affects economic conditions with long and variable lags.

*The Fed should formally reassess its forward guidance policy with an eye toward making significant changes. While failing to stimulate stronger economic activity, forward guidance has contributed to mounting economic and financial market distortions and has created a communications thicket for the Fed.

Regarding monetary policy:

*If the real federal funds rate were near zero, there could be a legitimate debate about whether or not to raise rates, but with sustained growth having pushed employment and inflation close to the Fed's dual mandate, there is no rational defense of anchoring the federal funds rate to zero. The Fed should raise the federal funds rate and should be clear in its Policy Statement that the rate rise is consistent with its Longer-Run Strategy, that the Fed is confident that economic growth will be sustained and that monetary policy remains extremely accommodative.

*The Fed should announce in an upcoming Policy Statement that it will wind down the reinvestment of maturing assets, thus allowing a passive and very gradual decline in its balance sheet over time. Any modest rise in bond yields—and in all likelihood they would be modest—would improve the alignment of yields with economic and inflation trends, and would have little if any effect on financial liquidity or the economy.



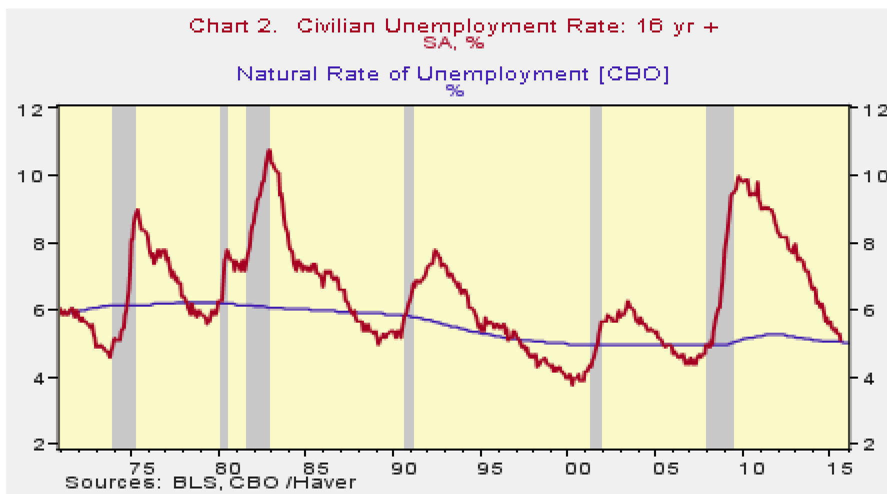


Table 1. FOMC Economic Forecasts of the FOMC, September 2015

Percent

Variable	Median[1]					Central tendency[2]				
	2015	2016	2017	2018	Longer run	2015	2016	2017	2018	Longer run
Change in real GDP	2.1	2.3	2.2	2.0	2.0	2.0 – 2.3	2.2 – 2.6	2.0 – 2.4	1.8 – 2.2	1.8 – 2.2
June projection	1.9	2.5	2.3	n.a.	2.0	1.8 – 2.0	2.4 – 2.7	2.1 – 2.5	n.a.	2.0 – 2.3
Unemployment rate	5.0	4.8	4.8	4.8	4.9	5.0 – 5.1	4.7 – 4.9	4.7 – 4.9	4.7 – 5.0	4.9 – 5.2
June projection	5.3	5.1	5.0	n.a.	5.0	5.2 – 5.3	4.9 – 5.1	4.9 – 5.1	n.a.	5.0 – 5.2
PCE inflation	0.4	1.7	1.9	2.0	2.0	0.3 – 0.5	1.5 – 1.8	1.8 – 2.0	2.0	2.0
June projection	0.7	1.8	2.0	n.a.	2.0	0.6 – 0.8	1.6 – 1.9	1.9 – 2.0	n.a.	2.0
Core PCE inflation[4]	1.4	1.7	1.9	2.0		1.3 – 1.4	1.5 – 1.8	1.8 – 2.0	1.9 – 2.0	
June projection	1.3	1.8	2.0	n.a.		1.3 – 1.4	1.6 – 1.9	1.9 – 2.0	n.a.	
Memo: Projected appropriate policy path										
Federal funds rate	0.4	1.4	2.6	3.4	3.5	0.1 – 0.6	1.1 – 2.1	2.1 – 3.4	3.0 – 3.6	3.3 – 3.8
June projection	0.6	1.6	2.9	n.a.	3.8	0.4 – 0.9	1.4 – 2.4	2.4 – 3.8	n.a.	3.5 – 3.8

Financial Market Behavior around Fed Monetary Tightening Cycles

	US Dollar		US Stocks	Interest Rates		
	Major Currencies*		%chg	10-year Bond Yield**		Spread**
	Nominal	**Real**	**S&P 500**	**Nominal**	**Real**	**10yr-1yr**
2004-2006						
12 Months Before	-3.8%	-2.5	14.7	-3.9	1.4	1.4
During	-7.0%	-3.9	5.0	2.3	0.0	-2.7
1994						
12 Months Before	-0.5	0.5	6.8	-0.3	-0.3	-0.3
During	-5.4	-4.3	1.2	1.5	1.4	-1.4
1987-1989						
12 Months Before	-13.7	-12.7	21.2	1.3	1.2	1.2
During	-4.7	-2.2	2.2	1.0	-0.4	-1.6
1983-1984						
12 Months Before	3.1	0.6	41.1	-3.9	-3.9	-3.9
During	8.3	7.6	0.2	2.3	2.7	-0.4

Notes: *Trade weighted dollar versus EuroArea countries, Canada, Japan, United Kingdom, Switzerland, Australia and Sweden; **measured in percentage points
Sources: Federal Reserve Board and Berenberg Capital Markets