# Communicating Monetary Policy

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Communicating monetary policy to the markets remains a challenge for the Fed. Its latest try is the balance of risks assessment released in the statement at the end of each Fed policy meeting. Not only do markets get the risk assessment but they also get a word or two indicating some time frame for how long the current federal funds rate will be in place. Both the balance of risk assessments and the hints about the timing of future funds rate changes can pose potential problems for the economy. What the Fed should be communicating is information about the primary objective of monetary policy and how it will respond to new information impacting that objective.

**The Value of Communicating.** The merits 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, including Fed actions. They build these future outcomes into current asset prices. Potential Fed policy actions that change the federal funds rate will impact current asset prices. Thus, the more the markets understand about Fed policy objectives and the process for achieving them, the fewer mistakes will be made in pricing assets.

If markets fully understand the Fed decision making process then they will react to incoming information in a manner consistent with the Fed. So when the Fed changes the funds rate there will be very little response in terms of asset prices since market participants will have already factored the funds rate change into them. If there are fewer surprises, then fewer investment mistakes will be made and fewer costs imposed on the economy. In short, Fed actions in response to new information would be both credible and predictable.

**A Desire to Communicate.** Back in the 1980's market participants gleaned information about Fed intentions from speeches and testimony of Fed officials, by reading six weeks old minutes of previous meetings and by carefully observing open market operations. In 1994 the Fed decided to communicate its decision about the funds rate immediately after each meeting rather than wait until the next day when open market operations signaled the change to Fed watchers. This was a useful step but did not add

much information about the policy process.

In December of 1998 the Fed made another attempt at communication by releasing the bias statement on a selective basis after each meeting. Some time in the early 1980's the Fed began discussing a tilt or bias for the direction of policy between meetings. The primary purpose of the bias was to determine how much leeway the Chairman had in moving the funds rate between meetings without consultation with the rest of the policy making committee. The original bias statement was not a communications effort as it was secret for six weeks after the meeting[1].

The bias statement was replaced with the balance of risks statement that is released at the end of every meeting along with the interest rate decision. Risk about the direction of the economy and of inflation are assessed and offered as an explanation for the policy decision. Apparently, this statement was not communicating enough information to the markets because in June of 2003 the Fed began including a statement indicating a rough time frame the current policy (current funds rate) would be in place. In June of 2003 the statement indicated that the current funds rate would be in place for the "foreseeable future." That wording was changed to "considerable period" in August and then to "patient" (with respect to moving the funds rate) in January of 2004. Announcing a rough time frame for the future course of the funds rate was a major break from past practice. It is likely that the Fed views its communication efforts as a work in progress with more changes to come.

But what information has the Fed provided that will help markets better understand policy objectives and how it will respond to new information indicating a deviation from those objectives? The answer is not much. Just as in past decades armies of Fed watchers attempt to glean insight about future funds rate movements from speeches and testimony of Fed officials. The focus remains on the policy instrument (the funds rate) not the policy objectives and the process for achieving them.

**Potential Communication Problems.** Maybe the efforts by the Fed to better communicate with the balance of risks statement and hints about the funds rate path will reduce surprises to market participants. But these efforts also raise some concerns. By telling market participants that the funds rate can be held at 1 percent for a considerable period, The Fed encourages more borrowing short and investing long than would occur if no time frame had been given. To many investors this situation might appear to be a one-sided bet too good to pass up. An investor, by borrowing at the over night rate of 1 percent and investing in a 5 year treasury note at 3 percent, earns 2 percent with no credit risk. As investors in numerous markets take advantage of this opportunity, a significant increase in leverage occurs. When the Fed indicates its time to move the funds rate up, there is a rush for the door by these leveraged investors as they try and exit their positions to limit losses. It may be an orderly exit with

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[1]Hoskins, Lee, "FOMC Bias", Shadow Open Market Committee, September 26-27, 1999, Washington D.C.

interest rates rising only slightly doing little damage to wealth and the economy or it may be a stampede that significantly raises rates and imposes cost on the economy. Did Fed communications about the course of interest rates contribute to excessive leveraging that will impose costs on the economy? The answer will likely be known over the course of the next year.

Using the balance of risks statement to communicate also has a potential downside. It can lead to confusion about which objective is dominant at any point in time. Is the sustainable growth objective more important than the inflation objective? For example, suppose job growth slows but the inflation rate continues to rise. Does the Fed start raising the funds rate or keep waiting until employment takes off? Markets have no way of knowing.

Moreover, balancing the risks of inflation along with the risks of sustainable growth gives the impression that the Fed can fine tune or at least gross tune economic growth. The experience of the 1970's should disabuse the Fed and markets of that notion. That decade of fine tuning started with low single digit unemployment and inflation rates and finished with both in double digits.
Slack in resource use, low capacity utilization rates or large output gaps are no guarantee of low inflation.

The balancing of risks with respect to inflation or deflation is misleading in that it gives the impression that inflation or deflation occurs independent from Fed policy. Central banks determine the price level not some accident of nature. The Fed has nothing to fear about price level changes but itself.

**Communicate a Primary Objective and Predictable Response to New Information**. The fundamental problem is not that the Fed is a poor communicator but that it cannot agree on its primary objective. As a result it is unable to provide a predictable policy response to new information. The aim of Fed policy meetings is to make a decision about the funds rate. While the objectives of price stability and sustainable growth will be discussed, no agreement about specifics is required.

For example, at the meeting tomorrow some policymaker will want to see better employment numbers before moving the funds rate. Others will want to move sooner in order to get a leg up on rising inflation. It is likely that those who want to wait will hold sway and those who want to move the funds rate up 25 basis points will be satisfied with dropping the word patient from the statement and getting the balance of risks skewed toward rising inflation.

No agreement need be reached on what is the appropriate inflation target nor the time frame for achieving it. No agreement need be reached on what the growth rate for the economy should be and whether or not the Fed should try and influence it. These are knotty problems over which reasonable people have strong differences. Yet, without clarity and specifics about objectives no predictable response to new information or shocks is possible. And without predictable policy responses, markets will be surprised and unnecessary costs to the economy will occur.

The best way for the Fed to insure sustainable growth over time is to maintain price stability. Attempts to respond to short term fluctuations in GDP often lead to big problems for the economy. Even an economy with a perfect monetary policy would still have recessions. Shifts are occurring in the economy that policymaker and market participants do not completely understand - for example

technology, productivity, and the changing tastes of consumers and investors. Significant uncontrollable events - shocks - occur and the economy is rocked. Market forces work to absorb and accommodate these events. Market forces work best in a stable policy environment. And only the Fed can provide price stability. The Feds primary objective needs to be price stability in order to achieve the broader goal of maximum sustainable economic growth.

The Fed has implicitly made price stability the primary objective. It now needs to make it explicit with a publicly announced multi-year target for inflation or the price level with a time frame for achieving the target. For example, the Fed could announce a permanent target of 0-2 percent for inflation. If off target, it could have a time frame of two years to get back on target. By doing so it would provide not only a low inflation rate but also anchor inflation expectations. The Fed would still have considerable discretion to respond to shocks and the markets would have a better understanding of how the Fed would react to shocks[2].

Bad data, bad models and bad news are going to continue to provide Fed officials and market participants with plenty of surprises. Neither the Fed nor markets can prevent them. The goal of Fed communication should be to insure that markets understand how the Fed will respond to such surprises.

[2]McCallum, Bennett, "Misconceptions Regarding Rules Vs Discretion for Monetary Policy", Shadow Open Market Committee, November 9-10, 2003, Washington D.C.