

**ECONOMICS:** US PERSPECTIVES—JANUARY 27, 2012

# Will the Fed's New Transparency Create Clarity or Confusion?

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A new chapter in Federal Reserve policy began this week, when policymakers published their individual rate forecasts. Although more transparency might help bolster confidence in the short term, we believe that it could backfire in the future as policymakers alter their views quickly amid changing economic trends.

For the first time in Federal Reserve history, US policymakers this week made public their individual projections of official rates, which are meant to correspond to their forecasts of economic growth, inflation and unemployment. In addition, each policymaker was asked to offer a view about when the initial phase of monetary tightening could be expected to begin.

These steps toward greater transparency, unveiled at the January 24 and 25 meeting of the Federal Open Market Committee (FOMC), are part of a new communication policy that has been promoted by Fed Chairman Ben S. Bernanke over the past few years. In his view, increased openness will foster a greater understanding of what the Fed is trying to achieve in the economy through its official rate decisions. Bernanke has argued that greater clarity on policy should make it easier for the general public and investors to understand the FOMC's objectives and, as a result, should improve the effectiveness of policy decisions.

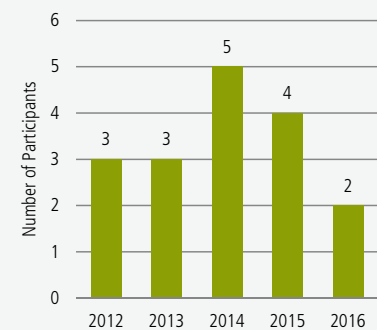
While the intent is laudable, we're not sure it will work. The Fed's dual mandate is to pursue maximum employment and stable prices over the long term, and policy changes take a very long time to manifest themselves in the general economy. Policymakers—like private sector forecasters and businesses—don't have perfect foresight on future economic trends. So providing an open microphone for the internal Fed debate may in fact create confusion rather than clarity in financial markets, as policymakers are late to detect significant cyclical shifts in the economy.

### Open Microphone on FOMC

The new detailed summary of economic projections, released after this week's FOMC meeting, showed that the majority of policymakers supported keeping official rates on hold until late 2014. Initially, financial markets read this statement to reflect a new Fed commitment to hold rates steady for longer. However, it is important to recognize that the current time horizon is not strictly comparable with the policy statement released in December.

Display 1  
Wide Dispersion of Views at FOMC

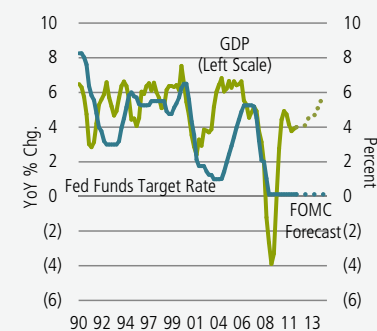
FOMC Members Prediction of Initial Rate Hike



As of January 2012  
Source: Federal Reserve Board

Display 1  
Steady Rate Outlook Not Consistent With Faster Nominal GDP

Fed's Forecast of Nominal GDP and Official Rates



As of December 2011  
Source: Bureau of Economic Analysis, Federal Reserve Board and Haver Analytics

That's because, before January 2012, official forecasts ran through the end of 2013, and now the forecast horizon extends through 2014; so policymakers were obliged to extend their view on official rates accordingly. It's possible that the FOMC "consensus" wanted official rates to remain on hold longer than expressed in earlier statements, but this was the first time they had the opportunity to say so publicly.

Beneath the surface, the disclosure by Fed members revealed a wide distribution of views (**Display 1, previous page**). Three FOMC participants said monetary policy should be tightened before the end of 2012, while three others would like to raise interest rates in 2013. In total, 11 FOMC members advocated tightening monetary policy before the end of 2014, with a median rate forecast of 1.5%. At the same time, four members said the first rate hike should be in 2015 and two didn't want to tighten policy before 2016.

### Inside the Fed's Debate

To decipher this debate, it's important to understand the FOMC's structure and who ultimately influences policy decisions. There are 17 FOMC members—five Federal Reserve governors and 12 Federal Reserve district bank presidents—who offer forecasts for growth, inflation, unemployment and official policy rates. But only 10 members of the FOMC (five governors and five district bank presidents on a rotating basis) vote on policy decisions and agree or disagree with the official statement issued at the end of each meeting.

In January, for example, all five Fed governors and four bank presidents agreed that official rates should be kept on hold until late 2014. At the time, only one bank president—Jeffrey Lacker of the Richmond district—disagreed with the commitment to hold rates for the length of time indicated in the official statement.

While it isn't possible to link the official rate projections to each of the FOMC's 17

members, the Fed bank presidents appear much more eager to raise rates than the governors. Indeed, all five Fed governors endorsed the official view of no official rate hikes before late 2014, while six non-voting members argued that rates should be raised before the end of 2013.

So what separates the more hawkish views of the Fed bank presidents from the more dovish governors? The answer isn't entirely clear. Still, several bank presidents have argued that the economy's uneven performance has nothing to do with the accommodative stance of monetary policy. Instead, they say, it is uncertainty over fiscal policy, including taxes and regulations, that is holding back the economy, so official rates must move up over time to sustain growth and maintain a stable and low inflation over the longer run.

### Is More Transparency a Good Thing?

Bernanke has repeatedly said the FOMC could use its communication policy to help influence financial conditions. This, he said, was one of the goals of this week's FOMC meeting: to provide a longer commitment to holding rates steady, which would affect investment portfolios and credit markets, and ultimately lead to higher equity prices and lower borrowing costs for individuals and businesses.

In the short run, we think the change in communication policy should have a positive, yet small influence on financial markets. But in the longer run it's the real economy that matters most. In our view, using a communication policy as a supportive element toward achieving specific economic results is not likely to work for long. The complexities and the dynamic nature of the economy make it almost impossible to say with any degree of certainty that today's policy setting is appropriate for the next three years.

For example, in the early 1990s, the US faced several similar headwinds (less severe than today's) that forced policymakers to keep real official rates near zero for an

extended period. At the time, the housing market was very weak, lending conditions were tight and the global economy was struggling, especially in Europe.

As these headwinds started to fade and economic conditions improved, it became clear to policymakers that nominal and real interest rates had to rise. This view was communicated by then-Fed Chairman Alan Greenspan in official testimony to Congress and in speeches early in 1994. However, as the economy gained momentum and pipeline inflation pressures began to build, policymakers realized that they were far behind the curve. They then aggressively hiked official rates by 300 basis points, from 3% to 6%, over a 12-month span. In this case, even though the Fed chairman openly discussed the need to raise official rates, the financial markets were clearly surprised by the speed and size of the move.

### Open Communication May Backfire

Today, nominal official rates are near zero and real rates are at -2%. In our view, although these interest rates may have been appropriately set for what has transpired over the past three years, they may not be right for what will occur over the next three (**Display 2, previous page**). Even a modest spurt in economic growth would take policymakers by surprise. If our bullish forecast for 2012 materializes, with real growth of 3% and a decline in unemployment to 7.9% at year-end, we think many policymakers will quickly reconsider their commitment to low rates for three years.

Today, financial markets may be applauding the greater transparency and the commitment to maintain near-zero rates through the end of 2014. However, we think that in time, the open communication plan could backfire. It may, in fact, lead to greater volatility in the financial markets, since the new policy tool reflects what policymakers know and see today—but not what they will confront and observe in the future. ■

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