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Economic Research:

The Fed: Parsing Its Communications

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The Fed: Parsing Its Communications

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The Federal Open Market Committee (FOMC)'s most recent release of its meeting minutes, on Jan. 3, 2013, caused some stir in the market. At its Dec. 11-12 meeting, the Fed seemed to ratchet up its aggressive easing by announcing, in tandem with the expiry of its "twist operation," that it would purchase $45 billion of longer-term Treasury securities per month for an open-ended amount of time. It also announced a change to its "forward guidance" relating to how long it would maintain "a highly accommodative stance of monetary policy" from being tied to a terminal date to being linked to specific thresholds for unemployment and inflation (1). The Fed's decision to start buying Treasuries again came on top of its decision in September to restart purchases (this time in an open-ended way) of mortgage-backed securities (MBS) at the rate of $40 billion per month.

Overview

- The minutes from the Dec. 11-12 meeting caused a stir in the markets because they seemed to indicate that many FOMC members were looking to wind up the open-ended MBS and Treasury purchases, announced in September and December, respectively, earlier than expected.
- The Fed, since September, has had two strands in its forward guidance, one relating to how long it intends to continue its open-end securities purchases, the other relating to how long it expects to keep the federal funds rate near zero.
- Because both elements of forward guidance are conditioned on improvements in labor market conditions, it is easy for observers to get confused.
- The Fed is committing to keep expanding its balance sheet until the labor market outlook "substantially improves," but that threshold is likely to be met well ahead of the unemployment rate coming down to 6.5%, the conditional threshold for starting to hike the policy rate.
- Regardless, the Fed gets high marks for continuing to push the envelope of unconventional policy, combining aggressive policy action and innovative communications.

Surprising Minutes

The minutes wrong-footed many observers because they seemed to indicate, contrary to the apparent "aggressiveness" of the FOMC's recent decisions, that many FOMC members were looking to wind up the open-ended Treasury and MBS purchases (combined, currently running at the rate of $85 billion per month or the equivalent of 6.5% of GDP on an annualized basis) fairly soon: "In considering the outlook for the labor market and the broader economy, a few members expressed the view that ongoing asset purchases would likely be warranted until about the end of 2013, while a few others emphasized the need for considerable policy accommodation but did not state a specific time frame or total for purchases. Several others thought that it would probably be appropriate to slow or stop purchases well before the end of 2013, citing concerns about financial stability or the size of the balance sheet. One member viewed any additional purchases as unwarranted."

The FOMC has 12 members--the seven members of the Board of Governors, the president of the Federal Reserve Bank of New York, and four of the other 11 regional Reserve Bank presidents. These last four seats rotate annually among the 11 banks. The members vote on monetary policy decisions. The nonvoting regional Reserve Bank presidents participate in FOMC meetings, so an important distinction to bear in mind when scrutinizing the minutes is between "members" (of which there are 12) and "participants" (of which there are 19). At the meetings, the members' views matter most because they get to vote; but, because of the rotation, all nonmember participants' views matter too because they may influence the votes of members today or because they will be members in the future. The precise definition of "a few" and "several" is kept deliberately vague in FOMC minutes. But, taking "a few" to mean at least two and "several" to mean three or more, at least six members--that is, at least half of them--seemed to want or expect asset purchases to stop (or at least be scaled back) by the end of 2013.

Does this mean that the FOMC is even more divided that it seemed? Is Chairman Bernanke's new-found apparent monetary aggressiveness hanging on a surprisingly thin reed? How does it sit with the fact that its own projections show that most FOMC participants (14 out of 19) do not expect the first increase in the target federal funds rate to be before 2015 at the earliest? Is the FOMC signal-jamming its communications? Not so fast.

The Fed's communication is clear, but it is complicated. The structure of its forward guidance (its monetary policy actions) is complicated, and, appropriately many would argue, the Fed has planted lots of caveats and conditioning variables in its forward guidance. It is state-contingent forward guidance, not iron-clad pre-commitment (2).

On top of this, the minutes gave information about participants' views and the debate that went on, that is, the process of monetary policy decision-making. Up until now, market participants knew only what the outcome of that process was. Statements in the minutes can provide useful additional information about the likely course of monetary policy, particularly because they provide information about the diversity and intensity of views as well as the thinking behind them. But, taken out of context or shorn of nuance, they can be misleading too. What the committee ultimately decides is much more important than what some participants or voting members might have said before that decision was made. That is where the rubber hits the road.

By using forward guidance about its future monetary policy actions, the Fed hopes to improve both the transparency and the effectiveness of its policy, thus making it easier to achieve its policy objectives. But the Fed's recent decisions have made its forward guidance quite complicated and, as a result, potentially confusing. The potential confusion arises because, since its September 2012 decisions, the Fed has been providing two forms of forward guidance, corresponding to the two easing tools it is using: interest rates and the balance sheet. The root of this potential confusion traces back to the epoch-making FOMC meeting in December 2008 (15-16), when the Fed announced that it was henceforth using the size of its balance sheet as its primary monetary policy tool. It arises also because not all observers are aware of, remember, or understand the implications of the caveats. Central bank communication wasn't meant to be easy, and in a big, wide world it isn't.

A Little Bit Of History

The Fed started using explicit forward guidance in this easing cycle in December 2008 when it cut the federal funds rate to a range of 0 basis points (bps) to 25 bps and stated that it "[anticipated] that weak economic conditions [were] likely to warrant exceptionally low levels of the federal funds rate for some time" (see table). But at this meeting, the FOMC, as well as cutting the policy rate to close to zero, took a momentous step by announcing that "The focus of the Committee's policy going forward will be to support the functioning of financial markets and stimulate the economy through open market operations and other measures that sustain the size of the Federal Reserve's balance sheet at a high level." The Fed, along with some other major central banks, had dramatically expanded the size of its balance sheet since the eruption of the financial crisis in September 2008 as a result of various emergency "credit easing" and lender-of-last resort operations: The balance sheet size was $940.34 billion just before the Lehman failure, an increase of 5.6% year over year, but by the time of the December 2008 meeting was $2.262 trillion, or 141% larger.

Evolution Of The FOMC's Forward Guidance Since The Financial Crisis: Key Changes

Meeting date	Content of, or change in, forward guidance
Dec. 15-16, 2008	"weak economic conditions are likely to warrant exceptionally low levels of the federal funds rate for some time"
Jan. 27-28, 2009	"weak economic conditions" changed to "economic conditions"
March 17-18, 2009	"for some time" changed to "for an extended period"
Nov. 3-4, 2009	"including low rates of resource utilization, subdued inflation trends, and stable inflation expectations" added to "economic conditions"
June 21-22, 2011	"including low rates of resource utilization, subdued inflation trends, and stable inflation expectations" changed to "including low rates of resource utilization and a subdued outlook for inflation over the medium run"
Aug. 9, 2011	"for an extended period" changed to "at least through mid-2013"
Jan. 24-25, 2012	"at least through mid-2013" changed to "at least through late 2014"
Sept. 12-13, 2012	reference to "economic conditions" omitted and "at least through late 2014" changed to "at least through mid-2015"; guidance added for asset purchases
Dec. 11-12, 2008	"at least through mid-2015" changed to numerical thresholds for unemployment rate and expected inflation rate, subject to caveats; "exceptionally low levels" changed to "this exceptionally low range"

Source: Board of Governors of the Federal Reserve System.

The Fed's December 2008 announcement, however, marked a new phase for its monetary policy because it announced that it would purchase large quantities of agency debt and MBS and was considering purchasing longer-term Treasury securities (which it subsequently did). In effect, the Fed was laying the groundwork for migrating its monetary policy modus operandi from "credit easing," as those crisis-spurred programs naturally unwound as financial dysfunction abated and markets normalized, to "quantitative easing" (QE) (3). However, in moving from using the policy rate as the main instrument of monetary policy to using the size of its balance sheet as its main instrument of monetary policy, the Fed tied its forward guidance to the federal funds rate, not to the size of the balance sheet. This was understandable because the Fed's natural inclination is to think in terms of interest rates--it sees forward guidance and QE as also having an easing effect on the term structure of interest rates. But it would sow the seeds of future confusion.

QE (and, to an extent, forward guidance) is best thought of as a policy that the central bank can use if it has run out of interest rate ammunition--that is, when it has cut the policy rate to, or close to, zero. The central bank cuts the policy rate to ease financial conditions, hoping to stimulate economic activity. But how the economy responds to the easing of financial conditions depends on economic conditions (e.g., the balance sheets and sentiment of households and corporations), and, if these are severe, cutting the policy rate to zero may not be enough to achieve the central bank's goals. Not to worry (too much). The so-called "zero (interest rate) bound" doesn't constrain the central bank. It can continue to ease financial conditions, or at least try to, by expanding its balance sheet--purchasing assets paid for by creating excess reserves--and by lowering the term structure of interest rates via its communication about how it intends to operate monetary policy in the future (i.e., by forward guidance).

Thus, QE supersedes interest rate policy. Yet the Fed couched its forward guidance in terms of the policy rate, not QE.

This misalignment between the monetary easing tool the Fed was using at the margin (QE) and the tool referenced by the forward guidance continued up to the Sept. 12-13, 2012, FOMC meeting. By the time of the July/August 2012 meeting, the forward guidance had evolved to the following: "To support a stronger economic recovery and to help ensure that inflation, over time, is at the rate most consistent with its dual mandate, the Committee expects to maintain a highly accommodative stance for monetary policy. In particular, the Committee decided today to keep the target range for the federal funds rate at 0 to 1/4 percent and currently anticipates that economic conditions--including low rates of resource utilization and a subdued outlook for inflation over the medium run--are likely to warrant exceptionally low levels for the federal funds rate at least through late 2014."

But at the Sept. 12-13, 2012, meeting, the FOMC, for the first time, added some forward guidance relating directly to its asset purchases or QE. In launching its open-ended MBS purchases, it stated that "If the outlook for the labor market does not improve substantially, the Committee will continue its purchases of agency mortgage-backed securities, undertake additional asset purchases, and employ its other policy tools as appropriate until such improvement is achieved in a context of price stability." The Fed signaled that when it would stop proactively expanding its balance sheet (a precursor, of course, to starting to deliberately scale it back) would depend on whether and by how much employment conditions improve. But the Fed kept this forward guidance vague and qualitative.

The FOMC also continued with its forward guidance regarding the federal funds rate, further pushing out its expected earliest likely hike in the federal funds rate: "To support continued progress toward maximum employment and price stability, the Committee expects that a highly accommodative stance of monetary policy will remain appropriate for a considerable time after the economic recovery strengthens. In particular, the Committee also decided today to keep the target range for the federal funds rate at 0 to 1/4 percent and currently anticipates that exceptionally low levels for the federal funds rate are likely to be warranted at least through mid-2015."

But, in doing so, it added a new wrinkle. The federal funds rate would remain pegged at or below 25 bps even after the economic recovery strengthened. The minutes of the September meeting made it clear: "That new language was meant to clarify that the maintenance of a very low federal funds rate over that period did not reflect an expectation that the economy would remain weak, but rather reflected the Committee's intention to support a stronger economic recovery."

Forward Guidance: Two For The Price Of One

So now there were two strands of forward guidance. The Fed would keep expanding its balance sheet until labor market conditions improved substantially and would keep the policy rate pegged close to zero until well after the recovery strengthened. Presumably, if labor market conditions improved substantially, the economic recovery would have strengthened, so the commitment to maintain a near-zero policy rate extended beyond the commitment to keep expanding the balance sheet. And that made sense given that QE is a policy that a central bank pursues after reaching the zero bound (or getting very close to it). But there was quite a bit of vagueness in how the two strands of forward guidance related to each other.

Things became clearer with the December decisions. The Fed reiterated that "If the outlook for the labor market does not improve substantially, the Committee will continue its purchases of Treasury and agency mortgage-backed securities, and employ its other policy tools as appropriate, until such improvement is achieved in a context of price stability." But it tied its forward guidance on the timing of the first possible hike in the federal funds rate to observable thresholds for unemployment and inflation: "To support continued progress toward maximum employment and price stability, the Committee expects that a highly accommodative stance of monetary policy will remain appropriate for a considerable time after the asset purchase program ends and the economic recovery strengthens. In particular, the Committee decided to keep the target range for the federal funds rate at 0 to 1/4 percent and currently anticipates that this exceptionally low range for the federal funds rate will be appropriate at least as long as the unemployment rate remains above 6-1/2 percent, inflation between one and two years ahead is projected to be no more than a half percentage point above the Committee's 2 percent longer-run goal, and longer-term inflation expectations continue to be well anchored."

There is a pitfall for the unwary (and, therefore, for the Fed) here. Because the Fed tied its forward guidance on continuing asset purchases to labor market conditions improving and its forward guidance on keeping the policy rate pegged low to the unemployment rate getting down to at least 6.5%, it is not surprising that market participants would conflate the two pieces of forward guidance.

These bits and pieces need to be considered alongside the information in the minutes and the economic projections that FOMC participants make four times a year. The unemployment rate was 7.7% (for November) at the time of the December meeting (later revised up to 7.8% and reported to be 7.8% for December). The projections made at the meeting show that participants expect the (average) unemployment rate in the fourth quarter of 2013 to be in the range of 6.9%-7.8% (or 7.4%-7.7% in terms of the "central tendency" (4) of participants' projections); this is well above the threshold for hiking the policy rate. They also show FOMC participants expecting inflation to be below the 2.5% threshold even out to the fourth quarter of 2015. So, no risk to a stable policy rate (target range) ending this year from either unemployment or inflation considerations. Consistent with that, 14 participants thought that it would be appropriate for the first increase in the target federal funds rate to occur during 2015 or later. By the fourth quarter of 2015, FOMC participants project the unemployment rate to be 5.7%-6.8%.

If at least half of current FOMC members expect asset purchases to be ended (or at least scaled back) by the end of this year, it must be that the threshold for judging that the outlook for the labor market has "improved substantially" is much lower than that for judging that the economic recovery has "strengthened" and sufficient time has elapsed since it has.

Reading The Fine Print

Complicating the mapping between the two strands of forward guidance is that, in an attempt to maintain some flexibility in its future actions in a world of uncertainty, the FOMC has attached riders to its forward guidance. These reflect three distinct considerations.

One is that, in using more aggressive monetary policy in an attempt to improve employment conditions at a faster rate than otherwise would be the case, the Fed is not prepared to sacrifice price stability. The Fed, of all entities, knows its monetary theory and central banking history and that it cannot sacrifice (operational) price stability on the altar of employment gains. It understands that keeping inflation expectations well anchored is key, hence its reference to "in a context of price stability" and "longer-term inflation expectations [continuing] to be well anchored" in its respective forward guidances.

A second consideration at work is that the unemployment rate is not a sufficient statistic for the health of the labor market. In considering whether the labor market outlook has improved sufficiently, the Fed will look at a wide variety of labor market indicators, including likely the labor force participation rate, the composition of the pool of unemployed, the nature of supply and demand mismatches, and its assessment of where the noninflationary rate of unemployment currently is and where it likely is headed.

A third set of caveats pertains to concerns that some FOMC members have about the side effects or possible unintended consequences of QE. Not everyone on the FOMC is as enamored of the Fed's balance sheet expansion as Chairman Ben Bernanke is, some having voted against additional asset purchases or spoken publicly about their limitations and dangers. Hence the minutes of the December meeting show that the "several" FOMC members who thought it would probably be appropriate to slow or stop purchases "well before the end of 2013" did so, not with reference to conditions in the labor market, but "citing concerns about financial stability or the size of the balance sheet." No wonder market participants are a little confused or sense some deep divisions within the FOMC. The FOMC has committed to keep expanding the Fed's balance sheet until labor market conditions improve, but some voting members want to stop expanding the balance sheet because they don't like how big it is getting!

Putting It All Together

So, all together, what is the Fed saying? It has two tools: the policy rate and the size of its balance sheet, and it can provide forward guidance about both. It thinks it can ease financial conditions more to speed up the recovery, thus getting closer to full employment faster than otherwise, by continuing to expand its balance sheet. But it sees risks, and not everyone is exactly on board, so it expects it would likely stop or scale back its purchases when it starts to see evidence of an improving labor market--which it thinks probably will happen going into next year. Even after it stops expanding its balance sheet, it intends to keep the policy rate pegged close to zero at least as long as the unemployment rate remains above 6.5%--if there is no inflationary threat or adverse side effects of its journey deep into unconventional monetary policy territory.

One very important point to bear in mind in all of this is that, according to the theory of QE, QE doesn't end when the Fed stops expanding its balance sheet because QE operates largely through a stock effect (5). "Quantitative tightening," or the winding back of quantitative easing, starts when the Fed begins to shrink its balance sheet by expunging excess reserves.

The bottom line is that the Fed continues to evolve and refine its monetary policymaking as it attempts to achieve its mandated objectives and support the economic and market recovery from the most severe global financial crisis and recession since the Great Depression. Criticized harshly from numerous quarters, some of them very respectable (6), and groping in the fog as it moves deeper into unconventional monetary policy territory, the Fed gets high marks from me for doing its job, even though it has abundant alibis for resting on its laurels.

Endnotes

(1) Specifically, the FOMC announced that it "currently anticipates that this exceptionally low range for the federal funds rate [of 0%-0.25%] will be appropriate at least as long as the unemployment rate remains above 6-1/2 percent, inflation between one and two years ahead is projected to be no more than a half percentage point above the Committee's 2 percent longer-run goal, and longer-term inflation expectations continue to be well anchored." See "The Fed: Full Steam Ahead," Dec. 21, 2012, for more details and analysis of this decision.

(2) On how the Fed sees its communications, and the role of central bank communications in modern monetary policymaking, see the important speech by Board of Governors Vice Chair Janet Yellen on Nov. 13, 2012, "Revolution and Evolution in Central Bank Communications." For another view in the same spirit, see the remarks delivered on Dec. 11, 2012, by Mark Carney, Governor of the Bank of Canada and governor-elect of the Bank of England, titled "Guidance."

Not all central bankers are so enamored of forward guidance, however. When Bank of England governor Mervyn King was asked a question at the Economic Club of New York on Dec. 10, 2012, on his view of using forward guidance about how long interest rates would (likely) remain low, he replied: "we don't believe in the Bank of England that we have a crystal ball which enables us to foretell the future. So we simply do not know what we will be deciding six months, twelve months, two years from now. …What we will actually choose to do at any particular date in the future will depend on the conditions at the time." The standard line of ECB President Mario Draghi, following in the footsteps of his predecessor Jean-Claude Trichet, is that: "we never pre-commit."

The Bank of Japan (BOJ), on the other hand, pioneered forward guidance, including with an element of pre-commitment, in its March 2001 to March 2006 quantitative easing. It reintroduced an element of forward guidance when it announced its "Comprehensive Monetary Easing" on Oct. 5, 2012, by stating that: "The Bank will maintain the virtually zero interest rate policy until it judges, on the basis of the 'understanding of medium- to long-term price stability,' that price stability is in sight, on condition that no problem will be identified in examining risk factors, including the accumulation of financial imbalances". According to the "understanding of medium- to long-term price stability," "on the basis of a year-on-year rate of change in the CPI, each Policy Board member's 'understanding' [fell] in a positive range of 2 percent or lower, and the midpoints of most Policy Board members' 'understanding' [was] around 1 percent." On March 13, 2102, the BOJ evolved its "understanding" into a "price stability goal in the medium to long term," setting a goal of "1 percent for the time being," and modified its forward guidance accordingly.

(3) Most of the Fed's expansion of its balance sheet took place in the first few months after the financial crisis, but the composition of the assets held has changed radically as the Fed moved from "credit" to "quantitative" easing. The latest size of the balance sheet is $2.919 trillion, 29.0% bigger than the balance sheet before the Dec. 15-16, 2008, meeting. The amount of securities held outright (Treasuries and MBS or agency debt securities) increased from $492.1 billion to $2.670 trillion in that period, with MBS and agency debt securities increasing from $15.8 billion to $1.003 trillion, assets held under the credit easing programs declining concomitantly.

(4) The "central tendency" excludes the three highest and three lowest projections, so it is the range of projections of the 13 "least extreme" FOMC participants.

(5) Market participants tend to focus on the flow of asset purchases because, from a trading perspective, that is what is perceived to "move markets," but it is the stock of asset purchases the flow gives rise to that underpins the "portfolio rebalance effect" of QE.

(6) Just last week, for instance, respected Harvard University economics professor Martin Feldstein published an op ed article in the Wall Street Journal ("The Fed's Dangerous Direction," Jan. 3, 2012), arguing that "The Federal Reserve is heading in the wrong direction. What the central bank describes as 'unconventional monetary policy' is creating dangerous bubbles in asset markets that will lead to higher future inflation and is supporting the explosive growth of the national debt. Its new 'communications strategy' will, moreover, only further confuse markets."

This is just one example of the Fed, and Chairman Ben Bernanke in particular, coming under attack from respected academic experts. Stanford economics professor John Taylor, of Taylor Rule fame, wrote in a Wall Street Journal op ed last March ("The Dangers of an Interventionist Fed," March 29, 2012) that "The Federal Reserve should move to a less interventionist and more rules-based policy of the kind that has worked in the past. With due deliberation, it should make plans to raise the interest rate and develop a credible strategy to reduce its outsized portfolio of Treasurys and mortgage-backed securities."

Carnegie-Mellon economics professor, and noted Federal Reserve expert, Allan Meltzer wrote in a Wall Street Journal op ed last July ("What's Wrong With the Federal Reserve?," July. 9, 2012): "By allowing its monetary policy to be influenced by elected politicians and market speculators, the Federal Reserve is putting its independence at risk. It is also neglecting basic economics, which was a great strength of its current chairman, Ben Bernanke."

In an earlier op ed in the Journal ("Fed's Anti-Inflation Exit Strategy Will Fail," Jan. 27, 2010), Professor Meltzer wrote: "Federal Reserve Chairman Ben Bernanke has explained his exit strategy to prevent future inflation. The Fed recently began to pay interest to banks on the reserves they hold in their vaults. Using this new tool, it claims the ability to get banks to keep the money instead of lending it out, thus containing the money supply and inflation. I don't believe this will work, and no one else should."

Suffice it to say, I disagree with (most of) the criticisms of the esteemed professors, but that is a topic for another piece.