The Fed Loosens Its Lips

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INTRODUCTION

Alan Greenspan, chairman of the Federal Reserve, is famous for his ability to say nothing and everything at the same time. He and the other members of the Federal Open Market Committee (FOMC), the decision-making body of the Fed, are often criticized for releasing statements that confuse the public and financial markets about Federal Reserve policy; some feel that the Fed should simply keep its mouth shut. What they don't realize is that until about 15 years ago, that is exactly what it did.

The Federal Reserve has been in existence since 1914, and has been a relatively opaque institution for most of that time. Indeed, most central banks, until recently, believed that secrecy around their decisions was necessary to implement effective monetary policy, following the monetarist argument that only "surprise" movements in interest rates have an impact on the economy. It has only been under Greenspan's tenure as chairman since 1987 that the Fed has moved toward increased transparency in its policy decisions.

Over the last few years, the Fed has taken transparency to a new level, using communication as a tool to implement monetary policy. The Fed has traditionally relied upon its control over the federal funds rate, a short-term interest rate that banks pay to borrow from each other overnight, to influence long-term interest rates and consequently the economy. During the last year, however, it has informed markets through speeches by Fed officials and minutes of FOMC meetings, among others, about its likely interest rate decisions before or sometimes even instead of making them. The Fed has thus been able to move long-term interest rates and affect the economy before actually changing the federal funds rate, and occasionally, without changing it at all.

In addition to providing greater democratic accountability, communication allows for faster reaction to economic news, greater public certainty about the economic outlook, a more nuanced approach to policymaking, and the ability to influence the economy even when the federal funds rate cannot be lowered any further. The practical difficulties in implementation—how best to clearly communicate the Fed's outlook and likely policy decisions in the future—are now the subject of debate, and offer room for improvement in the Fed's communication strategy.

Fed officials will likely continue to use speeches and official statements to update the public on their intentions. The Fed's reliance on communication as a policy tool at this level is unprecedented, but assuming that it is able to convey its intentions, there should be little to no economic effects from the Fed's actual decisions, as the increase in the federal funds rate will already be priced into the markets in the form of higher longer-term interest rates. The FOMC's decision on June 30 to raise the federal funds rate by 25 basis points caused almost no movement in long-term interest rates as the move was widely anticipated; the upcoming decision on August 10, in which another 25 basis point increase is expected, is also likely to produce few surprises.

Short-term Interest Rates and Monetary Policy

In exercising monetary policy decisions, the Federal Reserve uses primarily its control over the level of a key short-term interest rate, the federal funds rate. This rate stood at one percent for one year until the FOMC decided to increase it by 25 basis points at its June 30 meeting.

Short-term interest rates have little direct impact on the economy, but they influence the level of longer-term interest rates, such as mortgage rates, which in turn affect the economy. For instance, if short-term loans become more expensive, banks also have to start charging higher interest rates for longer-term loans to keep earning money. Long-term interest rates reflect the costs of borrowing in the present at short-term interest rates as well as expectations about future economic activities. This includes future interest rate levels, which are reflective of future growth and inflation expectations. Therefore, long-term interest rates depend not only on what the Fed does today, but even more so on what it is likely to do in the future.

The Fed raises and lowers interest rates with the primary goal of ensuring price stability and a secondary goal of promoting strong economic growth. Lower interest rates allow for cheaper borrowing, fueling economic growth by encouraging spending and investment; however, they also leave room for faster price increases due to greater demand. Higher interest rates have the opposite effect, so the Fed plays a balancing act, raising interest rates to curb inflation and lowering them to stimulate the economy whenever inflationary pressures are weak.

Currently, the Fed perceives that economic growth is relatively strong, yet inflationary pressures seem mild due to significant economic slack, especially in the labor market. In this environment, particularly with interest rates close to historical lows, the Fed has indicated that it would like to see interest rates rise to prevent demand-driven inflation in the future, but it has also shown that it does not want them to rise too fast given the remaining weaknesses in the economy. These weaknesses include slow wage and salary growth, large amounts of household debt, and disappointing increases in employment over the last year that have raised serious questions about the ability of the economic recovery to sustain itself. In trying to find the right balance, the Fed has taken pains to prepare markets as much as possible for a gradual increase in interest rates over the last several months via FOMC statements, speeches and testimonies.

Communication as a Fed Policy Tool

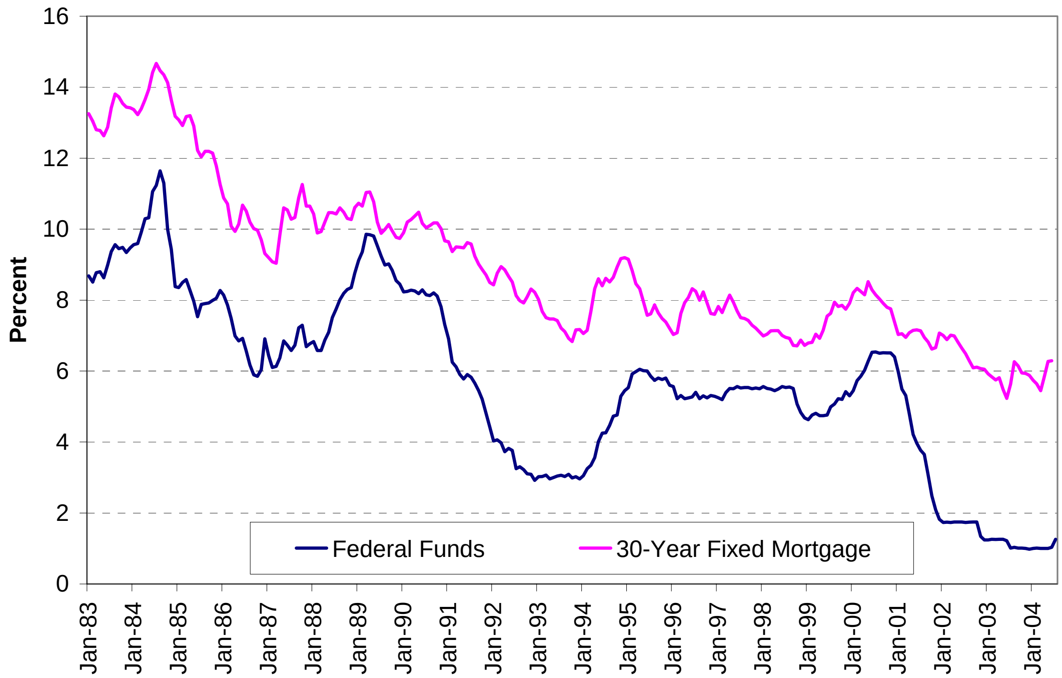
With so much publication attention as to whether and how fast the Fed will raise rates, it seems hard to believe only ten years ago, the Fed’s interest rate target was not even announced to the public. And it was only in 2000 that the Fed started issuing statements with each of its monetary policy decisions to clue the public in as to what the next move might be. Now, this kind of communication has become a new policy tool that the Fed has used with particular vigor over the last year.

Because long-term interest rates are partially determined by the path of short-term interest rates, information the Fed can provide markets about its future policy decisions can help move long-term rates in the direction the Fed wants. To do this, the three components of its policymaking that the Fed needs to convey are its goals (price stability and, secondary, output growth), instruments (control over the federal funds rate) and implementation (the Fed's interpretation of the economic outlook) (Carpenter, 2004). Markets are relatively clear on what the goals of monetary policy are and that the Fed primarily uses the federal funds rate to implement policy. But its economic outlook and future policy decisions are constantly changing and the weight that the Fed places on stable prices relative to output growth at any point in time can only be estimated by those outside the Fed. In making these estimates, Fed watchers rely on the Fed's communication.

When these intentions are conveyed to the public, markets and the economy adjust as the new information alters expectations about the path of monetary policy over the coming months. For example, the Fed made clear earlier this year that one of its primary economic concerns was the "lagging" job market. As a result, interest rates rose sharply once the March employment report showed a comparatively strong gain of 308,000 jobs that month, as market participants moved up their expectations for when the Fed would begin raising interest rates. Since May, the Fed has stated that it would move to increase interest rates, but would do so gradually. Long-term interest rates rose in anticipation of the 25 basis point increase during the month before the Fed actually raised the federal funds rate on June 30 and barely moved after the policy decision.

Central banks are discovering that increased transparency is not only beneficial for the democratic accountability it introduces into monetary policymaking, but that it can also help make policy more effective in achieving its goals. Giving the public access to the Fed's internal dialogue creates greater economic certainty, which reduces risk and thus provides a better environment for economic growth to take place. Fed Governor Ben Bernanke also points out that a more open policymaking process is likely to lead to better policy decisions as a more informed public can provide the central bank with helpful feedback, in the form of outside views and analyses (Bernanke, 2004). Finally, credible communication can help move long-term interest rates without moving short-term rates, which is particularly helpful when short-term rates are at their lowest and have little room to fall further (Figure 1).

Figure 1: Interest Rates



A catalyst in the decision to "talk down" interest rates last year was the incredibly low value that the federal funds rate hit in June of 2003. At one percent, the Fed had little room to lower the rate further should economic growth remain stagnant. The Fed was also worried about slower growth leading to deflation, or declining prices, which can have detrimental economic effects as consumers and businesses may delay purchases in expectations of lower future prices. By issuing statements that it intended to keep the federal funds rate at one percent for a "considerable period of time," the Fed was able to pull down long-term interest rates without lowering the federal funds rate further, and in turn provide added stimulus to economic growth and prices. Communication was thus one of the "unconventional" policy measures that the Fed debated and ultimately used to ease long-term interest rates in the absence of its usual policy tool.

There are undoubtedly problems with the communication strategy that the Fed has employed so forcefully over the last year. Evolving economic conditions may change the Fed's outlook on the economy and force it to raise interest rates either faster or slower than it has communicated it would. In addition, there is always the chance that the public may misinterpret what a Fed official or the FOMC statement says, resulting in unintended consequences. For example, Greenspan's seemingly upbeat testimony on the economy last summer sent long-term interest rates spiraling upwards despite a 25 basis point decrease in the federal funds rate on June 25, 2003, a clear disjoint between the policy the Fed intended to pursue and that which it ended up communicating (Ip, 2003). Finally, the FOMC is made up of 12 voting members, each of whom has his or her own view about the economic outlook. It is nearly impossible to convey an accurate intended path for monetary policy for the group as a whole, given that each has a different opinion on how fast or slow interest rates should rise. Despite these difficulties in implementation, however, attempts to more clearly convey likely policy decisions and the Fed's view on the economic outlook are moves in the right direction.

THE USE OF COMMUNICATION IN THE CURRENT TIGHTENING CYCLE

The 25 basis point increase in the federal funds rate on June 30 took no one by surprise, and that is just how the Fed wanted it. The FOMC statement from the previous meeting, on May 8, indicated that the Fed believed that strong economic growth and an improved job market warranted small and gradual interest rate increases over upcoming months. It stated that it believed interest rates could rise at a "pace that is likely to be measured." The FOMC followed through on this promise two months later, with the 25 basis point hike in June that was already fully priced into the market in the form of higher long-term interest rates.

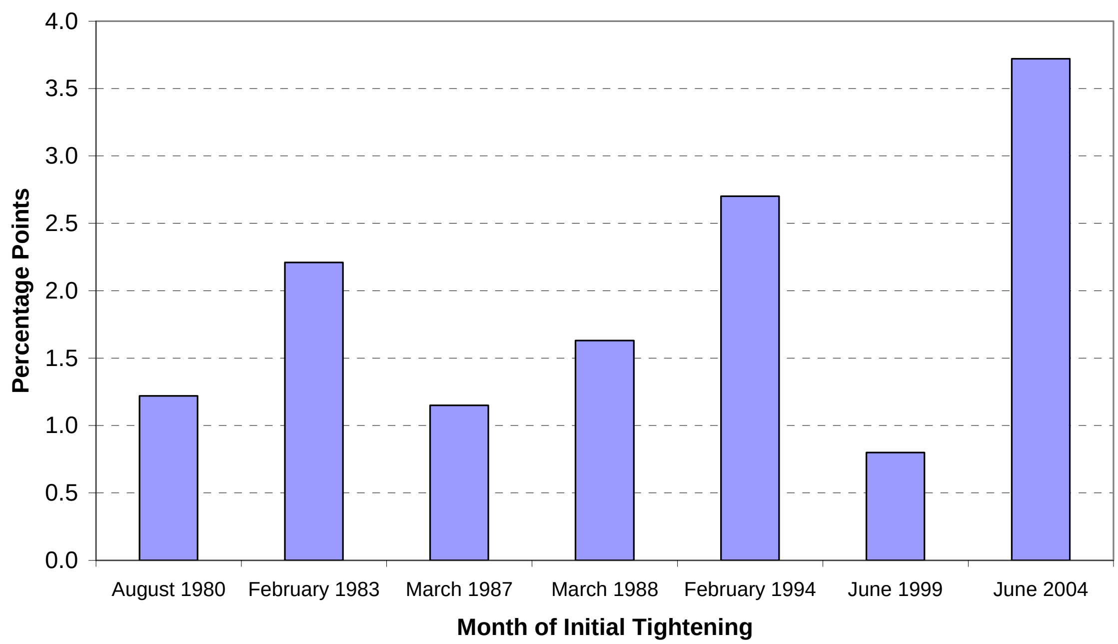
Some have commented that markets were actually over-prepared for the hike in interest rates in June (Task, 2004). The expectation for a 50 basis point increase in the federal funds rate at the June 30 FOMC meeting was significant earlier that month, but steadily declined as weaker economic data and comments by Fed officials led markets to (correctly) anticipate that the Fed would increase instead by only 25 basis points. In this situation, long-term interest rates have actually fallen from their highs in mid-May despite the increase in the federal funds rate, leading to a surge in mortgage refinancing as homeowners take advantage of what they perceive to be their last chance to obtain lower interest rate mortgages on their homes.

Contrast this scenario to that of 1994. In March of that year, the Fed began a series of interest rate increases that surprised financial markets and the economy. Though the Fed believed it had accurately prepared markets for the interest rate hikes, stronger than anticipated economic data forced the Fed to raise rates faster than it had thought would be necessary to prevent rising inflation. The federal funds rate was raised from three percent in March to 4.75 percent in October, a level that was a full percentage point higher than market expectations. The abrupt and unexpected increase in interest rates was blamed for the bankruptcy of Orange County, Calif., whose treasurer had made risky investments betting on low interest rates. As rates rose quickly, the investments lost money, and Orange County was forced to declare bankruptcy (Ip, 2004).

The Fed seems to have learned from the 1994 experience. Recent economic data have been mixed, making the Fed's upcoming policy moves even more uncertain. The FOMC and Chairman Greenspan have been careful to assure markets and the public that the pace of interest rate increases would be "measured" given the economic data and the financial difficulties that come with rising interest rates such as increased debt payment obligations. But they also realize that upcoming economic data could prove to be stronger than expected, necessitating a faster increase in interest rates. Greenspan does not want the markets to forget this and has used his recent testimonies in Congress to remind them that the Fed will not hesitate to push rates up in response to the specter of rising inflation, should it arise.

The extent to which communication helped increase long-term interest rates in the months before the Fed raised the federal funds rate is difficult to test empirically, as many factors influence movement in long-term rates. However, a quick inspection of the spread between the ten-year Treasury yield and the federal funds rate in the months prior to a tightening cycle shows that the spread is the largest it has been prior to any tightening cycle in the last 20 years (Figure 2). Given the weakness of the recovery, especially compared to the strength of the economy during the 1999 tightening, one might expect the spread prior to this cycle to be lower than in 1999. The Fed's use of communication to talk up long-term rates before raising the federal funds rate may be one explanation as to why the ten-year Treasury yield was so much higher than the federal funds rate before this tightening cycle compared to past ones.

Figure 2: Ten-Year Treasury Less Federal Funds Rate in Month Before Beginning of Tightening Cycle



If the Fed is able to convey its intentions clearly, there should be few surprises after the next several FOMC meetings. Although expectations will surely change as economic data provide new information about the future, by the time each meeting rolls around, markets should have a fairly good idea about the Fed's perspective on the economy and what its likely policy decisions will be.

CONCLUSIONS

The Fed's increased transparency over the last decade is a welcome policy change from the days of tight-lipped central banking, but there is still room for improvement.

The Fed's heavy use of communication over the last year in particular has given it a new tool with which to influence long-term interest rates, and through them, the economy. Because long-term interest rates depend in part on expectations about the path of short-term interest rates, the Fed can make its policy more effective by providing information that will help markets better anticipate the path of the federal funds rate. Communication can also help moderate the impact of rate cuts and increases, reducing risk and volatility in markets and providing a better environment for economic growth.

As a policy tool, communication's ultimate goal is to clearly express to the public what the Fed's objectives and outlook are so that markets can adjust their expectations accordingly. But the Fed has been criticized for making its statements too esoteric and sometimes confusing the public about its intentions. Several measures have been suggested both within the Fed and by outside analysts to improve Fed communication. These include releasing the minutes of FOMC meetings earlier (they are currently made public about eight weeks after the meeting); providing the public with descriptions of each FOMC voting member's outlook; preparing a longer and more detailed statement after each FOMC meeting; and making the Fed's economic forecasts more readily available to the public (currently, they are provided twice a year during the Fed chairman's Semiannual Monetary Policy Report to Congress). These policies need to be evaluated on the extent to which they provide a better signal to the public about the Fed's intentions as opposed to simply creating more noise and confusion.

Based on how little markets were surprised by the Fed's first move in June to increase the federal funds rate, it appears that the Fed has communicated its policy intentions fairly well so far in this tightening cycle. Similarly, there should be few surprises arising from the next Fed meeting. However, it remains to be seen whether this will work over a longer period of time as the Fed's task will remain difficult if the economic data continue to tell different stories about the strength of the recovery.

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