

Fed Communications in Unusual Times

BY JOHN A. WEINBERG

On occasion, communication between Fed policymakers and financial-market participants seems less than perfect. The Federal Open Market Committee (FOMC) releases a statement, or the chair makes a remark at a press conference, that triggers outsized market responses — outsized, that is, in relation to the likely economic impact of the Fed action in question. Invariably, in such cases, some commentators complain: Why can't the Fed get communications right?

These occasions may arise most often when policy appears to be near a turning point, or more generally when there is more than a normal amount of uncertainty about the path forward for the economy or policy. This, of course, is when markets would be expected to take the greatest interest in the Fed's exact words. For instance, in 2006, after the FOMC had been raising rates gradually and with great regularity for an extended period — a quarter of a point at every meeting beginning in June 2004 — observers scoured any change in the language of the Committee's statements for hints as to when this measured tightening might end.

The summer of 2013 provided a particularly notable episode of an apparently outsized market reaction. It centered around discussions about the first steps of tapering the Fed's asset purchase program. The program had started in September 2012, with purchases of \$85 billion per month in the form of a combination of long-term Treasury securities and mortgage-backed securities. At its inception, the program was open-ended, with the duration dependent on labor market conditions. Through the first half of 2013, as many market indicators performed better than anticipated, there were questions among observers about when the Fed might begin to scale back its purchases.

For some, Chairman Bernanke's June press conference indicated that the tapering might begin sooner than they had thought. They seemed to focus on his language that "the Committee currently anticipates that it would be appropriate to moderate the monthly pace of purchases later this year ... ending purchases around midyear [mid-2014]." On one hand, these observers gave little weight to surrounding language that emphasized the statement's highly conditional nature; on the other hand, one plausible interpretation was that the chairman was outlining what the FOMC viewed as the most likely course of events. Many commentators saw this episode as poorly handled communication, with the Fed not clearly describing what it was doing and why. Others pointed to the episode as an example of how the Fed's policies can cause financial-market volatility.

I would suggest that economic conditions in this period were ripe for an episode like the so-called "taper tantrum." While Fed communications tend to be of greater public

concern when, as I noted, policy appears to be near a turning point, the stakes involved in Fed communications are even higher than normal during an era in which the Fed is maintaining near-zero interest rates, as it has been doing since December 2008.

Before then, the Fed's interest rate policy since the mid-1980s followed a pattern that had become reasonably consistent and predictable. The statistical relationship between the Fed's policy rate and economic indicators — the Fed's policy reaction function — did a pretty good job of explaining movements in the Fed's interest-rate targets. In theory, forward guidance from the Fed is actually superfluous when its behavior is sufficiently described by such a reaction function and when the inputs into that function (measures of inflation and economic activity) are known to the public. The Fed was never *that* predictable — the Fed's guidance was important and attracted attention during this period — but it was more so than it is today.

What happened? In the Great Recession, the Fed's historical reaction function implied that interest rates should have been significantly negative. The FOMC's ability to set a nominal rate less than zero is limited, however. So the Fed's behavior was forced off of its historical pattern; people who had grown accustomed to that pattern lost their compass. The zero lower bound created a situation of greater uncertainty regarding the future path of interest rates. At the same time, after the Fed lost one of its important levers in influencing the economy — cutting the federal funds rate — the Fed itself became more reliant on forward guidance to attempt to stimulate the economy. These phenomena, in turn, increased the likelihood that statements from the Fed would be closely interpreted, and, in some instances, over-interpreted.

The situation looks like what economists might call a regime-switching problem. After decades of fairly consistent behavior by the Fed, the zero lower bound forced the Fed into a new regime. Now markets have to predict when the Fed will switch out of that regime. But because this is the first time that the Fed's behavior has been forced away from its typical patterns by the zero bound on interest rates, there are no data points about the Fed's behavior that anyone can look at to try to fashion a model and predict when the Fed is likely to do so.

So we see irregularities in how Fed communications and market behaviors interact with each other. It's an illustration of how deviating from predictable policy creates hard problems — both for the Fed and for markets. **EF**

John A. Weinberg is senior vice president and director of research at the Federal Reserve Bank of Richmond.