How will the Federal Reserve manage to reduce the blur?

As the year 2013 draws to an end, it is already a given that U.S. monetary policy will be among the topics most widely discussed in year-end reviews, especially when it comes to the management of communications. After signalling quite explicitly that a reduction in purchases was possible before the end of the year, the Federal Reserve (Fed) surprised in September by leaving intact its asset-purchase program. The U.S. fiscal crisis of October, however, supported the Fed’s decision to remain patient. It also helped pull the focus away from the central bank after the heavy criticism it endured after the September decision. Now that political tensions have abated for some time, investors’ attention converges back to the Fed and many challenges remain for the central bank in terms of communications. This Economic Viewpoint highlights the difficulties experienced in 2013 and discusses the possible adjustments that the Fed could try to make in order to clarify its message.

NOT SO GREAT TRACK RECORD IN 2013
By announcing an open-ended asset purchase program near the end of 2012, the Fed took a significant gamble, namely to be able to properly guide markets when the program would come to an end. Initially, the Fed had little regard for how it would eventually end the program but officials soon realized that it would be preferable to adopt an approach of gradual reduction (tapering) of purchases, rather than declare an abrupt end. It is from this point on that tapering became the big focus of investors. Fairly well understood was the fact that the tapering signal would cause a rise in bond yields. For example, in early spring, the Desjardins Economic Studies forecast projected a scenario where the Fed would begin to reduce its purchases in October, and it was envisaged that the signals sent beforehand would apply upward pressure on bond yields beginning in the summer.

This scenario has indeed materialized, but significantly earlier than expected, and that, because of surprising and sometimes scrambled communications by FOMC officials. For example, on May 22, the Fed released the minutes of the meeting that concluded on May 1, in which one could read that one official had been in favor of an immediate reduction in purchases, while another had declared supporting an increase. It was not so much the relatively extreme positions taken by two members (out of 19) that surprised the most but rather the fact that many FOMC officials had then expressed support for the idea of a beginning of withdrawal as early as the subsequent meeting (the one spanning over June 18 and 19), despite a still bleak context in several respects.

First, the information available at the time of the meeting of May showed a creation of merely 168,000 jobs per month on average between January and March. Second, the unemployment rate was at 7.6%, albeit down from the beginning of the year, but a decline mitigated by the fact that it had been caused in large part by a weaker labour force participation rate. Third, the Fed’s preferred inflation indicator, the personal consumption expenditure deflator excluding food and energy, stood at only 1.1%, well below the Fed’s operating target, set at 2%, exhibiting an almost constant deceleration since early 2012 (graph 1 on page 2). Fourth, the U.S. economy was under a fiscal shock after the sequestration cuts that took effect in March, the impact of which were difficult to evaluate. The fact that, in an environment as uncertain, a number of officials were already willing to reduce the pace of monthly purchases could only have one explanation: the Fed was concerned about the adverse effects on financial stability from holding on to the policy for too long. This message resonated very loudly in markets and was enough to send bond yields soaring.

On June 19, when Ben Bernanke confirmed in a press conference that a reduction was possible later in the...
year, markets read this as a signal for the meeting of September 17 and 18, that is, the next meeting that was to be accompanied by a Chairman press conference. In July, during a communication venture obviously aimed at preparing markets for the possibility of a move, officials issued three key warnings to markets. First, the pace of purchases was not to be perceived as having a predetermined path. It was a way for the Fed not to commit to a certain date. Second, the start of tapering did not imply in any way an earlier rate hike. Third, and crucially, tapering was not to be interpreted as a tightening gesture, but rather as a slower increase in the degree of monetary stimulus. It was armed with these arguments that several FOMC officials attempted to fight the selloff.

These efforts were unsuccessful; after a brief lull in July (graph 2) bond yields continued to rise in August and it would appear that a blur around monetary policy played a role in the second selloff wave. For example, the Federal Reserve of New York monthly survey of primary dealers conducted in early September (before the monetary policy meeting) showed that respondents felt that the most recent part of the selloff was due to the combination of a change in market perception about the path of interest rates, uncertainty over the succession to Ben Bernanke (Lawrence Summers had not yet withdrawn from the race), and a generally high level of uncertainty about monetary policy. In contrast, the evolution of the economic outlook was seen as having little influence (graph 3). For a central bank that has tried to convince markets that its decisions were data-dependent, this was a rather disappointing verdict.

Then, when the Fed caused a stir by not announcing tapering in September, several questions were raised about the third message conveyed by officials during the summer, that is, that the tapering was not tightening. The minutes of the meeting highlighted the fears among some FOMC members that announcing tapering would cause an even steeper rise in interest rates, especially those of mortgages (graph 4), in turn restricting growth. The incongruity in relation to the prior message was gaping.

CLEAR THE FOG

There is little question that the Fed will need to set the record straight. In particular, if it considers that tapering may be accompanied by large upward pressure on interest rates, this would imply that it faces at least two issues. First, it
Investors considerably moderated their expectations in the unemployment rate would lead to a reduction of approximately US$25B in the amount of purchased securities during the following month. The advantage of this approach is that investors would know better what to expect and the level of monetary support would remain linked to the achievement of economic goals, as desired by the Fed. The practical application of this concept, however, presents some obvious challenges. This would also not solve the problem of the level of unemployment as a faithful representation of overall macroeconomic conditions. It nonetheless illustrates the kind of tradeoff that the Fed faces: commit itself to a somewhat mechanical approach in favor of more predictability, or rather retain a degree of flexibility at the expense of a less transparent policy and more volatility. Until now, it has favored the second approach, but the tightening experienced this summer may have sparked a debate on the benefits of the first.

1) Specify the criteria guiding the decision to reduce purchases
The Fed mentions that tapering will become possible when there are signs that the economy grows sufficiently strong to generate a sustained improvement in the labour market and a gradual reduction in unemployment. However, officials have provided very little information on what constitutes a “sufficiently strong” economy and investors have been mainly focusing on job creation figures. For example, in early spring, some observers speculated that the Fed would be confident enough to make an announcement in September if job creation showed a monthly average of 200,000 by then. However, the tapering signals sent by Ben Bernanke in May and June blurred the picture and investors appear to have lost sight of the importance of economic data. Thus, despite the fact that at the time of the September meeting, the latest data showed that the three-month moving average of job creation stood at a meager level of 148,000, far from the 200,000 that were the subject of discussions in early spring, markets believed firmly that the Fed would announce tapering. Adding to the confusion, the unemployment rate had progressed from 7.6% in May to 7.3% in August, and Ben Bernanke had mentioned in June that by the time the Fed would be done purchasing assets, in about mid-2014, the unemployment rate could be expected to stand at around 7.0%.

Obviously, markets would have been less easily misguided if the Fed had been a little clearer. One of the problems came from the calibrating effort between financial stability considerations and the tone of economic statistics. Investors were not wrong in thinking that the tapering signal was partly motivated by financial stability concerns but the fact that the Fed has been able to provide little more than vague statements about economic conditions that would support of tapering is largely what mislead investors. The trouble is that officials themselves still appear to be in a fog over what ought to be the tapering reaction function.

Some are nonetheless aware of the problem and have made initial suggestions. For example, Governor Jeremy Stein recently proposed that the level of monthly purchases be established according to the evolution of the unemployment rate. A fictional version of this framework would stipulate that every tenth of a percentage decrease in the unemployment rate would lead to a reduction of approximately US$25B in the amount of purchased securities during the following month. The advantage of this approach is that investors would know better what to expect and the level of monetary support would remain linked to the achievement of economic goals, as desired by the Fed. The practical application of this concept, however, presents some obvious challenges. This would also not solve the problem of the level of unemployment as a faithful representation of overall macroeconomic conditions. It nonetheless illustrates the kind of tradeoff that the Fed faces: commit itself to a somewhat mechanical approach in favor of more predictability, or rather retain a degree of flexibility at the expense of a less transparent policy and more volatility. Until now, it has favored the second approach, but the tightening experienced this summer may have sparked a debate on the benefits of the first.

2) Manage the transition from the quantitative easing tool to the forward guidance tool
From the moment the Fed will no longer be buying assets, its main tool to influence the yield curve will be its forward guidance on the federal funds rate. The bond selloff of the summer of 2013 has illustrated how difficult this transition will be. Recall that the guidance is currently articulated to state that the federal funds rate will remain unchanged at least until the unemployment rate reaches 6.5%, provided that the inflation forecast in the next 12 to 24 months remains below 2.5% and that inflation expectations remain anchored. Markets did not comply with this guidance in the summer, as expectations regarding the first rate hike had been brought forward to the end of 2014 at some point (graph 5). This dynamic and the corresponding upward pressure on bond yields eventually played in the Fed’s decision not to proceed with tapering in September.

Graph 5 – Investors considerably moderated their expectations after Federal Reserve decision

However, the Fed cannot continuously delay tapering and in order to limit the tightening effect, it will need to be...
able to convince markets of the credibility of its forward guidance. One of the methods that have been mentioned a few times (including by Ben Bernanke) is a 0.5 percentage point reduction in the unemployment rate threshold, to 6.0%. Assuming a relatively unchanged forecast for the rate of unemployment, the benefit would then be able to signal a farther rate hike, to the extent that the Fed believes that this is the language adjustment to make in order to counter the tightening effect of tapering. However, this strategy would be problematic from the point of view of credibility. Indeed, changing the threshold would imply that the Fed has previously misjudged macroeconomic conditions characterizing an unemployment rate at 6.5%. There would be little reason to believe that a level of 6.0% would represent a better evaluation. In addition, assuming that a reduction would imply a greater tolerance to above-target inflation, markets may have difficulty adhering fully to the idea of a certain degree of *laissez-faire* on inflation after the Fed’s multi-decade efforts to build its inflation-fighting credibility.

An alternative strategy would be to give more assurance to the fact that the threshold of 6.5% is not an automatic trigger. This is all the more necessary that there is considerable uncertainty around the level of unemployment that characterizes a strong economy. A way for the Fed to reinforce this message would be to add an inflation outlook condition to the unemployment rate condition. Thus, the prospective indication could for example require that an unemployment rate of 6.5% is reached and that a sustainable return of inflation to its target of 2.0% is expected in the next six quarters. Jointly meeting these two criteria would arguably be more likely to represent an economy that performs satisfactorily than the only achievement of the 6.5% level. The Fed could moreover mention that these two thresholds still do not represent automatic triggers.

**FAMILIAR CASE FOR JANET YELLEN**

If it is likely that the Fed will make some of these adjustments, it is still not guaranteed that it can properly control the market’s reaction. The quantitative easing policy has brought with it a number of distortions such as the aberration of a negative term premium for two years (graph 6), increased use of leverage which has encouraged risk-taking, as well as large capital flows to emerging countries, to name a few. Rewinding it all without a glitch will be a challenge, which is why the appointment of Janet Yellen to succeed Ben Bernanke is of particular importance.

As head of the subcommittee on communications, she certainly shares some responsibility for the recent difficulties incurred by the central bank. As a major advocate for greater transparency, she had been a strong supporter of the shift from a date-based guidance to a threshold-based guidance, a framework that has shown its limitations. However, given that she is thoroughly familiar with the issue of communication and transparency, Janet Yellen is probably one of the best placed to make the necessary adjustments. About a year ago, she admitted herself that much remained to be done to refine communications. She mentioned among other issues the interpretation difficulties caused by the fact that the Fed’s economic forecast was an amalgam of individual members’ forecasts, rather than a single, consensual vision (such as the one issued by the Bank of Canada, for example). This is an important admission because the tapering signal and the forward guidance currently use Fed forecasts as critical input. At the minimum, it suggests that the Fed still sees communication refinement as work-in-progress and that some possibly major innovations might still lie ahead.

**CONCLUSION**

Even if the Fed should be in good hands with Janet Yellen, the delicacy necessary to perform this task necessarily means that new episodes of market volatility remain likely in coming quarters. Recent experience indicates that the Fed will tend to lean against too-abrupt tightening of financial conditions and will not hesitate to delay tapering if it feels that this is the best way to achieve this. Investors are therefore advised to integrate this dynamic in the weeks and months ahead. We nonetheless would expect the Fed to fairly quickly bring answers to many pending questions, and strive to deliver a more robust communication framework.

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