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Fed's New Communication Strategy: Will it Work?

In its monetary policy on August 9, 2011 Federal Reserve changed its communication stance. The earlier FOMC statements mentioned Fed would maintain exceptionally low rates for an extended period of time. The new statement mentioned Fed would maintain exceptionally low rates till mid-2013. Hence, from an open-ended commitment it becomes a close-ended commitment with a time frame.

This strategy of time based commitment was even followed by Bank of Canada in response to the 2008 crisis. This short note analyses and compares the two central banks policy statements with respect to this new communication strategy. It also looks at lessons from Bank of Japan as it implemented a communication strategy to fight deflation in 2001. The note ends looking at the growing dissent in FOMC and its likely impact on future Fed policies.

I. Bank of Canada vs. Federal Reserve Communications

Ben Bernanke has been a leading researcher in field of depressions and situations of zero interest rate policy. In his research on Japan he had mentioned that under Zero interest rate policy (ZIRP), central bank communications can play a large role in forming market expectations. Bernanke said central banks can also use communications apart from unconventional monetary policy of asset purchases. Communication strategy helps form market expectations that central bank would maintain low interest rates till economy recovers. This then leads to lower interest rates in the subsequent period which in turn helps promotes economic activity.

There are two kinds of central bank communications in a ZIRP - unconditional and conditional. Unconditional is when a central bank says it commits to keep policy rates at zero levels for a fixed period of calendar time. A conditional is not linked to the calendar but to economic conditions like inflation and growth. For example in May-01, Bank of Japan adopted conditional communication strategy of keeping rates at zero as long as economy experienced deflation. Federal Reserve also used conditional strategy in Aug-03 when it said policy accommodation can be maintained for a considerable period given unwelcome disinflation in the economy.

Based on this classification, let us look at recent communication strategies of Bank of Canada and Federal Reserve. In Mar-09, Fed communicated that it would keep policy rates low for an extended period of time given the economic conditions.

> *"The Committee will maintain the target range for the federal funds rate at 0 to 1/4 percent and anticipates that economic conditions are likely to warrant exceptionally low levels of the federal funds rate for an extended period."*

In a way Fed implemented the conditional communication strategy practiced in 2003. The policy rates would remain low for an extended period of time and conditioned on state of economy.

Bank of Canada (BoC) followed Fed and lowered policy rates in its Apr-09 monetary policy meeting to 0.25%. BoC also added a commitment of holding rates at 0.25% till Q2 2010 conditional on the inflation outlook.

> *"With monetary policy now operating at the effective lower bound for the overnight policy rate, it is appropriate to provide more explicit guidance than is usual regarding its future path so as to influence rates at longer maturities. Conditional on the outlook for inflation, the target overnight rate can be expected to remain at its current level until the end of the second quarter of 2010 in order to achieve the inflation target. The Bank will continue to provide such guidance in its scheduled interest rate announcements as long as the overnight rate is at the effective lower bound."*

So, BoC followed both unconditional and conditional communication strategy as it specified rates would be low for a specified time period and conditioned on inflation outlook. The main reason for this difference could be that as BoC is an inflation targeting bank, it needs to make its policies centered on inflation. In its Jun-10 policy, BoC removed the conditional commitment as Canadian economy recovered and raised policy rates by 25 bps to 0.50%.

In Oct-10, Bank of Japan announced further round of monetary easing to stimulate the struggling economy. It lowered the policy rates from 0.1% to a range of 0-0.1%. It adopted a conditional communication strategy just like it did in 2001:

> *Bank would 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.*

Bank also clarified that most of its board members understood medium to long term price stability as CPI at 2% or lower. Apart from inflation it also added financial stability as a condition.

II. Impact of Communications Strategy – Japan, Canada and US

Ben Bernanke, Vincent Reinhart and Brian Sack in a paper (Monetary Policy Alternatives at the Zero Bound: An Empirical Assessment, 2004) analysed the communications and asset buying policies of Bank of Japan (BoJ) during Japan's crisis. They find that there is no reliable relationship between one year ahead interest rate expectations and BoJ communications. So, in a way BoJ was either unwilling or unable to influence one year expectations. However, the yields in Japan were lower following the BoJ policies indicating the unconventional policy was effective albeit in limited manner. BoJ has always been criticized for not being clear in its policies and unwillingness to tackle Japan's economic problems. So, one cannot really say whether BoJ policies were ineffective because of lack of proper policies or lack of implementation.

However, in this crisis the central bank intent to fight the crisis has been clearer. Initial research by San Francisco Fed economists Puneet Chehal and Bharat Trehan showed that the BoC's specific and conditional commitment did not really matter. In a paper (Talking about Tomorrow's Monetary Policy Today, 2009) they showed that interest rates in Canada on average were lower than US in the period from April 21 (the date of the Canadian announcement) to the end of June, but rose to roughly equal the U.S. rate after the data moved out of the commitment window. The economists said that higher rates in Canada were on account of markets expecting better incoming data showing a more robust Canadian economy.

San Francisco Fed paper was written in Nov-09 when both Fed and BoC policies were just about 6 months old. In Aug-10, BoC economist Zhongfang He wrote another paper reviewing BoC communications strategy in the whole period from Apr-09 to Jun-10. He shows that the communications strategy helped in shifting Canadian yield curve downwards with lower short term and long term interest rates. The evidence appears to suggest that the Bank of Canada's conditional

commitment likely has produced a persistent effect in lowering Canadian interest rates relative to what their historical relationship with inflation and unemployment rates would imply.

III. Fed Policy from Aug - 2011

Federal Reserve shifted its communication strategy in FOMC held on Aug 9, 2011. Instead of saying it would keep policy rates lower for extended period, Fed has made it time-specific like Bank of Canada:

> *"The Committee 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 mid-2013."*

Hence, Fed has changed its communication policy from just conditional to both unconditional (having a time frame) and conditional (based on resource utilization and inflation). In a way, Fed is taking a cue from Bank of Canada for keeping its rates low for a specified period of time. This provides markets forward guidance on interest rates and policies. By doing this, Fed has ended speculation on the duration of extended period. The markets were expecting Fed to start raising policy rates sometime by 2012 but it is unlikely now unless the economic situation changes drastically to high growth and inflation.

Fed has been under pressure to provide further policy stimulus in wake of another soft patch. The economic conditions particularly confidence has declined even worse than what was seen before QE-II. The research shows QE-II was not as effective and both banks and companies have large cash reserves in their balance sheets. But neither banks are lending nor companies are investing because of uncertain economic environment. Fed can only create liquidity but cannot ask banks/companies to lend/invest.

In such a scenario, Fed has used this communication strategy to provide further comfort to the economy. The new communications strategy coupled with weak economic data has helped push US 10-year Treasury note to almost 2% levels. Cleveland Fed President, Sandra Pianalto, says the result of Fed's policy has been consistent with her anticipation that it would lead to lower policy rates. However, the lower policy rates are also on account of data showing US economy is again weakening. There is also a rush for safe haven assets as financial markets have been highly volatile. Hence, it is difficult to say whether the lower rates are because of Fed's new communications.

IV. The Three Dissents

The Fed policy of keeping low policy rates till mid-2013 met with stiff dissents in FOMC. Three members in FOMC dissented making it the first time that three members dissented since Nov-92 under former FOMC chairman Alan Greenspan's tenure.

> *"Voting against the action were: Richard W. Fisher, Narayana Kocherlakota, and Charles I. Plosser, who would have preferred to continue to describe economic conditions as likely to warrant exceptionally low levels for the federal funds rate for an extended period."*

These members also disclosed the reasons for their dissent:

- **Richard Fisher, President of Dallas Fed:** In a speech (Aug 17, 2011), Fisher expressed that Fed has refilled the tanks needed to fuel economic expansion with huge creation of money supply. However, banks and companies are not willing to engage in economic activity because of uncertainty created by political climate in US. The fiscal and regulatory policy in US has created a business environment where no one is willing to take a risk and invest. As a result, people are postponing projects leading to much weaker recovery. The debt ceiling episode has created further problems by showing how politicized the economic decisions in US have become. He says unless these problems are resolved there is not much hope and Fed cannot do anything about these issues:

  > *"It will be devilishly difficult for businesses to commit to adding significantly to their head count or to meaningful capital expansion in the United States until clarity is achieved on the particulars of how Congress will bend the curve of deficit and debt expansion and the "cloven hooves" are revealed. No amount of monetary accommodation can substitute for that needed clarity. In fact, it can only make it worse if business comes to suspect that the central bank is laying the groundwork for eventually inflating our way out of our fiscal predicament rather than staying above the political fray—thus creating another tranche of uncertainty."*

  He added he is not worried over inflation as it is expected to remain subdued because of low business activity.

- **Narayana Kocherlakota, President of Minneapolis Fed:** He explained his reason for dissent via a message published on Minneapolis Fed website. His stance is different from Fisher as he highlights growing risks from inflation as a reason for his dissent. He said macroeconomic data did not reflect a need to make monetary policy more accommodative than in November 2010. In particular, personal consumption expenditure (PCE) inflation rose notably in the first half of 2011, whether or not one includes food and energy. At the same time, while unemployment does remain disturbingly high, it has fallen since November. Hence, there is no real need for additional stimulus or creating a belief that economy is expected to remain weak till mid-2013.

- **Charles Plosser, President of Philadelphia Fed:** There are no official statements from Plosser but he has been suggesting for normalization of Fed monetary policy for a while. He thinks US economy has recovered and does not require any more stimulus. Plosser was quoted on Bloomberg radio calling Aug-11 policy as "the inappropriate policy at an inappropriate time." He added he would have liked to wait for Sep-11 data to make a decision.

All the three members have dissented for different reasons with some similarity in Kocherlakota'a and Plosser's views. As this communication stance is likely to be mentioned in FOMC statements till mid-2013, we should atleast expect continuous dissents in all FOMC meetings in 2011. None of these three regional Feds are voting members in 2012 and 2013, so there will be no dissents from them in 2012 and 2013. However, there could be new dissents from other members like St Louis Fed President James Bullard who said he would have dissented against Fed's Aug-11 statement as well. He said economy is expected to grow at a moderate pace through the second half of the year and there is no need for further stimulus unless data worsens significantly.

The dissents are healthy as it allows people to express their views and helps build a debate around issues. But in such times, they also lead to a lot of confusion and chaos in the markets. Hence, despite Fed saying that it would maintain low policy rates till mid-2013, market participants are uncertain because of the rising number of dissents in FOMC.

Fed is again being pushed to a corner by financial markets to initiate another round of stimulus. The same scenario happened in 2010 as well. Ben Bernanke talked about possible measures in Jackson Hole -2010 conference which was followed by QE-II in Nov-10 policy. After Bernanke's speech

markets were certain that QE-II was coming and most experts only discussed the quantum and nature of QE-II. The same is happening now with people expecting Bernanke to highlight measures in Jackson Hole-2011 conference and people expecting some measures in Sep-11 FOMC. John Hatzius, chief economist of Goldman Sachs has even said QE-III is a near certainty. Dallas Fed President Richad Fisher has expressed concern that these policies are increasingly leading to the belief that there is "Bernanke Put" where Fed will always ease policies if financial markets decline. This is a dangerous development and Fed will find it very difficult to break this rising belief.

It will be interesting to see whether Bernanke again takes the bait despite evidence showing that previous policies have not been as effective. Even if Bernanke is convinced of another round of stimulus, it would require a herculean effort to convince his FOMC counterparts of the need for the stimulus.

V. Concluding Thoughts

This paper points how the new Fed communication strategy of keeping low rates till mid-2013 is another attempt to maintain easy monetary policy in US. Markets were expecting Fed to end its easy policy rates by 2012 but Fed extended the period of low policy rates further to mid-2013. This communication strategy was used by Bank of Canada in the early part of the 2008 crisis. Initial research shows the Bank of Canada policy was successful in keeping interest rates lower than what they would have otherwise been. Even research from Bank of Japan shows the communications strategy along with quantitative easing helped keep interest rates lower in Japan.

However, the current times are different from those seen around 2008-09. The entire global economy was heading towards a steep decline in 2008-09 and stimulating policies of any kind did have some impact. Hence, we did see interest rates declining both in Canada and US following their central bank policies. But it is not the case currently with emerging markets and even some developed economies like Canada and Australia growing after recovering much faster from the crisis. They might again be impacted due to the US slowdown but is unlikely to be the scenario seen around 2008-09. The interest rates in US are already very low and it is unlikely that they would drift any lower. The low interest rates anyways have not been able to push consumption and investment activity. In such a scenario, the probable impact of Fed's new communication policy and other policies to be announced by Bernanke is likely to be muted.

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