Fed's Big Question: Not What to Do, But What to Say

With Economy at Crucial Point, Debate Rages Over How Bank Gets Message Out

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WASHINGTON -- When the Federal Reserve announced that it would be leaving its key interest rate unchanged after its August meeting, it added a significant comment: The rate could stay low for a "considerable period."

Behind those two words is an intense debate inside the Fed that has major implications for the future of the economy and for how the Fed manages it at a crucial turning point. Indeed, what to say -- as opposed to what to do -- about interest rates has become the most divisive issue at the Fed.

The reason: Inflation, for the first time since the early 1960s, is as low as the Fed wants -- so low, in fact, that there's a remote risk of the economy tipping into a debilitating deflation. Yet the Fed's key weapon in fighting deflation, the federal-funds rate, is at a 45-year low of 1% and can't go much lower. So one of the Fed's biggest levers today is using words to influence long-term interest rates. And with the economy at a crossroads -- recovering slowly but with an unusually weak job market -- the world is attending to the Fed's utterances more carefully than ever.

Special Meeting

Opposing camps inside the Fed have sprung up over how much to say. Last month, the Fed's policy-making body, the Federal Open Market Committee, held its first special meeting in 24 years to discuss how it communicates with the public.

When the FOMC met in August, it readily agreed to leave the target for the federal-funds rate -- what banks charge each other on overnight loans -- at 1%. But members of the committee disagreed sharply about what to say in the statement accompanying the decision, which markets dissect for hints about the Fed's future plans. Fed Chairman Alan Greenspan wanted to send a striking message: Interest rates could stay low for a "considerable period" without fueling inflation. It's exceedingly rare for the Fed to make any comment on how it will set interest rates beyond the next month or two. But Mr. Greenspan wanted to emphasize that the Fed didn't need to strike pre-emptively at inflation by raising rates, as it had in previous recoveries.
Many members of the committee -- made up of seven governors in Washington and the 12 reserve-bank presidents -- objected to language that sounded like a long-term commitment, according to people familiar with the debate. These members worried that the economy could take the Fed by surprise and force it to raise rates quickly and break its perceived commitment to keeping rates where they were -- or, worse, that the Fed would feel bound by its statement and keep rates low too long and let inflation revive. Either outcome could batter the Fed's credibility.

Seeking Agreement

Anxious to maintain as much agreement as possible, Mr. Greenspan took the unusual step of polling all 19 FOMC members, according to people familiar with the matter. Only 12 of the members vote on interest rates at a given meeting: the seven governors, the New York Fed president and four other reserve bank presidents on a rotating basis. The results of this previously undisclosed move: Seven members opposed the "considerable period" sentence, a surprising show of disagreement with the chairman. So, he and the other FOMC members agreed to keep the phrase "considerable period" but de-emphasized the link to inflation developments.

The Fed's new candor has created a new challenge: signaling when the "considerable period" is coming to an end. Officials know that dropping or changing the words could roil markets as much, if not more, than the rate increases that would follow. With unemployment high and inflation at risk of edging lower, any such increase is likely many months away. But long before that, the Fed will have to alter its message to reflect the improving outlook. The issue of how to do so without triggering a dramatic and harmful jump in long-term rates may come up as early as Tuesday's meeting of the FOMC.

"Most Fed members agree keeping the funds rate at 1% is unsustainable," says Bank of America chief economist Mickey Levy. But in the meantime, he says, investors are exploiting the Fed's commitment to low interest rates by making riskier investments in long-term and corporate bonds. When the Fed's rate outlook changes, those investors could dump their securities en masse, jolting the markets and the economy.

Opening Up

For decades, the Fed was so secretive that it wouldn't even say when it had changed interest rates, never mind how it might set them in the future. That began to change after Mr. Greenspan took office in 1987. The stock-market crash that year was one of several events that showed the value of being clear about policy-driven interest-rate changes. In 1994, the Fed began to issue a statement each time it changed rates. In 1998, it decided to also say when it had changed its "bias": the direction in which it was inclined to move rates in the next month or two. In January 2000, the Fed adopted its current policy of releasing a statement after each FOMC meeting -- there are eight each year -- even if it hadn't changed rates, and giving an assessment of whether weak growth or higher inflation was the greater risk.

The Fed has struggled to make this statement conform to economic reality and the vagaries of 19 people's opinions. It has changed the format repeatedly this year. Indeed, many officials objected to adding the "considerable period" language in August out of concern the Fed hadn't worked out the implications of prior changes to its communications strategy.

To address these concerns, the FOMC held a special meeting -- its first since 1979 -- the day before its regular Sept. 16 meeting to discuss how the Fed should be communicating with the public. Officials spent several hours over a buffet dinner in the Fed's boardroom taking turns giving their view but ended up sticking with the status quo. The Fed left rates unchanged in September and issued a statement
almost identical to August's, vowing to keep rates low for that undefined "considerable period."

The debate has continued in public. One school, led by rookie governor Ben Bernanke, argues that the Fed should talk more clearly about its thinking. The other school is led by Federal Reserve Bank of St. Louis President William Poole, who warns that talking more may mislead the market and hurt the economy.

Both Mr. Bernanke, 49 years old, and Mr. Poole, 66, were noted academics specializing in monetary policy before joining the central bank -- Mr. Poole at Brown University and Mr. Bernanke at Princeton. They still reflect their academic backgrounds: They are the only FOMC members with beards, and their speeches are laden with scholarly references. Both are longtime Republicans. And both agree that in the long run, the Fed's words won't matter unless they are backed up by its actions.

But they disagree on the value of talking about those actions. Mr. Bernanke argues that the Fed must be clearer about where it thinks the funds rate will go and what will drive its decisions, because that's the best way to influence bond markets and thus the economy. Refusing to talk isn't a solution, he says, because someone else will fill the vacuum. "From individuals speaking or from pundits speculating, it's just going to be noisier and more cacophonous than ever," he says. "Any kind of guidance we give from the FOMC has got to be better than that."

Mr. Poole counters: "More words don't necessarily create more clarity." He is deeply influenced by a study he co-authored that found that futures contracts based on the federal-funds rate were surprisingly accurate at predicting the Fed's moves. He says that's because Fed actions are based on economic developments that the Fed isn't any better at forecasting than the markets. If the Fed did talk about future moves, it could well be wrong and mislead the public. "You don't want firms making investment decisions ... that affect people on the basis of misinformation," Mr. Poole says. While the public will always make errors about the outlook, Fed officials should "minimize our contribution to those errors."

Of the two, Mr. Poole has more of a reputation as a maverick, but he isn't alone in his concerns: To some degree, at least half the 12 regional bank presidents share his concern that the Fed is inviting trouble by talking about future rate inclinations. This group also appears to be less worried about deflation and thus likely to press sooner for a rate increase. Meanwhile, Mr. Bernanke's fellow Washington-based Fed governors broadly share his belief in increased communication, though some think the Fed's recent commitment on future rates shouldn't become standard practice.

Mr. Greenspan's own position is complicated. Like Mr. Bernanke, he strongly believes in letting the markets know what the Fed is thinking. But like Mr. Poole, he is wary of making any sort of commitment that would tie his hands. The chairman also has the challenge of crafting a consensus among FOMC members.

To make the statement as reflective of the overall committee as possible, he reads the speeches and press coverage of other policy makers, attends board meetings of reserve banks and occasionally chats with Fed members by phone. But in the end he alone, with the advice of staff, writes the statement.

The dispute in August was over more than just the words "considerable period." As the importance of Fed talk has grown, some officials, especially reserve bank presidents, who see little of Mr. Greenspan between meetings, have chafed at their lack of input into the statement. It is typically handed out at the end of the meeting and while sometimes commented upon and tweaked, it is not normally put to a vote, as it was in August.

These long-brewing concerns over how the FOMC communicates were brought to the fore by the
summer's events, when the Fed wrestled with the issue of deflation, or generally falling prices. Deflation can hurt the economy by squeezing heavily indebted borrowers, as wages and profits fall but debts remain fixed. It also weakens the central bank's power to stimulate spending, because interest rates can't go below zero.

For years, deflation was considered impossible so long as the Fed could print as much money as it wanted. Even if the federal-funds rate went to zero, Mr. Greenspan told Congress last November, the Fed could simply purchase Treasury bonds to push down long-term rates, which move in the opposite direction of bond prices. In following months, numerous other Fed officials cited bond purchases as one option to fight deflation.

But as inflation began to drop rapidly early this year, he began to reassess the risk of deflation. With his blessing, the Fed's staff in Washington and New York embarked on a crash course to figure out the best "unconventional tools" for boosting the economy should the funds rate hit a floor at or near zero.

In April, Princeton economist Michael Woodford made a three-day visit to the central bank to discuss the significance for the U.S. of a paper he had co-written on how the Bank of Japan, which had cut interest rates to almost zero, could defeat deflation. Buying bonds wouldn't lower long-term interest rates, he argued at a session attended by four Fed governors, unless the Fed also convinced investors the federal-funds rate would remain low either for a long period or until some target was met, such as a particular inflation rate. If investors didn't believe the funds rate would stay low, they would sell bonds, pushing long-term rates up and overwhelming the offsetting impact of central-bank bond purchases.

Coincidentally, Mr. Greenspan was about to put that view to the test. For the May 6 meeting, he drafted a statement that split the Fed's risk assessment in two parts. It said risks to economic growth were balanced, but the risk of a "substantial unwelcome fall in inflation" exceeded the risk of an increase. That was the first time in more than 40 years the Fed had suggested inflation could be too low.

A few weeks later, on June 3, Mr. Greenspan told a conference of bankers that while he still thought deflation unlikely, the Fed needed a "firebreak" to ensure it didn't happen. The remarks sent traders scurrying to look up the definition of "firebreak" on their Bloomberg terminals' dictionary.

Daily Topic

Those statements, along with the earlier ones on bond repurchases, convinced investors the Fed would leave rates low for an exceptionally long time, and might soon start buying bonds to prevent deflation. "It was a daily topic of conversation at our investment-committee meetings, whether or not the Fed would, under certain circumstances, be a buyer of Treasurys," says Bill Gross, chief investment officer at Pacific Investment Management Co., the country's largest bond-fund manager. The yield on 10-year Treasury bonds -- yields move in the opposite direction of prices -- began to plunge, from 3.9% to as low as 3.1% in mid-June.

Fed officials were delighted -- at least initially. At a panel discussion in late May, Vincent Reinhart, the top Fed staffer leading the research on unconventional policy, showed a chart of how the May statement had prompted investors to push back the date when they thought the Fed would raise rates. Former Fed governor Lyle Gramley says Mr. Reinhart seemed to be boasting that the Fed had learned how to make markets do what it wanted. "There was a lot of self-congratulation," Mr. Gramley says. Fed officials say they weren't trying to manipulate markets but merely make clear what drives their interest-rate decisions.

As it turned out, the Fed and markets were actually misreading each other. Fed officials' unusually open exploration of deflation had led markets to misinterpret how worried they really were. Not only was the Fed nowhere near buying bonds, the FOMC hadn't even formally discussed unconventional policy.
When the FOMC scheduled a talk on the subject for the first day of its two-day June meeting, the members listened to the staff reports, offered their views and decided nothing -- other than to stick with using the federal-funds rate for now. Committee members then headed for supper at the British Embassy, where they listened to a Bank of England official discuss the euro. The meal was mostly memorable for the sweltering heat inside the embassy, whose air conditioning didn't seem to be on.

The next day, the FOMC agreed to a quarter-point rate cut as an insurance policy against further economic weakness. Investors, many of whom had expected a deeper cut and some sign that the Fed was about to employ unconventional means to prevent deflation, dumped bonds. With the economic picture also improving, yields skyrocketed about 1.5 percentage points to almost 4.6% in early August -- precisely what the Fed had wanted to avoid.

The reaction shocked Fed officials, almost all of whom blame the markets for misinterpreting the Fed. But the episode did little to settle the question of how much the Fed should say about its intentions. Mr. Bernanke says it demonstrates that what the Fed is expected to do is often more important than what it does, which makes communication all the more important. "On May 6, we didn't change the federal-funds rate, but in fact monetary policy eased because bond yields dropped," he notes. By contrast, in June, "we 'eased' monetary policy by lowering the federal-funds rate, but in practice monetary policy tightened quite significantly because bond rates jumped."

Mr. Poole took away a different lesson. Fed statements, he says, should be pared back so they merely repeat one of a handful of boilerplate sentences. That way, both markets and Fed officials would understand what the Fed intends to convey. But his minimalist approach has little support on the FOMC.

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**THE MESSAGE AND THE MARKETS**

A timeline showing major Fed statements on the economy and monetary policy, as well as bond yields and the federal-funds rate

- 5% Alan Greenspan says Fed could buy bonds to fight deflation
- 4 Greenspan calls for "firebreak" against deflation
- 3 Greenspan says U.S. "nowhere close" to deflation
- 2 FOMC warns of risk of "an unwelcome substantial fall in inflation"
- 1 Federal-funds target rate

Sources: Federal Reserve; WSJ Market Data Group

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