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Easy Money, FOMC Transparency, and Rate Volatility

Federal Reserve Chairman Ben Bernanke's press conference on 25 January 2012 after the FOMC meeting was one of the more interesting press briefings in a very long time. The FOMC has taken major steps toward greater transparency, and several of the new initiatives deserve commentary, including the release of FOMC participants' views on the likely path of the federal funds rate. In addition, the FOMC changed its guidance on the future path of the federal funds rate in its press release, now stating that "*…the Committee… anticipates that economic conditions…are likely to warrant exceptionally low levels for the federal funds rate at least through late 2014.*"

Transparency Initiatives

Chairman Bernanke has long been an advocate of greater transparency in the policy making process at the Federal Reserve. The FOMC has initiated several new steps toward greater transparency.

1) The FOMC in recognition of its dual mandate of price stability and maximum employment announced its long-run inflation target and unemployment rate estimates, specifically:

> *The long-run inflation target is 2%, as measured by the personal consumption expenditure (PCE) measure, and,*
>
> *The long-run unemployment estimate consistent with maximum employment is 5.2% to 6.0%, subject to future revisions since the unemployment rate is not directly determined by monetary policy and can be heavily influenced by non-monetary factors.*

2) The FOMC made available certain information about the projections of its voting and non-voting members (not including the Chairman) regarding the future path of the federal funds rate for the first time. Specifically, the FOMC released the following information on federal funds rate projections:

When asked the question in what year is it likely the FOMC will raise its federal funds rate target, the distribution of responses was as follows:

2012 – 3
2013 – 3
2014 – 5
2015 – 4
2016 – 2

When asked the question as to what the federal funds rate target might be at the end of 2012, 2013, 2014, and for the long-term, the following responses were released:

End-2012, 14 for 0.25%, 1 for 0.50%, and 2 for 1.00%
End-2013, 11 for 0.25%, 4 for 0.50% to 1.0%, and 2 for 1.75% to 2.00%
End-2014, 6 for 0.25%, 6 for 0.50% to 1.5%, and 5 for 2.00% to 2.75%

Longer Run, 17 for 3.75% to 4.50%.

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Implications and Interpretation

The decision by the FOMC to extend its guidance that the federal funds rate will remain at exceptionally low levels at least through 2014, as compared to the former time-frame of mid-2013, was an important shift. The extended period of a near-zero federal funds rate reflects that 11 of 17 FOMC members (not counting the Chairman) believe (1) that there is a need for the Federal Reserve to maintain an aggressively accommodative policy through 2014 to mitigate the risk of the economy falling back into recession and (2) that the inflation risk is minimal. With the benefit of the greater transparency, one should note that 6 FOMC members (not necessarily voting members) prefer an earlier return to a more normal monetary policy. That is, one-third of the FOMC participants advocate raising rates in 2012 or 2013, not waiting for 2014.

Also, with the benefit of the greater transparency, the long-run federal funds rate projections suggest that 17 out of 17 participants would view a normal federal funds rate to be in the range of 3.75% to 4.50% in the context of a 2% long-term average inflation rate. The implication is that once the FOMC starts on the path toward raising rates, there will be a number of steps heading upwards toward 4% federal funds rate territory.

Chairman Bernanke went out of his way to use the phrase "dual mandate" on multiple occasions in his post FOMC meeting press conference. He was intent on making sure that everyone understood that the Federal Reserve actively attempts to balance the objective of maximum employment with low inflation. Inflation is deemed well under control. Even the high end of the range of inflation projections of all the FOMC members, including the rate hawks, does not exceed 2.5% for the next three years, and the FOMC's target inflation rate is 2%. By contrast, the estimated long-run unemployment rate is 5.2% to 6.0%, and the current rate is 8.5%. Thus, the majority of the FOMC feels it is appropriate to maintain very low rates for an extended period.

The way that Chairman Bernanke framed the policy decisions in light of the Federal Reserve's dual mandate underscores that the most likely reason for the FOMC to change its policy would be if the US economy performs "substantially" better than expected. While Chairman Bernanke did not put numbers on what constitutes substantially better economic performance, one could reasonably assume that it might take real GDP growth of 3.5% per year and an unemployment rate closer to 7.5% and headed lower, to push the FOMC to raise rates sooner.

A couple of points to note in conclusion:

1) **If my more optimistic real GDP forecasts prove correct, the FOMC will see a substantially improved economy by early 2013 and the debate over whether to accelerate the normalization of monetary policy could erupt in the second half of 2012.** Rate volatility will follow economic data and relate to the FOMC debate, not the actual timing of the rate rise.

2) **Having greater transparency from the FOMC, including yearly federal funds rate projections, is not likely to dampen or increase rate volatility on average and over time**. Indeed, if anything, the increased transparency may allow for a better tracking of the degree of dissension within the FOMC, and that could lead to heightened volatility around times in which the FOMC appears to be divided over critical policy issues.

3) When the FOMC embarks on normalizing monetary policy, there will be a series of steps heading toward a 4% federal funds rate, which could take years. **Once the process of normalization starts, however, rate volatility will increase dramatically.** Markets always anticipate events. Substantially better than expected real GDP data in 2012 is likely to be the catalyst for higher rate volatility.

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