Fed Crossing the Line?

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New York Federal Reserve Bank (Fed) president Bill Dudley's speech Friday attracted much press attention, as it should have. His speech is correctly read, as in the press commentary, as providing a broad hint of more policy easing to come. During my tenure as president of the St. Louis Fed, I overlapped with Dudley, who, along with being president of the New York Fed, is Vice Chairman of the Federal Open Market Committee (FOMC). I know him to be a competent and cautious policymaker. It is hard for me to believe that he would not have cleared this speech with Chairman Bernanke before presenting.

During the Greenspan era, hints came from Greenspan himself, when he thought appropriate. Greenspan's hints were less frequent than many remember; indeed, he was widely viewed as talking in riddles much of the time. Policy decisions were made primarily at FOMC meetings, or at least ratified and announced at those meetings. Greenspan, of course, dominated the process, but he always seemed to me to be careful to respect the role of other FOMC members. When I believed the policy course was a mistake, I dissented, as did some others. Although I worked hard to clarify my general policy stance in my speeches, I always tried not to take specific policy positions in advance of FOMC meetings. For one thing, why should I do so if the Committee were about to adjust the federal funds rate in the direction I thought appropriate? For another thing, would I not have misled the market, and damaged my own credibility, if the FOMC went the other direction?

If every FOMC member were to indicate his policy position in advance of each FOMC meeting, the result would be chaotic. It seems to me that Dudley has crossed this line. His logic is clear. Unemployment is too high and inflation too low. Moreover, "…the timeframe over which they are likely to return to levels consistent with our mandate are unacceptable. … We have tools that can provide additional stimulus at costs that do not appear to be prohibitive." It is hard for me to imagine a stronger statement that Dudley will be arguing for the Fed to buy more assets—the policy discussed at some length earlier in his speech. "Unacceptable" is a pretty strong word.

Given this clear declaration, most likely with Chairman Bernanke's blessing, what happens if Friday's employment report is quite strong? One of the things I learned repeatedly is that data reports surprise. And sometimes the surprises are large. The bond market will take quite a hit if Friday brings a report of an increase of 200,000 in payroll employment and a decline of several tenths in the unemployment rate. But more than that. What is the hit to market understanding of Fed policy?

A buoyant employment report is not my forecast. I have no reason to depart from the market consensus of roughly no change in payroll employment and in the unemployment rate. However, surprises happen. What policymakers ought to do is to emphasize the conditionality of policy actions. I always argued that the FOMC would review all the information at hand at the time of the meeting and make the best judgment it could based on that information and the skilled staff analysis. That way, I left open the possibility that I would be dealing with a data surprise and I tried to convey to the market how I would react to it. Dudley does cover himself in his concluding remarks. "Thus, I conclude that further action is likely to be warranted unless the economic outlook evolves in a way that makes me more confident that we will see better outcomes for both employment and inflation before too long." Unfortunately, he provides little guidance as to what might lead him to be more confident and this sentence does not undo the strong language earlier in the speech.

Here is another problem with an unconditional policy announcement, which is how I read Dudley's speech. A strong employment report might well be explained by some anomaly in the data, and therefore not change the economic outlook. But it would seem very strange to the market if the FOMC pressed ahead on asset purchases shortly after a strong employment report. The November FOMC meeting occurs a few days before the October employment report, to be released November 5. Thus, the September employment report will be the most recent one available to the FOMC at its November meeting.

Finally, it is worth pointing out that Chairman Bernanke has misled the market before. In a speech in early December 2008, he indicated that the Fed might engage in large-scale purchases of long-term government bonds. Bond yields dropped sharply in response. When no such program was announced at the FOMC meeting later that month, yields rose and then rose further when no program was announced at the FOMC meeting in late January. Finally, at its March 2009 meeting the FOMC did announce and begin a program of buying Treasury bonds.

Bottom line: Bill Dudley seems to have provided clear policy guidance to the Treasury bond market, but traders should be wary.

P.S. I wrote the above commentary shortly after Dudley's speech was reported and I had a chance to read the speech. Now, on Monday, I see that Fed staffers are getting into the act. According to press reports, Brian Sack, in a speech in California, reinforced Dudley's message. In his speech, he made favorable comments about how expansion of the Fed's Treasury's portfolio could contribute to economic recovery.

Sack is not an obscure Fed staffer; he is the System Open Market Manager, which is one of the most important Fed staff positions. The Open Market Manager attends all FOMC meetings and makes a substantial presentation on the financial markets at the beginning of every meeting.

I know Brian a bit, and have very high regard for him as a professional economist and Fed staffer. However, is it wise for Fed staffers to join the policy debate fray a few days before an FOMC meeting? I do not think so. I realize that Sack's speech includes the usual disclaimer that he is speaking for himself but the chorus of voices runs the risk of misleading the market. Sometimes silence is the clearest communication possible.

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