Forbes

FOMC Statement: Evidence Of Policy Communications Failure

William Poole

January 7, 2015

At 2:09 PM December 17, a few minutes after the FOMC released its policy statement, the *Wall Street Journal* had this report on its website: “The Fed is a patient dove. U.S. stocks surged…after the Federal Reserve issued an especially dovish policy statement at the conclusion of the FOMC meeting….Equities were flying. The Dow surged more than 300 points….The sharp move in the equity market very likely illustrated the surprise at the more-dovish statement….Of course, the market’s going to have enough on its hands just figuring out what signals the central bank is sending.”

Is a positive surprise a positive omen? No. It is, instead, evidence of policy communications failure. I suspect (but do not know) that the Fed leadership did not intend to deliver a positive surprise. Although market commentary focused on the Committee’s substitution of “patient” for “considerable time,” the market probably reacted less to any particular wording in the statement than to its overall tone of “not yet.” Janet Yellen, in her press conference, emphasized that the substitution was not meant to signal a change in policy. The surprise, then, may have been inadvertent rather than deliberate. An inadvertent surprise is no more an advertisement for orderly policy than is a deliberate surprise.

Conditions for stable policy regime

Stable policy requires that two conditions be met. One is that the economy behaves as the Federal Reserve expects. How can the Fed know what to do if this condition is not met?

Second, the Federal Reserve must behave as the market expects. How can markets, of all types, determine sensible prices if this condition is not met?

The surge in equity prices shows that these two conditions are far from met. The Fed is making a huge mistake by continuing to treat the economy as if it is in a fragile state. It is not. Anyone who follows the data can count the ways.

Why surprises matter

Suppose your property tax assessor were to assess property values according to his view as to what was "fair." Besides creating an opportunity for corruption, uncertainty over assessments would interfere with a properly functioning property market. When the law requires that assessments be at fair market value, property owners have a good idea about their tax bills and an avenue of legal appeal when they believe their assessment is excessive. Assessments are "data dependent"—to use a favorite Fed term—in a specific, known way.

Similarly, monetary policy uncertainty creates inefficiency in the capital market. The FOMC gives lip service to policy predictability but its statements are vague. Creating monetary policy predictability is much harder than property-assessment predictability, but to me it does not seem that the FOMC is even trying. The FOMC preaches that policy is data dependent but will not tell us what data and how.

Statement bloat

The formal policy statement is much too long and full of meaningless verbiage. "The Committee expects that, with appropriate policy accommodation, economic activity will expand at a moderate pace…" Of course. If the FOMC sets policy correctly—"appropriately"— everything will be fine. Please, FOMC, help me understand what "appropriate policy" is. Otherwise, delete this sentence because it tells me nothing.

"The Committee continues to monitor inflation developments closely." Of course it does. Under what circumstances would the Committee modify that sentence? Again, delete this—it means nothing.

"When the Committee decides to begin to remove policy accommodation, it will take a balanced approach…" I cannot imagine that you will take an "unbalanced approach."

"This assessment will take into account a wide range of information, including measures of labor market conditions, indicators of inflation pressures and inflation expectations, and readings on financial developments." This is the data upon which policy will be dependent. Is there any information that is irrelevant to the Committee? Apparently not. How does the Committee weight various sorts of data? Silence.

"Based on its current assessment, the Committee judges that it can be patient in beginning to normalize the stance of monetary policy." Would the Committee ever reach a judgment based on anything other than its "current assessment?" Another meaningless clause.

Costs of such statements

The problem with statement bloat and the profusion of meaningless material is that it creates the inevitability of unintended surprises. The market will try to read intent into apparently innocuous changes in wording, such as the substitution of "patient" for "considerable time." Communication by indirection is a recipe for misunderstanding. Fear of creating negative surprises will lead the Committee into ever-greater cycles of ambiguity. At some point, when it is important for the FOMC to be clear about a change in policy direction, clarity will be impossible. A new policy statement will not easily cut through the baggage of inherited ambiguity. And, a timid Fed will not lead the markets but be whipsawed by them.

It promises to be quite a ride.

Mr. Poole is senior fellow at the Cato Institute. He retired as president and CEO of the Federal Reserve Bank of St. Louis in March 2008.