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Headline: Why Fed tells markets about its intentions

Why Fed tells markets about its intentions

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[SINGAPORE] Amid criticism of the communication policies of central banks, a Nobel laureate has conjectured that the powerful US Federal Reserve gives forward guidance about its intentions not so much to help the market, which is already using the same predictive model as the Fed. Rather, Fed management does so to tie the hands of successors to a consistent policy to maintain the institution's reputation.

Thomas Sargent, known for his work on rational expectations, made this speculation at the fourth Sovereign Wealth Fund Conference at the Singapore Management University (SMU) yesterday – calling his thoughts "beer-time conversation" and "common sense" about things he does not fully understand.

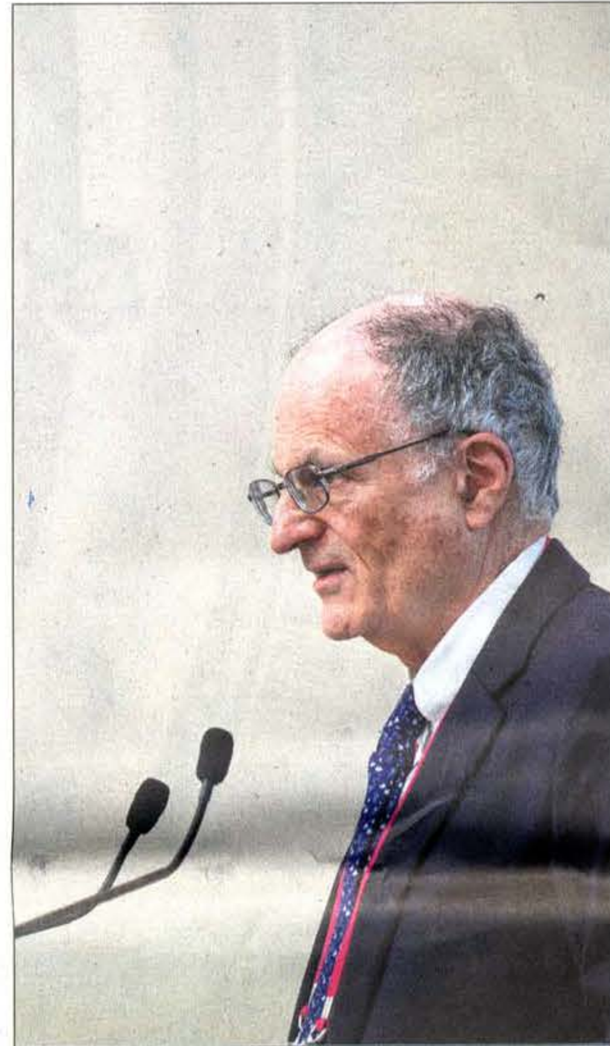
"The FOMC (Federal Open Market Committee) has 19 members, 12 who can vote at any one time. Their terms rotate. They're from all walks of life. They change their minds. They have good days and bad days," he said.

"They have staff telling them one thing at one time, one thing another, data rolling in . . . so it's a messy thing, this committee. They choose every five weeks. The strategy is emerging from this messy process.

"How does an institution like that work? Have you been in the army . . . there's a tradition, there's an army way of doing things, there's a Fed way of doing things."

One way for current Fed management to pass on a legacy is to commit itself in a way to "establish some kind of precedent about (its) reputation", said Prof Sargent, who won the Nobel Prize in economics in 2011.

Forward guidance has been a relatively new approach by the Fed, the European Central Bank and the Bank of England to bring long-term interest rates down, at a time when short-term rates cannot be cut beyond zero. The idea is to communicate clearly about short-term rates staying low for some time, and the market will follow suit with a fall in long-term rates.



Prof Sargent: *Calls his speculation 'beer-time conversation' and 'common sense' about things he does not fully understand.* PHOTO: BLOOMBERG

But the Fed has come under criticism for not communicating clearly enough and confusing markets, as seen in September when it did not taper its large-scale financial asset purchases to expectation. Similarly, the Bank of England has been criticised for its forward guidance policy of low rates as long-term rates have risen, not fallen, as a growing economy raised doubts about how long the ostensible pledge of low interest rates will last.

Under the theory of rational expectations, people automatically adjust and act according to changing events and information. The implication is that monetary policy and forward guidance to influence actions might be irrelevant as people already respond quickly. The Fed knows this, and wants to be able to do something unexpected to be effective, Prof Sargent said.

The fine line central bankers walk is wanting to be able to do some things now, like being able to commit to bail out a bank, while promoting different expectations about the future – that they will never do a bailout again.

An optimal central bank policy enables it to do that: commit now, and not bear the costs of current commitments in the future. Prof Sargent likens this to him wanting to go drinking with a buddy and come home late, while not disappointing his wife.

But there is a paradox of credibility. This behaviour will not make him, or central banks, credible.

If you want to keep a good reputation, you confirm what other people expect you to do while fearing the consequences of disappointing people, he said. Forward guidance thus helps maintain this reputation, he suggested.

The problem is, the situation might be "a bubble". The profit-maximising private sector wants to forecast as accurately as the central bank, and throws resources into doing so. The forecasting rules used by the private sector are also being used by the central bank, and vice versa.

A circular situation arises: "The central bank tells the market how the central bank thinks about what the market thinks the central bank will do in future."

It becomes unclear who is influencing whom, he said.

Economists *The Business Times* spoke to said that ultimately, Fed actions, not words, will influence the market. Markets still rise or fall on whether the Fed tapers or not, said SMU adjunct faculty member Larry Haverkamp.

Forward guidance is still useful for the market because the Fed can incorporate views based on non-public information for the market to read and be influenced by, added Eugene Kandel, head of Israel's National Economic Council.

"Reputation doesn't have to be a bubble if there's information asymmetry," he said.

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