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We need forward guidance to avoid the guessing game that follows when central bankers say nothing.

The Federal Reserve Ain't Broke, So Don't Fix It

By Alan S. Blinder

'If it ain't broke, don't fix it" can be thought of as a warning to policymakers, whose fixes often make things worse. Take the Federal Reserve, long considered one of Washington's best bureaucracies for its talented personnel, apolitical dedication to mission, integrity and more.

It doesn't look " broke" to me. That doesn't mean it never makes mistakes or that it can't be improved. But it does mean that major changes to it should be well-justified and carefully thought out.

Kevin Warsh, the Fed's new chairman, agrees—I think. Yet he must also believe the Fed is more "broke" than I do. Why else would he organize task forces to consider (recommend?) changes in communications, the Fed's balance sheet, the data the central bank uses, and the 2% inflation framework, and to study the effect of technology on growth and jobs?

Note

Of these five, I am worried about one: severely reducing Fed communications, including the elimination of forward guidance. Depending on the details, this reform might do more harm than good.

You don't have to look far back in history to find the dark ages of Fed communications. Until 1994, the Federal Open Market Committee didn't even announce its interestrate decisions as it made them. It let the markets figure it out by watching the reactions of the Open Market Desk. Some of Mr. Warsh's words suggest he looks back wistfully at those bad old days. I hope not.

Two arguments favor centralbank transparency, either of which should be dispositive on its own.

The first focuses on democratic accountability. Monetary policy is made by unelected technocrats but affects the whole society, sometimes in significant ways. These technocrats owe the public coherent explanations of what they are doing, why and what they seek to achieve. The days when Alan Greenspan could pride himself on "mumbling with great incoherence" are over.

Economists don't talk much about the accountability argument, but it is vital in a democracy. I presume Mr. Warsh agrees. It is the other rationale he seems dubious about.

The second argument holds that the central bank does a better job by being transparent rather than mysterious. Understanding why requires a short dive into monetary theory.

A central bank normally controls only the overnight interest rate—in the U.S., the federal-funds rate. But hardly any transactions that matter take place at this rate. Rather, oneyear interest rates, for example, depend on beliefs about the next 365 one-day rates, the 10-year rate on

the next 3,650 or so, and so on. If the FOMC sets the funds rate but offers no "forward guidance" on likely future rates, market participants are left to guess what those future rates will be—based on their view of the economy, their sense of the Fed's direction and the like.

Those guesses may be accurate or inaccurate. Mr. Warsh seems inclined to take his chances with the market's beliefs. But I was vice chairman of the Fed under the old system of "say little and say it cryptically," and I saw the market get it wrong time and again.

Markets tend to overreact. That's what led me to enunciate Blinder's Law of Speculative Markets: "Markets generally get the direction right but exaggerate the magnitude by a factor between 3 and 10." This, in turn, leads to excess volatility because long-term rates depend much more on expectations about the future than on today's short rate. It also makes the Fed's decisions tougher.

When the FOMC raises or lowers its one-day interest rate, it must guesstimate what markets will do to the longer-term rates that matter for business and consumer loans, mortgages, corporate bonds and more—even the stock market and exchange rates. If these estimates are off, the policy setting will be, too.

I remember this double-barreled guessing game well from my days on the FOMC. The markets were guessing what we would do, and we were guessing how they would react.

The FOMC can't end this guessing game completely—there is uncertainty in the world. But it can tighten the gear between short rates and long rates by making itself more transparent to the markets. Doing so probably includes providing some variety of forward guidance about where short rates are likely to go.

Mr. Warsh, apparently, doesn't like the idea. He wants the markets to take the lead by figuring it out themselves. But if the markets lead, does the Fed follow? If so, get ready to watch a dog chasing its tail.

Mr. Blinder is a professor of economics and public affairs at Prince--ton. He served as vice chairman of the Federal Reserve, 1994-96.
