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Fed Silence Leaves Markets Flying Blind

CAPITAL ACCOUNT

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Note

Alot happened in the weeks leading up to Kevin Warsh's second meeting as Federal Reserve chairman, when the central bank left interest rates unchanged: soft employment and inflation data, renewed war with Iran, higher oil prices.

To Warsh, though, most noteworthy was how markets responded to this information: bond yields went up. This, Warsh explained to reporters after Wednesday's meeting, justified his decision to stop commenting on economic developments and how the Fed might respond to them. Markets are "learning how to play the ball, not the referee."

But Warsh's analogy of the Fed simply calling balls and strikes, borrowed from future Supreme Court Chief Justice John Roberts, doesn't work. The Fed isn't a neutral umpire, it is the most important player in the game.

Note

Markets respond not just to data but how they think the Fed will respond to data. Investors plug each new bit of information into the Fed's assumed "reaction function," which then spits out the appropriate interest rate.

If the markets correctly understand the Fed's reaction function, then they can do some of the Fed's work for it. When the economy is overheating, bond yields will rise, which will slow the economy and squelch the threat of higher inflation. If the economy is weakening, yields will fall, and the economy picks up, safeguarding employment. Warsh alluded to this mechanism Wednesday: "Even while at some level we haven't done much in 42 days, the markets have done quite a bit."

Note

But this only works if the Fed actually behaves as mar--kets expect. Bond yields rise because they are pricing in higher short-term rates. If the Fed doesn't deliver, that pricing will reverse.

Note

Bond yields rose between the June and July meetings because of growing expectations that the Fed would raise interest rates. But the Fed didn't deliver. As to why, Warsh declined to say.

When June's benign inflation report was released, markets certainly saw that as a reason not to tighten. Yet Warsh said it was "not much" of a factor: "We are not relying on any one individual piece of data."

So how are markets supposed to interpret inflation data in the future if they are told such an important release had no bearing on interest rates?

Note

Warsh's preference for saying little harks back to an era when central banks were more mysterious, impersonal institutions. The motto of Montagu Norman, governor of the Bank of England from 1920 to 1944 was "Never explain, never excuse." Until the early 1990s, Note the Fed didn't even say whether it had changed interest rates; it conducted open market operations and let traders figure it out.

Even when the Fed said little, though, markets would seize on every bit of information to discern the Fed's next move. From 1979 to 1982 when the Fed was targeting the money supply, interest rates would gyrate with each weekly release of the money supply data. Tom Gallagher, for years Wall Street's top Fed watcher (now retired), had a line about this: If a Fed chairman one day mentioned purple traffic cones, Wall Street would hire a bunch of people to go out and count purple traffic cones.

After Ben Bernanke joined the Fed in 2002 as governor, he argued strenuously for more transparency. If the Fed didn't talk, others would fill the void, he said: "From individuals speaking or from pundits speculating, it's just going to be noisier and more cacophonous than ever. Any kind of guidance we give...has got to be better than that."

Fed officials did worry, as Warsh now does, that communicating introduced what they called the problem Note of "looking in the mirror"— were market prices just a reflection of what they said, rather than an independent judgment of reality?

For example, when inflation surged in 2021 as the economy emerged from pandemic lockdowns, bond yields barely moved as Fed officials argued inflation would be transitory.

But that same episode illustrated the perils of trusting markets. Even as investors saw little Fed tightening, they also expected inflation to soon fall back to the Fed's 2% target. Had the Fed trusted that market assessment, it would never have tightened. In the end, it tightened a lot, because it didn't trust markets' benign scenario. That is why some Fed officials today want to tighten.

It is early days, and Warsh may eventually conclude he should communicate more, while avoiding explicit interest rate guidance. If he doesn't, markets won't stop trying to guess what he's thinking: they'll just rely on other Fed officials' commentaries, some random bit of data, the latest version of purple traffic cones.