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His first move may be a much-needed change in communications.

The Warsh Era Begins at the Fed

REVIEW & OUTLOOK

Kevin Warsh presides over his first Federal Open Market Committee meeting as Federal Reserve chairman this week, and his eventual reform list is long. Reduce the balance sheet, review the Keynesian bias in its economic models, keep the Fed out of fiscal policy, and more. But his first priority, and an important one, is likely to be overhauling the way the Fed communicates.

Few innovations since 2008 have been as counterproductive as the adoption of "forward guidance" as a policy tool. Fed officials came to believe that by giving investors a heads-up on the central bank's intentions for short-term interest rates, it can steer longer-term rates and the economy as well.

But the constant yammering—long policy statements, press conferences after every FOMC meeting, nonstop speeches by Fed officials and above all the quarterly Summary of Economic Projections—has exposed how little the Fed understands about the economy and trapped officials in errant policies.

It's hard to remember when the Fed wasn't this talkative. Yet until the 1990s the central bank cultivated an air of inscrutability. Officials didn't even release announcements when they adjusted their overnight policy interest rate. The Fed played down its periodic publication of limited economic forecasts, which investors generally ignored.

Officials gradually started publishing statements of policy decisions after 1994. A fuller explanation of the FOMC's reasoning arrived under Alan Greenspan in 1999, when officials began explaining what came to be known as the "balance of risks"—whether they thought tightening or easing was likely to be more appropriate in the future.

The oversharing went into overdrive after 2008. After cutting rates to near zero and ramping up quantitative easing, Ben Bernanke lit on communication as a policy tool in its own right.

Mr. Bernanke was eager to persuade investors that he'd keep rates low for an extended period. Hence the adoption of an explicit 2% inflation target in 2012, to reassure investors that the Fed wouldn't tighten if inflation was below that level. In late 2007 the Fed had published the first iteration of what would eventually become the quarterly projections. The infamous "dot plots" depicting FOMC officials' anonymous guesses about future interest-rate moves appeared in early 2012.

In 2011 Mr. Bernanke began holding press conferences after some FOMC meetings, and the gabfests became a fixture after every meeting in 2019 under Jerome Powell. Along the way, Fed officials began delivering more and more speeches between meetings. Investors and journalists scrutinize these orations for clues about future policies.

This has been good for journalists but not for the Fed. Its quarterly projections are notorious for predictions about GDP growth, unemployment and inflation that turn out to be wrong.

The Fed's sages badly overestimated economic growth in 2011 and 2012, predicting about 3% in December of the previous years when the economy grew only 1.5%. But then it underestimated growth in 2017 and 2019 as it failed to appreciate the impact of the Trump tax reform. Its greatest recent mistake was underestimating inflation in 2021 and 2022 by a factor of about three. (Hat tip to our contributor Mickey Levy for the numbers.)

And because forward guidance encourages investors to react to what the Fed will do rather than sending market signals about economic conditions, officials mute a source of information that could inform policy-making.

One reason Mr. Powell was so slow to respond to accelerating inflation after the pandemic was that the Fed previously had committed to lower-for-longer interest rates. He reinforced this in August 2020 when the Fed promised to tolerate above-2% inflation to make up for periods of slower price rises. Note

A fear of spooking markets with unanticipated rate hikes deterred rapid action to fight inflation. Forward-guiding Fed officials kept calling inflation “transitory,” a word that will haunt the Fed for years.

Forward guidance also drags the Fed into politics since officials find it hard to resist opining on fiscal and other debates to explain their monetary views. Mr. Warsh may not be able to deter other Fed Governors from popping off in speeches. But he could set an example by ending the “dot plot” era, limiting his press conferences, and focusing his public statements on major policy turns and the semi-annual Humphrey- Hawkins testimony to Congress.

Mr. Warsh has said he welcomes debate over monetary policy, and that’s to his credit. But forward guidance has been a mistake, and a cacophony of Fed voices has confused markets and been harmful to the Fed’s credibility and independence. A course correction is overdue.

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