Steffy: Fed transparency could muddy economic outlook

By Loren Steffy **January 5th, 2012**

Welcome to the sausage factory of monetary policy.

Later this month, the Federal Reserve plans to begin releasing its policymakers' individual forecasts on interest rates. Previously, such details of Fed formulation were conducted in private. The Fed compiled the individual forecasts from members of the Open Market Committee into a consensus prediction, and even that it kept to itself.

Fed Chairman Ben Bernanke, in his efforts to make the central bank more transparent, earlier agreed to publicize the consensus forecast, and now he will make the individual predictions available as well.

We now will see how all the ingredients are mixed together to form the Fed's economic prognostications. Nothing about monetary policy, of course, is clear cut, and it's not likely that greater transparency on Fed forecasting will lead to greater clarity.

By providing more details on the Fed's forecasting, Bernanke seems to offer the market some reassurance, a clearer picture of what to expect. For example, by essentially telling the market, as Bernanke did a few months ago, that the Fed will keep the Fed funds rate at near zero at least through the middle of next year, it encourages lenders to keep long-term interest rates low, which ought to encourage economic growth.

"The market takes that as a promise," Robert McTeer, the former president of the Federal Reserve Bank of Dallas, told me.

In the past, individual Fed forecasts trickled out in speeches given by regional Fed presidents who might hint at what they saw ahead for the economy. McTeer made those speeches for 14 years, and one of the things he liked about them was that he could change his mind.

He worries that now, with their detailed forecasts made public, Fed presidents may become too wedded to their opinions.

"It tends to rob you of your flexibility," said McTeer, who's now a distinguished fellow at the National Center for Policy Analysis in Dallas. "Once you get associated with a certain position, you tend to rationalize sticking with it. It makes it difficult to change your mind."

Even Bernanke's pledge of low rates through June 2013 may have gone too far, he said. What if the economy does better than anyone expects? Bernanke could be forced to go back on his earlier pledge and raise rates or risk a rise in inflation.

Benefit to uncertainty

"There's a benefit to a little uncertainty," McTeer said. "You want people betting on both sides of the issue because it adds liquidity to the market."

Of course, all economic forecasts involve uncertainty, and a broader selection of predictions may actually cloud the Fed's outlook of the economy rather than bring clarity.

"The fact that they're predicting further into the future means that there will be more mistakes," said Fed watcher Sandy Leeds, a senior lecturer at the University of Texas' McCombs School of Business.

Bernanke has favored using public statements to set monetary policy, and the dissemination of the forecasts may be another step in managing expectations about the Fed's ability to boost the economy.

"The Fed seems to be increasingly focused on their ability to impact expectations," Leeds said. "It's hard to say whether that is because they think they can have a positive impact on the economy, avoid a panic or just think that transparency is the right thing to do."

Running out of tools?

By showing differing - and perhaps even conflicting - outlooks from its own policymakers, the Fed may be underscoring the notion that it has run out of effective tools for fixing the economy. Richmond Fed President Jeffrey Lacker underscored the point in a recent speech when he noted that "monetary policy is often credited with entirely too much influence on real growth."

That comment follows on an earlier theme from Bernanke that what the economy needs is a fiscal response from lawmakers, not a monetary response from central bankers.

"Ultimately, we'd be a lot better off if Congress would let us know when we could expect to end the gridlock and reduce the deficit," Leeds said.

In government, of course, transparency is essential. In monetary policy, though, seeing what goes into the sausage may be too much information.