A SYMPOSIUM OF VIEWS

Reforming The Fed

I. Should the Federal Reserve Reexamine Its Communications Policy?

The idea was to provide financial market participants with "forward guidance" about the institution's outlook and plans for the future. Instead, the policy has at times created needless market confusion. Are there reforms that could improve the central bank's communications with the outside world? Or should the Fed scrap its communications policy altogether and return to a more elusive positioning *vis-à-vis* the markets?

II. Should the Fed's Dual Mandate Be Reexamined?

Do the twin mandated goals of price stability and full employment fully reflect the institution's challenges and responsibilities? Or should financial market conditions be added to the list of the Fed's mandated concerns? The Fed, *de facto,* already seems to be carefully monitoring financial markets. Why not have financial conditions become part of the institution's official mandate? The wealth effect from financial market developments appears to have influence over the economic fundamentals. But would such a change essentially risk a whole new round of moral hazard? An officially sanctioned "Fed put"?

More than a dozen noted experts share their thoughts.

The Fed's current approach to communicating the stance of its monetary policy is unnecessarily vague and confusing.

GREGORY D. HESS

President, Wabash College, former staff member, Federal Reserve, and Member, Shadow Open Market Committee

The Fed's current approach to communicating the stance of its monetary policy is unnecessarily vague and confusing, and could be dramatically improved if it took three specific actions.

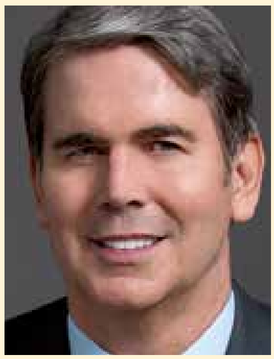
First, the Fed should adopt a Taylor-type reference rule for the federal funds rate as a benchmark for its policy actions. If the stance of policy differs from that indicated by the reference rule, the Fed should indicate the specific reasons why it does so, how long it should last, and how the current policy stance meets its federal mandates.

Second, the Fed should begin to articulate a reference rule for how it will manage the size of its portfolio. There is much work to be done here. The Fed is not specific as to the short-run and long-run objectives it is trying to accomplish as it adjusts its portfolio. Nor is it transparent about what it believes are the empirics of the transmission mechanism from changes to its portfolio, through financial conditions, and ultimately to the real economy. What the Fed is doing and why should not be left to market speculation.

Presumably, the Fed is trying to loosen or tighten financial conditions by adjusting the size and composition of its portfolio. Indeed, the Fed adopted an aggressive series of quantitative easing strategies in the aftermath of the financial crisis of 2008 in order to lower long-term interest rates, mortgage rates, and to raise animal spirits by pushing investors into higher-risk assets. Unfortunately, dismounting from this high wire act has induced financial tantrums, and made policy wobbly at best. The Fed can and should do better.

Third, the Fed should drop the term "data dependent." The oft-used catchall is unnecessarily vague and often misleading. How "data" form evidence in favor of a course of action or strategy for monetary policy is what market participants want. They want the Fed to be "evidence-dependent," not merely "data dependent." Data are never right or wrong. Evidence can be. Data combined with theory and projections form evidence—that's what a good policy strategy depends on. Data itself are not enough.

While these three changes would dramatically improve the Fed's communication strategy, the Fed should hesitate before it changes its three-part mandate for monetary policy: price stability, maximum employment, and moderate long-term interest rates. While typically overlooked, the mandate to keep long-term interest rates moderate is an indirect but important way that financial conditions feed into the Fed's monetary policy decision making. Moreover, it's also useful to distinguish the Fed's role in implementing monetary policy from its role as a central bank and financial crisis manager. Following Bagehot, during periods of financial crisis, a good central bank should lend to the market against good collateral on penalty terms. Those penalty terms could be directed towards interest rate terms, ownership interests in the bank, or against those that have participated in financial malfeasance.



The Fed is very likely to face attacks on its independence from both sides of the political spectrum.

SCOTT BESSENT

CIO and Founder, Key Square Capital Management

The Fed's recent record of maintaining financial stability has proved lacking. The last two U.S. recessions were caused by the bursting of asset bubbles. The Fed escaped the tech bust unscathed. Even in the aftermath of the housing bubble, Congress granted the Fed new oversight powers, with few encroachments into the institution's independence beyond requiring that it seek the approval of the Treasury Secretary when extending emergency lending facilities. Given today's fractious political environment and frothy financial markets, it would be naïve to assume the Fed can survive the next bust with its monetary policy independence intact. A likely mantra could be, if the Fed is merely a clean-up operation for financial calamities it may have caused or overlooked, are we any better off than in the Panic of 1907 before the Fed existed?

Certainly, the historical record is rich with attempts to subvert the Fed's hard-won independence. In 1965, President Johnson famously pushed William McChesney Martin against a wall and excoriated him for raising interest rates against his wishes. In the run-up to the 1972 election, President Nixon pressured Arthur Burns into easing policy, sparking an inflationary spiral that took nearly a decade to control. More recently, President Trump has made his views of the institution well known, accusing the Fed of "going loco." So far, the attacks have mostly been limited to 280 characters. But if this is what happens with 3 percent GDP growth and the unemployment rate at 4 percent, how will the administration, Congress, and the public react to a more serious asset market correction or a meaningful economic downturn?

Apart from the risk to Fed independence, there is also an argument to be made that having the lender of last resort be responsible for bank supervision and financial market stability raises the issue of moral hazard. How can the Fed deny a bank that becomes insolvent on its watch access to emergency liquidity facilities? And how could the Fed tolerate anything greater than a minor correction in asset prices if the Fed is charged with guarding against financial market instability? Might this not influence monetary policy decision making? At a minimum, it would reinforce the notion of a "Fed put" and open the Fed to criticism that not only does it inflate asset bubbles, but it also risks taxpayer money to clean up the mess it should have prevented in the first place.

We are nearly ten years into the economic expansion, fueled by unconventional monetary stimulus. If the bursting of another asset bubble causes the next downturn, as seems possible, the Fed is very likely to face attacks on its independence from both sides of the political spectrum. To protect its own independence, the Fed should be very wary of taking on any new responsibilities. Rather, it should proactively seek to offload some of its supervisory roles. Much better to support the creation of a separate macroprudential regulator now than risk a loss of credibility and independence if we have a third asset bubble burst within two decades.

Francis Browne contributed to this article. The views presented in this article are purely the opinions of the author and are not intended to constitute investment, tax, or legal advice of any nature and should not be relied on for any purpose.

The Fed's mandate needs a much broader Congressional review.

WILLIAM R. WHITE

Former Economic Adviser, Bank for International Settlements

The Federal Reserve has announced its intention to review in 2019 "how to best pursue the Fed's statutory mandate" of maximum employment and price stability. Suggestions have been made that the Fed pursue a price level target, or an average of inflation rates over a multi-year period, or nominal income targeting. These suggestions all reflect an underlying preoccupation: How might a new target framework generate expectations of higher inflation, leading in turn to more spending and more resilience to future economic downturns? In short, how can future monetary easing be made more effective?

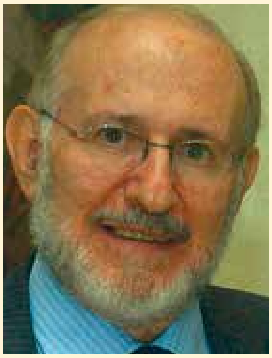
These suggestions are doomed to failure. They all rest on the assumption that expectations can be magically raised by a Fed statement of intent, even when circumstances (such as high unemployment) point expectations in the opposite direction. Moreover, they ignore the fact that other instruments of monetary policy will be increasingly constrained, which must cast further doubt on the Fed's capacity to deliver on its promises. Finally, when the next recession does call for monetary easing, the global "headwinds" of accumulated debt will prove immensely resistant to the Fed's best efforts. In short, we are in a place where we do not wish to be.

The Fed's mandate needs a much broader Congressional review. Near-term price stability has been vastly oversold as a vehicle for achieving overall economic stability. More specifically, the case for avoiding price declines caused by productivity increases has never been adequately made. Indeed, monetary easing in recent decades, to resist inflation coming in below target levels, might have contributed materially to many of our current problems. Debt levels have risen as has wealth inequality. Resource misallocations and zombie companies have reduced productivity growth. Low intermediation margins and the search for yield have fostered financial instability.

At the very least, the Fed should be pursuing price stability over a much longer time period than hitherto.

Given how little we know about the welfare effects of moderate inflation or deflation, or about the capacity of central banks to influence domestic prices, why have central banks responded so aggressively to decimal point deviations from announced targets? Similarly, the Fed should be given a mandate for financial market stability, defined quite broadly as avoiding "boom" conditions in credit markets that set the stage for subsequent "busts" and financial stress. This restraining influence would be the very opposite of the Fed "puts" that we have seen in recent years. Such expectations, together with Fed communication practices that raise Sharpe ratios, have encouraged leveraged speculation rather than reducing it as intended.

What remains unexplored is how to respond to the next recession, assuming that monetary policy is no longer fit for that purpose. I suggest reliance on a combination of sustainable fiscal policy (near-term stimulus and longer-term debt brakes) and significant private sector debt restructuring. None of this would be pleasant, but making Wall Street pay a price, at last, for having made bad loans would certainly find favor on Main Street.



Central bank independence is being seriously questioned.

MARIO I. BLEJER

Vice Chairman, Argentine Mortgage Bank, former Governor, Central Bank of Argentina, and former Director, Bank of England

While the overwhelming majority of academics and central bank practitioners continue to support central bank independence, it is clear that the golden age of monetary independence ended with the crisis a decade ago, and it did not ended gently. The first wave of charges against central banks involved a straightforward claim: the worst financial crisis since the 1930s took place after independent central bankers worldwide were handed most of the economic management levers, and there is no way they can now avoid blame. The prestige of "independent central bankers" was severely damaged, removing partially the implicit taboo involved in asking the unmentionable: perhaps central banks should not be so independent after all?

However, there was no lethal follow-up because central banks managed to avoid (with huge help from government and regulators) a system collapse. But the seeds of doubts about independence were planted and more questions arise. It is now acceptable today to claim that in 2005–2010, western central banks fueled major credit inflation followed by a serious deflation causing the great recession. This bad press may translate into the political arena, as voters chase those seen as responsible for the crash and austerity.

Moreover, the most important and recent central bank achievement—the success of central bank independence in the achieving price stability—is being seriously questioned. The claim is that such success was overstated given the disinflationary consequences of technology and globalization. Even more serious is the near-consensus around the view that independent central banks spectacularly failed to achieve and maintain financial stability, just as crucial a mission.

Of course, nobody claims that a country where politicians can overrule the central bank to promote excessive credit or to print too much of their own currency is a good place to invest. But ignoring the regulatory side and playing with the monetary accelerator at will ("independently") are also seen now as dangerous.

In summary, recent crises left the impression that central banks paid no price for their collective failure and in fact they emerged even more powerful than before. Moreover, independence is further endangered by the fact that the crisis pushed central banks into making choices with lasting distributional consequences. By making massive purchases of government bonds, quantitative easing has held both short- and long-term interest rates low for a very long time. While this may have helped to stimulate declining economies, it has done so by making rich owners of financial assets richer still. At the same time, poorer savers relying on bank deposits have been getting next to nothing in interest.

These could be a watershed in the public approach to central banks. It is inconceivable that tolerance will continue for decisions with important fiscal consequences (as those related to bank resolutions) or affecting income distribution to be unilaterally made by unelected bodies.

Central bankers are much too aware of the circumstances. They admitted that broadening the role of the central bank necessitates some review to its governance. But they also claim that their mandate remains relatively narrow and that they are agreeable to strengthening transparency and accountability. In the court of public opinion, however, it will be more difficult than before to maintain support for independence even after central banks "normalize" policies and attempt to return to the secure grounds of conventional policymaking.

Simpler, more transparent, and more accountable.

LORENZO BINI SMAGHI

Former Executive Board Member, European Central Bank

Forward guidance reflects the policymakers' (good) intention to provide markets with a fairly adequate indication of the stance of monetary policy over the relevant horizon. The problem is that such a guidance cannot be unconditional. It has to be based on the available information about underlying economic conditions and on the forecast of the relevant variables, in particular the policy targets. As a consequence, the guidance needs to change and be adapted when the underlying conditions and forecasts change, which may happen with a certain frequency, as new information becomes available.

This creates a dilemma for the policymakers. If the guidance changes too frequently, it may create volatility and add noise in the formation of market expectations. If the guidance is instead adapted infrequently, it may become obsolete. Rather than giving forward guidance on the path of interest rates, it could thus be more efficient to provide financial markets with information about the central bank reaction function, and let the markets extrapolate how new information about underlying conditions would in turn affect the expected policy path. This would put greater responsibility with market participants to form their own expectations about the future policy path. The central bank could intervene occasionally, with appropriate communication, if the consensus expectation deviates excessively from is considered reasonable.

As for the Fed mandate, if it is to be changed, it should be in the direction of making it simpler, more transparent, and more accountable. This suggests that if more than one objective is included in the mandate, there should be an explicit ranking of priorities. Not setting a hierarchy of objectives, as is the case currently between price stability and employment, leaves to the central bank a high degree of discretion. This can be problematic, especially in cases in which the achievement of one target can jeopardize the other. Indeed, it may be questionable whether a non-elected body like the central bank has the democratic legitimacy for choosing between different targets that affect citizens' welfare. This exposes the Fed to pressure from the political authorities and can undermine its independence, thus reducing over time the effectiveness of monetary policy. Adding an additional target, like financial stability, would make the problem even worse. There are clear instances where the pursuit of price stability may require policies that have an immediate impact on financial markets. Trying to achieve more than one target with a single instrument is bound to create instability and negatively affect the reputation of the central bank.

The Fed is adrift, more politicized than it has been in four decades.

CHARLES W. CALOMIRIS

Henry Kaufman Professor of Financial Institutions, Columbia University

Credible communication by the Federal Reserve about its future policy path would be extremely useful, but communication is only helpful if it is credible, and such communication occurs in the context of a systematic framework for policy that makes communication credible. By explaining what it will do in an understandable way, the Fed reduces market volatility and, perhaps more importantly, insulates itself from myopic political pressures by making it hard to deviate from its clearly defined framework. But absent a systematic framework in which communication occurs, forward-looking statements may be ineffectual cheap talk, or worse—they may add risk by inviting confused speculation or mobilizing political forces to apply pressure on policymakers. At the moment, the Fed is adrift, and the lack of a systematic framework has made the Fed more politicized than it has been in four decades.

Fed policymakers disagree about the long-term real rate of interest that they should reach, and about how fast to get there. Given the changing structure of the economy and the many uncertainties inherent in economic forecasting, that disagreement is reasonable and unavoidable. But that does not mean that Fed officials are right to avoid deciding now as a group, and announcing to us in a credible way, what they believe the long-term real interest rate is, and what specific circumstances will determine the speed with which they intend to reach it. As they learn over time, they can revise their opinions accordingly, and then we can learn with them.

The dual mandate needs to be revised to accord with the current state of monetary policy thinking. A vague dual mandate that espouses the twin goals of price stability and high employment falsely assumes that inflation and employment objectives conflict in the long run, a point of view contradicted by economic theory and evidence. A single primary mandate of price stability combined with a systematic framework for explaining how countercyclical policy will weigh short-term changes in inflation and unemployment will accomplish the achievable objectives that Congress had in mind and avoid the confusion from the current vague and illogical adherence to a dual mandate.

Adding financial stability to the monetary policy mandate is wrong-headed for two reasons. First, monetary policy is a weak and blunt instrument for achieving financial stability. Financial stability can be achieved better by relying on macro-prudential tools (such as capital or provisioning requirements) that are more powerful, and that can be targeted to achieve specific objectives (such as more stable credit growth). Second, adding another goal to the monetary policy mandate would sow further confusion about monetary policy, and by making policy less predictable and less committed to an understandable and systematic framework, it would increase systemic risk and breed even greater myopic politicization of monetary policy.

Trying to return to a less transparent communications regime would undermine policy effectiveness and political legitimacy.

WILLIAM B. ENGLISH

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The Federal Reserve has greatly expanded its monetary policy communications in recent years. It has provided a statement of its monetary policy goals and strategy, including an explicit numerical inflation objective; introduced quarterly forecasts of the economic and policy outlook in its Summary of Economic Projections (SEP); and initiated press conferences following each policy meeting. These enhancements are valuable for two reasons. First, clear communications regarding the Fed's monetary policy objectives and how it intends to use monetary policy to foster them can help to anchor public expectations for inflation and employment, thereby making monetary policy more effective. Second, as an independent central bank operating in a democracy, the Fed has an obligation to be transparent about its decision-making. The Fed must be accountable to the Congress and to the public, and clear communication is critical to that accountability.

Communicating successfully about monetary policy is difficult, however, and communications shortfalls can contribute to financial market volatility and economic uncertainty. But trying to return to a less transparent and accountable communications regime, like that of a generation ago, would undermine policy effectiveness and the Fed's political legitimacy. Instead, the Fed should continue to make improvements to its communications approach. The current communications tools do a good job of conveying the Fed's assessment of the most likely outcomes for the economy and policy, but they are less effective at communicating how future policy decisions will depend on economic and financial developments and the consequent uncertainty about the path for policy. One step in that direction would be to add to the fan chart showing the uncertainty around the median policy path, and participants' assessments of the uncertainty and risks around that path, as is done with the projections of growth, unemployment, and inflation. It would be even more helpful to provide information about how the path for policy could respond to changes in the economic outlook—that is, about the Fed's reaction function. Providing such information is challenging because Fed policymakers have different views about the appropriate reaction function. That said, the Fed shows, in its semi-annual Monetary Policy Report, the prescriptions from several simple policy rules that explicitly link policy to economic variables. The Fed could use those rules to provide information on its possible reaction function by also showing the policy implications of different economic scenarios under the rules.

In contrast to communications, where ongoing improvement should be a priority, there is little need to augment the Fed's current dual mandate of maximum employment and price stability with a separate mandate for financial stability. A financial stability goal is not needed because, to the extent that financial stability risks have implications for employment and inflation, monetary policy should already take account of those possible effects. Moreover, if the Fed interpreted a financial stability mandate as requiring it to take steps to counter short-term financial market volatility seen as unlikely to affect economic outcomes, the expectation of such steps could encourage excessive risk taking and so potentially undermine financial stability over time.

The Fed's communications are muddled.

MICKEY D. LEVY

Berenberg Capital Markets, and Member, Shadow Open Market Committee

The Federal Reserve has significantly improved its communications, but it is far from transparent on many key issues. Most favorably, in January 2012 the Fed formally adopted a "Statement on Longer-Run Goals and Monetary Policy Strategy" that elaborates on its dual mandate goals. That updated Statement emphasizes that while inflation over the longer run is primarily determined by monetary policy, "the maximum level of employment is largely determined by nonmonetary factors that affect the structure and dynamics of the labor market." The Fed should heed this message and modify its communications accordingly.

In practice, the Fed's communications are muddled because they reflect both the lack of a systematic approach to achieving its goals and disagreements between Fed members about the relationship between its employment and inflation goals and the role of monetary policy in achieving its goals. Notably absent from the Fed's communications is its balance sheet strategy. The Fed was very descriptive when it first implemented quantitative easing, but has become noticeably quiet about its ultimate goals for its balance sheet size and excess reserves, its intentions on operating procedures, and its implications for its dual mandate.

The Fed's official Policy Statement following each Federal Open Market Committee meeting and statements by FOMC members focus heavily on current economic conditions, conveying the impression that the Fed's goal is managing short-term real economic fluctuations even though they are beyond the control of monetary policy and have little to do with the Fed's mandate. Implicit in many Fed assessments is the Phillips Curve, a theoretically flawed framework that has proved highly unreliable for decades. The Fed's communications challenge is compounded by its mediocre forecasting track record. Its quarterly forecasts (the Summary of Economic Projections) convey important forward guidance, but changes in them are frequently inconsistent with the FOMC's policy rate forecast.

The Fed's strategic review of communications necessarily involves an assessment of its monetary strategy.

The Dodd-Frank Wall Street Reform and Consumer Protection Act establishes the Fed's role and responsibilities in macro-prudential risk management through the Financial Stability Oversight Council's and the Office of Financial Research's mandate to coordinate efforts to anticipate and respond to financial crises. The Fed's Strategy Statement indicates that the Fed's policies reflect risks to the financial system.

Successful pursuit of its dual mandate would dramatically reduce the probability of financial crisis, but "financial market conditions" definitely should not be added to the Fed's dual mandate on par with employment and inflation.

Fluctuations in interest and exchange rates, corporate bond yields, and global stock markets are critically important to efficiently functioning economic systems. Interpreting the boundaries of financial stability and instability would be arbitrary, and using monetary policy to achieve stability goals in most instances is less effective than regulatory tools. Efforts would likely tilt toward excessively fine-tuning financial markets. This would distort monetary policy and harm economic performance, and add to misinterpretations, market inefficiencies, and undercut the Fed's credibility.

The Fed should establish rigorous capital adequacy and leverage requirements and rules for violations, and work with the FSOC to reform the government-sponsored enterprises and too-big-to-fail financial institutions. It should steer clear of efforts to make financial market conditions part of its monetary policy mandate.

"Forward guidance" is valuable but limited.

JAMES E. GLASSMAN

Managing Director and Head Economist, JPMorgan Chase's Commercial Bank

Fiat monetary systems anchored by the policies of a central bank have a successful track record in the modern era, supporting the economy in difficult times while fostering low inflation. Communications ("forward guidance") about the Federal Reserve's long-run goals, now formalized in the annual "Statement on Longer-Run Goals and Monetary Policy Strategy," are the most important step in that regard, because monetary policy is inherently vulnerable to political pressures and, in a democracy such as ours, the Fed delivers the best outcomes when it has the support and understanding of the public that it serves.

The conduct of monetary policy is more challenging during difficult economic times, because the economy recovers slowly from recessions and interest rate actions work through the economy with long lags. That requires the Fed to hold interest rates down for long spells and then to return them to normal when it judges the economy to be operating satisfactorily. In such times, the Fed's intentions can be confusing to the public. Premature market expectations of Fed tightening back in 2010 (the Fed didn't start raising its rates until December 2015) motivated the Fed to elevate communications as one of its policy tools. Good interest rate management requires central bankers to set policies based on educated hunches (forecasts) about the most likely evolution of the economy.

"Forward guidance" is valuable, but it is limited by uncertainty about the future. The Fed only knows what its goals and intentions are. And policymakers often are not of one mind. So "needless market" confusion caused by "forward guidance" typically is the result not of the Fed's communications but rather of the uncertainty about the future. Volatility associated with uncertainty about the future may be needless, but it is a fact of life.

In the end, however, the Fed's 2 percent inflation target may be the most important innovation in the evolution of central banking. That's because it provides clarity about the Fed's endgame amid the fog of uncertainty about the near-term direction of the economy. It provides a benchmark for financial markets, reflected in the inflation expectations that anchor the value of fixed income securities. And it provides monetary policy continuity in times of leadership changes at the Fed and shifting political winds. The Fed's recent emphasis on "patience" is best understood not as a response to intense political criticism of its recent actions, but as a reasonable response to the tame behavior of inflation despite popular worries that last year's fiscal initiatives could "overheat" our fully employed economy.

In theory, the dual mandate is redundant. The level of unemployment consistent with the "maximum employment" mandate is uncertain and that is why the Fed has no target for the unemployment rate. Yet it has a precise target for inflation. Notably, the 2 percent inflation target is by definition consistent with (and would be expected to promote) maximum employment. Nonetheless, the "maximum employment" mandate serves a useful purpose. Amid debates about the linkage between the state of the economy and inflation, it signals to the public that the Federal Reserve is concerned about unemployment.

Expanding the Fed's mandate to include targets for financial variables would be misguided. U.S. financial markets are deep and liquid, and millions of investors and borrowers are more capable of assessing the appropriateness of financial conditions than the nineteen policymakers at the Fed no matter how competent they and the staff that support them are. Market participants are capable of understanding the role of monetary conditions for the economy and financial markets. Speculative excesses almost always have been the result of unprecedented developments that even the central bank did not fully grasp. That doesn't mean the Fed shouldn't incorporate financial conditions (better yet, consider the fundamental developments that are reflected in financial conditions) into its judgments about the outlook.

Two recent "financial" episodes, the dot.com speculation of the 1990s and the housing speculation of the last decade, underscore the challenges for proposals to target financial assets. Had the Fed hiked rates back in the 1990s to suppress the bull market in equities, it would have choked a powerful force that fueled the digital revolution in this millennium. In retrospect, the 1990s stock market is best understood as front-running the internet economy. In the last decade, the use of interest rate policies to counter housing speculation would have proven far more damaging to the economy than a reliance on macroprudential policies.

In other words, when it comes to the valuation of financial assets, it may be wisest to leave to markets what belongs to markets.

The market and the Fed have different opinions on the impact of quantitative tightening.

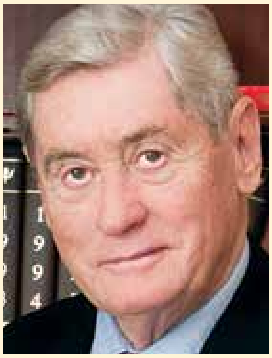
MARC SUMERLIN

Managing Partner, Evenflow Macro

The Federal Reserve communicates with financial markets primarily through its projections of policy rates and frequent speeches and press conferences. The FOMC projects policy rates out three years, which is meaningless for an institution that is prohibited from predicting a downturn since recession is a policy failure. Their projections should be limited to one year ahead, which more closely correlates to current momentum in the economy and provides as much visibility as possible. FOMC members should also have their initials on their individual projections to increase accountability.

Speeches for the chair and vice chairs should be limited to moments when something needs to be said. Frequently repeating the same points provides little value while offering the chance for market-crunching mistakes. Currently, the market and the Fed have different opinions on the impact of quantitative tightening (the reduction in the size of the balance sheet). The Fed's official position is that quantitative easing was an effective policy change, quantitative tightening is not a policy change at all, and reinstating QE (that is, reversing QT) would provide effective policy easing in the next downturn. No wonder markets are confused.

The Fed was set up after the Panic of 1907, so financial stability is deep in its roots. Its mandate has changed over time and currently says: "The Board of Governors of the Federal Reserve System and the Federal Open Market Committee shall maintain long-run growth of the monetary and credit aggregates commensurate with the economy's long-run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates." The so-called dual mandate is only a subpart of the full mandate. While the instruction from Congress does not mention financial stability, the focus on stable credit aggregates leads to the same point. A distinct boom-bust pattern to corporate credit has been fundamental to at least the last three recessions. A boom-bust pattern in household credit was also fundamental to the financial crisis. The Fed already has a mandate to lean against credit booms and assist during credit busts; it just chooses to ignore this part of their instruction from Congress.



Effectively regulate the financial sector, by micro- and macroprudential measures.

HANNES ANDROSCH
Former Finance Minister and Vice-Chancellor of Austria

In the last two decades, the dual mandate of the U.S. Federal Reserve, which puts an equal weight on price stability and full employment in the conduct of monetary policy, has delivered low and stable inflation and—with the exception of the immediate years after the outbreak of the global financial crisis—a comparatively low unemployment rate, which has fallen to 3.5 percent by end of last year. In contrast, the primary focus of the European Central Bank's monetary policy on price stability and its embedded deflationary bias is conceivably part of the numerous institutional disadvantages faced by the economy of the eurozone. From this perspective, the ongoing debate in the United States to leave price stability as the only mandated goal seems to be misplaced.

A similar argument can be made regarding the call for broadening the mandate by also including financial stability in the Fed's monetary policy objective function. True, prolonged periods of monetary accommodation, in particular the measures taken since the global financial crisis, including quantitative easing, have the potential to undermine financial stability by inflating housing and stock prices and leveraging up the economy more generally.

But using interest rate policy to lean against the excesses in leverage and risk-taking in the financial sector may involve trade-offs with the other objective of the mandate—high employment. Too often, low economic activity and the build-up of financial imbalances go hand in hand. An increase in the interest rate to break a bubble comes at the risk of higher unemployment.

Accordingly, a better alternative than using monetary policy to lean against the wind is to effectively regulate the financial sector, by micro- and macroprudential measures. The global financial crisis prompted sweeping reforms to constrain risk-taking and prevent future financial distress. The regulatory reform initiatives were definitely ambitious, but regrettably they were only partial. Regulatory arbitrage is not nearly eliminated and a watering down of prudential standards and the dismantling of some elements of the so-called Dodd-Frank law have been observed.

But another concern is that regulation is centered on a class of institutions (most commonly banks) rather than on specific intermediation functions. Examples of the latter are debt-to-income and loan-to-value restrictions in mortgage lending, or minimum margin requirements on derivatives transactions at clearinghouses for all the clearing members, and so on. These measures, when well targeted and effective, can target imbalances much closer to their source than monetary policy does. The strong regulatory focus on banks had the side effect of shifting risks to shadow banks and shadow banking activities. Post-crisis regulatory reforms have only partially progressed in addressing the risks stemming from shadow banks. Effectively regulating the growth and leverage of the shadow banking system would put less burden on monetary policy for leaning against the wind, allowing interest rate policy to be more focused on the traditional price stability and full employment objectives.

To explicitly include financial stability as part of the Fed's mandate is, however, welcome, as far as it does not enter the monetary policy's objection function. Again, the avoidance of moral hazard and greater risk-taking that are too often a consequence of central banks' function to provide liquidity to solvent but otherwise illiquid economic entities has to be addressed by effective regulation, resolution tools, and bail-in instruments.

The financial stability role of the Fed should be strengthened along those lines. An ill-defined financial stability mandate of the Fed, however, might foster the expectations the Fed will respond with all the tools at its disposal, including providing liquidity to protect the creditors of large financial institutions. The anticipation of this support may invite financial market participants to set off new adventures, eliciting ever more rescues. The financial stability mandate should broaden the scope for the Fed—in cooperation with other regulatory authorities—for micro- and macroprudential regulation, and, first and foremost, avoid regulatory bypass by reining in the shadow bank entities and activities.

The FOMC's members' model of the economy is hard to understand.

RICHARD JERRAM
Chief Economist, Bank of Singapore

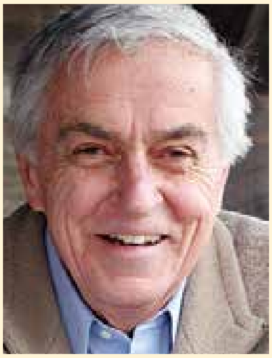
In the wake of the global financial crisis, plenty of thought was given to the question of whether central banks should target asset prices. Monetary policy is a blunt tool to manage asset price bubbles—even if you think the Fed could reliably spot one—with too many possible side effects. Moreover, it does not matter too much if the Fed thinks asset prices are too high—what matters is the damage that might be caused if they deflate, and that is better addressed by regulatory policy. Of course the Fed has to pay attention to financial markets, as they can be leading indicators (though not reliably) and they can affect the path of the economy, but that is very different from targeting asset prices.

Rather than Fed's dual mandate, questions need to be asked about the policy framework. The "Statement on Longer-Run Goals and Monetary Policy Strategy" that accompanied the January Federal Open Market Committee meeting noted, "monetary policy actions tend to influence economic activity and prices with a lag," which is hard to square with the current "data dependent" stance that implies reacting only after inflation has moved above target.

The Federal Open Market Committee's members' model of the economy is similarly hard to understand, as it appears to contain no link between growth (or unemployment) and inflation. If the inflation forecast simply reflects the stability of price expectations (wherever they come from), then the significance of trend growth or full employment seems to go out of the window and it is hard to understand the transmission from interest rate policy to the outlook for inflation.

A final problem is the Fed's reaction function. Policy guidance swung dramatically in the six weeks between the December and January FOMC meetings on the basis of very little new information on the economic outlook. It is hard to escape the conclusion that the Fed took fright at financial market volatility, without taking the time to judge whether it represented "noise" or "signal." After such a poorly explained flip-flop, it is difficult to see what would drive a swing back to a more prudent stance. I dislike the term, but we have to call it a "Powell Put."

So the question of whether the Fed should reexamine its communications policy is secondary. First, it should reexamine its monetary policy. Once it has worked that out, it should find a way to communicate more effectively.



Forward guidance is likely to intensify political pressures when the path involves higher interest rates.

RICHARD ERB
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Compared to the early days in my career when "fed-watching" was part of my job as an economist working for Henry Kaufman at Salomon Brothers, the Fed provides an enormous amount of valuable information about its objectives and operating polices, its views on the state of the economy, and its analytical approach to monetary policymaking.

Including other challenges like divining the FOMC's monetary policy objectives and operating policies, I was expected to assess whether the FOMC had a Fed funds target and what it was. Among other activities, this meant talking each day to Salomon's U.S. treasury trading desk about the timing, estimated magnitude, and interest rate developments around the New York Fed's open market operations that day.

Today, Fed-watchers have it easy but still complain! The FOMC tells them not only what the current Fed funds target is but what the future path might be. But is the FOMC going too far with its forward-looking interest rate communications policy?

When the FOMC provides forward guidance revealing its future monetary policy path, it is in effect providing a baseline economic forecast, with its own policy path an important determinant of that baseline. There may be economic circumstances when such an approach is appropriate; for example when an economy is mired in a deep recession or experiencing high and rising inflation.

But especially when market expectations are more widely dispersed, for example at a possible turning point, an explicit interest rate policy path may lead to bad FOMC decisions and market instability. If the baseline forecast turns out to be wrong, the previously announced policy path is likely to be wrong. FOMC decision makers may find it more difficult to adapt its policy path to changed circumstances because they do not want to admit to a previous bad judgment or because they fear that deviating from a policy path may itself contribute to financial and economic instability.

Forward guidance with an explicit policy path is also likely to intensify political pressures when the path involves higher interest rates. An interest rate increase at a moment in time normally triggers a negative political response. Why intensify that response by simultaneously announcing future rate increases? ◆