The fed's new approach

When you hear about the Federal Reserve in the news, you are typically hearing about the Federal Open Market Committee (FOMC). This committee issues directives for the Fed to manipulate the money supply, which it does in order to influence interest rates. Over the years, the FOMC has had very different attitudes about how much information it should reveal about its intentions.

Back in the 1970s, the FOMC did not give guidance about what interest rate policies it was likely to adopt in the future. Here is how monetary policy worked back then. For example, consider the case when the economy was in a recession. The Federal Reserve would hope to surprise Americans by increasing the money supply. With more money in the economy, banks had to lower interest rates to make enough loans to use up the extra money that was entering the banking system.

These lower interest rates affected the economy. Firms had the prices of their input costs and of the goods they sold locked in at relatively low prices. So when the interest rate decreased, firms could profitably expand their output, hopefully by enough to end the recession. Eventually, the increased money supply will cause inflation. And once that happens, workers will demand higher wages, and suppliers will demand higher prices for inputs. With these higher costs, firms will no longer be able to profitably produce the extra output.

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The Fed wanted to surprise the public because if workers knew that the Fed was going to increase the money supply and cause inflation, then the workers would demand higher wages as soon as they knew of the Fed's intentions. And if the firms were paying higher wages, their costs of operating would increase enough so that the lower interest rate would not provide enough of an incentive for the companies to expand output. And without this extra output, the economy would not emerge from the recession – at least not because of Fed policy.

By the mid-1980s, the FOMC stopped trying to trick people with surprise changes in the money supply. For example, if the FOMC thought it had to increase interest rates to combat inflation, it would make small changes over a long period of time to reach this goal. Not only that, but it gave clear and accurate guidance about what it planned to do in the future. The era of the Fed trying to trick the public with surprise policies seemed to be over. This policy was so successful that it led to good economic outcomes between the mid-1980s and 2007.

The current Fed chair, Kevin Warsh, is adopting a new approach to divulging information. He no longer provides guidance about what the FOMC is likely to do in the future. He makes a good point for why he withholds this information. He argues that if the Fed divulges what it plans to do in the future, markets (such as the stock market) will incorporate this information in their prices. This creates a problem because the Federal Reserve uses markets to gain information about where the economy is and where it is heading. Warsh does not want markets to provide information that is influenced by expected Fed policy. He already knows that. He wants new information.

But like most policies, there are tradeoffs. Warsh gains better information about the economy by stopping the Fed policy of providing guidance for what the Fed is likely to do in the future. But there is a cost to this policy. Economic actors will face more uncertainty because they will no longer have insight into how the Fed is likely to try to manipulate the economy in the future. When people face uncertainty, they often postpone decisions until they have better information. These delays will curtail economic activity – which, of course, hurts the economy.

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