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Bernanke Needs Some Bounce in His Tail: Stevenson and Wolfers

By Betsey Stevenson and Justin Wolfers - Mar 5, 2012

Federal Reserve Chairman Ben Bernanke is trying out a new communication strategy that has the potential to dramatically change the outlook for the economy. The idea: By telling people more about its longer-term plans, the Fed can stimulate the economy even when interest rates are as low as they can go.

Unfortunately, Bernanke's timid approach could doom the strategy to failure.

To explain, we ask readers to suspend disbelief and join us on a trip to the Hundred Acre Wood, where Eeyore and Tigger have become central bankers. The wood's economy is suffering the repercussions of a recent honey binge. Both Eeyore and Tigger want to help the recovery along, a goal they hope to achieve by holding interest rates low for a long time. But each communicates this differently.

Chairman Eeyore is a true dismal scientist, who sees bad news everywhere. He's sure the economy will be in the doldrums for years. Indeed, he's so worried that folks who don't understand his pessimistic outlook will make bad decisions that he gives a speech warning them about it. He says the economy is so weak that he'll need to keep rates low for several years.

Eeyore's message is so sobering that it mutes the desired stimulus effect of the low interest rates. After all, why would you buy anything, or invest in producing it, if you have just learned that some of the smartest forecasters in the country think the economic outlook is so awful that they dare not raise rates until 2014?

Terrific Party

Chairman Tigger has a totally different approach. He figures that the prospect of a terrific party will revive everyone's animal spirits. He also knows what folks are thinking: Every time the economy gets going, the Fed spoils the party by taking away the punch bowl -- that is, by raising interest rates to keep inflation in check. So Tigger gives a speech promising to keep interest rates low for several years -- even when the economy recovers.

The prospect of low interest rates sustaining a long and robust recovery leads everyone to start spending. After all, good times are just around the corner.

Eeyore and Tigger both did essentially the same thing. They announced that interest rates would be low for several years. But their messages are importantly different, and so yield very different effects.

Economists studied this issue in the early 2000s, and concluded that when you can't push interest rates any lower, Tigger's strategy is best. Markets want to know that the Fed is committed to helping the recovery and won't risk it to fight the specter of inflation.

More recently, a third great central banker -- Bernanke -- has also said he's going to keep interest rates low for several years. Will this speed the recovery, or hurt it?

Welcome to the arcane world of "forward guidance." It's the hot topic among today's central-banking glitterati, the perfect marriage of necessity -- the central bank can't reduce interest rates any further -- and an intellectual fashion that views business as rational, forward-looking and obsessed with monetary policy.

The parable of Eeyore and Tigger shows there are some difficult issues that need to be worked out. Eeyore is providing what economists call "outlook guidance" -- he's sharing what his economic-forecasting team thinks about the future. By contrast, Tigger is providing "policy guidance" -- telling us what the central bank is going to do, and promising it will do it, no matter what.

Eeyore's Playbook

Is Bernanke trying to take a page from Eeyore's playbook, or from Tigger's? In its latest monetary-policy statement, the Fed said it anticipates that economic conditions "are likely to warrant exceptionally low levels for the federal funds rate at least through late 2014." Sounds just like Eeyore. Yes, rates will be low, but only because the Fed is forecasting a weak economy. The Fed "anticipates" low interest rates, but isn't promising them.

However much Fed officials want the benefits of Tigger's strategy, they are scared of the costs. If the economy recovers fast enough, Tigger's promise limits their ability to fight inflation. But by retaining the flexibility to adjust rates as economic conditions warrant, they have become Eeyore.

Small as it may sound, the distinction is important. Businesses are always suspicious that Bernanke may try to sound like Tigger, but revert to being Eeyore when the recovery starts. To succeed at the game of forward guidance, Bernanke needs to convince us he's committed to low rates in the short term even if the economy improves. It's about fully embracing a loveable tiger, or risk being mistaken for a miserable donkey.

It's time, Chairman Bernanke, to bounce on your tail.

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