Bloomberg

# How to Understand What the Fed Says

By Justin Wolfers - Jun 18, 2013

The world will be paying close attention tomorrow when the Federal Reserve announces the results of its two-day policy-making meeting. The big question is what, if anything, the announcement will communicate.

At its previous meeting, the Fed reaffirmed its promise to keep injecting $85 billion a month into the economy "until the outlook for the labor market has improved substantially in the context of price stability" -- a message markets took to mean that stimulus would continue for the foreseeable future.

Now, thanks to the utterances of various Fed officials, markets aren't so sure. Investors are on tenterhooks in expectation of an announcement about when the Fed will start to reduce, or "taper," the rate at which it is injecting money into the economy. The uncertainty has sent bond yields, currencies and stock markets around the world into gyrations.

There's no guarantee that the Fed's statement, or the subsequent news conference by Fed Chairman Ben S. Bernanke, will provide clarity. A decision to taper bond purchases could mean any of three things about the economy: The situation is improving, the Fed doesn't think it can do more to help, or the Fed is abandoning its past promises to keep stimulus going.

Let's walk through the possibilities.

1. Good news. A pullback on bond purchases could project confidence about the strength of the economy. If Bernanke and company are willing to take their foot off the accelerator, we can infer that they must see sunny times ahead. Studies have documented that Fed forecasts are typically more accurate than those of private-sector economists, so even sophisticated economists should become more optimistic when the Fed's outlook improves. Bernanke's confidence could have a positive effect on businesses, making them more likely to invest and helping to strengthen the recovery.

2. Mission accomplished. The tapering of stimulus, at a time when job growth remains middling, might tell us more about the Fed than it does about the economy. Maybe the Fed thinks that the unsatisfactory pace of economic recovery is good enough. Consider it the monetary equivalent of a "Mission Accomplished" banner: premature and unconvincing.

Such a decision might signal that Fed officials think the labor market can't improve much faster. Or perhaps they no longer believe that further bond purchases will make a difference.

The prospect that the U.S. economy is dependent on a Fed that is willing to put down its weapons and declare victory when the battle isn't yet won is deeply worrying. Such an announcement would lead businesses to think twice before investing, hurting the recovery.

3. Bait and switch. A shift away from stimulus could mean that Bernanke is reneging on his pledge to stimulate the economy until the labor market improved "substantially." He promised open-ended quantitative easing, hoping to stimulate investment. Now that those investments have been made, he doesn't need to actually deliver.

If this is what's happening, it could be particularly harmful. Promises to maintain stimulus in the future -- known as policy guidance -- are one of the Fed's few remaining tools at times like the present, when short-term interest rates have fallen to zero. If the Fed reveals that it can't be trusted, then businesses that had been thinking of investing based on the Fed's past promises to keep rates low will hold off, and the recovery will sputter.

The range of possible interpretations demonstrates that the Fed has botched its communications policy. Transparency isn't about talking a lot. It's about being clear. Had the Fed clearly explained how it would respond to changes in the economic outlook, then Fed watchers would know what changes in its policy mean. Sadly, that's not the case.

The language that Fed officials have chosen -- continuing bond purchases, known as quantitative easing, until "the labor market has improved substantially" -- is so slippery that nobody knows what the talk of tapering signals. Add to this the escape clause they have built in -- that in deciding how to proceed with asset purchases "the Committee will continue to take account of the likely efficacy and costs of such purchases" -- and they are practically inviting you to believe they were never really committed to maintaining stimulus until after the recovery took hold.

When you are reading the Fed decision, don't focus on whether they decide to taper asset purchases or not. It's much more important to understand why, and what this says about future policy. The best outcome would be if Fed officials took a truly revolutionary step: Tell us what they are going to do, then follow through by doing it.

(Justin Wolfers is a professor of public policy and economics at the University of Michigan, a nonresident senior fellow of the Brookings Institution and a Bloomberg View columnist. The opinions expressed are his own.)

To contact the writers of this article: Justin Wolfers at jwolfers@umich.edu.

To contact the editor responsible for this article: Mark Whitehouse at mwhitehouse1@bloomberg.net.