Kevin Warsh

The latest meeting of the Federal Open Market Committee (FOMC) on July 28 has triggered a sort of revolt. The reduced amount of information released by Kevin Warsh is disliked by the financial markets. It runs against the decades-old evolution of most central banks toward maximum transparency. But Warsh has a point.

The transparency logic is clear. Central banks set the very short-term interest rate, which they can easily control, but which has no direct effect on the real economy. What matters are longer interest rates as they affect borrowing, investment and consumption. The policy interest rate influences the longer-term rates inasmuch as it signals the intentions of the central bank. By transparently signaling its intention, so the reasoning goes, the central bank can be more effective. It has even been suggested that this is the most effective tool of central banks.

This logic has led to the increasingly popular practice of forward guidance. Central banks have been eager to share their policy rate intentions over horizons that extended two or even three years ahead. Some central banks, like those of New-Zealand, Norway and Sweden have even published their policy rate predictions over such horizons. The Federal Reserve has published the dot-plots, which report the policy rate previsions of individual FOMC members. It soon emerged that forward guidance is much more complicated than it seems.

A first issue is how forward guidance is interpreted by the financial markets. Is it revealing the central bank intended behavior or its forecasts about future macroeconomic developments? The fact is that central banks do not know more about the future than the financial markets. The only informational advantage of central banks is that they know what they think. But, much as professional forecasters routinely disagree, members of central bank monetary policy committees may hold different views. Naturally therefore, forward guidance has triggered continued discussions about what is going on within the central banks. Are the published macroeconomic forecasts produced by the staff or are they endorsed by the decisionmakers, who are unlikely to always agree? Practices differ. Fed decisionmakers sometimes publicly disagree, which leads to what is aptly called a cacophony. There was a time when the ECB president insisted that its policy committee worked as a perfectly consensual team so that voting was unnecessary. Until recently, the SNB was perceived as driven exclusively by its president, which is the legal practice in New Zealand. All of this shows that “maximum transparency” is an endless quest, which limits the power of forward guidance.

A second issue is whether the central bank feels committed to deliver on its previous statements when the macroeconomic situation changes. Without such a commitment, forward guidance is not credible. But a firm commitment faces the temporal inconsistency problem: precommitments may be ill-suited to unexpected macroeconomic developments. Before the Covid crisis, when inflation had remained lower than its stated targets, many central banks promised to keep their policy rates “low for longer”. When inflation started to rise, they were embarrassed to renege on their repeated promises, and they delayed raising the interest rates until inflation surged to unimaginable levels. Of course, reasons were provided for the delays, chiefly the conviction that inflation will promptly decline once the global supply chains start functioning again. In fact, inflation did decline, just when central banks were raising interest rates. In the event they were blamed both for getting cornered into an unwise commitment and for their reaction that came too late.

Forward guidance is now out fashion. A more sophisticated approach is the use of scenarios. This idea was suggested by Ben Bernanke, a former president of the Fed, in a report to the Bank of England. Instead of publishing unrealistically precise forecasts and associated forward guidance, central banks construct a few alternative scenarios describing possible inflation and growth paths and they indicate how they would react to each scenario. At the same time, they assert that they will react to new information as it arises and stand ready to act whenever and in whichever way they will feel needed. This is not very transparent.

Clearly, this approach will have to evolve to more coherent. The ambiguities of forward guidance raise a bunch of thorny issues. At the heart of it all lies the relationship between central banks and financial markets. The central banks need to carry along the markets since this is where longer-term interest rates are set. The financial markets, whose purpose is to bet on future developments, look to central banks for crucial information about their intentions.

The problem is that central banks face the same uncertainties as the market. If credible, their pronouncements, right or wrong, have the advantage of allowing market participants to coalesce around a limited set of possibilities. If central banks turn out to be wrong, financial firms cannot be blamed for having listened carefully to the central banks. This matters a lot when they have to explain to their customers why they lost money. Blaming central banks is an irresistible excuse. But it is not obvious why central banks should feel obliged to provide excuses.

This matters a lot in times when uncertainty rises, as is currently the case given the war in Iran and, more generally, the highly unsettled world order. The fundamental question is who bears the risk. Central banks must make policy decisions, which is already challenging. The key function of financial firms is to manage uncertainty, for themselves and on behalf of their customers. When they limit their communication, central banks greatly complicate the task of financial firms, some of which may suffer massive losses and an exodus of customers. This can easily lead to financial crises.

As a result, financial firms must raise the risk premium that they charge on the interest rates that they charge to their customers. This is precisely what happened after the last meeting of the FOMC, and it was accompanied by a wave of criticisms of Kevin Warsh. Higher interest rates stand to discourage private sector borrowing and thus to slow down investment and consumption spending. But this is a normal reaction at times of high uncertainty. It is sometimes argued that the responsibility of central banks is to support spending if it declines and to prevent financial crises. Obviously, there is no simple solution.

Risk premium or expectations

We can remember Alan Greenspan, a former president of the Fed. One his legacies is Greenspan-speak, obtuse statements designed to convey as little as possible of his intentions. Another legacy is Greenspan-put, which consists in letting the financial markets carry all the uncertainty and to intervene only when a crisis occurs. Both strategies have been washed away when central banks adopted forward guidance and accepted responsibility for financial stability. Yet, this is what happens in the aftermath of the 2008 financial crisis and again when Silicon Valley Bank collapsed in 2023.

One can see Warsh as moving in the direction of Greenspan. This is not illogical in view of the disappointing results from forward guidance. Something in-between might be worth experimenting.