



The Warsh Doctrine: what a quieter Fed means for the rates market

Global Fixed Income

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- Kevin Warsh's first FOMC meeting as Chair marked a meaningful shift in the Federal Reserve's communications regime. The Committee shortened its policy statement and removed forward guidance about the likely path of interest rates, and Warsh declined to submit forecasts to the Summary of Economic Projections.
- Some recalibration of Fed communications may be useful, but less communication risks less clarity about how the Committee is likely to respond to incoming data.
- For fixed income investors, the shift points to a more volatile interest rate environment, wider confidence bands around the policy outlook, and potentially a higher term premium. While this may reduce the efficiency of monetary policy transmission, it presents opportunities for active managers with a strong view on the economy and the Fed's reaction function.

Kevin Warsh's first FOMC meeting as Chair marked a significant change in Federal Reserve communications. The policy statement was shortened and forward guidance about the policy outlook removed, as was reference to the employment side of the mandate. Chair Warsh also did not submit forecasts to the Summary of Economic Projections, and in the press briefing he declined to answer questions about the policy outlook. The message was clear, even if final changes to communications strategy will await recommendations from a new communications task force: under Warsh's leadership, the Fed is likely to say less about how the Committee is interpreting incoming data and where policy may be headed.

Some recalibration of Fed communications is welcome. Forward guidance¹ can occasionally become stale, and the policy statement has been prone to boilerplate language that adds words but little value. The dot plot, too, is not indispensable: it can imply a false sense of Committee confidence in the economic and policy outlook and ignores alternative scenarios. And at times the economic projections can paint a misleading picture of the reaction function as the median projections across variables might be drawn from different Committee participants.

But a streamlined communications regime is only beneficial if the Committee continues to explain its reaction function.

1. The discussion of forward guidance in this note focuses on Fed communications that provide information on how policymakers would likely respond to specific economic outcomes. It sets aside commitment-based guidance under which the Committee commits to specific policy outcomes, historically in the service of easier monetary policy. Commitment-based guidance was used at the zero interest-rate bound, for example during the sluggish recovery

Markets do not stop forming expectations about monetary policy because the Fed chooses to say less. They simply must infer more from less information. The result is greater uncertainty about how the Committee views the economic and policy outlook, the balance of risks, and the tradeoff between price stability and full employment.

Warsh has been clear about his motivation. In the press briefing, he argued that market prices provide a stronger signal to policymakers when the Fed itself is less central to the pricing process. If markets are simply reflecting back what the Fed has already said, then policymakers risk losing an important source of information.

There is some logic to this argument. A central bank that over-engineers market expectations can inadvertently weaken market discipline. History provides cautionary examples. During the mid-2000s, for example, the Greenspan Fed's commitment to tightening "at a pace that is likely to be measured" strongly anchored expectations around a steady and predictable path of rate increases. That predictability likely contributed to lower volatility, but it may also have encouraged excessive risk-taking in parts of the financial system, including housing-linked assets.

Still, conditional guidance on the policy outlook does not require the Fed to pre-commit to a particular path of interest rates. Instead, it involves policymakers explaining how they are likely to respond to different outcomes for inflation and the labor market. An extensive literature supports the argument that clear communication helps markets price the reaction function and thus improves policy transmission.² Nor is there much evidence that Fed communications pollute market pricing in a way that prevents policymakers from extracting useful signals from financial markets. For example, research finds that markets continue to respond to macroeconomic news during periods of forward guidance, consistent with investors treating guidance as conditional rather than a commitment.³

If the Fed provides less information on its reaction function, financial conditions may become more volatile because investors are less certain about how the Committee will

interpret and react to new information. That uncertainty should be most visible at the front end of the Treasury curve, where expectations for the policy path are most important. But it can also affect longer maturities through a higher term premium, as investors demand more compensation for uncertainty around inflation, real rates and the Fed's tolerance for deviations from its full employment and price stability objectives.

In the wake of the FOMC meeting, some have argued that the new focus on price stability could tamp down inflation expectations and the inflation risk premium, helping to lower nominal Treasury yields. The statement language was notable in this respect, with the Committee adding that it "will deliver price stability" while removing references to the employment side of the mandate. One could argue that this "revealed preference" to focus on price stability is a form of communication about the reaction function. If investors come to believe that the Fed will be more forceful in returning inflation to target, then stronger credibility could offset any upward pressure on rates from a higher term premium. But that credibility is enhanced when the reaction function is clear, and the public understands how the Committee arrived at a particular policy stance.

The potential limitation of Warsh's approach was most apparent when he was asked why the Committee did not raise rates at this meeting. His answer, that he had nothing more to say beyond the statement itself, was consistent with his broader communications philosophy but also highlights the central problem. While Warsh said the Committee would deliver price stability, he did not explain how it would do so and over what time frame, or why, given that objective, the Committee chose not to raise rates. The reaction function went unexplained.⁴

This is particularly important because the Fed's inflation credibility has already been tested. Inflation has been above target for several years, and the Committee is increasingly confronting the possibility that policy may not be as restrictive as previously assumed. In that environment, a renewed commitment to price stability is more credible when accompanied by a clearer explanation of the conditions that would lead the Fed to tighten policy,

from the Great Recession. The Committee again rolled out commitment-based guidance as part of its implementation of Flexible Average Inflation Targeting in 2020.

² See, for example, Michael Woodford, "Central Bank Communication and Policy Effectiveness" (2005); Alan S. Blinder, Michael Ehrmann, Marcel Fratzscher, Jakob De Haan, and David-Jan Jansen, "Central Bank Communication and Monetary Policy: A Survey of Theory and Evidence" (2008); Refet S. Gürkaynak, Brian Sack, and Eric T. Swanson, "Do Actions Speak Louder Than Words? The Response of Asset Prices to Monetary Policy Actions and Statements" (2005); and Glenn D. Rudebusch and John C. Williams, "Revealing the Secrets of the Temple: The Value of Publishing Central Bank Interest Rate Projections" (2006).

³ See, for example, Richhild Moessner and William R. Nelson, "Central Bank Policy Rate Guidance and Financial Market Functioning" (2008); and Michelle Bongard, Gabriele Galati, Richhild Moessner, and William R. Nelson, "Connecting the Dots: Market Reactions to Forecasts of Policy Rates and Forward Guidance Provided by the Fed" (2021).

⁴ As a further example, the median Committee participant's submission to the Summary of Economic Projections does not show inflation returning to two percent until 2028. This gradual return of inflation to target has been a consistent theme of the projections in recent years, and thus the latest projections do not reveal a newfound emphasis on price stability, irrespective of changes to the policy statement. Warsh did not submit projections, and given that he declined to provide insights into his reaction function during the press briefing, it is unclear if the views of the Committee as reflected in the projections are consistent with his focus on price stability and his frequent comment that "inflation is a choice" of the central bank.

remain on hold, or eventually ease. Saying less may preserve optionality, but it also makes it harder for investors to distinguish between flexibility and opacity.

For investors, this new communications regime has direct implications. With less guidance, investors have fewer reference points for gauging how the Committee will respond to incoming data. This could increase the risk of policy surprises, widen confidence bands around the rate outlook, and create more frequent and larger repricing across the Treasury curve.

The environment is likely to be less comfortable for investors that rely on stable policy signals or passive duration exposure. But it should be more attractive for active fixed income managers. If the Fed is going to say

less, the value of independent macroeconomic analysis will rise. Investors will need to assess not only the direction of inflation, growth and labor-market conditions, but also how a less communicative Fed is likely to interpret those developments. More volatility is a risk. But it is also a source of opportunity for managers with the flexibility, analytical depth and policy insight to take advantage of markets that may increasingly need to price the Fed without as much guidance from the Fed itself.

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