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Boosting the Fed's Signal-to-Noise Ratio

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The contemplation of signal-to-noise ratios is usually the exclusive domain of electrical engineers. But this subject has become of increasing relevance to economists due to the sheer number of Fed Governors and Presidents who are now proffering their myriad views on a daily basis. It has become increasingly difficult to separate what constitutes a reliable signal of future monetary policy from the inconsequential noise. The monetary policy signal-to-noise ratio is currently very low. This partly explain why expected bond market volatility remains so high – central bankers as a collective are not offering anything close to a clear path forward.

In this brief report, we explain why the Fed's signal-to-noise ratio is so low, and provide suggestions for who to listen to, and what to listen for. Note that our formal preview of next week's Fed decision will be released on Monday.

Why So Much Noise?

There are many things that curse the Fed to a low signal-to-noise ratio. None are by explicit design, but most are nonetheless rather firmly embedded in the system, and it is not realistic to think that they will abate any time soon.

Cyclicality: There is always a cyclicality to the Fed's noise, with the ebb and flow based at least in part upon the timing of FOMC meetings. The next Fed decision will be made this coming Wednesday (November 4th), and Fed officials are all scrambling to get their say before the cone of silence descends.

Many Voices: The Federal Reserve has a remarkably large number of Governors and Presidents – as many as nineteen (currently seventeen). This simply makes for a lot of speeches, comments, and opinions.

Varied Views: Unlike some central banks, which insist upon consensus and a uniformity of message, the Federal Reserve approach permits differences of opinion, which are ultimately settled by a vote. This means that not only are there as many as nineteen voices, but they can possess as many as nineteen different views. And whereas previous Fed Chairman Alan Greenspan ruled with an iron fist, insisting upon conformity, current Chairman Bernanke does not have the same tight rein on his fellow members.

Varied Allegiances: While the obligations of the twelve District Presidents ultimately extend to the nation's overall economic interests, they have an additional subtle incentive to slant their analysis in a direction that slightly favours their home district. It is worth noting that they are initially selected by a committee of local business people, and are only subsequently approved by the Board of Governors. Regional economic performance varies, and this can contribute to different views from the various District Presidents. It is also the case that each District President is geographically separated from the others, and has their own economic official forecast and a large team of economists. This creates the risk of an echo chamber, and of substantial divergences of view between Districts.

Opinions Fill Vote Void: Not every Fed District President gets a vote at the FOMC meeting. At any particular vote, seven out of the twelve have no formal way to influence the Fed's decision. To be sure, they rotate through the voting roles with regularity, but it is possible to be without a vote for sixteen consecutive meetings. In circumstances such as these, alternative avenues must be pursued to influence the outcome, and it is a popular game to speak widely and with enthusiasm to the media in the hope that one's view will gain a following among other voters and decision-makers. Even for those with a vote, there is an implicit expectation that dissents be made only in unusual circumstances, and so voters also have an incentive to make their views known in an effort to shift the dialogue and the potential votes of others.

Jaw-Boning as Policy Substitute: One of the most important tools of monetary policy is the ability to influence the market's expectation about the future, creating an effect not entirely dissimilar to an outright change in the fed funds rate itself. This creates an incentive for all participants to make their views as widely known as possible to the market and the public. The extreme hawks and doves – who are almost by definition dissatisfied with the current stance of policy – have a particular incentive to try to influence the market so as to simulate their own preferred outcome. For instance, talking up the risk of rate hikes encourages the market to price in more rate hikes, and in so doing removes stimulus from the economy. The fact that the influence of this jaw-boning upon the market can only be temporary unless ultimately validated by the FOMC seems not to concern the market.

Only The Most Shrill Can Thrive: It is an unfortunate reality of the constant pressures of the media cycle that only the newest, most unusual, and most exciting opinions will capture headlines. By contrast, a more reasonable, long-standing, and practical view held by a large number of Fed participants will fail to attract nearly as much attention. It just isn't "news". This creates a situation in which the least representative views get disproportionate attention, distorting the market's sense of the true feelings of the Fed. This effect has arguably grown over time as economists and their ilk increasingly populate the world of talking heads.

Uncertain Outlook: It goes without saying that the current diversity of Fed opinion also relates to the considerable uncertainty over the economy recovery, the unprecedented level of monetary stimulus, and the host of unconventional policy tools that are still being applied.

Boosting the Signal

Given all of the noise, how does one go about boosting the strength of the signal so as to get a reasonable perspective on the future path of U.S. monetary policy? We present a few tricks and tips.

Listen to the Chairman: There is great value in listening to Chairman Bernanke. He may not have perfect control over the FOMC, but he is still by far the most important member and carries considerably more clout than the rest. He rarely misleads, and provides a reasonable, middle-of-the-road view.

Listen to the Governors: In the absence of explicit direction from the Chairman himself, the Fed Governors offer greater insight than the District Presidents. This is for several reasons. One is that the Governors tend to vote in a bloc (representing as many as seven out of twelve votes – a majority), and so the view of one will likely reflect the views of the others, including the Chairman. This amplifies their importance by as much as six times relative to that of a District President. Two is that – by contrast – the views of the District Presidents tend to be more varied, and so any one voice is less representative of the overall inclination of the FOMC. This requires that one listen extremely selectively to Fed voices, because the Governors perversely tend to attract less media attention than the District Presidents due to their generally blander views, and also because the District Presidents have constituents of a sort – the businesses, households, and organizations in their geographic region – that call upon them to make a larger number of speeches.

Bounding the Fed: While the extreme opinions such as those of the hawkish Plosser do little to help in assessing the most likely central tendency for the Fed, they are good for at least one thing. They provide a useful bound for the possible range of Fed actions. In other words, if the extreme hawks are arguing for rate hikes in six months time, that tells us that there is virtually no chance whatsoever of rate hikes before then. But in no way does it suggest that rate hikes in six months are at all likely.

Looking Beyond The News: The real challenge in getting the true message from the Fed is in looking beyond the news. The market and media are so accustomed to searching for whatever is "new" in a Fed speech that they have missed the point of the exercise. The most important message in these speeches is *not* what is new, but rather what has been repeated by each and every Fed speaker ad nauseum. This is truly the message that should be taken from the Fed, and anything new should be regarded with extreme suspicion until it has been corroborated by several Fed speakers, and preferably by a Governor or two.

Our Findings

Let us now apply this signal-boosting methodology to the current situation, arriving at the conclusion that the Fed has no near term action in mind.

Chairman Bernanke is the first person to look towards. His last two speeches have not even bothered to reference the monetary policy outlook, signalling no particular discomfort with where the market is priced. An earlier speech – from October 8th – reiterates that "accommodative policies will likely be warranted for an extended period. At some point, however, as economic recovery takes hold, we will need to tighten monetary policy to prevent the emergence of an inflation problem down the road." This does not suggest that the Fed is racing to depart from its belief that "economic conditions are likely to warrant exceptionally low levels of the federal funds rate for an extended period", as stated in the September 23rd rate decision. One risk to watch is that the Chairman recently referenced a need for confidence in the U.S. dollar – a rare subject, and one that suggests there is some concern over the speed of the currency's downward push.

The Governors also deserve close attention. Once again, the latest speeches have not tended to dwell upon the specifics of monetary policy or the economic outlook, signalling both that little has changed in the overall view since the September 23rd rate decision, and that there are bigger fish to fry regarding regulations and the international dimension of economic imbalances.

That said, there are two speeches by Governors since the last Fed decision that are worth dwelling on. On October 13th, Vice Chairman Kohn discussed the economic outlook, and called for a "gradual strengthening of economic activity", an absence of a V-shaped recovery, and reiterated the commitment to unusually low interest rates for an extended period. On September 25th, Governor Warsh penned an editorial in the Wall Street Journal and gave a speech covering the same ground. The emphasis was on "substantial slack in resource utilization that is likely to continue to damp cost pressures" and another reiteration of the "extended period" commitment. He then went somewhat further than the standard boiler plate analysis, and discussed a desire for more symmetry in the unwinding of monetary policy relative to its implementation. This would seem to refer to the risk of a more rapid than usual pace of rate increases when rate hiking finally happens. We concur, and believe this may be a widely held view by Fed Governors.

Serving as a useful upper bound for monetary policy, Philadelphia Fed President Plosser said in a September 29th speech that the Fed will have to "take the necessary steps to prevent a second Great Inflation" and that there could be costs imposed on the economy "if we fail to act promptly, and perhaps aggressively, when the time comes to do so." But even in his speech, there is not the sense that he wishes to vote for a rate hike immediately. Rather, "the issues of when and the pace at which we unwind the extraordinary measures… …are high on my list of priorities."

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The TD view remains that the Fed will surprise many in how long it manages to remain on hold, with a first hike coming in Q1 2011. Subsequently, the pace of policy removal will be somewhat faster than the traditional dribbling of 25bps rate hikes. This seems in line with the sorts of comments coming from Bernanke and the Governors. We will be providing a detailed preview of the coming FOMC decision on Monday.

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