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Warsh Is Wise to Ditch the Dots

Fed 'forward guidance' was supposed to encourage transparency, but it ended up doing real damage.

By Donald L. Luskin

The first major component of Federal Reserve Chairman Kevin Warsh's reform agenda to be implemented is the elimination of "forward guidance" by the Federal Open Market Committee and Fed officials as to future policy positions. The FOMC's postmeeting statements have seen a 49% reduction in word count from one year ago, its minutes have slimmed down by 24%, and the number of speeches made by Fed governors is down by 27%. Mr. Warsh resolutely refuses to be goaded into making news at post-FOMC press conferences.

Perhaps Mr. Warsh is taking on forward guidance first because he understands that it is like most big-government programs: Its goals sound noble, but in pursuit of them, government agencies become bloated with mission creep and infested by rent-seekers. And for all that, it turns out that government can't achieve the goals anyway.

Forward guidance has high-minded objectives: making the Fed more transparent and accountable and giving markets the information they need to adapt to future policy shifts without undue surprises. Critics are censuring Mr. Warsh for turning his back on those goals. But most of the criticism comes from the self-interested Fed-industrial complex. Wall Street is afraid it will be deprived of trading opportunities and transaction fees. The media is afraid it won't get juicy headlines from Fed officials. Those officials are afraid that they won't get their 15 minutes of fame when financial television hosts can no longer elicit their latest pearls of wisdom about the economy.

But even if we ignore the self-interest of critics and assume that forward guidance was created with good intentions, it simply doesn't work in practice. Through the years, forward guidance has been worse than useless at revealing what the Fed will actually do.

The most explicit form of forward guidance is the "dot plot" chart that represents FOMC members' projections of the federal-funds rate published quarterly in the Summary of Economic Projections. It started under Chairman Ben Bernanke in January 2012. Of the 46 quarterly three-year projections to year-end 2025 since then, only two have been right. The average error is 1.8 percentage points, which is stunningly bad considering that the year-end federal-funds rate itself has averaged 2%.

The most egregious error in the dot plot was in the summaries of December 2020 and March 2021, when the funds rate was zero. The dot plot was promising markets a zero funds rate all the way out to year-end 2023. At year-end 2022, the funds rate had been hiked to 4.38%, and by year-end 2023 to 5.38%.

One consequence was that Silicon Valley Bank became insolvent in March 2023, in part because it detrimentally relied on the zero funds rate promised by its primary federal regulator, buying long-term Treasurys at low pandemic-era yields. These catastrophically depreciated when the Fed unexpectedly raised rates in one of the most aggressive hiking cycles in history. The Fed was then forced to backstop similarly distressed banks by lending against the full maturity value of their depreciated bonds. But that was too late for what had been the 16th-largest bank in the U.S.

Another consequence was that the nation had to endure the worst inflation since the early 1980s. In March 2020, as the global economy began to shut down in response to the pandemic, the FOMC lowered the funds rate to zero and said it expected to keep it there "until it is confident that the economy . . . is on track to achieve its maximum employment and price stability goals."

In December 2021 the unemployment rate fell to 3.9%, and inflation was running at 6.1%. Yet the funds rate was still zero, and much of the same forward guidance remained in the FOMC statement. Inflation peaked several months later, in the summer of 2022, after the Fed finally started raising rates in the spring. Officials belatedly admitted that inflation wasn't "transitory" and that their words and dots had dramatically underestimated the recuperative powers of the economy—which had returned to new all-time high real gross domestic product a whole year earlier. It seems the Fed had made itself reliant on its own wrongheaded forward guidance just as Silicon Valley Bank did.

Mr. Warsh can't entirely abolish forward guidance. It is mandated by the 1978 Humphrey Hawkins legislation, which requires a semiannual report "containing a discussion of the conduct of monetary policy and economic developments and prospects for the future, taking into account past and prospective developments."

But he can dial communications back to where they were before 2007, when Mr. Bernanke introduced the Summary of Economic Projections, in which FOMC participants gave their individual projections of growth, employment and inflation every quarter. In 2012 Mr. Bernanke added the dot plot of the future funds rate. That was a time when inflation was running persistently below the Fed's 2% target, the funds rate had been stuck at zero for four years, and Mr. Bernanke was eager to find ways to stimulate the economy by lowering long-term yields. Promising a low funds rate with forward guidance was one strategy. Repeated quantitative easing was another. None of it worked.

Mr. Warsh resigned as a Fed governor in 2011, partially in protest over the Fed's second round of quantitative easing. He wasn't there in 2012 for the introduction of the dot plot. Having abstained from contributing a dot at his first FOMC meeting as chairman in June this year, he remains to this day dot-free. If he has the courage to defy his critics and continue down the road to reform, then we can all be free of Fed forward guidance that has done more harm than good.

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