Lift-off, Fedspeak and the perils of too much disclosure

There are few things more frustrating when travelling than lengthy flight delays. One such delay recently reminded me of the parallels between the dangers of too much disclosure on timing around lift-off of two sorts: a delayed flight and the Federal Funds rate. First, the flight delay.

After sitting on the tarmac for at least twenty minutes, an announcement from the captain indicated that the Qantas flight from Brisbane to Hong Kong was delayed due to a technical issue and that flight engineers were investigating. Little did the passengers at the time know that this would be the first sign of a very long and frustrating day.

Following another half an hour, the captain revealed that the readings between different fuel tanks were inconsistent and that to test the accuracy of the gauges, fuel would need to be pumped from one tank to the main tank.

Regular disclosure continued, and within half an hour, the captain announced that a valve in the fuel tank had been identified as faulty and that engineers were confident of sourcing a replacement valve at Brisbane airport.

Subsequently, the updates became less frequent. It was one thing identifying the fault; it was another thing altogether fixing it within a relatively tight timeframe. Another hour now passed before the next update; that it was taking longer than expected to resolve the problem and passengers would need to disembark the plane for the benefit of our comfort. Read: we do not know how long it will take to fix, and you will go stir crazy if you remain stuck on the tarmac for much longer.

Once we had disembarked, information vacuum was complete. Despite the growing frustration of passengers, during this time Qantas had

obviously made a decision that it was better to remain silent than provide regular updates on a situation that was highly uncertain and in flux.

After three hours, the captain finally announced that he had good and bad news. The bad news was that the engineers were still having problems in fixing or replacing the valve and there was no clarity in how long it would take to resolve. The good news was that he was flying to Sydney to pick up a plane and would fly it back to Brisbane that evening. The sting in the tail of the good news was that the flight to Hong Kong would not be departing until the following morning.

The lack of communication for a three hour period is testimony to the fact that Qantas had to manage its reputational risk at a time when there was a tremendous uncertainty surrounding just how long it would take to resolve the problem. Regular disclosure during this time would have amounted to an admission that it simply did not know, unnerving passengers and denting its credibility, a precious commodity for an airline.

Qantas' communication during the flight delay – particularly its decision to remain quiet at a time when it had little understanding of how long it would take to fix the faulty fuel valve - provides some salutary lessons for the US Federal Reserve, which finds itself in a similar dilemma. It has to manage investors' expectations at a time of high uncertainty surrounding whether the economy can withstand an exit from its policy of forward guidance and zero interest rate policy (ZIRP).

On the one hand, progress is being made on reducing slack in the labour market but underutilisation remains high, whether gauged by the still high rate of long term unemployed, under-employment or sluggish growth in hourly wages. Further, inflation continues to undershoot its target.

Better too late than too early

The Fed has deliberately and astutely given itself plenty of wiggle room in its interpretation of its goals of promoting full employment while maintaining price stability. In the minutes released overnight, the Fed again committed to keeping interest rates close to zero for a considerable time after the end of its quantitative easing program and after its goal of full employment is achieved.

This approach has merit for two reasons. First, the costs of a premature exit from ZIRP are substantial, notably the risk of another recession, a policy error that The Fed committed in the mid-1930s which tipped the US economy back into recession in 1937. Just as damaging would be the dent to the Fed's credibility as a forecaster if it had to reverse course and cut the Fed Funds rate soon after tightening.

In contrast, the costs of a delayed exit, while not trivial, are arguably not as significant; the Fed would need to rein in growing inflationary pressures through a series of larger than anticipated and rapid fire rate hikes, which could endanger the recovery and give rise to dislocation in financial markets. But the last time this happened in 1994 – during the global bond market meltdown brought on by the Greenspan Fed raising interest rates aggressively to quell growing inflationary pressures - this did not derail the economic recovery.

Second, the very nature of the Fed's forward guidance offers a sound intellectual foundation for a delayed and slow exit from ZIRP. In what has quickly become a classic, Michael Woodford's paper at the Jackson Hole symposium in 2012, he argued that the zero lower bound does not render monetary policy impotent. Rather, forward guidance can and should be used to influence expectations about future interest rates.

He recommended that the Fed commit to a policy whereby ZIRP would be maintained long after the economy warranted a lift in interest rates, and that this could be used to influence household and business sector expectations of lending rates in the out-years and encourage them to bring forward spending and capital expenditures.

Thus, by committing to not remove the punch bowl just at the party is getting into full swing, forward guidance helps to boost the psychology and revive the animal spirits of the household and business sectors. Of course, much depends on the credibility of the central bank to follow through on its commitment.

Less is better

The problem the Fed has around its exit strategy is really one of communication. As the recovery in the labour market continues to gain traction and as the thresholds surrounding what constitutes full employment are met, the Fed needs to buy time to 1) ensure that the economy will be robust to rate hikes and 2) to honour its commitment to ZIRP that has formed part of its forward guidance.

Too much information disclosure on the part of the Fed might well belie a low level of confidence about the economy's resilience and timing of the Fed's exit strategy. As difficult and counter-intuitive as this might appear to a central bank that has long prided itself on its openness and transparency, the Fed might be better off by disclosing less than more.

Too many cooks spoil the communication broth

The 'what to' question of communication is also complicated by the 'whom'. The Qantas captain had the benefit of communicating in the 'one voice'. The airline has recently adopted a policy whereby only the flight captain can communicate to passengers, issues around significant delays and technical faults. In contrast, the efficacy of Fedspeak in managing investors' expectations is muddied by the many disparate voices of voting and non-voting FOMC members. The ability and willingness of some FOMC members to publicly air their views – some of which are contrary to the decisions of the FOMC – has hampered the ability of the Fed to influence expectations through quantitative easing and forward guidance. Although diversity of opinion should be encouraged and welcome, at times it can dull the potency of monetary policy and pose a risk to a central bank's reputation.

The asymmetric payoff of corporate guidance

The costs of too much disclosure are not confined to central banks and airlines. In the wake of the financial crisis, there was a significant rise in the number of companies that ceased giving investors earnings guidance, at a time when economy wide uncertainty was high and factors beyond the control of management were asserting an undue influence on profitability.

Many CEOs and CFOs understood that guidance offers an asymmetric payoff: the reputational risks of not meeting guidance far outweigh the benefits of meeting or exceeding guidance. Insiders' views of uncertainty and sensitivity to systematic factors also played an important role in whether guidance continued or not; companies in cyclical industries – those that were more exposed to the economy wide impact of the crisis – were more likely to stop giving guidance.

The flight to Hong Kong was eventually cancelled and a new plane departed 24 hours after the original departure time. Safely in the air, the captain spoke at length and was forthcoming about the technical issues that had caused the delay and cancellation. The captain was at pains to highlight that the airline did not apologise for putting passenger safety ahead of flight schedules, and we arrived in Hong Kong safely, with Qantas's reputation as one of the world's safest airlines firmly intact. But the previous day, when uncertainty around the ability to fix the problem in a timely fashion was high, Qantas rightly chose to manage its reputational risk carefully by opting for less over more disclosure.

At a time of growing investor uncertainty surrounding the US economy's ability to withstand higher interest rates, and timing of its exit strategy, the Fed could take a leaf out of the communication policy at Qantas and appreciate the virtues of being quiet sometimes. If prolonged silence leads to a significant lift in bond market volatility as investors speculate about the future path of interest rates, this is a small price to pay for the Fed to preserve its credibility.

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