Interest rate: Psychology of the Fed's decision

By Prof Dr Teodoro D. Cocca

Market reaction to the decision by the Federal Reserve to leave its benchmark interest rate unchanged shows that investors are focusing on a new mental model: economic outlook.

The main event on the financial market in recent days was the decision by the Federal Reserve on 17 September to leave its benchmark interest rate unchanged. Market reaction to this decision allows us to draw analytical conclusions as to the current mental models prevailing on the financial market. In behavioural economics, cognitive representations of problem situations are referred to as mental models. They are depictions of reality, i.e. they are developed on the basis of external impressions and allow people to structure their environment by creating logical interdependencies and using them to find their way.

If the common hypothesis previously seemed to consist of celebrating low interest rates and falling into dejection at any indication that interest rates would be raised shortly, the collective reaction pattern to decisions on interest rates by the Fed has now changed for the first time. In retrospect, market reaction must be interpreted to the effect that the Fed raising interest rates would have been viewed as a positive signal because it would have confirmed the central bank's belief in the sustained recovery in the U.S. economy.

The "patient" (the financial market), which was previously dependent on liquidity, therefore seems to have been treated successfully. However, it is now the Fed's misfortune that the patient discovers just before the supposedly final therapy session that the therapy is

Prof Dr Teodoro D. Cocca

to be extended. This conveys the feeling that the therapist does not believe the patient has been cured and throws him into a new depression. From this, it is clear that the Fed's decision on 17 September was perceived by investors in accordance with entirely new cognitive patterns for the first time for a long period.

Structural break in the thought process

The Fed's decision was no longer viewed in the light of a more or less accommodating monetary policy (old mental model) but now considered as the Fed's economic outlook (new mental model). In principle, both mental models are entirely rational and comprehensible; in this instance, it is merely a matter of establishing that greater weight is now, apparently, attached to the new mental model in the aggregate perception of market participants.

Consequently, the mental development of the market now actually corresponds precisely to that which has been the Fed's greatest challenge for years, namely effectively breaking the market's chronic dependency on liquidity injections and giving it the confidence to stand on its own ("economic") feet. The Fed has achieved precisely this – consciously or unconsciously – since 17 September, as each increase in interest rates will now be viewed as confirmation that the central bank expects a strong U.S. economy.

However, structural breaks in thought processes of the kind we are now experiencing naturally create uncertainty in the initial phase because of the resultant cognitive dissonances until the new thought pattern is firmly established.

Had the Fed based its decision on market psychology, it would have to increase the benchmark rate at the September meeting from a purely psychological perspective. The impact on the real economy of an increase in interest rates of 0.25 percentage points, for instance, would have been negligible. By contrast, the psychological signal it would have given would have been of relevance for shaping market opinion and could easily have triggered a positive information cascade. The question can be raised as to how far the Fed should take account of the reaction of financial markets at all, as ultimately it must manage factors in the real economy and not portray every tiny emotional movement by the market as the problem. However, recent years in particular have shown that the interactions between the financial

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market, central bank policy and the real economy are close. Viewed from this perspective, it is essential that every central bank includes the psychology of the markets in its calculations to influence the transmission mechanisms of its instruments more effectively.

Breaking the argumentative corset

With the reference in the Fed's communiqué to taking global imbalances into account, another problem for its future decision-making is added, as by including global factors in its perspective, the question as to when there will ever be a suitable time for raising rates arises. The more broadly the perspective is drawn in geographic terms, the more likely it is that a black spot tarnishes the overall picture. The Fed must find a way out of this self-imposed argumentative corset as soon as possible.

The reverse of the new mental model is dangerous

A further easing of monetary conditions would increasingly be seen as an admission that the previous monetary policy measures had not worked and that concerns about economic growth are far more serious than had previously been assumed. This loss of confidence in the effectiveness of decisions on interest rates would constitute the actual disaster for the Fed in terms of market psychology.

Market sentiment would be particularly unstable in this case since neither the old nor the new mental model would be sufficient to explain the connections. If the expectations resulting from perceptions are refuted too frequently by reality, mental models will be lost, which leads to increased uncertainty. This risk definitely exists if the fact that central banks are operating on very unfamiliar terrain and the uncertain efficacy of ultra-loose monetary policy is taken into account.

Managing herd behaviour

A key behaviour pattern here is the almost irresistible urge to find an explanation for every – however accidental – market reaction. Since this is the case for so many, associative lines of argument are repeated thousands of times – not least thanks to modern media – which increases the willingness to accept them as plausible.

Accordingly, one of the dominant mental models of the last two years was the "lack of any alternative" to shares, which was propagated on all sides. As is so often the case, the line of argument in question may contain rational elements but, in its entirety, it shows how one-sided thought patterns can become. In our need (to explain), we focus on one aspect and feel vindicated if others emphasise the same aspect although they are ultimately just as clueless as we are ourselves.

As a result, herd behaviour is reinforced on markets through the coordinative effect of a mental model that is accepted on all sides. Central banks play an ever more important role in managing this herd behaviour, since their recent "ultra-transparent" communication policy forces each analyst to analyse, scrutinise and interpret every published word almost obsessively.

In this regard, central banks are viewed as the supreme authorities who are able to assess the future more accurately than market participants because they have better access to data – a mental model which also requires scrutiny.

Dr Teodoro D. Cocca *is Professor for Wealth and Asset Management at the Johannes Kepler University in Linz/Austria and Adjunct Professor at the Swiss Finance Institute.*

The Modern Practice and Cloud Accounting

By Kim Youle

The business world is changing and this includes the accounting industry. Cloud-based accounting is revolutionising the way that accountants work. The major accounting firms are already alert to this, making partnerships with the main software providers and entering into the small and medium sized entity market at extremely competitive price points.

Small and medium sized accountancy firms are slowly waking up to the efficiencies that can be obtained by using Cloud packages and the future of accounting software is undoubtedly in the Cloud, but the present reality for