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IMF Urges 'Improved' U.S. Fed Policy Transparency as It Mulls Easy Money Exit

By Ian Talley

WASHINGTON--The International Monetary Fund Friday urged greater clarity from the U.S. Federal Reserve as the central bank considers its exit strategy from a long period of easy money policies.

A lack of Fed clarity could cause a major spike in borrowing costs that could cause severe damage to the U.S. recovery and send destructive shockwaves around the global economy, the IMF said in its annual assessment of the American economy.

"Improved transparency" and "enhanced policy communications with the public are vitally important prior to and during the exit," IMF staff, including a former New York Fed economist, said in the report.

The fund estimated that investor fears of a premature Fed exit from easy money policies could cause a spike of at least 125 basis points in 10-year Treasury bonds, especially if markets are uncertain about the central bank's plans. The estimate was based on markets mistakenly assuming the Fed would start scaling back its easy money policies two quarters sooner than the IMF assumes is healthy.

IMF chief Christine Lagarde said in recent weeks the fund advises the Fed maintain its $85 billion-a-month bond-buying until at least the end of 2013. That is in contrast to the Fed, which has said it is considering an earlier wind-down of its buying, if the economy shows improvement.

Still, central bank officials are expected at their meeting next week to discuss whether to refine or revise their guidance to the public on their future plans.

The IMF's comments come as the world's top finance officials last week said stimulating growth was the highest priority, trumping the need in some advanced economies to cut debt levels in the near term. It also follows fears, particularly from emerging markets, about sudden market moves sparked by the Fed's guidance that hurt their economies.

The fund warned in its review of the euro-zone economy Thursday that an early Fed exit could create more headwinds for the currency union already bogged down in a deepening recession.

The IMF also said the U.S. dollar is mildly overvalued, up to 10% higher than fundamentals suggest it should be.

After years of extraordinarily low interest rates meant to spur a weak economy, the Fed is considering how and when to start returning its policies back to normal. Signals of that policy course change earlier this year prompted investors around the globe to reshuffle their portfolios. That sudden shift in capital created volatility in currency, bond and equity markets around the globe.

The IMF said clearer Fed guidance can give markets time to adjust.

But, it added, "A smooth and gradual upward shift in the yield curve might be difficult to engineer, and there could be periods of higher volatility when longer yields jump sharply--as recent events suggest."

Fed officials told the fund they have beefed up surveillance of potential risks from the exit and low interest rates, telling the IMF they are prepared to boost their buying if needed and can use their financial regulation tools to nip problems in the bud.

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