17th Annual DNB Research Conference

Challenges Associated with Forward Guidance

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* The views expressed are my own and not necessarily those of the officials or staff of the Federal Reserve System.

What is Forward Guidance?

- A conditional statement by the central bank about its future intentions for monetary policy

- Between a forecast of policy and a commitment
  - Regularly produced forecasts are revised up or down freely
  - Commitments tend to be unconditional and reneging on them would likely reduce a central bank’s credibility significantly

Objectives of Forward Guidance

- Increased transparency
  - Provide information about the central bank's policy preferences and outlook
  - Or simply reflects a one-off agreement on characteristics of the path for policy.
- Provide stimulus (in recent years)
  - Indicate to market participants that policy will be more accommodative in the future than had been expected
  - Or increase market confidence about the likely path of policy rates, reducing term premiums
  - Or reduce the likelihood that market expectations will shift toward tighter policy in the future

Recent FOMC Forward Guidance

- Since December 2008, with the fed funds target at its effective lower bound, the FOMC has used several different types of forward guidance
  - Qualitative guidance (the federal funds rate is likely to be near zero for "an extended period")
  - Date-based guidance ("at least through mid-2013")
  - Threshold-based guidance ("at least as long as the unemployment rate is above 6½ percent and projected inflation is below 2½ percent")
  - Mix: "Considerable time after the end of asset purchases."

- Separately, the FOMC began publishing participants' projections for the federal funds rate in January 2012

Challenges Associated with Forward Guidance

- There is a Catch-22 associated with forward guidance
  - For the most part, forward guidance provides stimulus by convincing market participants that policy rates will be lower for longer than they had previously anticipated
  - At the same time, the central bank likely wants there to be only a small chance that it will want to tighten policy earlier than implied by the forward guidance
  - There may be no guidance that accomplishes both objectives, except when the market significantly underestimates the central bank's intentions to provide accommodation
- The outlook for policy *after* the guidance period has a big impact on longer-term rates and so on aggregate demand
  - If the guidance does not change the public's understanding of the Committee's preferences, then any promise to be easier for a while will be undone by an expectation to be tighter subsequently

Challenges Associated with Forward Guidance (cont'd)

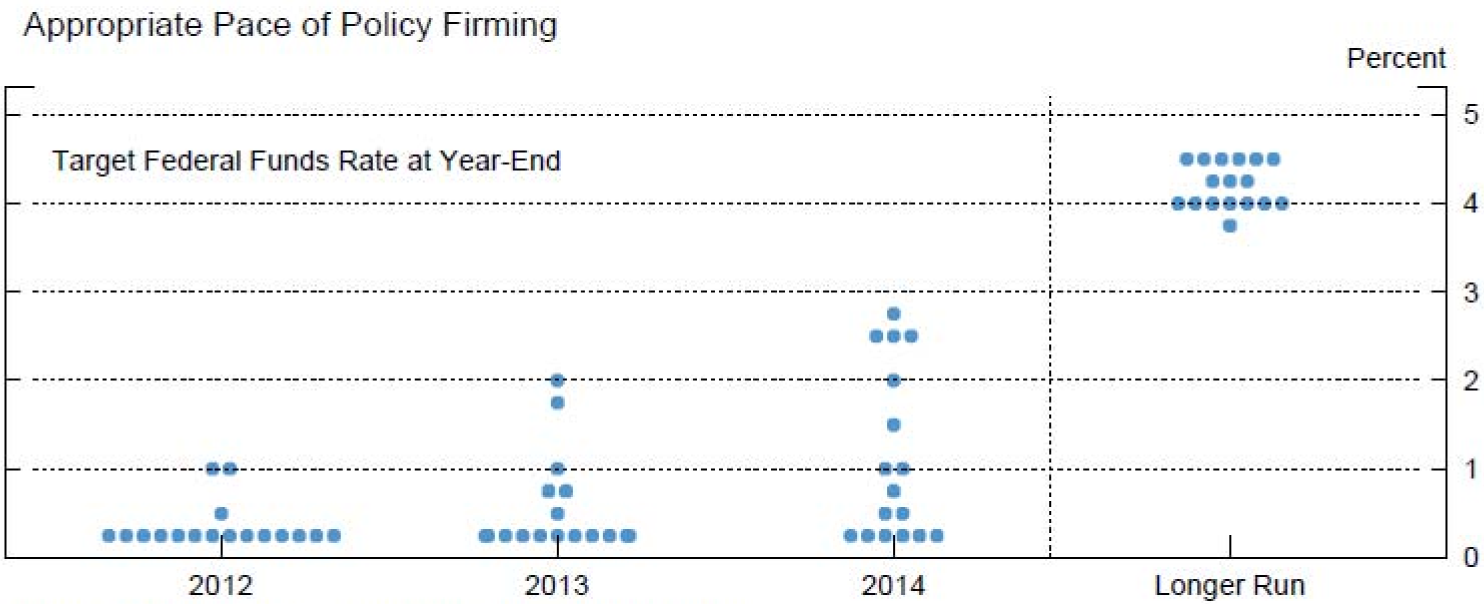
- Difficult to avoid the misimpression that date-based or even qualitative guidance is a commitment
  - The switch from date-based to threshold-based guidance clarified the conditionality of the Committee's guidance while still providing accommodation
- Lengthening the guidance period can damage confidence in the economic outlook

"economic conditions are likely to warrant [a funds rate near zero] at least through…"

"…will remain appropriate for a considerable time after the economic recovery strengthens. In particular…"

Challenges Associated with Forward Guidance (cont'd)

- It has been difficult at times to explain the differences between the fed funds forecasts in the SEP and the forward guidance
  - The forward guidance conveys the consensus view of the Committee.
  - In January 2012, "…at least through late 2014" but the SEP showed:



Source: Summary of Economic Projections, January 2012.

Forward Guidance about LSAPS:

- Flow-based asset purchase program required the Committee to provide guidance about future purchases
  - "…at least until the outlook for labor market conditions has improved substantially, subject to an ongoing review of efficacy and costs"
  - After tapering began:
    - "If incoming information broadly supports the Committee's expectation of ongoing improvement in labor market conditions and inflation moving back toward its longer-run objective, the Committee will likely reduce the pace of asset purchases in further measured steps at future meetings"

Challenges associated with communicating about LSAPs

- Moessner and Nelson (2008) found that market participants don’t take guidance incorrectly as a commitment, don’t overreact.
- Taper tantrum (and earlier drop in rates) calls that conclusion into question.
- The sharp reaction may have reflected the difficulty of predicting the total amount purchased under the program.

Challenges associated with communicating about LSAPs (cont'd)

- The taper tantrum also illustrates a challenge associated with providing guidance about two different policy tools
  - The expected path for the federal funds rate moved up in May-June when market participants adjusted down their outlook for asset purchases

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