What is the right amount of guidance?

The Experience of the Bank of England with forward guidance

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Mensch tracht und Gott lacht

"men plan and God laughs"

Source: Bank of England

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Woody Allen version…

"If you want to make God laugh tell him about your plans"

Mike Tyson version…

"Everyone has a plan until they get punched in the mouth"

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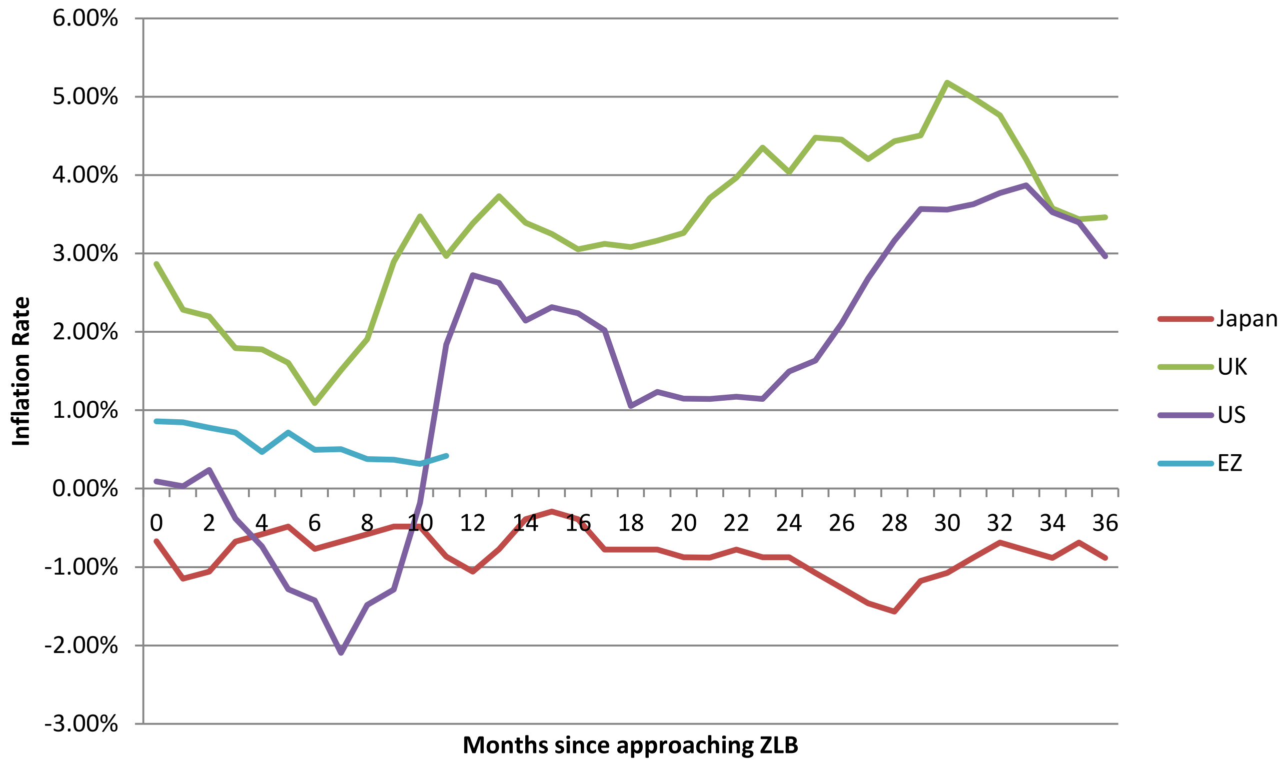
August 2013 guidance

- We will not tighten policy until unemployment is below 7%, unless inflation pressures are heading in the wrong direction.

Path of CPI inflation in selected zero-lower-bound experiences



Start of series for:

- Japan = October 1999 (policy rate first hit 0%);
- UK = March 2009 (policy rate at 0.5%);
- US = December 2008 (policy rate at 0.25%);
- EZ = November 2013 (policy rate at 0.25%)

Sources:
Thomson Reuters; Statistics Bureau, MIC, Japan; Bank of Japan; ONS; Bank of England; US Bureau of Labour Statistics; Eurostat; ECB.

Press coverage of forward guidance

- “The Bank of England's commitment to low rates will be welcome news for borrowers and is likely to make fixed-rate loans even more attractive, experts said today.”, *Daily Telegraph*, 7th August 2013.

- “What is forward guidance? It is making a promise about the future, particularly about future interest rates.” *BBC*, 12 Feb 2014.

- “Forward guidance was, in effect, a promise to keep rates low for a long time.” *The Economist*, 15 February 2014.

- “The world's major central banks are returning to a more opaque and artful approach to policymaking, ending a crisis-era experiment with explicit promises that they found risked their credibility and did not substitute for action.” *Reuters*, 7 July 2014

“Why don’t we get more certainty and less flip-flopping? “

- Most vocal criticism is that Bank does not say what it is going to do.
- Might it makes sense to commit to a particular setting of policy for some horizon?
- In many models sticking to a particular path for interest rates over a specific horizon can mean that at the end of that horizon interest rate may need to move dramatically to prevent serious instability.
- If the certainty about the path of rates for some near horizon comes at the cost of far higher uncertainty down the road that hardly looks ideal.
- To explore this issue of the effects of committing to a specific path for interest rates I will use a simple model of the economy which accounts for uncertainty and explores how that should affect monetary policy.

A simple model with 4 sources of uncertainty

- about the degree of spare capacity in the economy. How much slack is there?

- about the impact of monetary policy. Interest rates have been at such low levels for so long there is unusual uncertainty about how the return towards more usual levels will affect the economy.

- about how fast the economy grows in the absence of monetary stimulus (i.e. at a neutral setting for policy).

- about the extent to which productivity growth responds positively to output growth.

- Calibrated as uniform distributions, eg slack is uniform on interval 0-4%.

Figure 2: Bank Rate, simulation

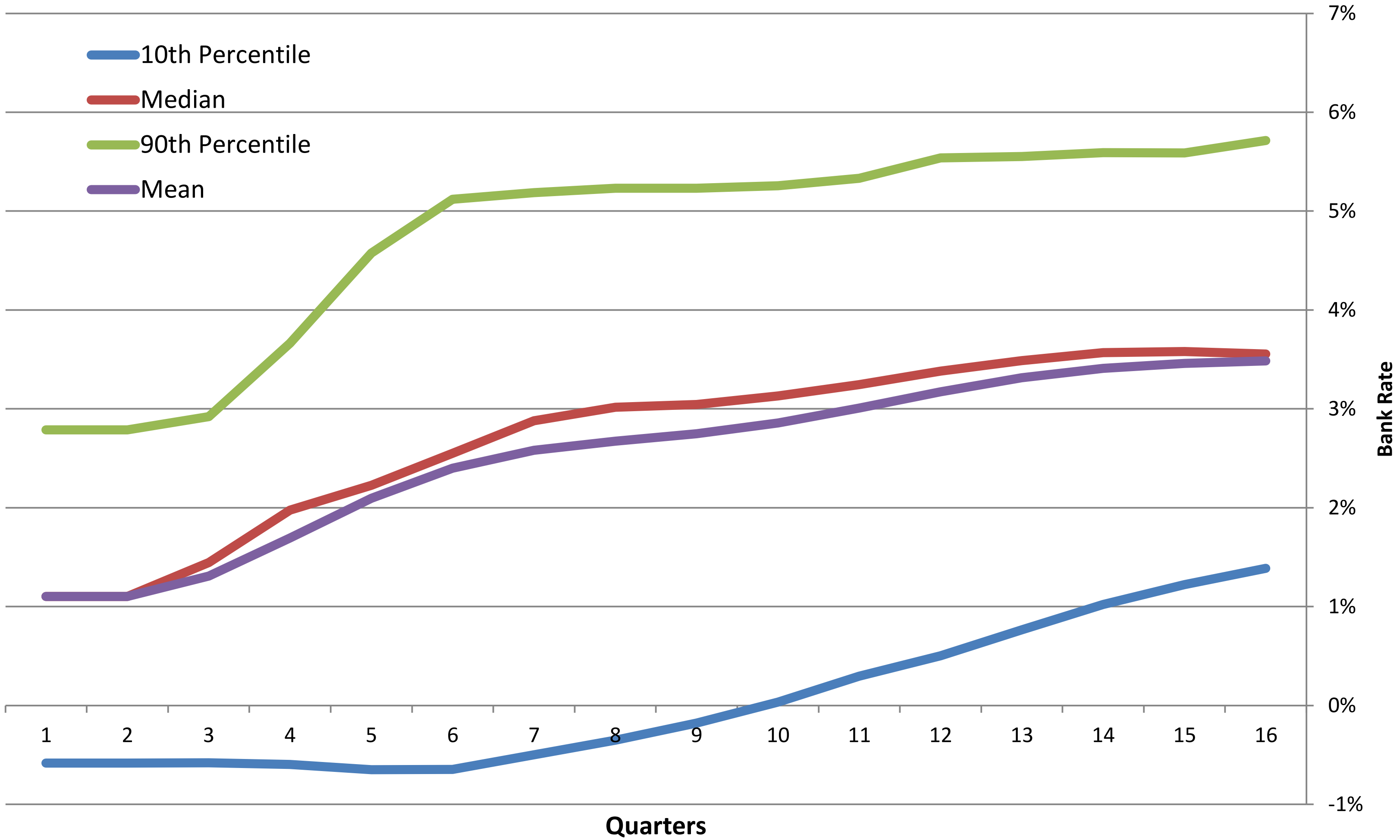


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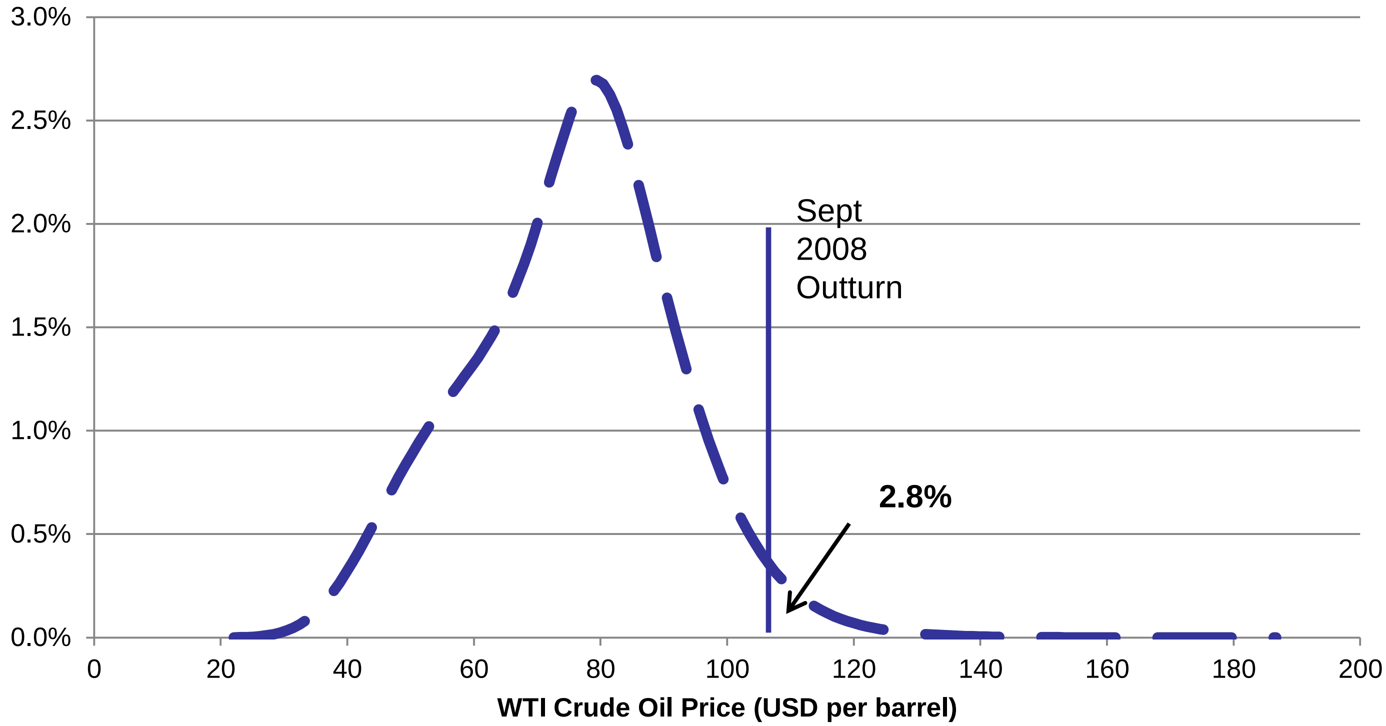
Figure 3: Option-implied distribution for crude oil price 1 year ahead - as of end Sep 2007



Source: Bloomberg, Chicago Mercantile Exchange and Bank calculations.

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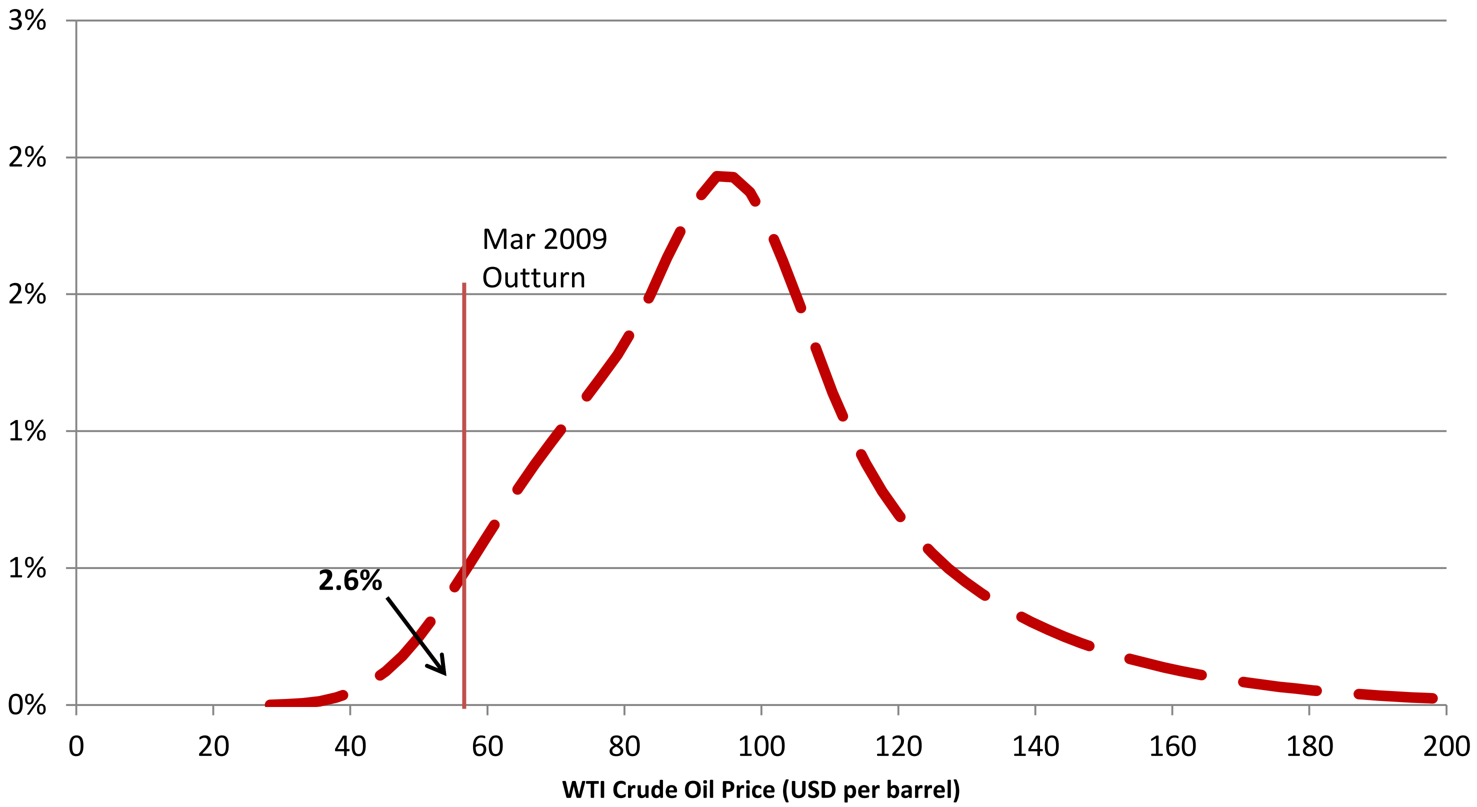
Figure 4: Option-implied distribution for crude oil price 1 year ahead - as of end March 2008



Source: Bloomberg, Chicago Mercantile Exchange and Bank calculations.

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If fixing a path is bad what should we do? What does economics tell us?

- There may be no role for guidance in a world of (a) complete information *and* (b) ability to commit to a strategy.
- People could work out what policy would be in any state.
- But in practice people cannot do this.
- Might supplying a “reaction function” be the answer?
- There are practical problems: to be accurate it might need to be complex.
- With a diverse and changing committee what is ***the*** reaction function?
- People would still need to know about likely economic environment.

What a reaction function might look like…

The Committee intends at a minimum to maintain the current highly stimulative stance of monetary policy until economic slack has been substantially reduced, provided this does not entail material risks to either price stability or to financial stability. In particular, the MPC intends not to raise Bank Rate from its current level of 0.5% at least until the Labour Force Survey headline measure of the unemployment rate has fallen to a threshold of 7%, subject to the conditions below.

The MPC stands ready to undertake further asset purchases while the unemployment rate remains above 7% if it judges that additional monetary stimulus is warranted. But until the unemployment threshold is reached, and subject to the conditions below, the MPC intends not to reduce the stock of asset purchases financed by the issuance of central bank reserves and, consistent with that, intends to reinvest the cash flows associated with all maturing gilts held in the Asset Purchase Facility. The guidance linking Bank Rate and asset sales to the unemployment threshold would cease to hold if any of the following three ‘knockouts’ were breached:

in the MPC’s view, it is more likely than not, that CPI inflation 18 to 24 months ahead will be 0.5 percentage points or more above the 2% target;

medium-term inflation expectations no longer remain sufficiently well anchored;

the Financial Policy Committee (FPC) judges that the stance of monetary policy poses a significant threat to financial stability that cannot be contained by the substantial range of mitigating policy actions available to the FPC, the Financial Conduct Authority and the Prudential Regulation Authority in a way consistent with their objectives.

The Committee will continue to set the level of Bank Rate and the size of the asset purchase programme each month, taking these criteria into account. The action taken by the MPC if any of these knockouts were breached would depend upon its assessment at the time as to the appropriate setting of monetary policy in order to fulfil its remit to deliver price stability. There is therefore no presumption that breaching any of these knockouts would lead to an immediate increase in Bank Rate or sale of assets.

Elements needed for optimal policy swathe

1. **An assessment of all the random factors** (or shocks) that can impinge on the economy and their probabilities

2. **A model of how those shocks then impact on the outcome you care about** – inflation, growth, output etc.

3. **A model for how monetary policy affects those outcomes** and can be used to offset the impact of shocks

4. **An assessment of what the optimal policy response to such shocks is** (use 1-3 above to derive a rule that maximises some specified target function)

5. **Committee need to reach an agreement on 1-4**:

   - if members responsible for their own votes need to reconcile a unique path of rates (for given realisation of shocks) with individual accountability in an environment where people will take different views

Guidance in everyday language

How you might describe in everyday language the message that figure 2 conveys?

Interest rates are likely to rise gradually from their current exceptionally low point, but probably to a level that is meaningfully short of the level of around 5% that used to be thought normal.

But the exact path that interest rates should follow cannot be known for certain since how the economy will evolve is not known in advance.

So this guidance is more in the way of an expectation and certainly not a commitment.

Conclusion

- In an ideal world (and in idealised models) the Central Bank can just explain its objectives and reaction function.
- But unless outsiders have as good information on the economic outlook – and can plug that into the reaction function – then they may be left floundering in attempting to assess the prospects for interest rates.
- Any reasonable approximation to a reaction function might be very complex. (Indeed it is very likely that it is; otherwise MPC meetings would be mechanical affairs lasting 5 minutes).
- The central bank’s giving some assessment of the likelihood of interest rates following different paths is likely to be helpful, particularly in situations in which past action and communication is not so helpful.
- But people can confuse central expectations with promises – they certainly do in the UK!

Conclusion

- Constructing an explicit probability distribution for the central banks own policy rate that is based on the realities of how policy is made and gets across a message that can be widely understood is a major challenge.

- Attempting to provide a specific central path with probability bands may go beyond what is feasible and useful. Spurious accuracy is unhelpful.

- I am open minded about whether the MPC should provide fan charts for interest rates, but I am not convinced that is clearly a step forward.

- Currently, it might be just as useful – and probably less misleading and possibly even more accurate – to give forms of guidance which are more qualitative, such as:

“interest rate rises will probably be gradual and likely to be to a level below the old normal”.

- That says something substantive; **and** most people can understand it.