Challenges Associated with Forward Guidance

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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:

![Graph showing appropriate pace of policy firming](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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