BY TIM SABLIK

The Future of Forward Guidance

Talking about the future has become a valuable tool of monetary policy, but recent events have prompted a reevaluation

For much of the Fed's history, its leaders prided themselves on their inscrutability. Alan Greenspan, who served as Fed chair from 1987 to 2006, famously perfected the art of "Fedspeak," carefully crafting his statements on monetary policy to be vague and obscure so that he could avoid roiling financial markets. But by the end of his tenure, the Fed had become increasingly transparent in its communications with the public. Today, Fed Chair Jerome Powell holds a press conference after every FOMC meeting, and the committee issues a post-meeting statement explaining both its current policy stance as well as how it expects policy to evolve in the future.

This prognosticating language, known as "forward guidance," has become an increasingly important tool for policymakers since the Great Recession of 2007-2009. But recently, Powell indicated that the Fed might be putting that tool back on the shelf, at least for now. In June, the FOMC voted to raise the Fed's benchmark interest rate by three-quarters of a percentage point — its largest single rate hike in nearly three decades. The following month, the committee approved another historic 0.75-point hike. At the press conference following the July decision, Powell was asked to provide some guidance on how far and how fast the FOMC was thinking about raising rates to deal with inflation.

"We're going to be making decisions meeting by meeting … and not provide .. the kind of clear guidance that we had provided on the way to neutral," Powell replied. That same month, European Central Bank (ECB) President Christine Lagarde said that the ECB would also be ditching forward guidance to maintain the flexibility to adjust monetary policy based on incoming data.

Do these moves mean that central bankers have soured on forward guidance? Or is it simply the wrong tool for the Fed's present challenges?

THE ORIGINS OF FORWARD GUIDANCE

In February 2000, under Greenspan, the committee first began regularly including an early form of forward guidance in its policy statements: an assessment of the balance of risks facing the economy. In 2003, it added guidance about the likely path of monetary policy. That change coincided with the publication of an important paper earlier the same year by Gauti Eggertsson of Brown University and Michael Woodford of Columbia University. They were exploring how central banks could conduct monetary policy when their policy rate was at or near zero and couldn't go lower. Eggertsson and Woodford showed that a central bank could achieve additional stimulus by credibly communicating an intent to keep its policy rate low into the future after the economy had started to recover — that is, by providing forward guidance. If markets believed the central bank's pledge, then the interest rates of longer maturity securities would fall in anticipation of a lower policy rate in the future, and that would help stimulate economic growth.

Eggertsson and Woodford had the Bank of Japan in mind when they wrote their paper. Its policy rate had been near zero since the mid-1990s. As it turned out, however, the Fed soon found itself in a similar position. The economy was still recovering from a brief recession in 2001 following the dot-com crash and the 9/11 terrorist attacks. In June 2003, the FOMC lowered its policy rate to 1 percent and chose not to go any lower. Committee members still wanted to provide some additional stimulus, however, so in the August 2003 policy statement, they noted that the Fed's accommodative policy could continue for "a considerable period."

The FOMC continued to employ forward guidance over the next several years to signal future accommodation and then to communicate its plan for raising its policy rate once the economy had recovered. During the Great Recession of 2007-2009, the Fed's policy rate went even closer to zero, and the FOMC once again turned to forward guidance. The committee initially employed the same type of language it had used in 2003, but as the deep recession gave way to a slow recovery, the guidance became more specific. The FOMC experimented with detailing how long it expected to keep rates low and laying out specific criteria it would want to see before raising rates. (See table.) More detailed guidance may give the public a better window into what the Fed is thinking, but it comes with its own trade-offs.

"The higher the level of specificity, the higher the risk that you'll bind yourself to a less than optimal path," Richmond Fed President Tom Barkin has explained. (See "Challenges of Forward Guidance," *Econ Focus*, Fourth Quarter 2021.)

This trade-off between commitment and flexibility is central to a key question about forward guidance: Does it work as well in practice as it does in theory?

The Evolution of the Fed's Forward Guidance

The FOMC has experimented with different formulas for its guidance over the last two decades.

2/2/2000	"...the Committee believes the risks are weighted mainly toward conditions that may generate heightened inflation pressures in the foreseeable future."
8/12/2003	"...the Committee believes that policy accommodation can be maintained for a considerable period."
1/28/2004	"With inflation quite low and resource use slack, the Committee believes that it can be patient in removing its policy accommodation."
12/16/2008	"...the Committee anticipates that weak economic conditions are likely to warrant exceptionally low levels of the federal funds rate for some time."
8/9/2011	"The Committee currently anticipates that economic conditions...are likely to warrant exceptionally low levels for the federal funds rate at least through mid-2013."
12/12/2012	"...the Committee...currently anticipates that this exceptionally low range for the federal funds rate will be appropriate at least as long as the unemployment rate remains above 6-1/2 percent, inflation between one and two years ahead is projected to be no more than a half percentage point above the Committee's 2 percent longer-run goal, and longer-term inflation expectations continue to be well anchored."
3/19/2014	"The Committee currently anticipates that, even after employment and inflation are near mandate-consistent levels, economic conditions may, for some time, warrant keeping the target federal funds rate well below levels the Committee views as normal in the longer run."
9/16/2020	"The Committee...expects it will be appropriate to maintain this target range until labor market conditions have reached levels consistent with the Committee's assessments of maximum employment and inflation has risen to 2 percent and is on track to moderately exceed 2 percent for some time."
12/15/2021	"With inflation having exceeded 2 percent for some time, the Committee expects it will be appropriate to maintain this target range until labor market conditions have reached levels consistent with the Committee's assessments of maximum employment."
1/26/2022	"With inflation well above 2 percent and a strong labor market, the Committee expects it will soon be appropriate to raise the target range for the federal funds rate."
3/16/2022	"...the Committee decided to raise the target range for the federal funds rate to 1/4 to 1/2 percent and anticipates that ongoing increases in the target range will be appropriate."

SOURCES: Federal Open Market Committee statements

THEORY VERSUS REALITY

In his 2020 American Economic Association presidential address, former Fed Chair Ben Bernanke declared forward guidance a "powerful policy tool." Bernanke had been instrumental in elevating forward guidance and quantitative easing (QE) from unconventional to conventional monetary policy tools during his tenure at the Fed. In his lecture, he analyzed the impact of these two tools using the Fed's FRB/US computer model of the U.S. economy. He concluded that forward guidance combined with QE granted the Fed significantly more space to provide accommodation when its standard policy rate was near zero.

Other economists who have studied the effects of forward guidance have come to similar conclusions. Combined with QE, forward guidance significantly mitigates the danger that the Fed could be stuck at the zero lower bound with no ammunition. But it quickly became clear that some of the ways that forward guidance behaves in standard economic models were unrealistic.

In a 2012 paper, Marco Del Negro of the New York Fed, Marc Giannoni of Barclays, and Christina Patterson of the University of Chicago demonstrated that a standard macro model predicted that forward guidance became more powerful the further into the future it went. If the Fed pledged to keep its policy rate low for two or more years, the model showed that this would have "explosive" effects on inflation and economic output. In essence, the model implied that the Fed should be able to dig the economy out of any hole just by talking and pledging actions further out into the future. The researchers dubbed this the "forward guidance puzzle."

The strength of this result stems partly from the fact that, in standard models, the Fed can perfectly manage the expectations of financial markets and households through its forward guidance. As a result, longer-term interest rates immediately adjust to make the Fed's guidance a reality. The real world is much more complicated, however. The Fed's communications are not always clearly understood by the public, and the FOMC's forward guidance statements have never provided an ironclad commitment to follow a scripted policy path.

That is largely unavoidable given the fact that Fed policy is set through the majority vote of a committee whose composition changes over time. No present-day members of the FOMC could credibly bind the hands of future members to follow through on forward guidance. Indeed, this is one of the reasons why for decades Fed policymakers avoided giving any guidance about policy, even though they were aware of the potential benefits. In a 2021 working paper, Edward Nelson of the Board of Governors showed that Fed leaders understood the principles underlying the use of forward guidance as early as the 1950s, but they did not want to risk binding their own hands or the hands of future policymakers to a path that turned out to be suboptimal.

It is also more difficult to believably communicate plans for the future the further away that future is. A lot can change in a year or two, which might lead the public to be rightly skeptical of the Fed's ability to predict its actions that far in advance. Jeffrey Campbell of the University of Notre Dame and Filippo Ferroni, Jonas Fisher, and Leonardo Melosi of the Chicago Fed allowed for such skepticism in their model of forward guidance. In a 2019 article in the *Journal of Monetary Economics*, they found that the Fed's ability to influence market expectations diminishes the further into the future it tries to communicate a policy path.

"If the Fed were to say something about rates one to four quarters in the future, agents in our model believe the Fed will follow through with that guidance," says Melosi. "At horizons longer than one year, it is much harder for the Fed to commit to future actions, arguably because macroeconomic uncertainty is typically large at those horizons."

COMMUNICATION COSTS

Empirical evidence supports the idea that forward guidance is effective. In a 2021 paper in the *Journal of Monetary Economics*, Eric Swanson of the University of California, Irvine examined FOMC announcements from July 1991 to June 2019 to identify the separate effects from changes to the federal funds rate, forward guidance, and QE. He found each tool had significant and distinct effects on financial markets. Forward guidance had the largest impact on shorter-term Treasury yields and assets — those dated between one and five years — while QE was more effective at moving longer-term Treasuries and corporate bonds with 10-year maturities.

"When you look at the reaction to FOMC announcements, most of the movement in Treasury markets is due to what the FOMC statement says, what the chair says during the press conference after the announcements, or what the chair says in speeches throughout the year, rather than the actual change in the federal funds rate," says Swanson. "In that sense, forward guidance has been very important over the last 20 years."

Although his findings focus on financial markets, Swanson suspects that forward guidance also had an impact on macroeconomic variables like unemployment. It is just harder to measure those interactions. Overall, the evidence supports Bernanke's claim that forward guidance is a potent tool.

But that doesn't mean there aren't costs. As Barkin noted, more explicit guidance imposes a greater constraint on the Fed's flexibility. While it is true that the Fed's guidance has never made an absolute commitment — the FOMC has always left room to deviate from its guidance if circumstances change — it has sought to live up to its guidance in practice, says Swanson. Indeed, it has never used those escape clauses; it has postponed tightening for longer than it previously indicated but not tightened sooner.

In a 2019 working paper, Taisuke Nakata of the University of Tokyo and Takeki Sunakawa of Hitotsubashi University showed that the reputational cost of breaking previous forward guidance can itself act as a form of commitment. If a central bank were to renege on its previous forward guidance, that would erode its credibility, and future attempts to use forward guidance would be less effective because the public would not trust the central bank to keep its word. To the extent that the Fed wants to avoid that outcome, its forward guidance is binding, even if the option to break it still exists. Sticking with previous guidance to preserve credibility could delay the Fed's response to unexpected economic developments. Indeed, some have argued this was the case during the recent uptick in inflation.

"In 2020 and 2021, the Fed was very explicit that it didn't want to raise the fed funds rate for some time," says Swanson. "Looking back, it now seems like they were too slow in raising interest rates. Probably part of the reason they were too slow was that they wanted to follow through with the guidance they had given."

There is also some evidence that too much talking by the central bank could drown out other valuable market signals. A 2019 paper in the *Journal of Monetary Economics* by Gaetano Gaballo of HEC Paris and Michael Ehrmann, Peter Hoffmann, and Georg Strasser of the ECB studied the use of forward guidance in different countries. They discovered that when central banks provide calendar-based guidance over a short time horizon, it can paradoxically raise the sensitivity of government bond prices to surprising economic news. This is because market participants pay too close attention to central bank communications, weakening normal market price signals and leading to larger shocks when unexpected news hits.

CHOOSING THE RIGHT TOOL

In an Oct. 12 speech, Fed Governor Michelle Bowman spoke about the trade-off between specificity and flexibility when using forward guidance. Less detailed guidance could allow the Fed to be nimbler in the face of unexpected developments, but it might also mean that the Fed's communications are less clear and effective. In contrast, more precise language might be more effective at aligning market expectations but could limit the Fed's ability to quickly adjust its policy path.

In the end, Bowman argued, the Fed must weigh the costs and benefits of using forward guidance in each economic environment. In the aftermath of the 2008 financial crisis, she said, the benefits of using forward guidance were clear. The Fed couldn't reduce its main policy rate any further, and it seemed a safe bet that the fed funds rate would remain low for some time. Communicating an intention to keep its policy rate lower for longer in this environment "was not seen as posing significant risks to the Committee's credibility," she said.

In contrast, the current economic environment poses a very different challenge for the Fed. It must balance between tightening too much in response to inflation and not tightening enough. That makes it harder for the FOMC to know the appropriate size and duration of policy moves in advance. Additionally, the Fed's primary policy tool is no longer constrained by the zero lower bound now that it is raising rates, making the Fed less dependent on tools like forward guidance to achieve its policy goals.

"Putting it all together ... the case for explicit forward guidance is much less compelling today than it was in the years that immediately followed the 2008 financial crisis," said Bowman. "My own view is that discussions about the use of explicit forward guidance as a policy tool should be limited. It should be used during periods when the Committee cannot adjust the federal funds rate any lower due to the effective lower bound, and when the Committee also has reasonable confidence that the federal funds rate will need to remain near zero for a period of time to stimulate growth and when inflationary pressures are expected to be subdued."

Neither Bowman nor any of her FOMC colleagues have advocated for significantly scaling back the overall increase in transparency that the Fed has made in recent decades. Such moves are widely viewed as beneficial by economists and policymakers alike. Indeed, while the Fed seems to be stepping back from what Bowman calls explicit forward guidance, it is still providing some general guidance about its plans.

During his address at the annual Jackson Hole Economic Symposium in August, Powell noted that "restoring price stability will likely require maintaining a restrictive policy stance for some time." And in November, the FOMC said that the pace of its future policy rate increases would "take into account the cumulative tightening of monetary policy, the lags with which monetary policy affects economic activity and inflation, and economic and financial developments."

To the extent that such statements qualify as forward guidance, then reports of the tool's demise were premature. Instead of phasing out forward guidance altogether, it seems likely that the Fed may need to periodically adjust how it communicates with the public to best meet the economic challenges of the day. **EF**

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