

# FORWARD GUIDANCE- HUBRIS OR COMMON SENSE?

Background for Keynote Address at 50th Anniversary  
SUERF/Banque de France Conference  
Paris, 22 November 2013

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INSPIRATION TO TAKE UP FORWARD GUIDANCE CAME NOT ONLY FROM ITS TOPICALITY BUT MORE SPECIFICALLY FROM A COMMENT, BURIED DEEP INTO BILL WHITE'S SURVEY ("IS MONETARY POLICY A SCIENCE?", ch. 3 of SUERF volume) WHERE BILL WRITES (p. 102):

"Another possibility (in addition to QE, NT) in such circumstances is Forward Guidance about the future stance of monetary policy. Suggestions of this nature seem to assume that central bank statements will have direct effects on private sector behaviour. Fundamentally, this is a variant of the rational expectations hypothesis..."

I WANT TO ELABORATE ON THE INTERPRETATION OF THIS PERSPECTIVE ON FORWARD GUIDANCE – ARE CENTRAL BANKERS SHOWING SIGNS OF HUBRIS, OR ARE THEY USING COMMON SENSE BY ADDING ANNOUNCEMENTS OF FUTURE ACTIONS TO THEIR CURRENT USE OF POLICY INSTRUMENTS?

THE RATIONAL EXPECTATIONS HYPOTHESIS (REH) STARTED FROM MUTH (1961) WHO APPLIED THE OPTIMIZATION PRINCIPLE TO THE EFFORTS OF EACH ECONOMIC AGENT TO USE ALL AVAILABLE INFORMATION TO FORECAST THE FUTURE

LUCAS AND SARGENT IN THE 1970s GAVE THE SPECIAL INTERPRETATION OF THIS PRINCIPLE THAT MACROECONOMIC FORECASTING COULD BE APPROXIMATED BY THE COMMON USE OF THE "BEST" MACROMODEL AVAILABLE

SARGENT (2005) HAS A STRIKING DESCRIPTION OF THE REH ANALYTICAL APPROACH TO MACROECONOMICS; RESPONDING TO A QUESTION ON DIFFERENCES BETWEEN AGENTS IN THEIR PERCEPTIONS OF THE FUTURE (FORECASTING STRATEGY), (p. 566):

”The fact is that one simply cannot talk about those differences within the typically rational expectations models. There is a communism of models. All agents inside the model, the econometrician, and God share the same model. The powerful and useful empirical implications of rational expectations... derive from that communism of models”

THIS PURE VERSION OF THE REH SITS UNEASILY WITH OBSERVATION OF BEHAVIOUR – AGENTS HAVE GREAT DIFFICULTIES IN EVALUATING FUTURE PROSPECTS, AND THEY DISAGREE AMONGST THEMSELVES MOST OF THE TIME

THEY CONTINUE TO LEARN AND REVISE THEIR FORECASTING STRATEGIES, SO THE NOTION OF IMPERFECT KNOWLEDGE ECONOMICS DEVELOPED BY FRYDMAN AND GOLDBERG (2013) IS MORE APPROPRIATE THAN THE COMMUNISM OF REH MODELS ABSTRACTING FROM UNPREDICTABLE, NON-ROUTINE STRUCTURAL CHANGES

YET, THERE ARE TWO REASONS WHY ANY COME-BACK FOR "A VARIANT OF REH" AFTER THE FAILURE TO ENCOMPASS THE FACTORS THAT LED TO THE CRISIS IS NOT AS IMPLAUSIBLE AS IT MAY SOUND

- REH RECOGNIZED EARLY ON IN THE LUCAS CRITIQUE (1976) THAT ANNOUNCED OR PERCEIVED CHANGES IN THE MONETARY POLICY REGIME WAS THE ONE ELEMENT OF STRUCTURAL CHANGE WHICH ECONOMIC AGENTS WOULD WANT TO TAKE INTO ACCOUNT IN THEIR FORECASTING STRATEGY, BECAUSE A REGIME CHANGE ENTAILS NEW INFORMATION ABOUT THE CENTRAL BANK'S STRATEGY
- THE CENTRAL BANK WILL USUALLY HAVE A STRONG CLAIM TO BE THE LEAD BUILDER OF MACROECONOMIC MODELS IN ANY COUNTRY – WHILE MAKING MONETARY POLICY ITSELF

THESE TWO REASONS MAKE IT INTERESTING TO TRY TO BUILD ON BILL'S HINT

IS THERE – OR WAS THERE AT THE PRE-CRISIS TIME – A PRETENTION IN SOME CENTRAL BANKS THAT THEY HAD DEVELOPED *THE* MODEL FOR THEIR ECONOMY?

NO CENTRAL BANK WOULD PUBLICLY FIND SUCH HUBRIS WARRANTED, PARTICULARLY AFTER 2008 WHEN MAJOR ERRORS OF FORECASTING IN EITHER DIRECTION HAVE BEEN EVIDENT, ALSO IN CENTRAL BANK MODELS - BOTH THE DETAILED MACROECONOMETRIC ONES EXEMPLIFIED BY THE FRB MODEL AND THE SIMPLER DSGE-MODELS, MOST DIRECTLY INSPIRED BY REH

MOST CENTRAL BANKS WOULD REPLY, AS DID SPENCER DALE, CHIEF ECONOMIST AT THE BANK OF ENGLAND IN PRESENTING THE NOV 2013 INFLATION REPORT:

”...The value of forward guidance...does not come because we think we have some monopoly over forecasting...the value is helping people to understand how we are likely to behave as the economy changes”

TO GET TO GRIPS WITH THE MOTIVATION, BENEFITS AND COSTS OF FORWARD GUIDANCE (FG) IT IS HELPFUL TO USE THE TERMS "DELPHIC" AND "ODYSSEAN" IN ANALYZING THE DIFFERENT AMBITIONS INVOLVED IN THE SEVERAL FORMS OF FG, SEE CAMPBELL (2013) AND PRAET (2013)

THE DELPHIC – THE TERM IMPLIES NO INTENTION OF AMBIGUITY – ELEMENT IS THE CENTRAL BANK'S, FORECAST, BASED ON ALL INFORMATION AVAILABLE TO IT, INCLUDING ABOUT ITS OWN ACTIONS WARRANTED BY THE FORECAST (THE AREA WHERE THE CENTRAL BANK HAS AN INFORMATIONAL ADVANGE)

THESE "WARRANTED" ACTIONS MAY BE MODIFIED AS EXPERIENCE BUILDS UP; THE CENTRAL BANK HAS NOT TIED ITSELF TO THE MAST



BY CONTRAST, THE ODYSSEAN ELEMENT CONTAINS A COMMITMENT TO A MONETARY STRATEGY, NOT TO BE REVISED DURING A DEFINED PERIOD, OR ONLY AFTER CERTAIN MACROECONOMIC THRESHOLDS HAVE BEEN TRANSGRESSED

UNTIL ONE OF THESE CONDITIONS HAS BEEN MET, THE CENTRAL BANK COMMITS TO BE TIED TO THE MAST OF ITS DECLARED STRATEGY

WE CAN OBSERVE PURELY DELPHIC FG OR A MIX OF BOTH, WHILE PURELY ODYSSEAN FG IS VERY HARD TO IMAGINE, SEE BELOW

LET US LOOK AT THE EXPERIENCE AND TRY TO CLASSIFY THE FORMS OF FG OBSERVED UNTIL NOW

# VARIANTS OF FORWARD GUIDANCE

- (1) CENTRAL BANK PUBLICATION OF WARRANTED FUTURE INTEREST RATE PATH
- (2) "MONETARY EASE FOR SOME TIME" (OR SIMILAR), TIGHTENING "AT A MEASURED PACE", FED 2003, ECB's DEFENSIVE, OR DECOUPLING EFFORT (JULY 2013)
- (3) ANNOUNCEMENT OF LARGE-SCALE ASSET PURCHASE TO LOWER LONGER-TERM INTEREST RATES THROUGH PORTFOLIO BALANCE EFFECT (FED) OR TO REPAIR FRACTURED TRANSMISSION MECHANISM (ECB's SMP, COVERED BONDS, OMT)

## VARIANTS OF FORWARD GUIDANCE (ctd)

- (4) COMMITMENT WITH DATES TO UNCHANGED POLICY (FED, AUG.11, FEB. 12, SEPT. 12)
- (5) COMMITMENT TO UNCHANGED POLICY (AT LEAST) UNTIL MACROECONOMIC SLACK IS REDUCED, SIGNALLED BY CROSSING OF UNEMPLOYMENT THRESHOLD (FED AND BANK OF ENGLAND, 2012-13)
- (6) MODIFICATION OF POLICY OBJECTIVE (BANK OF JAPAN ANNOUNCEMENT OF HIGHER INFLATION OBJECTIVE, 2013)
- (7) REPLACEMENT OF POLICY OBJECTIVE, e.g. NOMINAL INCOME INSTEAD OF INFLATION AS MAIN TARGET (WOODFORD, 2012)

OF THESE VARIANTS THE FIRST SIX HAVE BEEN TRIED, WHILE THE SEVENTH REMAINS –  
SO FAR – A MORE ACADEMIC PROPOSAL

THE EFFECTS HAVE BEEN MOSTLY HELPFUL IN EASING THE CONSTRAINT OF THE ZERO  
BOUND, WHILE AMBIGUITY IS BEGINNING TO ARISE IN THE US AND THE UK, AS  
RECOVERIES GET UNDER WAY

USING FG IN THE NEXT, MORE "NORMAL", PHASE WILL BE EVEN MORE CHALLENGING  
AND RISK AN OVER-RELIANCE ON REH AND CASES OF TIME-INCONSISTENT POLICIES

# COMMENTS ON INDIVIDUAL VARIANTS AND THEIR RELATION TO REH

*ANNOUNCING THE CENTRAL BANK'S INTEREST RATE PATH* WARRANTED BY AND INTEGRATED INTO THE CURRENT PROJECTION WAS A FASHION AMONG CENTRAL BANKS IN SMALLER COUNTRIES PRIOR TO THE CRISIS (NEW ZEALAND, NORWAY, SWEDEN)

INTELLECTUALLY DEMANDING, DIFFICULT TO AGREE ON IN A POLICY COMMITTEE, MAY BE EVEN AMONG BANK STAFF

IT IS QUANTITATIVE, RELIES ON CENTRAL BANK AUTHORITY IN MODELLING – BUT IT IS WITHOUT COMMITMENT, i.e. DELPHIC

AS A METHOD OF PERSUASION ITS HAS A QUESTIONABLE RECORD – DID MARKET CONSENSUS ON THE RATE PATH CONVERGE TO THE BANK'S PATH OR THE OTHER WAY ROUND? (GOODHART AND ROCHET, 2010)

ANNOUNCING MONETARY EASE (OR TIGHTENING) FOR SOME TIME, BUT WITHOUT COMMITMENT TO A HORIZON WOULD APPEAR TO BE NEITHER DELPHIC, NOR ODYSSEAN - AND NOT TO RELY ON REH

THAT DOES NOT IMPLY THERE IS NO IMPACT, THOUGH THAT WAS LESS THAN HOPED FOR IN THE IMMEDIATE POST-CRISIS FED ANNOUNCEMENT AS WELL AS FOLLOWING THE MESSAGE ON TIGHTENING "AT A MEASURED PACE" AFTER EXITING FROM THE FED'S 1% POLICY RATE IN THE 2003; AT THAT TIME LONGER-TERM RATES DID NOT MOVE UP – CHAIRMAN GREENSPAN'S "CONUNDRUM"

THE ECB'S JULY 2013 FG, EXPECTED "THE KEY ECB INTEREST RATES TO REMAIN AT PRESENT OR LOWER LEVELS FOR AN EXTENDED PERIOD OF TIME" TO DECOUPLE FROM RISING US RATES WAS AN EXAMPLE OF A LIMITED, BUT USEFUL INITIATIVE IN PERSUADING MARKET PARTICIPANTS THAT THE US OUTLOOK WAS DIFFERENT

*ANNOUNCEMENT OF LARGE-SCALE ASSET PURCHASES (AND THE SUBSEQUENT IMPLEMENTATION) HAS BECOME A MAJOR TOOL FOR BRINGING LONGER-TERM RATES DOWN IN THE US AND THE UK (AS WELL AS IN JAPAN FOR NEARLY TWO DECADES)*

THIS IS A VARIANT OF ODYSSEAN COMMITMENT AND LIMITED RELIANCE ON MODELLING – IT IS OUTSIDE PAST EXPERIENCE

THE COMMITMENT IS POWERFUL, AS DEMONSTRATED BY US 2013 EXPERIENCE WITH ANNOUNCEMENT ON "TAPERING", THE EFFECTS OF WHICH TEMPORARILY SUPERSEDED THE FED COMMITMENT TO VERY LOW POLICY RATES UNTIL 2015

ONE DIFFICULTY: SHOULD THE POLICY BE MEASURED IN STOCK OR FLOW TERMS?

THE US AND UK LSAPs HAVE HAD A GENERALLY EXPANSIONARY PURPOSE, OPERATING ON PRICES FOR ALL (IMPERFECTLY SUBSTITUTABLE) ASSETS VIA PORTFOLIO REBALANCING AS PRICES FOR GOVERNMENT BONDS ARE KEPT HIGHER THAN OTHERWISE

BUT THE MAIN RATIONALE IN THE EURO AREA HAS BEEN TO REPAIR PARTS OF THE TRANSMISSION MECHANISM BY PURCHASING SOVEREIGN BONDS OF SOME ISSUERS (THE SECURITIES MARKET PROGRAMME 2010-11) AND COVERED BONDS, WHILE STERILIZING THE LIQUIDITY IMPACT OF SUCH PURCHASES

THE MOST SPECTACULAR EXAMPLE OF FG, BASED ON A PURE ANNOUNCEMENT EFFECT, IS THE ECB'S OFFICIAL MONETARY TRANSACTIONS (OMT), CONFIRMING A READINESS TO BUY BONDS OF SHORT MATURITIES, PROVIDED THE ISSUING COUNTRIES HAVE NEGOTIATED A CONDITIONAL LOAN



COMMITMENT WITH DATES TO UNCHANGED POLICY HAS BEEN ANNOUNCED ON THREE OCCASIONS IN THE US, AS THE FED FOUND THAT MARKETS CONTINUED TO EXPECT RAISES IN THE POLICY RATE WELL BEFORE THEY SEEMED WARRANTED BASED ON THE FED OUTLOOK

THIS VARIANT IS PRIMARILY ODYSSEAN, BUT IT MAKES SENSE BY COMBINING IT WITH FORECASTING, SO IT IS ALSO DELPHIC

STUDIES BY FED ECONOMISTS, FEMIA *et. al.* (2013), AS WELL AS BY FINANCIAL SECTOR ECONOMISTS, DEUTSCHE BANK (2013), SUGGEST THAT ON EACH OF THE THREE OCCASIONS ON WHICH THE TIME HORIZON FOR EASY POLICIES WAS EXTENDED THERE WAS A DOWNWARD SHIFT IN 10-YEAR TREASURY YIELDS AND IN THE PATH OF THE FED FUNDS RATES, THOUGH DIMINISHING EFFECTS

*COMMITMENT TO UNCHANGED POLICY (AT LEAST) UNTIL AN UNEMPLOYMENT THRESHOLD IS CROSSED* WAS ADOPTED IN THE US AND THE UK FOR TWO REASONS:

- FURTHER EXTENDING THE COMMITMENT TO A DATE WOULD HAVE STRAINED CREDITBILITY TOO MUCH
- LINKING THE FIRST STEP(S) AWAY FROM MAXIMAL ACCOMODATION TO THE MAIN REAL MACROECONOMIC INDIACATOR, UNEMPLOYMENT, ATTEMPS TO CLARIFY THE CENTRAL BANK'S "REACTION FUNCTION" - AS SUCH AS IT HAS BEEN SEEN BY ACADEMICS, WOODFORD (2013), AS WELL AS BY FINANCIAL SECTOR ECONOMISTS AS A CLEAR IMPROVEMENT OF STRATEGY

HOWEVER, BY MAKING THE ANALYTICAL CONTENT SHARPER THAN IN THE TIME HORIZON VARIANT, CONFLICTS BETWEEN THE CENTRAL BANK'S FORECAST AND THOSE OF OTHERS ARE BROUGHT CLOSER TO THE CENTRE STAGE

SUSPICIONS OF HUBRIS BY OVER-RELIANCE ON REH ARISE

BOTH THE US AND THE UK EXPERIENCE SUGGEST SOME CONFUSION, AS A STRATEGY TO DELAY A BEGINNING OF THE END OF ACCOMODATION WELL INTO THE FUTURE WAS IMPLEMENTED AT A TIME WHEN ECONOMIC RECOVERY WAS MOVING CLOSER

THE UK EXAMPLE MAY BE THE CLEAREST: UNDER-ESTIMATING THE UPWARD MOMENTUM IN THE UK WHICH IS FINALLY SHOWING UP IN 2013 IMPLIES THAT THE 7% UNEMPLOYMENT THRESHOLD WILL BE REACHED MUCH EARLIER THAN THE BOE EXPECTED

IN THE US THE UNEMPLOYMENT THRESHOLD IS 6.5%, ABOUT ONE PERCENTAGE POINT HIGHER THAN THE FED'S ESTIMATE OF NAIRU (5.6%)

BUT OTHER FORECASTERS ARE WELL ABOVE THE FED AND RECENT WAGE TRENDS WHICH POINT TO A PICK-UP IN MOST SECTORS SUGGEST THEY MAY BE RIGHT

THE US ECONOMY IS AT A POINT WHERE MANY MARKET PARTICIPANTS SEE A TAPERING OF LSAP AND UPWARD MOVEMENT IN THE FEDERAL FUNDS RATE EARLIER THAN THE FED SEEMS READY TO CONTEMPLATE

"READING OF FED TEALEVES SUBSTITUTING FOR INDEPENDENT THOUGHT" (WILLIAMS, 2013), BUT THE FED STRATEGY MAY BE COMING CLOSE TO SAYING: "WE SHALL TELL THEM UNTIL THEY UNDERSTAND – AND BELIEVE" - (AND THERE ARE MANY WHO WOULD LIKE TO BELIEVE)

*MODIFICATION OF THE OBJECTIVE OF MONETARY POLICY*, EXEMPLIFIED BY THE BANK OF JAPAN RAISING THE INFLATION TARGET (FROM 1 TO 2%) AND PROMISING TO REACH IT WITHIN TWO YEARS QUALIFIES AS A REGIME CHANGE AFTER TWO DECADES OF ZERO INFLATION AND OF ZERO INFLATIONARY EXPECTATIONS

DOUBTS ABOUT THIS MORE RADICAL VARIANT RELATE TO WHETHER THE OBJECTIVE COULD BE REALIZED – AND PARTICULARLY OVER A RELATIVELY SHORT HORIZON

EVEN IN THE BOOM PERIOD JUST BEFORE 1990 CONSUMER PRICE INFLATION WAS VERY MODEST – AND IT LIES BEYOND ANY MODELLING EXPERIENCE TO BRING ABOUT A MAJOR RISE IN INFLATIONARY EXPECTATIONS

*REPLACING AN INFLATION OBJECTIVE BY A NOMINAL INCOME OBJECTIVE IS SEEN BY SOME AS A VARIANT OF FORWARD GUIDANCE WITH THE POTENTIAL TO BREAK OUT OF EXCESSIVELY LOW INFLATIONARY EXPECTATIONS, WOODFORD (2012)*

IF THE ONLY WAY OUT OF LOW ACTIVITY IS TO DRIVE REAL INTEREST RATES CLEARLY BELOW ZERO, A NOMINAL INCOME TARGET - AND EVEN FORMULATED IN LEVELS - MIGHT BE THE APPROPRIATE SIGNAL TO SEND

BUT NEITHER THE REAL, NOR THE NOMINAL COMPONENT WOULD BE EASY TO RAISE OVER ANY SHORTER TIME HORIZON – AND THE APPARENT INDIFFERENCE BETWEEN THE TWO IS STRONGLY COUNTERINTUITIVE

## TO SUMMARIZE:

FORWARD GUIDANCE COMES IN SEVERAL VARIANTS

SOME – THE NON-COMMITTAL, OR PURELY DELPHIC ONES – ARE TOO VAGUE TO HAVE MUCH IMPACT

INTERMEDIATE ONES BASED ON COMMITMENT FOR A DEFINITE TIME HORIZON, OR UNTIL AN UNEMPLOYMENT THRESHOLD HAS BEEN CROSSED, HAVE HAD AN IMPACT IN LOWERING LONGER-TERM RATES

BUT THEY ARE RAISING QUESTIONS ABOUT CENTRAL BANK HUBRIS AND OVERCONFIDENCE IN COMMUNICATION

CAN THESE INTERMEDIATE VARIANTS OF FG SURVIVE AS STRATEGIES FOR MANAGING IN MORE NORMAL TIMES? PROBABLY NOT

THE MORE RADICAL VARIANTS – CHANGING THE INFLATION OBJECTIVE, ADDING NEW OBJECTIVES (UK?), NOMINAL INCOME TARGETING – MAY LOOK APPEALING, BUT THEY COULD HARDLY BE IMPLEMENTED

ANALOGIES TO STOPPING MAJOR PAST INFLATIONS UNCONVINCING

BOTH THE INTERMEDIATE AND – PARTICULARLY – THE RADICAL VARIANTS WOULD REQUIRE SOME "KNOCKOUTS" WITH REFERENCE TO FINANCIAL STABILITY TO AVOID REPEATING THE RUN-UP TO THE CRISIS

THAT RUN-UP TAUGHT POLICY-MAKERS THAT FINANCIAL STABILITY CAN BE AT SERIOUS RISK BEFORE INFLATION HAS TAKEN OFF



# POST SCRIPT

ONE TYPE OF FORWARD GUIDANCE IN SMALLER OR MEDIUM-SIZED ECONOMIES IS LEFT OUT OF ACCOUNT IN THE INTERNATIONAL DEBATE AND HENCE IN THE ABOVE: EXCHANGE-RATE TARGETING

APPLICABLE TO SOME OF THE EMERGING MARKET ECONOMIES WHO COMPLAIN ABOUT FIRST AGGRESSIVE US MONETARY EASING, THEN THE (UNINTENDED) IMPACT OF "TAPERING" IN THE LSAP

THEY COULD HAVE PROTECTED THEMSELVES TO SOME EXTENT AGAINST AN EXCHANGE-RATE CYCLE BY FORWARD GUIDANCE BASED ON THEIR EXCHANGE RATE

STRUCK BY THE POTENTIAL OF SUCH A ROLE FOR FG WHEN VISITING THE CENTRAL BANK OF TURKEY, NOW REFERRED TO AS ONE OF THE "FRAGILE FIVE"

MAY BE I AM CARRIED AWAY BY OBSERVING HOW WELL FG VIA AN EXCHANGE-RATE OBJECTIVE HAS WORKED IN MY OWN COUNTRY, DENMARK, WHOSE CURRENCY IS TIGHTLY PEGGED TO THE EURO

FG IN THIS FORM MAY REQUIRE AN ECONOMY NOT TOO FAR FROM EXTERNAL BALANCE AND WITH A NATIONAL INFLATION RATE BROADLY IN LINE WITH THOSE OF TRADING PARTNERS

YOU MAY SAY THAT THEN THERE IS NO OBVIOUS NEED FOR UNORTHODOX MONETARY POLICIES, INCLUDING FG