

# The Future of Forward Guidance

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# Forward Guidance: 3 types

1. Explanation of nature of objectives and assessment of where economy is and where likely to go, with some idea of reaction function – but short of a predicted path for rates.
2. As with 1. but plus an expect path for expected rates – could be called Delphic
3. A commitment to a particular path – or at least to a concrete rule which would NOT be the same as the rule you might otherwise follow without pre-commitment. This is Odyssean.

## Forward Guidance: 3 types

It is hard to be against forward guidance 1. Few central banks have followed the guidance of Montagu Norman – never explain, never apologise. Certainly not BoE since 1997.

Guidance 2. is debatable – not entirely clear how best to do it with a committee of individuals with their own votes. This is not insuperable of course. You could vote over paths of rates.....but messy. Voting over a rate today (0.25 or 0.5) is straightforward.

Guidance 3 (Odyssean) is I think deeply problematic...

# Odyssean guidance

There is a logic behind it. Suppose QE or other policies do not work; then helpful at ZLB if you can convince people you will leave rates lower than normal rule after leaving the ZLB.

BUT....

How do you credibly commit? – members of MPC change so not enough to commit personally.

Suppose what you commit to has clearly become very bad policy at the time you get to tomorrow as you learn about the structure of the economy?

Does QE (and other policies) at ZLB really not work?

# What did BoE do?

Had certainly done loads of guidance pre 2013 – Inflation report, minutes of meetings, loads of speeches.

George Osborne (then Chancellor) asked Bank to write a report on use of forward guidance. He seemed to be convinced we were missing something.

Report was written – quite long, quite complicated. And mpc embarked on a sort of forward guidance.

It was not a very happy episode.

# What did BoE do?

MPC did not want Odyssean option – in part because many of us felt we had other options (QE, incentivised long term lending to banks)

Did see some advantages in explaining policy which at ZLB was in uncharted territory

Did see danger that at signs of growth and unemployment falling people might think rates would go up quickly.

But any hard rule like “We will not raise rates for 24 months” or “We will raise rates when unemployment reaches x%” was far too inflexible and likely counter-productive.

# What did BoE do?

Reached a decision to publish a rule which just ruled some things out. Here it is:

“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.”

# What did BoE do?

This is complex; It was only acceptable to a majority of MPC if it did have all these over-writes (or knock-outs)....

In practice unemployment came down fast....but so did inflation and the policy rate has subsequently gone marginally lower and asset purchases resumed.

Unemployment was 5% when policy made more expansionary

Of course that is not logically inconsistent with the 2013 guidance. But then again almost nothing is logically incompatible with that guidance.....!



## What did BoE do?

Shows problems of forward guidance or BoE messed it up?

I am inclined to former. But we could have done job by saying that raising rates as soon as unemployment started to fall was a bad idea. No need for 400 words.

Interesting recent paper by Eric Swanson finds that QE has had lasting effects; finds forward guidance non persistent effect. Quite big on day 0 - but gone in a month or two.

BoE now produces fan charts showing market expectations and unchanged rates....and commentary on those projections plus MPC members speeches. That is loads of guidance .....probably more than enough.