Talking Hawkish and Acting Dovish:
FOMC Forward Guidance 2009-14

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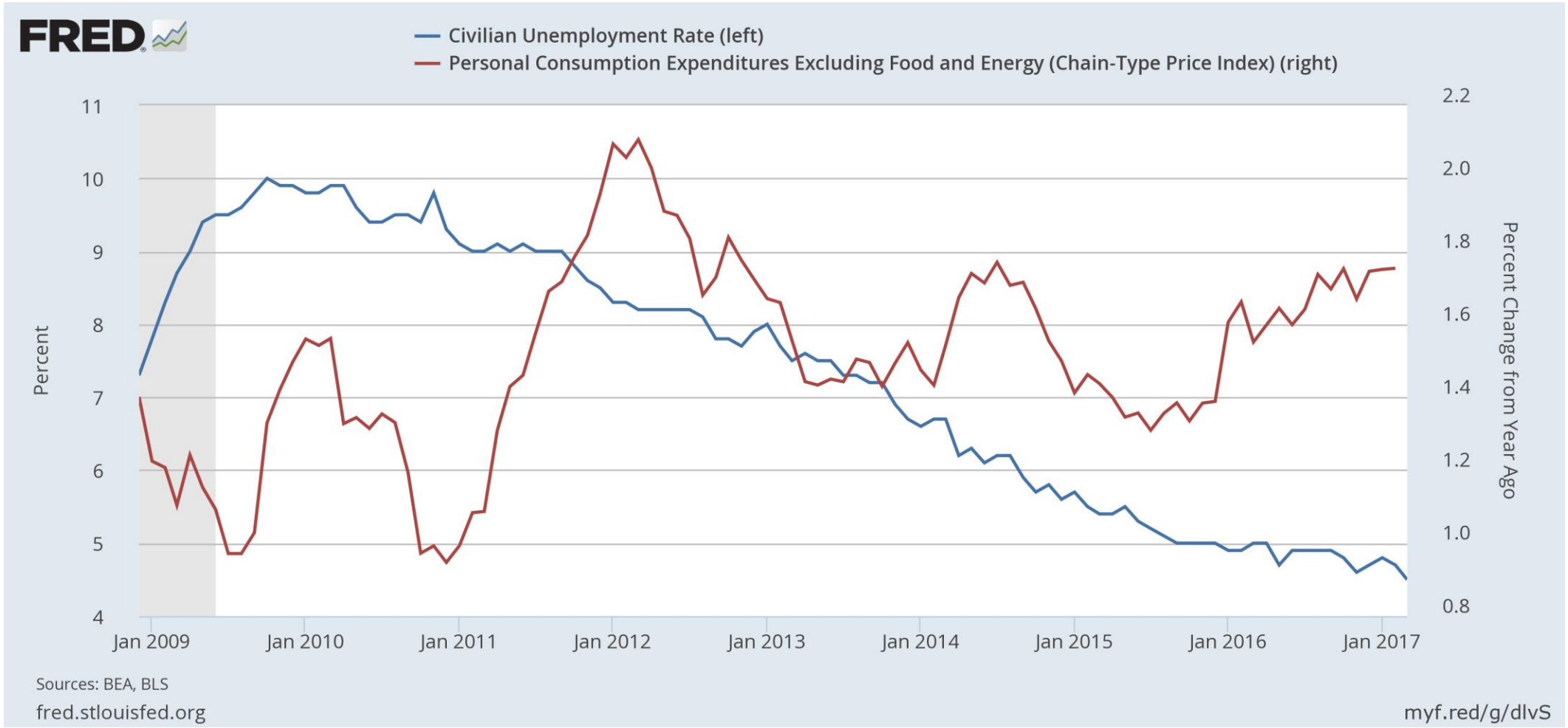
7 Long Years …

- FOMC lowered the fed funds rate target range to [0,0.25%] in December 2008.

- It initiated “liftoff” (next raised the fed funds rate target range) in December 2015.

Room for Improvement in Forward Guidance



Three Stages of Forward Guidance About Liftoff

1. **March 2009-June 2011**: “extended period” language

2. **August 2011-September 2012**: “date-based” forward guidance

3. **December 2012-March 2014**: “state-based” forward guidance

Stage 1: Extended Period Language

- Generally interpreted as: “Fed won’t raise rates for at least six months”. This guidance was very cautious:

- **2009Q1**: Survey of Professional Forecasters (SPF) expected that the unemployment rate (UR) would be **9% (and still rising)** in six months.

- **2011Q2**: SPF forecast is that the UR would have fallen to **8.5%** in six months.

Stage 2: Time-Based Guidance

- **August 2011**: FOMC said liftoff wouldn't occur earlier than **mid-2013.**
  - SPF forecast in 2011:Q3 was that **UR would be 8.1%** in 2013.

- **January 2012**: FOMC said liftoff wouldn't occur earlier than **late 2014**.
  - SPF forecast in 2012:Q1 was that **UR would be 7.4%** in 2014.

- **September 2012:** FOMC said liftoff wouldn't occur earlier than **mid-2015.**
  - SPF forecast in 2012:Q3 was that **UR would be 7.0%** in 2015.

Stage 3: State-Based Guidance

- **December 2012**: FOMC said that liftoff wouldn't occur until the UR had reached **6.5%**.
  - As long as the one-to-two-year-ahead outlook for the inflation rate remained below 2.5%.

- **March 2014:** FOMC drops fed funds rate forward guidance when the UR reaches **6.7%**
  - FOMC initiates liftoff nearly two years later when the UR reaches 5%

Problems

- In terms of the conditionality surrounding liftoff, the FOMC's communications were a lot more hawkish than its later actions.

- Monetary policy works through **expectations** – so, the hawkish communications robbed the eventual actions of much of their stimulative force.

- The communications/actions discrepancy also weakened the credibility of the FOMC, especially among those investors who were looking forward to interest rate increases.

Not the Academic ZLB Problem

- All of this is very different from the academic literature on the zero lower bound.
  - That literature suggests that the central bank would like to talk dovish (commit to overshoot on inflation, for example) at the ZLB in order to generate stimulus.
  - It later would be tempted to make choices that are more hawkish than its prior promises.
- We don't see this kind of time-consistency problem in the Fed's 2009-14 behavior – it ends up acting more dovish than was implied by its (***overly) hawkish*** prior promises.

To Be Fair …

- The FOMC honestly didn't know what its reaction function would turn out to be.

- Many, if not most, FOMC participants were heavily influenced by (backwards-looking) Taylor Rule and its implications for liftoff -
  - Kocherlakota (2017, BPEA).

- FOMC seems to have evolved over time toward a more forward-looking policy approach.

Going Forward

- We can use the recent ELB episode as a way to obtain a rough guide to the FOMC's likely reaction function in future ELB episodes.

- The FOMC can then communicate that reaction function upon hitting the ELB.

- Even better: it can communicate that reaction function now - doing so might help lessen the chance of actually hitting the ELB.

Communication, not Commitment

- To be clear: Any such guidance is **not** intended to be a **commitment** - I'm highly skeptical of the FOMC's ability to commit future versions of itself.
  - In particular, given the Fed's apparent fear of ever having 2%+ inflation, it seems like it would be a mistake to promise an inflation overshoot.

- Rather, the goal is to use the 2009-14 data to figure out how an outlook-oriented future FOMC actually will approach the decision to leave the ELB …

- And then **communicate** that information to the public.

An Estimated Reaction Function

- My own estimate of the FOMC's reaction function is that, after hitting the ELB, it will not raise the fed funds rate at the bound until at least one of two conditions is met:

    1. Inflation is expected to rise back to 2%, in a sustainable way, within two years.

    2. The unemployment rate falls back to near 5%.

- **Possible exceptions:** signs of unanchored inflation expectations or financial instability.

An Interesting Historical Counterfactual?

- Suppose the FOMC had announced this reaction function in December 2008.

- It could have put significantly more downward pressure on long-term interest rates and (so) upward pressure on demand.

- This would have provided much needed support to the economy, especially in the face of many subsequent adverse shocks.

This Picture Would’ve Looked Better …