



BANK FOR INTERNATIONAL SETTLEMENTS

Forward guidance through interest rate projections: does it work?

by Leif Brubakk, Saskia ter Ellen and Hong Xu

Richhild Moessner

Bank for International Settlements

12 May 2017

Conference on The Future of Forward Guidance, Sveriges Riksbank

The views expressed in this presentation are those of the author and not necessarily those of the Bank for International Settlements



Overview

- Method
- Results
- Comments



BANK FOR
INTERNATIONAL
SETTLEMENTS



Research questions

- Effects of explicitly publishing central bank policy projections on market interest rates
- Extent to which the intended forward guidance by the central bank, as revealed by published interest rate paths, affects market interest rates



Data and Method

- Central bank interest rate paths published by Riksbank and Norges Bank, and market interest rates from 2001-2016
- Construction of two proxy measures for the surprises in published interest rate paths:
 - difference between the central bank's published path and market interest rates on the day before the publication of that path; and
 - difference between the revision of the expected path from one meeting to the next as published by the central bank and the market's revision of future expected interest rates shortly before the announcement
- Construction of 'target factor' and 'market path factor' following Gürkaynak et al. (2005) (GSS)



Results

- Explicit forward guidance in the form of publishing interest rate paths succeeds in moving market interest rates in the desired direction, but less than one-to-one.
- Information contained in the published interest rate path has a significant effect on the market path, and can explain up to 47% of the market path factor
- Central bank and market revisions of interest rate expectations are strongly correlated, suggesting that market participants largely understand the monetary policy reaction pattern



Comments

- Very interesting paper, topical and relevant research question:
 - analyses effect of explicit forward guidance, introduced by Riksbank, Norges Bank and RBNZ before the global financial crisis, and introduced by some other central banks as an unconventional monetary policy tool, in addition to large-scale asset purchases (LSAPs), after the global financial crisis
- Careful analysis; very useful approach to construct proxy measures for surprises in published policy rate paths, which is not commonly done (some exceptions: Moessner and Nelson 2008 for New Zealand, Bongard et al. 2016 for Federal Reserve)
 - similarly, surprises in unconventional monetary policy tool of LSAPs are not commonly measured in analysis of effects of LSAPs



Comments

- Very useful analysis, since as paper mentions "there are relatively few empirical studies investigating the merits of publishing interest rate projections" and "Even less attention has been devoted to investigating the effects on market rate movements from explicitly publishing central bank policy projections":
 - See also recent survey on 'Communication about future policy rates in theory and practice' of Moessner et al. (JES, forthcoming) on this



Comments

- Interesting to relate to more commonly used approach following GSS of taking market reactions around monetary policy announcements as the monetary policy surprises by constructing 'target factor' and 'market path factor'
 - For GSS approach, not clear whether 'market path factor', which is taken as the measure of forward guidance, is due to publication of policy rate path, rather than other elements of the monetary policy announcement, or large-scale asset purchases



Comments

- Results for Sweden and Norway are consistent with those for New Zealand (Moessner and Nelson 2008) and Federal Reserve (Bongard et al. 2016):
 - Surprises in published policy rate paths affect market expectations, but less than one-for-one
 - Results for Sweden and Norway are consistent with results for Sweden that market reaction to macroeconomic news was not reduced by introduction of publication of policy rate paths in 2007, controlling for effect of the ZLB (Moessner et al. 2016)
- evidence that markets understand conditionality of the policy rate paths published by central banks



Comments

- Changes in market expectations between publication dates of policy rate paths are correlated with changes in published policy rate paths
 - But this need not be due to a good understanding of the central bank's reaction function, as suggested in the paper.
 - It could also/instead be due to signalling by the central bank (eg in speeches) in between policy path publication dates, without providing a better understanding of the reaction function



Comments

- For Norway, 1-month market interest rates are constructed from US interest rates, spot and forward exchange rates against the USD by assuming CIP
- Large and persistent deviations from CIP for the USD have occurred during the global financial crisis and in recent years, see eg Avdjiev et al. (2016).
 - How relevant are CIP deviations for NOK and SEK against the USD at the 1-month horizon?
- Could control for effects of macroeconomic news, especially in persistence regressions using changes in market interest rates over several days



Comments

- Federal Reserve introduced explicit forward guidance already before date of December 2012 mentioned in the paper
 - For effects of explicit Fed forward guidance pre-crisis see Moessner and Nelson 2008, post-crisis see eg Moessner 2013.



THANK YOU



BANK FOR
INTERNATIONAL
SETTLEMENTS

