Forward Guidance and its Challenges:
The Federal Reserve's Experience
February 25, 2023

In the aftermath of the Global Financial Crisis of 2008, the Federal Reserve and other central banks embraced forward guidance as both a mechanism for communicating goals and strategy and a valuable monetary policy tool in its own right. Forward guidance continued to be used by the Federal Reserve through most of the next decade and in response to the economic downturn caused by the pandemic. However, the strong recovery from the pandemic recession along with inflation rates not seen in 40 years raises questions about whether and how best central banks can provide guidance without becoming locked into a particular course or being seen as reneging on a commitment. This note provides a brief overview of forward guidance, reviews the Federal Reserve's use of forward guidance, and offers a few thoughts on the challenges posed.

Forward Guidance and Communications

Forward guidance entails telling the public and markets about the expected future path of the central bank's policy interest rate. A few central banks go so far as to provide the monetary policy-making committee's forecasts of inflation, output and other key variables along with the interest rate path that their models say will produce these results. However, most central banks are not so forthcoming.

The Federal Reserve began to use forward guidance when its policy rate (federal funds rate) was close to zero. Because investors can switch into cash, zero – the return on cash – puts a floor under interest rates. This floor is called the Zero Lower Bound and it constrains monetary policy, which uses lower interest rates to stimulate the economy. (Because large quantities of cash are more inconvenient to hold than securities or bank deposits, the lower bound is actually slightly below zero.)

To compensate for their inability to reduce interest rates into negative territory, the Federal Reserve and some other central banks gave forward guidance in which they said they would keep interest rates low for longer than they would have otherwise. The hope was that the prospect of interest rates that would be low for longer would encourage economic actors to invest and spend.

Delphic vs. Odyssean Forward Guidance
A distinction is sometimes made between Delphic and Odyssean forward guidance. Delphic refers to the Oracle of Delphi whose advice and prognostications were sought by the ancient Greeks but whose wise words had to be carefully interpreted or disaster might ensue. Odyssean refers to another ancient Greek figure. Sailing home from battle, king Odysseus had to pass the sirens, whose beautiful songs lured seamen to their deaths. Odysseus had his men's ears plugged with beeswax so they would not be tempted. But Odysseus had himself tied to the ship's mast, so he could hear the songs but not respond.

He was enchanted by the singing and fought to free himself but remained bound to the mast. King, men and ship survived the encounter.

Applied to forward guidance, Odyssean means making a commitment – tying oneself to the mast – in order to affect expectations of future interest rates and thereby influence economic activity today. Delphic guidance explains how the central bank sees economic developments ahead and how it plans to react, but there is no commitment. The guidance may be detailed and specific – forecasts of inflation and employment and the policy rate consistent with those outcomes. Or it may be general: the Committee expects inflation to rise and will raise interest rates as appropriate. But the understanding is that policy adjusts to a changing economy. With Odyssean Guidance, the policy is given – subject to conditions.

Subject to conditions is key to whether this is a meaningful distinction. Federal Reserve officials have tended to see themselves as offering Odyssean-type guidance in most of the period after the Global Financial Crisis and Great Recession. In particular, from 2009 to 2015, FOMC policy statements tried to convey that the federal funds rate would be held close to zero for longer than under past or "business as usual" policy regimes. However, a study of forward guidance issued by eight central banks from 1990 to 2020 claims that Odyssean guidance is very rare.[1] Until 2020, only two of the eight central banks used Odyssean guidance: Bank of Canada in 2009-10 and the Swedish central bank in 2014-15. The Federal Reserve did not. Although the Federal Open Market Committee's policy statements expressed a strong inclination to keep interest rates low for longer than normal, these statements also included that the FOMC looks at a range of information and as this changes it adapts accordingly.

<u>Fed's Use of Forward Guidance – Blow by Blow</u>[2]

Those not interested in a detailed overview of the policy statements issued after meetings of the Federal Open Market Committee should skip to page 7 and <u>Thoughts on Forward Guidance.</u>

Early Guidance – In Code but Clear

The Fed's first effort at forward guidance was in the recovery from the 2001 recession. The recovery was slow and inflation was low. The federal funds rate had been reduced to 1 percent. In the statement following its August 2003 meeting, the Federal Open Market Committee (FOMC) observed that "the Committee believes that policy accommodation can be maintained for a considerable period." The "considerable period" wording – and the federal funds rate – remained unchanged through 2003. In January 2004, the FOMC's guidance shifted to signal a possible increase in the federal funds rate, with "the Committee

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[1] Sutherland, Christopher S. 2020 "Forward Guidance and Expectation Formation: A Narrative Approach." Staff Working Paper 2020-40. https://www.bankof canada.ca/2020/09/staff-working-paper-2020-40. Later (2022), BIS Working Paper No. 1024. https://www.bis.org/publ/work1024.pdf.

[2]All quoted FOMC statements in this section are from the relevant Federal Reserve press releases "Federal Reserve issues FOMC statement" at https://www.federalreserve.gov/newsevents/pressreleases.htm

believes it can be patient in removing its policy accommodation." In May, with unemployment coming down and inflation edging up, the time for patience was ending; and "the Committee believes policy accommodation can be removed at a pace that is likely to be measured." The following month the FOMC approved the first of an extended series of ¼ percent increases in the federal funds rate.

Global Financial Crisis and Recession
In December 2008, in response to the Global Financial Crisis and recession, the FOMC reduced the federal funds rate to near zero (0 to ¼ percent) and began again to provide information about the rate's future path, stating "the Committee anticipates that weak economic conditions are likely to warrant exceptionally low levels of the federal funds rate for some time." The FOMC also referred to plans to buy large quantities of securities.

In the March 2009 statement, the guidance was tweaked slightly, changing "for some time" to "an extended period." In November 2009, the FOMC began to spell out the economic conditions warranting such low interest rates: "low rates of resource utilization, subdued inflation trends, and stable inflation expectations." In mid-2010, a sentence was added saying the Committee would monitor the outlook and financial developments and would use its tools to promote recovery and price stability (later changed to inflation consistent with its mandate.)

Qualitative to Dates
In August 2011, the FOMC replaced "an extended period" with "at least through mid-2013." The Fed may have been influenced by the Bank of Canada (BOC), which had adopted forward guidance in the spring of 2009, but using a specific date rather than a qualitative time horizon. Canada came through the recession relatively well, and forward guidance was the BOC's primary unconventional monetary policy tool. However, a specific date was not the only difference between the BOC's and the Fed's guidance. In the press release in which the BOC first offered forward guidance, the headline stated that the BOC had reduced its policy rate to ¼ percent and that it "commits to hold current policy rate until the end of second quarter of 2010," conditional on the inflation outlook.[3] Even with the caveat about inflation, the BOC statement indicates a stronger commitment than the FOMC's anticipation that economic conditions would warrant low rates.

In 2012, the FOMC twice pushed out the time interval warranting exceptionally low rates – from mid-2013 to late 2014 and then, to mid-2015.

Dates to Indicators
In December 2012, the FOMC dropped the date-specific approach. Going forward, the need for exceptionally low interest rates would reflect the performance of the economy with respect to selected indicators. Specifically, the Committee anticipated that exceptionally low interest rates would be warranted as long as the unemployment rate remained above 6.5 percent, inflation one to two years out was forecast to remain below 2 ½ percent, and long-run inflation expectations remained anchored.

[3] Press Release April 21, 2009. https://www.bankofcanada.ca/2009/04/fad-press-release-2009-04-21

The focus on the unemployment rate and inflation addressed concerns that date-based forward guidance could be misinterpreted. Statements that policy would be accommodative until, say, mid-2015 might be understood by households and businesses as meaning the Fed expected the economy to be weak through mid-2015, perhaps even weaker than private forecasters expected. Instead, the intended message was that policy would be more accommodative than expected.

FOMC statements also began referring to the Federal Reserve's longer run goal for inflation of 2 percent. Internal discussions at the Fed had long used 2 percent inflation as the measure of price stability, but this value had not been formally announced to the public.

While perhaps clarifying the FOMC's message, the indicator-based approach to forward guidance presented its own challenges. The December 2012 statement said the Committee viewed the new approach as consistent with the former date-based approach. However, the unemployment rate seems to have fallen faster than expected. From 7.7 percent in December 2012, the unemployment rate fell to 6.7 percent at the end of 2013 and 5.6 percent at the end of 2014.

Forward Guidance remained largely unchanged through 2013, although explanatory comments about the Fed's objectives and assessment of economic conditions began to place more emphasis on inflation running below the 2 percent target. In December, with the unemployment rate approaching the threshold value, the Committee anticipated that maintaining the federal funds rate near zero would be appropriate "well past the time" the unemployment rate fell below 6 ½ percent.

Indicators back to Qualitative

Early in 2014, the FOMC removed the reference to the unemployment threshold. No alternative indicator or date was substituted. Instead, moving away from the federal funds target of 0 to ¼ percent would depend upon progress towards the Fed's objectives as assessed by the Committee based on a wide range of information. Even when employment and inflation reached levels consistent with the Fed's mandate, the Committee anticipated conditions would still warrant a policy rate lower than normal.

In October 2014, the FOMC announced the conclusion of its asset purchase program, ending the expansion of its balance sheet. Forward guidance did not change: a target of 0 to ¼ percent for the federal funds rate was still appropriate. However, the statement hinted at a future rate increase, observing that faster/slower progress towards the Committee's inflation and employment goals would likely mean a faster/slower increase in the federal funds rate than "currently anticipated." In December, assessing progress towards its objectives, the FOMC judged "that it can be patient in beginning to normalize the stance of monetary policy."

First Rate Increase

In March 2015, the FOMC reaffirmed the 0 to ¼ percent range for the federal funds rate but signaled that an increase lay ahead. The "be patient" language was replaced with new

guidance: "in determining how long to maintain this target range," the Committee would assess progress towards its objectives and anticipated that an increase would be appropriate when the Committee saw further improvement in the labor market and was confident inflation would rise to 2 percent. The statement added that an increase at the next meeting was unlikely and the change in guidance did not mean the Committee had decided on the timing of the initial increase.

Subsequent statements retained the same forward guidance but without references to timing. Then in October, "in determining how long to maintain this target range" was replaced with "in determining whether it will be appropriate to raise the target range at the next meeting." At the next meeting, in December, the target range was increased to ¼ to ½ percent. According to the accompanying guidance, "the Committee expects that economic conditions will evolve in a manner that will warrant only gradual increases in the federal funds rate; the federal funds rate is likely to remain, for some time, below levels that are expected to prevail in the longer run."

Gradual Increases

As it turned out, "only gradual increases" meant no increases for a year. Labor market conditions improved but inflation remained below the Fed's 2 percent objective. In September and again in November, the FOMC observed that the case for an increase in the federal funds rate had strengthened but it decided to hold off. However, in December 2016, the FOMC raised the target to ½ to ¾ percent. Forward guidance remained the same, with only gradual increases likely to be warranted and the federal funds rate remaining below what was expected in the long run.

In March 2017, the FOMC announced another increase in the funds target, to ¾ to 1 percent. It also changed its guidance: "conditions will warrant only gradual increases" became "conditions will warrant gradual increases." Removing "only" shifted the emphasis from a reluctance to raise rates to an intent to raise them, albeit in small steps. The target range was increased ¼ percent in June and again in December.

In January 2018, the forward guidance was altered to "conditions will warrant further gradual increases" in the federal funds rate, although the rate was likely "to remain, for some time below levels expected to prevail in the longer run." The target was increased ¼ percent in March and another ¼ percent in June.

No Forward Guidance

In June 2018, the FOMC largely eliminated forward guidance. As before, future rate adjustments would be based on the FOMC's assessment of economic conditions relative to its objectives. However, the FOMC statements did not follow this with any guidance on the direction of future rate changes or comparison with rates expected in the longer term. Elsewhere in its statement, the FOMC said sustained economic expansion was consistent with further gradual rate increases; but in discussing future changes, decisions would be based on the Committee's assessment of economic conditions taking into account a wide range of information. Rates were increased in September and December, reaching a range of 2 ¼ to 2 ½ percent.

In January 2019, the FOMC signaled a change in mindset and a pause in rate increases. In response to global developments and muted inflation, the Committee would be patient in determining appropriate adjustments to the federal funds target. By mid-summer, the uncertainties were judged to have increased. In July, the FOMC cut the federal funds rate ¼ percent. In considering the future path of the federal funds rate, the Committee promised to act as appropriate to sustain the expansion, but it did not offer more explicit guidance. Further cuts came at the September and October meetings. In December 2019, the Committee voted to maintain the rate at 1 ½ to 1 ¾ percent and observed that it considered the stance of monetary policy to be consistent with sustained expansion. Then came the pandemic.

Pandemic and Return to Near Zero Rates

In response to the pandemic, the FOMC cut the federal funds rate to 0 to ¼ percent in two sessions in March 2020. Forward guidance was reinstituted with the statement that the Committee expected to maintain the 0 to ¼ percent target until the economy had "weathered recent events and was back on track to its maximum employment and price stability goals." The Committee would assess when those conditions had been met. The Committee also asserted that it would use all its tools to support its goals and announced plans to purchase securities on a large scale.

Forward guidance remained unchanged through the summer. Then in September 2020, the FOMC announced a new approach to monetary policy and new guidance. The new approach aimed for an inflation rate that averaged 2 percent over time. Since inflation had been below 2 percent for much of the previous decade, this would mean allowing inflation to moderately exceed 2 percent going forward. Previously, the goal had been to achieve and maintain a 2 percent inflation rate, without taking account of past shortfalls. The new approach also was less concerned about the inflationary risks of tight labor markets.

According to the new guidance, the Committee expected to hold the federal funds rate at 0 to ¼ percent until the labor market had improved to "levels consistent with maximum employment" and until inflation had moderately exceeded 2 percent "for some time." Given the recent history of low inflation rates and the Fed's desire for some averaging out, a plausible inference was that interest rates would remain near zero for the foreseeable future, although the Committee added a qualifier that policy could shift in response to risks.

The FOMC continued to offer this guidance through most of 2021. In April, the FOMC noted that inflation had picked up – to 3 to 4 percent year over year, depending upon the inflation measure – but attributed the increase to transitory factors.[4]

[4] The FOMC's preferred measure of inflation is the price index for personal consumption expenditures (PCE); some members focus on core PCE, which excludes food and energy. For most of the public, a more familiar measure is the Consumer Price Index (CPI), with food and energy included. Prices for energy are very volatile; as a result, the CPI fluctuates much more than core PCE.

In December 2021, the FOMC seemed to acknowledge that economic conditions were not unfolding as expected. The FOMC left the target for the federal funds rate at 0 to ¼ percent. But with year over year inflation about 5 to 7 percent, the FOMC dropped the goal of raising the inflation rate as a justification for low interest rates. Instead, near zero interest rates were appropriate until labor market conditions were consistent with maximum employment. Not said was that with an unemployment rate of only 4 percent, the time for higher interest rates was not far away.

Catching up with Inflation

The January 2022 statement was clearer. Although the FOMC retained the 0 to ¼ percent target for the federal funds rate, the Committee announced that "with inflation well above 2 percent and a strong labor market," an increase would soon be appropriate. At the next meeting, in March, the target was increased by ¼ percent and the Committee anticipated further increases. In May, the target was increased ½ percent. The Committee stated that inflation was expected to return to 2 percent while the labor market remained strong, "with appropriate firming in the stance of monetary policy" and that it anticipated "ongoing increases" in the federal funds rate would be appropriate. The Committee also decided to begin reducing the size of its balance sheet. To reinforce its new message, "The Committee is highly attentive to inflation risks" was added to the statement.

In June, the FOMC increased the funds target by ¾ percent to 1 ½ to 1 ¾ percent and anticipated additional increases. An increase of ¾ percent is large by the Fed's historic standards. Another sentence was added affirming the FOMC's intention to rein in rising inflation: "The Committee is strongly committed to returning inflation to its 2 percent objective." The target was increased ¾ percent in each of the July, September and November meetings, with the Committee saying it anticipated that further increases were appropriate and repeating its attentiveness to inflation risks and its commitment to bringing inflation back to 2 percent. However, in November, a new note was also sounded: the Committee added that it would consider the cumulative effects of earlier increases and the lags in monetary policy in its rate decisions.

In December, the FOMC increased the target federal funds rate only ½ percent and in February 2023 only ¼ percent. The federal funds target in February was 4 ½ to 4 ¾ percent. The FOMC statement was very similar to that in November.

<u>Thoughts on Forward Guidance</u>

Commitment Concerns

The main issue associated with forward guidance is that of commitment. Is the central bank committing to a particular path for interest rates or is it merely providing information about the monetary policy committee's current thinking? Central banks are understandably reluctant to make commitments. Economic conditions may change in surprising ways and the new environment may call for - even demand - different policies. A striking example is the Fed's experience in the recovery from the pandemic. After a decade in which inflation fell short of its 2 percent target and a pandemic in which inflation fell below 1 percent, the FOMC in September 2020 expected that near zero rates would be needed to bring inflation

up to 2 percent. But a year later, inflation was well above 2 percent; and in the summer of 2022 comparisons were being made to the high inflation 1970s. Clearly, the policy envisioned in 2020 was not appropriate.

A commitment is problematic not only because conditions change, but also because households and businesses may act upon the commitment in their consumption and investment decisions. If the central bank then reneges – even for good reasons - those who acted on the commitment and experienced losses will feel aggrieved; and the central bank's credibility and reputation may suffer. Further, concerns about disappointing those who relied on the central bank's guidance could cause the central bank to hesitate in adjusting policy. Interestingly, these concerns do not seem to apply in the same way to quantitative easing and balance sheet policies. While clearly sensitive to the dangers of disrupting financial markets, the Fed seems willing to adjust course more readily.

Some central bankers are also concerned that forward guidance discourages financial market participants from making their own independent judgments about interest rates. As a result, market interest rates no longer provide useful information about market conditions to the central bank. Instead, market rates mirror the central bank's announced path.

The case for Odyssean forward guidance is strongest in those situations when the economy is weak and interest rates are near the zero lower bound. As already noted, the central bank hopes to compensate for its inability to lower interest rates into negative territory by promising to keep them low for longer than they would otherwise. Did this work? The Federal Reserve appears to have thought so, as they continued to offer forward guidance long after the Global Financial Crisis and quickly returned to it in the pandemic; many academics seem to agree. However, other monetary policy experiments were being conducted at the same time, notably quantitative easing; so it is difficult to sort out the effects of the different policy tools.

This use of forward guidance at the ZLB raises the question: what would the alternative policy have been? If rates in the future are to be lower longer than expected, what did households and businesses expect before the guidance? And once a central bank has tried lower for longer, does that become the expectation if the central bank again faces a weak economy with interest rates close to zero? A few economists have suggested dealing with the uncertainties of lower for longer by using a Taylor Rule-type analysis to calculate how long rates should be held at zero to compensate for the inability to go negative. However, I believe most central bankers and monetary policy economists think that this would be confusing to the public and would restrict central banks excessively. I share those concerns.

Delphic Guidance
Are there drawbacks to full-scale Delphic forward guidance, where the central bank lays out the expected path of the policy rate and how it was calculated but makes no commitment? To me, the appeal is that it seems to meet public and political demands for transparency. If well explained, it could enhance understanding of the workings of the economy and the effects of monetary policy. However, it could also be confusing.

Households and businesses may not appreciate that the interest rate path is only today's forecast and not a commitment. The general public will probably not understand what lies behind the forecasts, while academics and investors may think their own models and forecasts are superior to those of the central bank. Making data, models and equations available to all interested parties does not substitute for thoughtful analysis and a clear message, even one acknowledging uncertainty. Pressures not to back track remain, not because backtracking would break a promise but because the central bank would be admitting it was wrong.

When I joined the Boston Fed in the 1970s the FOMC did not even announce whether it had decided to move interest rates – or not – after its meetings. However, the lack of transparency was part of a mystique surrounding the central bank. Monetary policy was made by wise, all-knowing, and mysterious beings. However, if central bankers said too much, they might prove otherwise. Delphic forward guidance may be a good thing, but it has its own challenges.

Having Cake and Eating It

The Federal Reserve's approach to forward guidance has an element of having it both ways. The FOMC's statements about its decisions since the Global Financial Crisis have always been qualified. There is almost always a statement - and sometimes more than one - that if conditions change, the Committee will change its policy as appropriate. However, for much of the time, the Fed wanted households and businesses to act as if there was a commitment – specifically, a commitment to low rates – and to spend and invest accordingly. The Fed may have reaped the consequences in 2022: as it raised its policy rate aggressively to bring down inflation, financial markets seemed to question its seriousness and to expect a quick return to low inflation and low interest rates.

Keeping a commitment to a particular monetary policy stance for an extended period depends not only on economic conditions but also on the decision-makers. In most central banks, certainly the Federal Reserve, monetary policy is made by a committee. Committee members have different understandings of how the economy works and while all presumably agree with the central bank's mandated objectives, they may attach different weights to inflation and employment and other issues. Committee members usually have long but staggered terms and turnover can be high. Thus, over time, decisions are made by a changing cast of characters and the policy-makers of tomorrow may not agree with those of today. Concern for institutional reputation may create a bias towards continuity; but tomorrow's policy-makers know they will be judged by the decisions they make during their tenure and by the economy's performance under their watch – not their predecessors'.