Mixed messages on forward guidance
Central banks risk increasing rather than lowering uncertainty
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The sharp rise in the use of forward guidance by central banks stems from a perceived need to find new, more effective monetary policy tools at the zero lower bound, where the application of standard tools is seen as ‘pushing on a string’. Numerous theoretical papers in recent years have been calling for new tools. It is worthwhile focusing on forward guidance and the problems associated with applying it – in particular, the danger that central banks end up giving mixed messages that create more confusion and uncertainty than they dispel.

The idea that central banks should not only care about the expectations of economic agents, but also provide them with guidance is nothing new. After inflation targeting became almost universally accepted, central banks found themselves getting increasingly involved in this activity.

Cryptic utterances
What started as cryptic utterances developed into code phrases and well-defined words (as used by the ECB). Central banks started publishing fan charts plotting the expected future path of interest rates and, in some cases (including the Czech National Bank), the exchange rate. All the same, providing higher quality, more detailed and explicit and more binding guidance appears to be de rigueur for any self-respecting central bank at or near the zero lower bound.

What is meant by forward guidance? Traditionally, central banks simply elaborated on and clarified their future expectations and forecast assumptions. The zero lower bound has pushed them into trying to do more. They have started to signal the bias that exists at the zero lower bound, i.e. that the risk of deflation must be taken more seriously than the risk of inflation, and to communicate the conditions under which they will exit their non-standard policies.

They have adopted mantras such as: ‘We will not exit this or that policy until we see a significant increase in inflationary pressures.’ Such statements effectively mean that the policy will not be ended until policymakers are quite sure they will not have to restart it in the foreseeable future. I regard such communication as quite appropriate to the circumstances. It makes the discontinuation of a particular policy conditional on the policymakers’ subjective state of mind.

A more elaborate – and quite widely recommended – way of communicating this bias is based on making the end of a particular policy (often zero rates) conditional on achieving some above-target level of inflation for a specified period of time, for example, in the case of a 2% target, inflation of ‘3% or above for three years’. This takes us into a world where the reversal of a policy is conditional on quantitatively described values of a set of macroeconomic variables, as opposed to the board members’ state of mind.

This sort of forward commitment has gained popularity among academics and advisers because of its seemingly stronger nature. A more ‘objective’ commitment, the reasoning goes, will deliver a more effective change in economic agents’ expectations, thereby enhancing the effect of the chosen set of non-standard macro-policy tools.

In practice, it appears that many central banks have succeeded in subjectively communicating their own individual perception of the risks associated with the exit from zero interest rates or other policy measures. However, the Federal Reserve’s first forward guidance on tapering has been anything but an unqualified success. The Fed and the Bank of England have started providing forward guidance in objective form, making their policies conditional on the state of the world. I am afraid this may not improve the effectiveness of the policy message.

In most models, forward guidance that makes policy changes conditional on objective events, i.e. the values of particular variables, reduces the uncertainty of agents and therefore generates superior welfare outcomes. However, at the zero lower bound, where central banks face greater uncertainty, this is more an artefact of the model than a feature of the real world. But this feature implicitly assumes that the central bank correctly guesses three things: the state of the world in which it will want to change its policies; the current and future quantitative relationships between the different economic variables; and the future meaning and content of particular data series.

These are rather brave assumptions even under normal policy circumstances. However, in the normal case, one can argue that the central bank’s knowledge of the economy gives it an advantage over other economic agents. Unfortunately, at the zero lower bound, there is not much difference between the knowledge of the average agent and that of the central bank.

Policy-making at the zero lower bound is partly an attempt to limit economic fluctuations, but it is also a special process where a central bank tries to navigate the economy from a transitional pre-crisis state to a more permanent post-crisis equilibrium. In addition, financial stability risks may force a central bank to end abruptly its unconventional policy measures.

Modern monetary policy
Modern central banks can operate under modern monetary policy frameworks – and under inflation targeting in particular – only because such frameworks involve the central banks constantly refining their procedures and models. This process enables the central bank to lead other agents. The problem is that a central bank that is supposed to be formulating objective forward guidance may not have accumulated sufficient knowledge about the zero lower bound economy.

This is why central banks are adding other, non-quantitative conditions to their numerically formulated forward guidance, conditions such as ‘under normal circumstances’ or ‘unless something unexpected hits the economy’. But the additional ‘small-print’ of such forward guidance may confuse the original message.

We central bankers should clearly limit ourselves to subjective forward guidance, i.e. guidance that makes any change in policy clearly-conditional on the state of mind of policy-makers, not on the state of the world.

This approach may be less clear to economic agents, but they must learn with us the unknowns of the zero lower bound and how we communicate them. By admitting that the world is an uncertain place, central bankers may end up giving more effective guidance on interest rates than by setting complicated conditions which are then watered down or ignored.

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