



Monetary Policy

(Advanced Monetary Economics)



ECON 4325

Outline:

- Introduction to Forward Guidance
- Forward Guidance at the ECB – by **Peter Praet**
- Empirics on Forward Guidance – by **Bletzinger and Wieland**
- Criticism of Forward Guidance – by **Goodhart and Sheard**
- The ECON 4325 **EXAM** : Q&A

- Forward guidance is the practice of communicating the future path of monetary policy instruments.
- Very very relevant in central banking.
- For Norway: Øystein Olsen speech at Columbia on 8 April, 2014:
- <http://www.norges-bank.no/no/om/nyhetsarkiv/2014/foredrag-i-new-york/>
- Why so important?



For not only do expectations about policy matter, but (...) very little else matters

(Woodford 2005)

Introduction

Different types of Forward Guidance

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- The effect of Forward Guidance highly depends on **Central Bank Credibility**. Why?
- How to achieve such credibility?
 - The answer to this question can be traced back to ancient Greece!

Odyssean

Just like Odysseus tied himself to the mast in order not to fall for the temptation of the Sirens' song, the central bank should commit itself to future policy decisions in order not to be drawn towards re-optimization.
(Dieffenthaler 2014)

Delphic

As the Delphi Oracle, the central bank seeks to provide guidance of what it views as the most likely outcomes for important variables in the economy, and it is crucial that this is communicated in a way that does not signal commitment of the form the Odyssean forward guidance provides.
(Dieffenthaler 2014)

Introduction

Different types of Forward Guidance

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Delphic

- Forecasts, but no commitment.
- Four central banks announce their explicit interest path. Which ones?

Odyssean

- Commitment
- **State-contingent** versus **Time-contingent** Odyssean Forward Guidance
- Can you think of examples of each?

Is one of these examples better than the other?

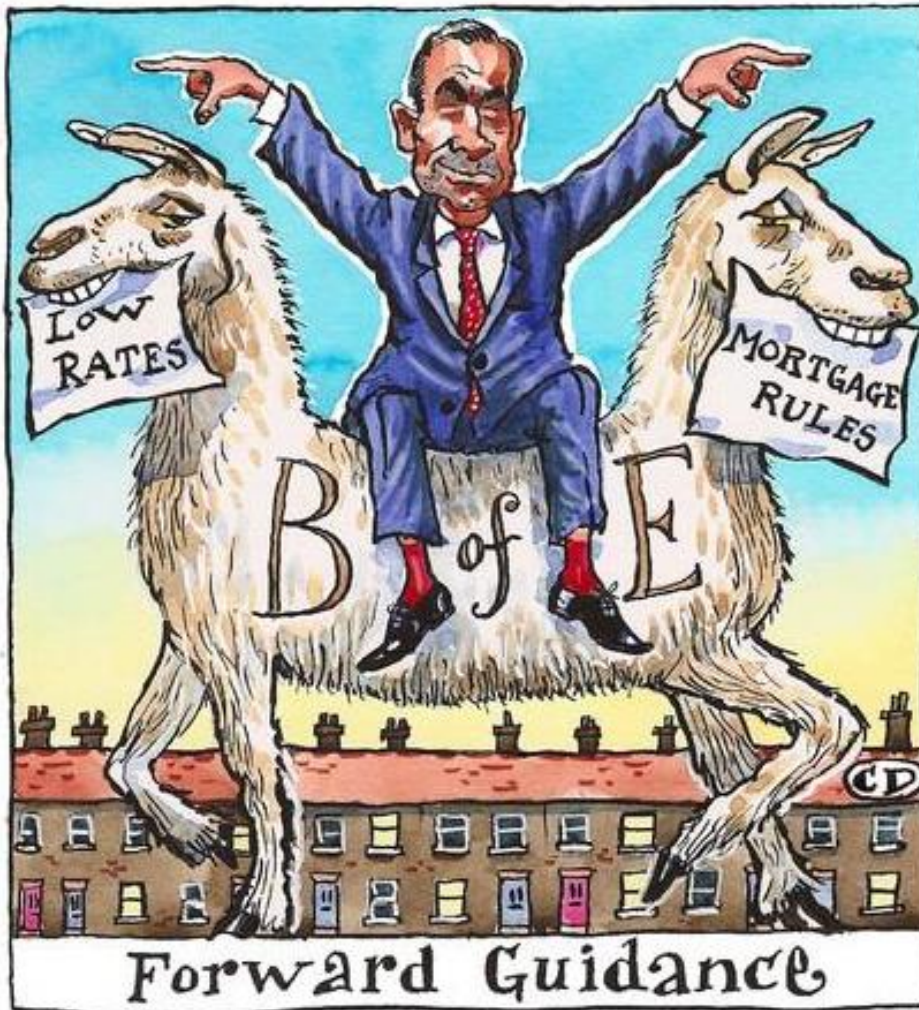
Why? Why not?

Is it a time-contingent answer (routine versus recent FG)?

Introduction

Forward Guidance and expectations

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Introduction

Pros and cons of Forward Guidance

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Arguments **in favor of** forward guidance

- Provides information about the CB's reaction function (strategy)
- Why is this a motivation?

Arguments **against** forward guidance

- Provides too much information (How can this be a problem?)
- The announced forward guidance may be time-inconsistent

Introduction

Key lessons about Forward Guidance

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1. No implementation of Forward Guidance has managed to closely align market expectations with policy makers' intentions.
2. Forward guidance aimed at stimulating growth creates a tension between this short-term objective and the central bank's objective of low and stable inflation rates in the medium term.
 - Does this result reduce the effectiveness of FG?
3. Communicating the **nuances of Forward Guidance** is a challenge. There is always a risk that the public mis-interpret the intentions of the CB.
4. Forward guidance may be beneficial even if it doesn't fundamentally affect anything because it may signal to the world that central banks will leave no stone unturned.

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ECB Forward Guidance

Introduction

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- The introductory statement to the Press Conference on 4 July 2013:

The Governing Council expects the key ECB interest rates to remain at present or lower levels for an extended period of time

- What type of Forward Guidance is this?

Main messages from Peter Praet (pages 25-35 in E-book):

1. Evidence indeed supports the view that **the way** in which a central bank communicates decisions is perhaps as important as the decision itself.
2. FG intervenes on both components of the expectations channel:
 - A central bank commits to never lose sight of its general purpose as spelled out in its mandate and statutes (**Odyssean**)
 - Monetary policy is contingent on the direction that the economy is expected to take (**Delphic**)

ECB Forward Guidance

How to interpret it?

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The Governing Council expects the key ECB interest rates to remain at present or lower levels for an extended period of time

- The purpose was **not** to communicate a suspension – even temporarily – of the ECB's strategy. Quite the opposite: it was a sharp and definite pronouncement to **reassert** it.

Why did the ECB find this necessary?

- Because private expectations regarding the stance of monetary policy and its evolution had become somehow detached from the ECB's assessment of the state of the economy, and monetary policy inclinations, given that assessment.
- The **Delphic** part: clearly conditional on the Governing Council's current assessment of the outlook for price stability.
 - If the facts change, they might change their minds!
- The **Odyssean** part: The FG is an expression of commitment to the ECB's primary objective

ECB Forward Guidance

Peter Praet's conclusions

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The Governing Council expects the key ECB interest rates to remain at present or lower levels for an extended period of time

Peter Praet:

1. This FG has **contributed to more clarity** over the ECB's assessment of the outlook and the reaction function.
2. This FG has contributed to **more stable money market conditions**
3. This FG has **helped to anchor market expectations** more firmly.
4. This FG has **ensured that the ECB monetary policy stance is not excessively vulnerable** to shocks that are disconnected from the underlying economic and monetary conditions in the euro area.

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Estimating the ECB Forward Guidance

What does it mean?

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The Governing Council expects the key ECB interest rates to remain at present or lower levels for **an extended period of time**

- How long is an extended period of time?
- Mario Draghi on August 1, 2013: Future rates are conditional on the ECB's macroeconomic outlook but there's no deadline.

*“As a matter of fact, you can ...
extract a reaction function and, from there,
estimate what would be a reasonable extended period of time”*

- Volker Wieland and Tilman Bletzinger (page 79-85 in E-book) tried to do this, i.e.:
 - Use a reaction function from the literature to project the interest rate path that is consistent with the macroeconomic outlook.

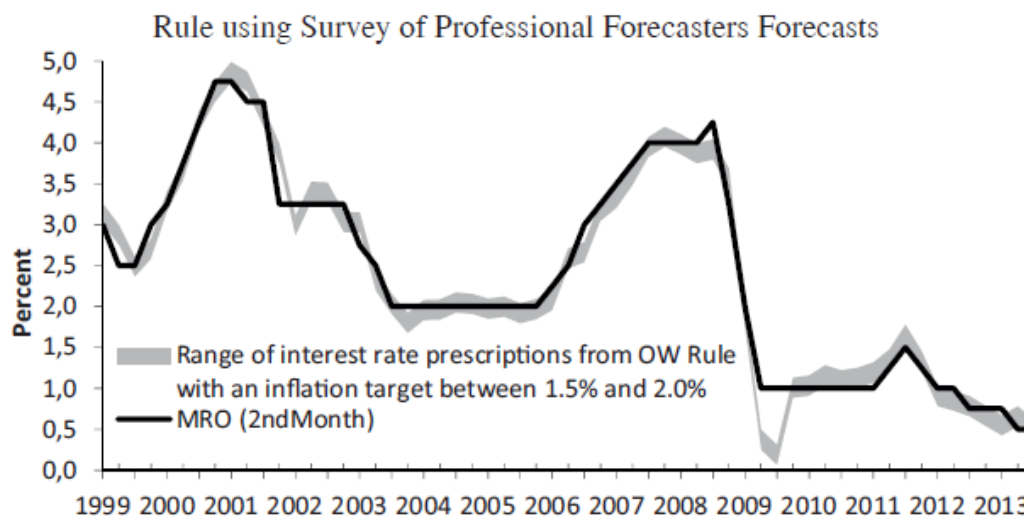
ECB Forward Guidance Estimation

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- **A two-step procedure:**
 1. Find a rule that captures the interest rate movements well.
 2. Forecast future movement.
- The **Orphanides-Wieland rule** assumes that the ECB changes the interest rate in response to the following two deviations (with equal weight):
 1. Deviations between forecast inflation and the ECB's target
 2. Deviations between forecast GDP growth and estimated GDP growth potential.

Matches the ECB's rate decisions well:

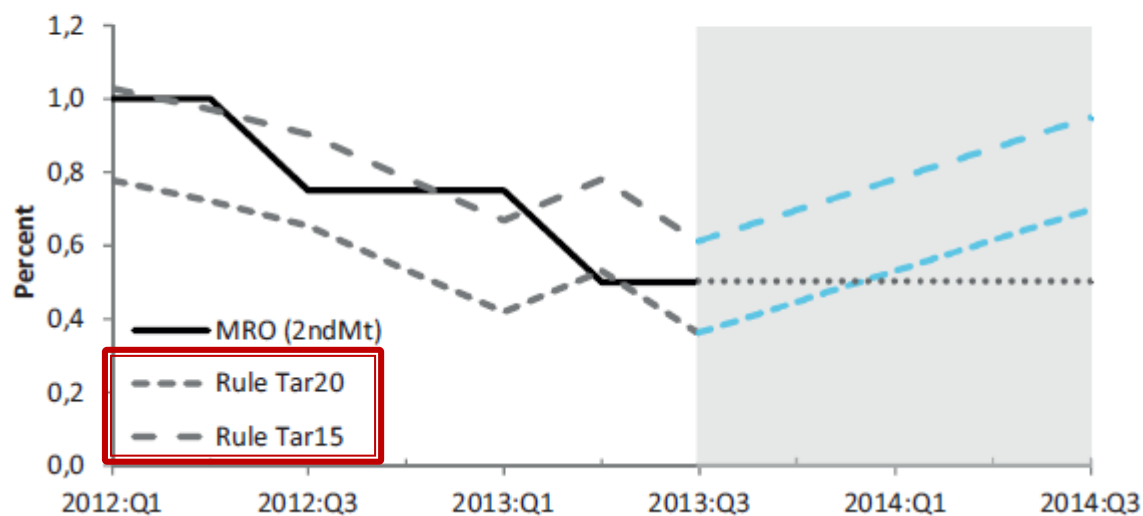
Figure 1 Main refinancing operations rate versus Orphanides and Wieland (2013)



Estimating the ECB Forward Guidance Results

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Figure 2. Projected rate path using the Orphanides and Wieland Rule with Survey of Professional Forecasters forecasts until 2014:Q3



Why do they provide projections for two different inflation rates?

1. The lower projection (based on the 2% target) breaches the current interest rate setting in Q1 2014.
2. By Q2 2014, both projections are above the current interest rate, which was then at 50 basis points.
3. The projections change with different forecasting tools

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Criticism of Forward Guidance

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A promise to be irresponsible (Paul Krugman)

Goodhart (pages 151-154 in E-book):

- Existing evidence does not support the main arguments in favor of forward guidance
- **Main argument in favor:** The CB knows best what it will do in the future and withholding that information would be suboptimal.
 - **Criticism1:** Not necessarily helpful for the public if the forecasts are wrong
 - **Criticism2:** Constantly changing the forecasts might hurt CB credibility
- **Main argument against:** An interest rate path is constructed by CB staff, not the committee.
 - Shifts power from the MPC to central bank staff and whichever members of the MPC are most involved in the forecasting process.
 - External members of the MPC who do not participate in the forecasting process will find that their power in setting policy rates has been significantly reduced

Sheard (pages 157-164 in E-book)

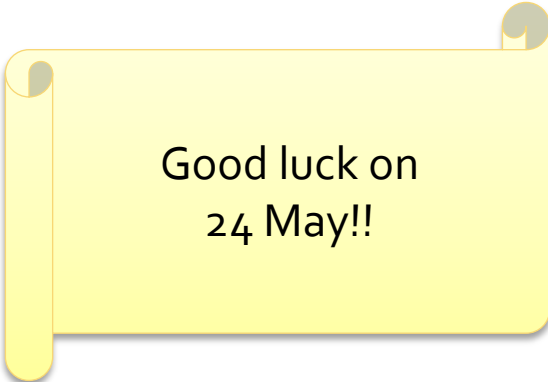
1. Because **economic data are noisy**, conditioning forward guidance on observable economic variables may infect the public's expectations formation process.
2. **More communication is not always better.**
Monetary policy works through financial markets, so central banks need to influence the expectations and behavior of financial market participants.
 - The more central banks communicate, the more market participants are incentivized to listen, which may create an unintended **"amplification effect"**.
 - Because countless market participants focus on every incremental message from the central bank, but often **react to the headline not the nuanced message**, the market's reaction to a communication surprise is prone to be amplified
 - The more transparent and generous with their communication central bankers become, the more they invite markets to hang on their every utterance, and the more prone markets may become to this amplification effect.

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The Exam Q&A

- We go through relevant exam information
 - What is required to get a good grade?
 - How is the exam built up?
 - How to best prepare?
- We go through last year's exam
 - How did we grade it, and why.



Good luck on
24 May!!

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