US Rates Strategy

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Forward guidance: Misguided or misjudged?

The FOMC statement and the new Chair's press conference indicate that the Fed is moving away from providing forward guidance. But criticism of forward guidance may be overstated. The slow policy response in 2022 reflected policy assumptions based on the post-GFC recovery. Guidance may work better if it is more data contingent. Ironically, this might require more Fed communication.

- Critics of forward guidance can point to the surge in inflation after COVID and the Fed's slow response. Inflation had risen to 8.5% by the time the Fed lifted off in March 2022.

- **However, we think there were two reasons for this slowness. Neither is necessarily a flaw in the concept of forward guidance. Instead, each reflects an overcorrection from past policy mistakes**.

- First, the Fed's policy framework was tilted toward maximum employment and the Fed wanted to proceed in an orderly manner from QE to tightening to prevent a replay of the 2013 taper tantrum.

- Because the Fed is credible, markets view the Fed's forward guidance as essentially a promise. This is reinforced by the sense that it "knows more" than the average forecaster. **That said, Fed models tend to overstate the significance of forward guidance – particularly at longer horizons**.

- **Since the dot plot does not provide context, it is difficult for markets to see the Fed's rate projections as being *contingent* on the state of the economy**. Forward guidance may be more useful as an "if/then" statement that may or may not be executed.

- We think there is a case for abandoning – or at least, significantly, changing – the dot plot. **Ironically for the new Fed chair, ceasing publication of the dots might require more Fed communication if it seeks to avoid surprising markets**. We think the Fed would need to communicate more details about its policy reaction function and update them more frequently.

Forward guidance

Forward guidance can take two forms. **In the one that has attracted the most attention and criticism, the Fed pre-commits to a specific policy over a certain horizon**. Policy pre-commitment has been used when the Fed is at the zero lower bound and cannot cut interest rates further. The time horizon can be calendar-based or more goal-based. Alternatively, forward guidance can be more contingent. Here the Fed outlines how its policy would respond to various economic conditions and maps out its policy reaction function. **We think of this other approach as equivalent to an "if/then" statement in computer programming**. Like the computer program, the guidance doesn't have to execute. As policy is more data contingent it can also be nimbler without disrupting markets.

The Fed's earliest pre-commitment forward guidance was calendar-based. The Fed considered forward guidance in conjunction with QE after it had cut interest rates to 0% and the post-GFC recovery remained weak. Initially, QE was meant to reduce the supply of safe assets to force investors into riskier ones to bring term, credit and mortgage rates lower. But QE also worked to strengthen the recovery because it was a forceful (pre)commitment to maintaining easier policy. This shaped expectations and pulled forward future spending and investment.[1]

In August 2011, the Fed argued that "low levels [of interest rates were] warranted at least through mid-2013. It extended the horizon to late 2014 in January 2012. But in September 2015 it combined calendar guidance with a more open-ended approach – rates would remain low "until after the recovery strengthens…at least through mid-2015". **In September 2020, the Fed removed any reference to a calendar timeline and instead pre-committed to keeping rates low until *both* inflation was at or above 2% *and* full employment was achieved**. It kept this language until December 2021.

Forward guidance or overcorrection?

Critics of forward guidance argue that the Fed maintained its post-COVID rate pre-commitment too long.[2] Indeed, by the time it lifted off in March 2022, CPI inflation had reached 8.5%. However, we think there were two reasons for the slowness of the Fed's response. Neither is necessarily a flaw of the concept. Instead, each reflects issues with its implementation. First, the Fed's policy framework was guided by the slow post-GFC recovery. And second, the Fed wanted to proceed in an "orderly, methodical and transparent" manner from QE to tightening to prevent a replay of the 2013 taper tantrum. Implementation flaws argue for a nimbler, more contingent approach to forward guidance.

Both implementation flaws in 2020 stem from overcorrections from past policy errors. In 2020, the Fed made two significant changes to its policy framework. First, it argued that the Phillips curve might be flatter. Using cross-sectional regional data, Hazell et al observed that a 1% reduction in the unemployment rate would increase inflation by just 0.34%.[3] A flatter curve would make it possible to run the economy hotter with a lower unemployment rate without pushing inflation higher. Indeed, as the unemployment rate fell to 3.7% in July 2019, inflation remained below 2%. Second, the Fed adopted FAIT – flexible average inflation targeting – where it would allow inflation to run above 2% for a time to make up for earlier sub-2% readings.

As a result, the Fed's policy was tilted to respond more to an undershoot in employment than an overshoot in inflation. While the FOMC was to base its decisions on "assessments of the shortfalls of employment from its maximum level", the framework didn't provide any numerical guidance. Based on the long-term forecasts from the September 2020 Survey of Economic Projections (SEP), maximum employment seemed consistent with a 4% unemployment rate. The Fed kept its September 2020 guidance in place

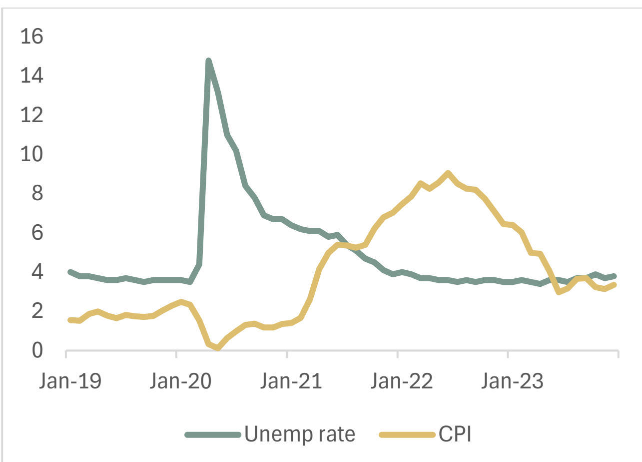
[1] As we discuss below, the scale of this effect is debated.
[2] See, "The Inflation Surge of the 2020s: The Role of Monetary Policy", G. Eggertsson and D. Kohn, Hutchins Center, Brookings Institution, 2023
[3] See, "The Slope of the Phillips Curve: Evidence from US States", J. Hazell, J. Herreno, E. Nakamura, and J. Steinsson, Quarterly Journal of Economics, 2022.

until December 2021, when the unemployment rate fell below 4%. But by then inflation was above 7% (Figure 1).

Mechanically, and as Chair Powell argued in his June 2021 press conference, the FOMC wanted to move from QE to tightening in an “orderly, methodical, and transparent” manner. But to avoid disrupting markets, this meant the Fed would move slowly to end its balance sheet expansion before lifting off. Tapering would be telegraphed in advance. **The Fed’s orderly approach reinforced the market’s view that it could not raise interest rates until it had completed the QE taper**.

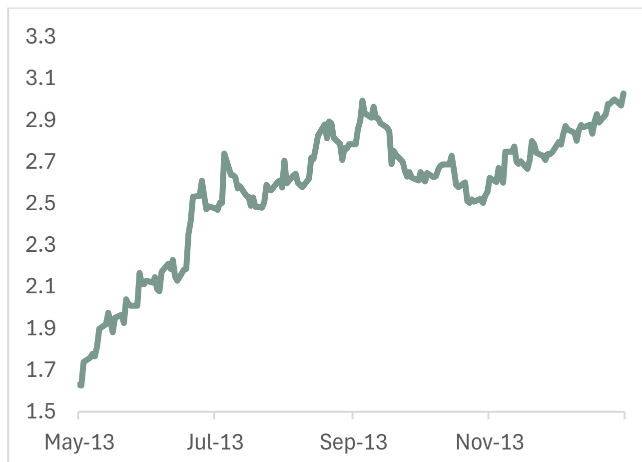
The Fed’s “go slow” and orderly approach to tapering and lift-off reflected memories of the 2013 taper tantrum. Back then, markets interpreted plans to slow asset purchases as a prelude to tightening. Between May 22, 2013, when Chair Bernanke first hinted at tapering QE to September, 10y yields rose 100bp (Figure 2). Although the Fed spent the summer arguing that the conditions necessary for lift-off were more robust than those arguing for a reduction in the pace of asset purchases, the Treasury market continued selling off. Markets were unable to separate slower asset purchases from tightening – even though lift-off did not occur until December 2015. And even then, the next hike wasn’t for another 12m.

Figure 1: CPI and unemployment (% y/y, %)



Source: BLS, SMBC Nikko

Figure 2: TSY 10y yield (%)



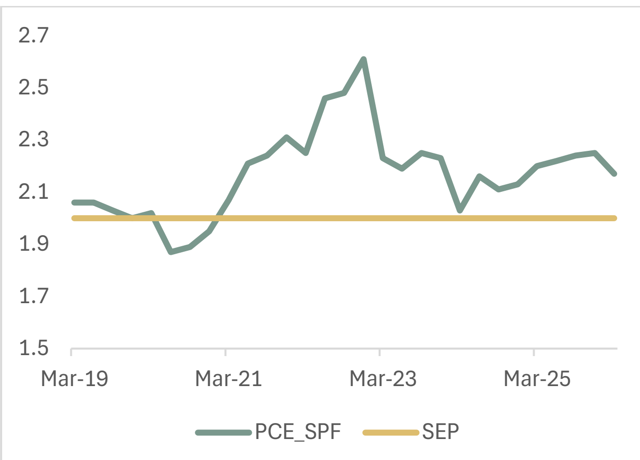
Source: Bloomberg, SMBC Nikko

Too credible?

A stronger critique of forward guidance is that markets interpret it as an unconditional guarantee. Because the Fed is credible, markets see the guidance as essentially a promise. Indeed, even as inflation was rising in 2022, the market’s long run inflation expectations were mostly stable and only rose above 2.5% in late 2022 (Figure 3). In the figure we plot the 10y projected PCE inflation rate from the Philadelphia Fed’s Survey of Professional Forecasters against the long-term PCE forecast from the FOMC’s Survey of Economic Projections (SEP). In effect, markets were willing to heavily discount current data in favor of the Fed’s long-run inflation projection. There is some disagreement about the sensitivity of market expectations to changes in the SEP. Bongard et al look at how macroeconomic news shaped expectations of the timing of the Fed’s lift-off. They conclude that markets do not entirely ignore the data flow and instead view forward guidance as (somewhat) conditional.[4] That said, the market's year-ahead rate forecasts and those in the SEP are quite close (Figure 4).

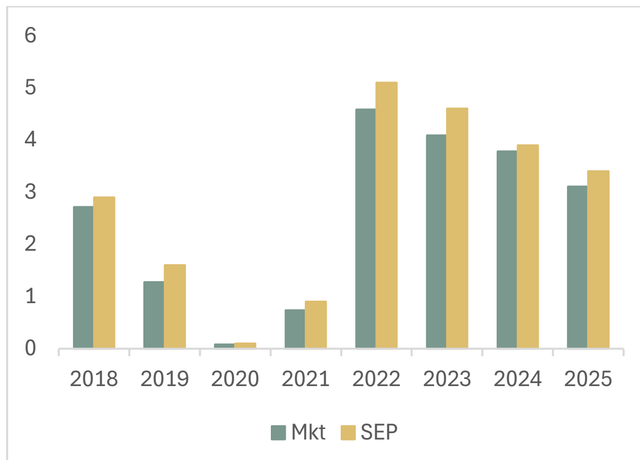
The market's belief that the Fed's forward guidance will come to fruition is compounded by the sense that it "knows more" than the average forecaster. Changes in policy guidance are thus "Delphic" – projections that suggest deeper knowledge of trends that have yet to show up in the broader, published data. There is some justification for this. After all, FOMC members have huge staffs that regularly speak with businesses across regions and process volumes of survey and economic data. That said, Warsh and others argue that the quality of this data is more "Delphic" – it is, vague, impressionistic and subject to interpretation. Much of the data collected is what the Chair described as historical "echoes" of an economy that no longer exists.[5]

Figure 3: Long-term inflation forecasts (%y/y)



Source: Philadelphia Federal Reserve, Federal Reserve, SMBC Nikko

Figure 4: Year-ahead fed funds forecasts (%)



Source: Bloomberg, Federal Reserve, SMBC Nikko

Fed models tend to overstate the significance of forward guidance – particularly at longer horizons.[6] This reflects the structure of these models which overstate how consumption responds to changes in future interest rates – that is, the willingness of households to substitute future for current consumption. Since households face borrowing constraints and income risk, they may be less able (or willing) to perform this spending shift. Accounting for these frictions reduces the stimulative power of forward guidance. Del Negro et al propose model modifications that account for more heterogeneity across households and the sensitivity of their spending to changes in interest rates.[7] That said, both studies suggest that forward guidance does work – at least at the zero lower bound.

[4] See, "Connecting the Dots: Market Reactions to Forecasts of Policy Rates and Forward Guidance Provided by the Fed", M. Bongard, G. Galati, R. Moessner and B. Nelson, De Nederlandsche Bank, September 2016
[5] Data issues are a focus of one of the Fed's task forces this year.
[6] See, "The Power of Forward Guidance Revisited", A. McKay, E. Nakamura, and J. Steinsson, American Economic Review, 2016.
[7] See, "The Forward Guidance Puzzle", M. Del Negro, M. Giannoni, and C. Patterson, Federal Reserve Bank of New York, December 2015.

However, it is not clear that pre-committed policy works well outside of emergencies. We think the market's difficulty in separating pre-commitments from contingent based forecasting is compounded by the Fed's dot plot. **Since the dot plot does not provide context, it is difficult for markets to see the Fed's rate projections as forecasts *contingent* on the state of the economy**. Markets cannot parse changes in the Fed's reaction function from changes in the Fed's underlying economic assumptions. We think this is an argument for abandoning – or at least, significantly, changing – the dot plot.

While we expect the dot plot will be an area of focus for the Warsh Fed, it is not clear if the FOMC is in favor of abandoning the dots without replacement.[8] **Ironically for the new Fed chair, ceasing publication of the dots might require more Fed communication if it seeks to avoid surprising markets**. We think the Fed would need to communicate more details about its policy reaction function and update them more frequently. This could include providing details about its underlying assumptions and, an "if/then"-like statement on the fed funds rate response. Analysts would then plug in their own growth and inflation assumptions into the Fed's reaction function. When real-time data deviates from their or the Fed's assumptions, the market could automatically update its rate projections. In theory, this should make it easier for the Fed to respond to changes in the economic outlook earlier without disrupting markets.

[8] We are waiting to learn more about the composition of the Fed's communications task force.

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