Forward Guidance and Monetary Policy Communications: Use Your Words and Connect the Dots

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Introduction

I thank Governor Ueda, the Bank of Japan, and its Institute for Monetary and Economic Studies for inviting me to participate on this panel. In the brief time allotted for my prepared remarks, I will discuss forward guidance. My basic point will be that the effectiveness of forward guidance as a policy tool in extraordinary times can be enhanced by improving monetary policy communications in normal times. Two phrases you often hear in real life are “use your words” and “connect the dots.” In my view, both should be applied to the FOMC’s monetary policy communications. Of course, the views I will present as a panelist will be my own and not necessarily those of the Federal Reserve System or of my colleagues on the Federal Open Market Committee (FOMC).

Forward Guidance as a Policy Tool

In extraordinary times, in particular, when the policy rate has been lowered to its effective lower bound, theory suggests that explicit forward guidance about the future path of policy can be used as a policy tool and not just for the purpose of transparency and communications. It has the potential to increase the current degree of monetary policy accommodation by influencing the public’s expectations. By reducing uncertainty about the future path of policy, forward guidance can help lower interest rates by reducing the premiums investors demand to compensate them for interest-rate uncertainty. In addition, in theory, if the central bank indicates that the future path of short-term interest rates will be held lower and for longer than would be consistent with the central bank’s past behavior, this can put downward pressure on longer-term interest rates, thereby adding accommodation. It has the potential to spur current economic activity because if people believe that the central bank is committed to keeping interest rates very low, they will expect higher economic activity and higher inflation in the future and that will induce them to make investments in capital and labor today. Note, though, that for forward guidance to have this effect, the public must believe that the central bank is committed to setting policy differently than it has in the past. If the public doesn’t understand this but, instead, believes that the central bank is behaving as usual, it could misinterpret a very low policy rate as suggesting a gloomier outlook, and this misinterpretation would work to depress current activity – the exact opposite of the intended effect.[1]

The Fed, along with other central banks, used forward guidance as a policy tool during the global financial crisis and during the pandemic.[2] As the FOMC gained experience, the form of its forward guidance during the global financial crisis changed over time, from qualitative guidance giving a qualitative characterization of the length of time economic conditions would warrant keeping the policy rate exceptionally low, to calendar-date guidance, to state-contingent guidance giving thresholds for the unemployment rate and inflation that would need to be met before moving off of the effective lower bound on the policy rate.[3] In the pandemic, the FOMC used state-contingent forward guidance, indicating that it expected to keep the funds rate target at 0 to 1/4 percent until the economy had reached maximum employment, and inflation had risen to 2 percent and was on track to moderately exceed 2 percent for some time. It put this guidance in place in September 2020, after the August release of the results of the FOMC's framework review and revised long-term strategy statement. And it kept this guidance in place until December 2021, when PCE inflation had been running over 3 percent since April 2021.

Challenges to Using Forward Guidance as a Policy Tool

Reviews undertaken after the global financial crisis suggest that forward guidance was, in general, a useful monetary policy tool, partly as a communications device and partly because it helped to support other unconventional actions taken by central banks.[4] But the reviews also suggest that forward guidance

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[1] See Woodford (2012).

[2] These were not the Fed's first experiences of providing some communication about future interest rates. The FOMC began releasing policy statements in 1994, and 2003 was the first time it included forward guidance on the expected future path of the policy rate. For a discussion of earlier episodes of very low interest rates in the U.S., see Carlson, Eggertsson, and Mertens (2008).

Other central banks used forward guidance before the global financial crisis, including the Bank of Japan, which introduced forward guidance in April 1999, two months after lowering its policy rate to zero in the wake of deflation. See Committee on the Global Financial System (CGFS, BIS) (2019).

[3] For a timeline of the forward guidance that the Fed used during the global financial crisis, see Mester (2018).

[4] See Committee on the Global Financial System (CGFS, BIS) (2019).

was challenging to design and estimates of the resultant reduction in long-term interest rates differ over studies. The changing nature of the forward guidance used during the global financial crisis and the formulation of forward guidance during the pandemic when inflation rose to unanticipated levels support the view that implementing the guidance is not an easy thing to do.

Two inherent difficulties come to mind. First, theory suggests that to be effective as a policy tool, forward guidance involves committing the policymaker to a future policy path that differs from one implied by the policymaker's usual policy reaction function. In other words, it commits the policymaker to using a different reaction function. But policymakers are loath to make those types of commitments – time-inconsistency problems loom large.[5] Contingencies can be included in the guidance, but that tends to limit the commitment, thereby watering down the potential effectiveness. Also, it is not clear that market participants pay enough attention to the conditional nature of the guidance. If they do not, then a change in policy, even if implicit in the guidance, could lower the central bank's credibility. Given the time-inconsistency problems, it is challenging for central banks to credibly commit to a policy path that differs from normal policy without a temporary change in the framework, e.g., price-level targeting. This suggests that explicit forward guidance about the rate path should be used judiciously and only in extraordinary times.

A second difficulty is that the effectiveness of forward guidance in extraordinary times depends on the public understanding that the policy path in the forward guidance is a deviation from normal behavior, which means the public needs to understand the policymakers' normal reaction function, which conveys how policy normally reacts to changes in economic conditions, whether those changes were anticipated or

[5] Evans (2017) discusses the time-inconsistency problems inherent in what he calls Odyssean forward guidance, which involves commitment, in contrast to Delphic forward guidance, which central banks use in normal times.

The literature has suggested different mechanisms for increasing the credibility of the commitment inherent in forward guidance, including temporarily increasing the inflation target, targeting nominal GDP instead of inflation, and targeting the price level instead of inflation. See the discussion of forward guidance and other policies at the zero lower bound in Woodford (2012).

not. It has been challenging to convey how policy is likely to respond *conditional* on how the economy evolves without implying that policy is pre-committed to a particular policy path *regardless* of how the economy actually evolves.

Enhancements to Monetary Policy Communications in Normal Times

The Fed has been enhancing its communications over time. Still, there are times when market participants' policy expectations differ from the FOMC's, which raises the question about the effectiveness of our communications in terms of their transparency and/or credibility. Market participants' expectations of the path of policy can differ from policymakers' expected path because market participants have a different economic outlook despite seeing the same data or because they don't understand policymakers' reaction function or don't view it as credible. Similarly, research suggests that the public also doesn't necessarily understand or pay attention to central bank communications, thus limiting the effectiveness of those communications.[6] But recent research using randomized trials suggests that the general public's belief that the central bank will maintain price stability can be enhanced with effective policy communication.[7] To the extent that enhancements to policy communications strengthen the public's understanding of the Fed's reaction function in normal times, it would make explicit forward guidance more effective when it is used in extraordinary times. I will make two recommendations for FOMC communications: use your words and connect the dots.

(1) Use your words: The FOMC policy statements have become shorter over time, giving less information about the FOMC's medium-run outlook and risks around that outlook, which form the basis of our policy decisions. While simpler is often seen as a virtue, it can also be a detriment, since policymaking has to be done in an uncertain world, one in which the economy is constantly being buffeted by shocks that can lead economic conditions to evolve differently than anticipated.[8] With short

[6] See Knotek, et al. (2024).

[7] In a study using randomized information treatments in the six largest euro area countries, Ehrmann, Georgarakos, and Kenny (2024) find that communicating information about the inflation target can increase the central bank's credibility to maintain price stability over the medium term, even in periods in which inflation has risen.

[8] I discuss uncertainty and monetary policymaking in Mester (2016).

statements, each word takes on added significance. Short statements suffer from what I call a "Hotel California" problem: we are reluctant to change particular words because of the possible signal that doing so may send. Words "check in" but it is hard to get them to "check out" even when it is desirable. One could argue that the use of "transitory" to describe inflation stayed in the FOMC statement far too long, given economic conditions.[9] Short statements also make it harder for the public to see the linkage between economic developments and policy action or inaction. When members of the public don't understand the rationale for policy decisions, it can leave them with the impression that policymakers are acting in a discretionary manner and that lessens credibility.

In my view, it would be preferable for policymakers to take control of the narrative by using more words to describe the current assessment of economic developments, how they have influenced the outlook, and the risks to that outlook. Putting somewhat less weight on the modal outlook and more on potential risks to the outlook would help the public understand that if certain risks are realized, policy may have to deviate from the previously communicated modal path. It would give market participants and the general public a better sense of the contingent, data-dependent nature of policymaking and would raise the central bank's credibility in that a change in policy would be seen less as a breach of promise. Scenario analysis should also be incorporated as a standard part of communications.[10] This could be particularly useful in periods like today when the underlying structural elements of the economy may have changed.

(2) Connect the dots: My second suggestion is for the FOMC to connect the participants' policy path dots and their economic projections in the Summary of Economic Projections (SEP).[11] In other words, the FOMC should publish the anonymized matrix of economic and policy projections so that

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[9] "Transitory" was removed as a characterization of inflation in the FOMC's December 2021 statement. Year-over-year PCE inflation had been running above 3 percent since April 2021.

[10] I discussed this recommendation in Mester (2023).

In his review of the Bank of England's forecasting and communications, Bernanke (2024) suggests including analyses of alternative scenarios in both internal discussions and as part of communications to the public. Such alternative scenarios could illuminate salient risks to the outlook when economic conditions evolve differently than expected or the underlying structure of the economy differs from what is assumed in the models.

[11] I discussed this recommendation in Mester (2018).

market participants can see the linkage between each participant's outlook and his or her view of appropriate monetary policy associated with that outlook. Currently, the variables in the SEP are not linked across participants, and the median paths provided don't necessarily represent a coherent forecast. For example, there is no guarantee that someone projecting the median inflation path would necessarily be projecting the median output path. There is no way for the public to know whether a person low in the range of unemployment rate forecasts is high in the range of inflation projections. And two participants could project the same federal funds rate paths, but those paths could be associated with very different economic forecasts. If we were to connect the dots to the forecasts within the SEP, the public would get a better sense of each individual policymaker's reaction function.

Of course, broader enhancements to communications should be considered, including reconsidering the formulation of a consensus forecast of the FOMC, providing more information on how the FOMC considers financial stability issues when setting monetary policy, the interplay between balance-sheet policy and interest-rate policy, and the use of simple monetary policy rules as benchmarks for explaining policy decisions.[12] Enhancements to communications would make monetary policy more effective in normal times and also improve the effectiveness of nonconventional policy tools, such as forward guidance, in extraordinary times. I expect that the FOMC will consider communications as part of its next monetary policy framework review, given the central role communications play in the implementation of monetary policy.

[12] In 2012, the FOMC experimented with developing a forecast representing the consensus of the Committee. I discuss the benefits and challenges of formulating a consensus FOMC forecast in Mester (2016).

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