Systematic Policy and Forward Guidance

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Building on the Legacy of Charles I. Plosser (1948-2025)
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The path towards better policy and communication

"Over the past several years, the Fed has taken some beneficial steps toward increased transparency, which I believe will serve the economy well now and in the future. I believe the Fed should continue on this path by more clearly articulating a systematic approach to policymaking, centered on using robust simple rules as guides to both its policy decisions and the way in which it communicates those decisions." (November 15, 2012.)

Forward guidance in theory

"[F]orward guidance is communication about future policy actions – the likely future path of the policy rate or monetary policy more generally.

...

Appropriately employed, forward guidance can help the public form more accurate expectations about the future path of monetary policy and thus help promote stability in financial markets and the economy." (February 12, 2013.)

Discretion undermines policy effectiveness

"The Committee has repeatedly opted for language that allows a great deal of discretion to behave as it chooses, depending on the circumstances. But effective forward guidance demands commitment. When the Committee stresses the general flexibility of its policy decisions or makes vague references to data dependency, it does little to clarify the FOMC's intentions about future policy, even though clarity is what the FOMC wants to provide to the markets through its forward guidance. Thus, there is a fundamental tension between wanting to provide clarity as to the forward course of policy and wanting to maintain complete discretion. The Committee has failed to address this tension, which undermines the effectiveness of its policy. (July 12, 2013.)

The problematic nature of date-based forward guidance

"*Date*-based forward guidance is problematic. Instead, a systematic approach provides *data*—-based forward guidance. Policy decisions should be made and explained in terms of economic conditions, not the calendar." (November 15, 2012.)

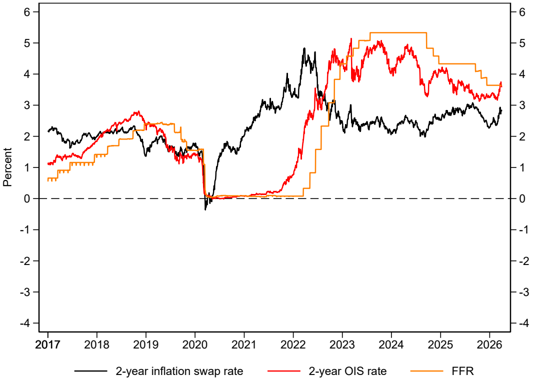
"We must avoid a false sense of certainty regarding future policy or a mistaken sense of commitment to a specific path of policy rates." (May 28, 2014.)

Forward guidance is not an independent tool

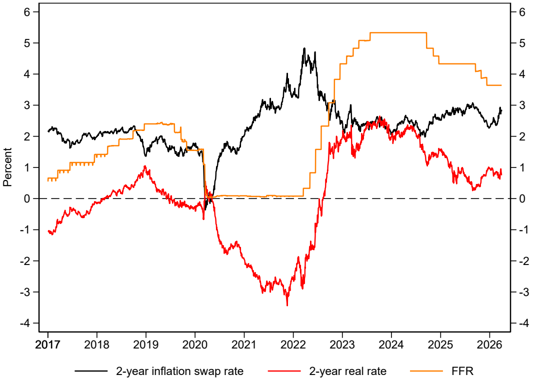
"However, forward guidance is not a separate or independent tool of policy. Its effectiveness is intimately related to other features of monetary policy. For example, a credible, systematic approach to policy and the general openness and transparency of the policy process are essential elements in shaping expectations and thus must be considered when formulating forward guidance." (May 28, 2014.)

The forward guidance trap

Expected inflation and nominal interest rate



Expected inflation and real interest rate



Expected inflation as measured by 2-year inflation swap rate. The real interest rate reflects the 2-year OIS rate minus the 2-year inflation swap rate.

Systematic policy and forward guidance

"[A]rticulating rules as guides provides the best kind of forward guidance, which would be helpful in stabilizing the economy and the path of inflation."
(November 15, 2012.)