Benoît Cœuré: The usefulness of forward guidance

Speech by Mr Benoît Cœuré, Member of the Executive Board of the European Central Bank, before the Money Marketeers Club of New York, New York, 26 September 2013.

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The slides referred to in the speech are available on the ECB website.

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Ladies and Gentlemen,

It's a great pleasure to speak to you tonight.

I will use this opportunity to elaborate on the latest tool that central banks have adopted to deal with the macroeconomic consequences of the global financial crisis. This tool is forward guidance.

What does forward guidance mean in a monetary policy context?

Well, if you allow a brief definition, forward guidance can be described as explicit statements by a central bank about the likely path of future policy rates. These statements are typically conditioned – more or less explicitly – on the evolution of certain key macroeconomic aggregates.

Up until 1970s that central bank communication was based on secrecy and market surprise[1]. But central banks moved away from surprising markets and, instead, moved to open and transparent monetary policy making. Guidance on the future course of monetary policy was even common practice in some central banks before the crisis. For example, since 1997, the Reserve Bank of New Zealand has included in its communication practice the release of the numerical projection of the future path of the policy rate.

However, forward guidance as it was introduced during this crisis has been an unprecedented step for many central banks; both in terms of scope as well as clarity. I will argue that this recent initiative of central bank communication is a useful addition to the central bank toolkit. At a time of unprecedented challenges, it ensures that central banks do not only act with a steady hand but also speak with a steady voice.

To set the stage, I will first give you my take on the design considerations surrounding forward guidance, including its rationale; the pros and cons of different types of forward guidance; and ways for measuring the effectiveness of forward guidance.

Then, I will zoom in on the euro area and discuss the ECB's forward guidance along these dimensions.

Forward guidance: design considerations

So what's the purpose of forward guidance?

Forward guidance aims to ensure that market expectations on future monetary policy are indeed consistent with the policy intentions of the respective central bank. Of course, a central bank's communication should always provide reliable signals to markets that make their way through the yield curve to affect the financing conditions in the economy. Otherwise, monetary policy may, in itself, become a source of volatility, thus complicating the economic decisions of private actors – the exact opposite of what it should achieve.

[1] See Brunner (1981) and Goodfriend (1986). For an empirical evaluation see Cook and Hahn (1989).

But the premium on clear communication is particularly large in extraordinary situations, for example when policy rates are at, or close to, their effective lower bound, or when the normal channels of monetary policy transmission are impaired, or when there is exceptional uncertainty on the state of the economy. Such situations occur only seldom. This makes it difficult for private agents to infer the future monetary policy path from past regularities. Hence, there is a clear added value in such a situation to making central bank communication more explicit.

This explains why many central banks that had previously *not* used forward guidance adopted this tool in recent times.

How does forward guidance work?

Well, first of all, most central banks have linked forward guidance to their main policy interest rates.

In implementing their monetary policy, central banks calibrate their main policy tools so as to establish a certain level of short term interest rates in the market. At the same time, *expected* future short term interest rates are a key ingredient for the determination of long term interest rates. Long term interest rates in turn are essential for saving, consumption and investment decisions, and ultimately for the development of prices and inflation in the economy.

Indeed, some recent papers on central bank communication provide clear evidence that central banks' communication on their policy decisions and their assessment of the macroeconomic environment can have an important effect on long term interest rates.[2]

Through forward guidance – that is by providing more systematic guidance on the expected path of future policy rates – central banks can exert a stronger influence on market expectations of future short term interest rates. In fact, the central bank will have more direct leverage on broader financing conditions along a broader maturity spectrum. Some central banks have also attempted to influence the term structure at longer maturities more directly, for example by giving regular indications to markets on the future pace, composition and timing of their asset purchase programmes.

In any case, forward guidance is a means to establish consistency between the current policy measures and the long-term policy orientation. But for this to work, the content of the forward guidance has to reflect the central bank's mandate. Only then will the central bank's announcements be perceived as credible.

Let me explain this in more detail. From a conceptual perspective two types of forward guidance can be distinguished depending on the objective pursued[3].

First, forward guidance can aim at merely providing greater transparency about policy intentions. This can entail two elements. The first element is to provide greater clarity about the central bank's assessment of the economic outlook that is relevant for the assessment of medium term risks to price stability and further policy goals it may pursue. The second element is to provide more clarity on how the central bank will react to such outlook.

In certain cases, the market's assessment of the economic outlook may clearly deviate from the central bank's assessment. Moreover, even with a shared assessment of the outlook, the market may expect a systematically different policy response than pursued by the central bank.

In these cases, forward guidance can help the central bank in clarifying its assessment of future economic conditions and its reaction function.

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2 See Brand et al. (2010), Gürkaynak et al. (2005), Kuttner and Posen (1999), Bibinger et al. (2013).

3 See Praet (2013) for a detailed exposition of this distinction. See also Campbell et al. (2012) for the taxonomy of "Odyssean" vs. "Delphic" forward guidance underlying this distinction.

This can be especially valuable at times when upward volatility in financial markets risks creating risk premia along the yield curve, thereby inducing a premature withdrawal of monetary accommodation.

Second, forward guidance can serve to communicate to market participants that the central bank's policy intentions have changed.

Most notably, the central bank may try to convince markets that it would keep interest rates low, even if this would imply inflation well above its previous objective, at least temporarily. The promise of higher future inflation, if credible, induces private agents to substitute future for current consumption, hence providing additional stimulus today. This type of forward guidance is closer to the academic concept of forward guidance in the strict sense – as discussed, for example, in Woodford (2012).

The main challenge of such guidance is its inherent inconsistency over time and thus lack of credibility. When the time comes, the central bank may be tempted to deviate from its prior commitment: once the benefits of higher inflation expectations in terms of front-loaded spending have been reaped, the central bank may not be willing to pay the bill in terms of higher inflation afterwards. If the public foresees this temptation, expectations might remain unaffected in the first instance and the desired inter-temporal substitution of spending might not materialise.

This is a possible explanation why, in practice, central banks have refrained from using forward guidance in a way that implies a major change in strategy. Therefore, central banks' forward guidance has rather aimed at providing greater clarity on the reaction function and the assessment of future economic conditions.

But forward guidance also faces challenges if it merely serves to clarify economic outlook and reaction function.

In particular, the adoption of forward guidance may be interpreted as a sign that the central bank is indirectly disclosing negative information about risks to the economic outlook. In this case private agents may infer from the forward guidance statement that the recovery may be slower or deflationary pressures stronger than widely anticipated. As a consequence, forward guidance could have a contractionary, rather than an expansionary, effect on economic sentiment.

Hence, in order to be effective, the announcement must emphasise the path of future policy rates, albeit conditional on the underlying state of the economy.

The ECB's forward guidance

These considerations have been integral to the design of the ECB's forward guidance. Let me explain why.

In its July meeting, the Governing Council announced that it expected the key ECB interest rates to remain at present or lower levels for an extended period of time. This expectation has been based on the overall subdued outlook for inflation extending into the medium term, given the broad-based weakness in the real economy and subdued monetary dynamics.

The decision to adopt forward guidance was motivated by the sustained upward and steepening trend displayed by the structure of money market interest rates in the preceding months (see Slide 2). This trend had led to a situation in which part of the accommodation introduced through earlier policy action was being withdrawn.

Moreover, the increased volatility in money market rates made expectations of the effective stance vulnerable to shocks that were disconnected from underlying economic conditions.

Thus, precise communication about our monetary policy orientation was necessary to protect the still nascent economic recovery and the healing of euro area capital markets from overly tight and volatile monetary conditions.

Against this background, the ECB's forward guidance follows two concrete objectives: first, to curb interest rate volatility over the policy-relevant horizon; and second, to anchor rate expectations more firmly around a path that ensures the degree of monetary accommodation warranted by the outlook for price stability.

The ECB's objective is not to *suppress* money market volatility. In this crisis, abundant central bank liquidity has compressed prices in many financial market segments. The ability of markets to price two-way risk will be a factor of resilience along the normalisation path. Our objective is therefore not to steer money market rates towards a predefined value but to ensure that their fluctuations remain within reasonable bounds and do not hurt economic recovery.

When interpreting the Governing Council's forward guidance, three elements are particularly relevant.

First, it has been provided before exhausting the scope for further reductions in the key ECB interest rates. In fact, the forward guidance formulation, as decided unanimously by the Governing Council, explicitly incorporates an easing bias, thereby accounting for the possibility of further cuts in policy rates.

Second, and most importantly, forward guidance is firmly anchored on the ECB's mandate and monetary policy strategy. In particular, the path of the policy rates remains conditional on the outlook for inflation and will be reviewed over time within the analytical framework provided by the ECB's monetary policy strategy.

This analytical framework assesses both economic and monetary developments relevant for inflation. In particular, the conditionality of the forward guidance reflects the two-pillar strategy. That is: the medium-term outlook for inflation is evaluated in terms of economic analysis indicators confirming a broad-based weakness of real economy; and it is evaluated on the basis of monetary analysis indicators confirming subdued monetary dynamics.

Third, forward guidance helps us to focus on our mandate, as it de-emphasises the policy relevance of any single data release and concentrates on the medium term. In other words, through our forward guidance we communicate one – and only one – expectation on how our key interest rates will evolve. It is this – and only this – communication that is relevant to assess our policy orientation. Unless this communication changes, the policy orientation remains unchanged.

Has forward guidance achieved its objectives? It is probably too early to answer. But allow me a preliminary assessment. Looking at money market conditions, a number of indicators give us comfort that, in the absence of forward guidance, money market rates would have displayed more upward volatility than was observed.

First, the influence of shocks coming from outside the euro area has been dampened (see Slide 3). Before 3rd July when our forward guidance was announced, econometric evidence from high frequency money market data could not exclude that the 1y1y OIS swap rates in the US and the euro area exhibited a stable relationship. This relationship broke down after 3rd July, but recovered after a while, although with a lower coefficient than before the introduction of forward guidance.

Second, the uncertainty about future monetary policy has declined, which represents a positive outcome of forward guidance (see Slide 4). Less uncertainty about our policy orientation is consistent with lower term premia in money market rates.

And third, forward guidance has somewhat reduced the sensitivity of money market forward rates at various horizons to news and data surprises – of the type which should have a muted impact on our monetary policy conditions.

These include news that are unrelated to euro area fundamentals, for example communication by other central banks about their own monetary policy decisions. And they include data releases that merely confirm our assessment of the outlook, and hence do not bring new information that can change that assessment.

However, one might reasonably ask whether the impact of forward guidance for the whole euro area has been constrained by financial fragmentation. To this I would respond that it is important to emphasise again that the ECB's forward guidance is linked explicitly to the main policy rate(s) in the euro area. And however fragmented interbank markets are, guiding expectation about the future path of the main refinancing rate is relevant for the refinancing conditions of banks across the euro area.

Overall, preliminary evidence suggests that forward guidance has helped to anchor money market conditions in the euro area more firmly to levels which we consider as an appropriate monetary policy stance, given our present assessment of the outlook for price stability. This can only be confirmed over time. And it is over time that forward guidance will prove its usefulness in protecting our nascent economic recovery.

Conclusion

Let me conclude.

Faced with sluggish economic activity and limited room for manoeuvre, several central banks have adopted more explicit communication on their future policy orientation in the form of forward guidance. This has served to reassure market participants and the general public that central banks will preserve their monetary accommodation against the backdrop of persistently low growth, employment and inflation.

In designing their forward guidance, central banks have been guided by the particular features of their respective economies and the specificities of their mandates.

The common feature among the different forms of forward guidance that have emerged over recent months is that they all aim at reinforcing rather than changing expectations on the overall policy orientation of the respective central bank. It is an essential condition for them to be credible.

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