What the future holds – Benefits and limitations of forward guidance

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1 Introduction

Ladies and gentlemen,

More than 200 years ago, French scientist Pierre-Simon Laplace proposed that the universe was essentially deterministic and, hence, predictable. Some being – later called a demon – with sufficient information and calculating power would be able to know all the states of the universe: past, present and future. [1]

In today's financial markets, Laplace's demon could easily earn a fortune. But despite all the progress in computing, it has never come into existence. Still, some people may dream of its possibility. Brazilian author Paulo Coelho once quipped that everything was possible: "from angels to demons to economists to politicians". [2]

Financial market participants are no demons: they carefully monitor every word uttered by central bankers, because failing to anticipate the central bank's next move could be costly.

For a long time, central bankers were reluctant to provide hints on their expected future course of action or communicate openly. A good example is former Fed Chair, Alan Greenspan, who once told Congress: “If I seem unduly clear to you, you must have misunderstood what I said”. [3] And according to Otmar Issing, central banking was “presented as an esoteric art”. [4]

Over time, monetary policy has clearly become more of a science and less of an art. [5] Economists have formulated reaction functions, which are supposed to summarise how central banks respond to economic conditions. Often, relatively simple rules such as a common Taylor rule are considered. Of course, monetary policymaking is much more complex than that. But just for the sake of argument, I would ask you to think of such a standard rule when it comes to the reaction function.

Central banks have also increased transparency and extended communication in order to enhance their accountability to the public and make monetary policy more effective. In the wake of the financial crisis, as policy rates approached zero, more and more central banks switched from dipped beam to full beam: using forward guidance, they began to shed light on their reaction function.

By indicating that they would withdraw the monetary policy stimuli later than the public expected at the time, central banks attempted to further reduce longer-term interest rates when policy rates had already reached low levels. [6] In this context, I would like to distinguish two approaches to forward guidance:

First, the central bank can clarify its reaction function if there is a misperception or uncertainty about it among the public due to imperfect information.

And second, the central bank could communicate that it intends to deviate from previous behaviour in the future.

However, just as in the case of any other policy tool, the public may face the problem of disentangling information regarding the central bank’s policy from information on the state of the economy. In times of considerable uncertainty, observers could – falsely – interpret an unexpected expansionary policy move as a signal that the central bank deems aggregate demand to be weaker than they had anticipated. By dampening inflation expectations, the surprise could have an unintended adverse effect on the economy temporarily. [7] Therefore, monetary policy decisions need to be communicated very carefully and clearly.

What is more, the lines between the two types of forward guidance I have laid out may be less clear-cut in economic reality. However, to keep it simple, I will squarely attribute the communication provided by the Eurosystem and many other central banks to forward guidance of the first type. [8]

Today, I would like to reflect on the experience we have made in the last few years, but I will also discuss possible pros and cons of the second, more daring type of forward guidance. I will close with some remarks on monetary policy in the euro area.

2 Clarifying the reaction function

In recent years, the Eurosystem's forward guidance evolved and, at times, communicated the Governing Council's expectations on both the lift-off of policy rates and the duration of asset purchases.

With the introduction of the Asset Purchase Programme (APP) in 2015, guidance was given along two dimensions by providing a timeframe and outlining the necessary progress of inflation towards our policy aim. The calendar-based component was easy to communicate and understand. And the state-contingent element acted like an automatic adjustment mechanism to economic news. If incoming data indicated a delay in the firming of inflation towards our policy aim, it implied continuation of net asset purchases beyond the calendar-based component.

Later, the forward guidance on policy rates was linked to the duration of the Eurosystem's net asset purchases. A prolongation of these purchases shifted the timing of the first rate hike further into the future. This connection was well-understood and worked accordingly. Indeed, Bundesbank research shows that rate forward guidance linked to the APP contributed to the observed decline in longer-term interest rates to a significant extent. [9] In other words, part of the expansionary effect of the purchase programme was due to the management of expectations about interest rates in the more distant future. [10]

Last year, the Governing Council announced the end of APP net purchases after December 2018 and decided to link the two elements of forward guidance directly to policy rates. This reformulated guidance succeeded in anchoring expectations about future short-term rates despite the end of net purchases and, therefore, contributed to keeping longer-term interest rates low.

More generally, by using rate forward guidance, central banks can do what they also do when employing asset purchases, namely to influence long-term rates and stimulate the economy when conventional policy is constrained.

Besides shaping expectations, asset purchases can work through other channels, such as portfolio rebalancing, as well. But they also entail different risks and possible side effects, all the more so in a monetary union with fiscally autonomous member states. In this particular set-up, government bond purchases involve the fundamental risk of mutualising sovereign liability risks through the central banks' balance sheets, blurring the lines between fiscal and monetary policy.

Given its effectiveness, forward guidance could be a preferred policy tool near the lower bound of interest rates. Indeed, the reformulation of forward guidance introduced in September maintained the focus on policy rates.

3 Lower for longer

At the effective lower bound, theory, at least, suggests that the central bank could do more if it switches to the second type of forward guidance. By committing to hold interest rates lower for longer than implied by the monetary policy rule, the central bank pledges to let inflation overshoot its target in the future. In this way, it could provide an additional stimulus to the economy via inflation expectations. If people expect future inflation to be temporarily higher than anticipated so far, real interest rates will decline even when nominal rates remain unchanged. This, in turn, will induce them to consume and invest more in the here and now.

But why have central banks so far shied away from using forward guidance in this manner?

One important reason may be the problem of time inconsistency. [11] Let's say that a father wants to make sure his son studies up on his Latin vocabulary. It makes sense, then, to announce that he will quiz his son next Thursday evening. But when Thursday arrives and Arsenal takes on Eintracht Frankfurt, there is every reason for the father to cancel the test, since he has already made his son study. His optimal choices are time-inconsistent. And his son is not outsmarted so easily. He will call his father's bluff, as he knows the Europa League schedule just as well as his father does.

Similarly, a one-off promise of "lower for longer" holds the allure of a monetary stimulus now, at the cost of higher inflation in the future. But when the time comes to make good on the promise, the benefits have already been reaped, and only the cost of higher inflation remains. At this point, policymakers have an incentive to renege on their promise as well.

But such an approach still raises further problems. In the case of the euro area, it should be kept in mind that, according to our existing strategy, the Governing Council defines price stability as a year-on-year increase in the HICP for the euro area of below 2% and aims to maintain inflation rates below, but close to 2% over the medium term. Thus, intentionally higher inflation rates would not be consistent with this strategy and may pose a communication challenge and a credibility risk.

Moreover, for “lower for longer” to work as intended, inflation expectations of firms and households need to respond accordingly: short-term expectations have to adapt to the central bank’s guidance without de-anchoring long-term expectations from the inflation target. This is certainly no mean feat. A study on various advanced economies suggests that expectations of households and firms do not respond much to announcements on monetary policy in an environment of low inflation. The researchers refer to this as a “veil of inattention”. [12] Central banks would need to pierce it by adjusting and intensifying their communication in order to use inflation expectations as a more active policy tool.

Furthermore, after a long period of low interest rates, holding interest rates lower for even longer would aggravate the risks and side effects of a very expansionary monetary policy.

For example, the longer the period of negative rates persists, the more likely it is to place a burden on banks that primarily generate their income from traditional deposit-taking and lending operations. This is what we observe in the euro area. In this context, the relief which the new tiering system will provide to banks is likely to be perceptible, but modest. It is the indirect effects of negative interest rates and, for banks engaged in maturity transformation, also the flat yield curve that matter more.

Of course, safeguarding the profitability of banks is not a task of the Eurosystem. However, the pressure on bank profitability arising from negative interest rates could eventually cause banks to cut back on lending despite additional expansionary monetary policy measures, thereby impairing the transmission of monetary policy.

Beyond its impact on bank profitability, a prolonged period of low interest rates may also induce investors in search of yield to take on undue risks that could sow the seeds of financial imbalances. Eventually, this could undercut the central bank’s ability to maintain price stability.

Clearly, the first line of defence against financial imbalances should be macroprudential policy. But this policy approach is still in its infancy, and our knowledge about the effects and transmission channels is incomplete. Given this uncertainty, macroprudential policy may be prone to an inaction bias – that is to say, the inclination to act too tentatively and thus too late, or not at all. [13] Hence, we should not be over-confident about the role macroprudential policy can play in addressing systemic risks. Monetary policy cannot be complacent if its policy stance raises long-term risks to price stability through the build-up of financial imbalances.

4 Achieving price stability in the euro area

As Luis de Guindos said on Monday, we are aware that the expansionary stance of monetary policy in the euro area comes with side effects, and that the side effects are increasing. [14] And I keep on making this point for quite some time now.

At the same time, price pressures in the euro area remain subdued. Therefore, monetary policy accommodation is still warranted.

At least, financial market expectations of considerable further policy rate cuts have receded in recent weeks and months. Among other positive news, the German economy did not slip into a technical recession, and first tentative signs emerged that the downturn in its export-oriented industry could level off.

Moreover, wage pressures in the euro area point in the right direction. In the second quarter of 2019, hourly wages went up by 2½% year-on-year, and the total wage sum increased by almost 4%.

True, a recent Bundesbank study finds that the cyclical impact of wages on prices in Germany has become weaker since the 1970s. In recent years, however, the pass-through has remained roughly stable and intact. [15] Our economists estimate that a 1% rise in wage costs in Germany increases consumer prices by around 0.3%. But the analysis also shows that the transmission can take several years. With that in mind, the slow strengthening of inflation shouldn't really come as a surprise to us.

An ECB study suggests that this is also the case for other major euro area economies. [16] In a low inflation setting, the transmission could even take longer than under normal circumstances.

The Governing Council has deliberately geared its policy aim towards the medium term without further specification. This allows us to take lags into account, such as the pass-through from wages to prices. Our strategy also gives us the leeway not to respond to every slight revision in the inflation outlook mechanistically or even with full force, as long as the overall trajectory is still intact and the relevant inflation expectations remain anchored.

But it is also true that near the effective lower bound of interest rates, fiscal policy is less at risk of crowding out private demand. Under current conditions, this makes it a potentially powerful instrument if economic developments were to take a marked turn for the worse – which, just to be clear, is not what is generally expected.

5 Conclusion

Ladies and gentlemen,

Dennis Gabor, the British physicist who invented holography and won the Nobel Prize in 1971, noted that the future cannot be predicted, but it can be created. [17]

It is worth investigating which monetary policy approaches allow the Eurosystem to respond vigorously in an economic downturn. But these policies have to be evaluated carefully in light of both potential benefits and costs. In my short remarks today, I have only been able to highlight a few issues on forward guidance.

I fully agree with Christine Lagarde. The monetary policy strategy should always evolve in a way that best serves our mandate. [18] Since our strategy has been in place since 2003, it may be worth collecting lessons from the financial crisis and the more recent past at the appropriate time.

In my view, this should include, among other things, the question how to handle long-term risks to price stability arising from financial imbalances.

As Claudio Borio once warned us, economic lessons "are learnt, forgotten, re-learnt and forgotten again". [19]

Laplace's demon would know better.

Thank you for your attention.

Footnotes:

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