Challenges of Forward Guidance

For much of its history, the Fed was famously tight-lipped about its actions. It's hard to believe now, but until 1994, we did not publicly release a policy statement after each Federal Open Market Committee (FOMC) meeting. The minutes of meetings also remained secret until the late 1960s and then were released only after about a 90-day lag.

We have come a long way since those days. Today, the Fed issues a policy statement immediately after each FOMC meeting, releases the minutes three weeks later, and releases verbatim transcripts after five years. This increased transparency is healthy for the Fed as a public institution, and it was also supported by a growing body of research that emphasized the importance of central bank communication and credibility.

The Fed's initial steps toward greater transparency involved providing more information about current monetary policy. But in the early 2000s, the Fed also began to provide general information about the likely path of future policy through "forward guidance." During the Great Recession, the Fed again employed and continued to evolve its forward guidance. At first, the FOMC used general language as it had previously. Then, it introduced specific, calendar-based guidance in its August 2011 statement, signaling that it would likely be necessary to maintain low rates "at least through mid-2013."

The move to calendar-based forward guidance was heavily debated within the committee at the time, as the transcripts of the meetings from that period reveal. Some policymakers felt that a calendar date helped reinforce the Fed's forecasts for the future path of the economy, which the FOMC began releasing in the form of the Summary of Economic Projections, or SEP, earlier that year. But others

worried that tying future policy to a date put the Fed in an awkward position. If economic conditions didn't evolve the way policymakers predicted, then they would either have to follow through on a date-based plan that no longer made sense or revise the date, diminishing its value as a signal of future behavior. In times of great uncertainty, that was asking for Fed credibility to be put on the line.

THE SHIFT TO OUTCOME-BASED GUIDANCE

In December 2012, the FOMC moved from calendar- to outcome-based guidance. It said it would be "appropriate" to keep rates low "at least as long as the unemployment rate remains above 6-1/2 percent, inflation between one and two years ahead is projected to be no more than a half percentage point above the Committee's 2 percent longer-run goal, and longer-term inflation expectations continue to be well anchored."

This approach made it clearer that Fed policy would be driven by economic conditions, not dates. It was an effort to provide the public with a clearer understanding of how the Fed would react to new data, and it gave the Fed greater flexibility in times of heightened uncertainty.

Still, the transition to outcome-based guidance wasn't seamless. The formula outlined at that time isn't a simple one. Certainly, those three criteria don't just roll off the tongue. It's also not a precise one, as judgment calls are required. How would the public know if inflation expectations were no longer well-anchored? (See "Forecasting Inflation," p. 24.)

Another potential problem is that the outcomes in the statement could prove wrong if the economy shifted. This means that as with dates, the Fed might need to revise its outcomes, leading to similar communication and credibility challenges. This is one reason why the Fed doesn't attach a specific number to the employment goal in its forward guidance today.

The Fed is facing challenges now as it seeks to navigate a highly uncertain recovery from the pandemic. Inflation has been above our long-run 2 percent target for months, but how long will this run-up in prices persist? Employment remains far below pre-pandemic levels, but has the economy changed in ways that have shifted the maximum level of employment? What about fiscal policies not imagined when our guidance was defined?

Finally, it seems clear to me that many audiences find outcome-based guidance unsatisfying because it cannot provide a definitive roadmap of the Fed's future policy path. Trading instruments are often date-based, so traders would prefer to know exactly when monetary policy is going to change. For reporters and the public they serve, outcome-based guidance can seem like inside baseball and is not as easy to process as dates.

WHERE DO WE GO FROM HERE?

If the public keeps asking for dates, should the Fed go back to issuing calendar-based forward guidance? It's clear from past experience that this isn't the optimal path. Markets and reporters may want clear dates, but in times of high uncertainty, the Fed can't credibly commit to guiding policy by dates rather than data.

Sticking with outcome-based guidance, the Fed could try to be more specific about its thresholds, but past experience also suggests this approach has limitations. It's harder to get alignment among the committee. The higher the level of specificity, the higher the risk that you'll bind yourself to a less than optimal path. Surely, there's some value to leveraging good judgment. In addition, some of the Fed's objectives, like maximum employment, are hard to forecast and are influenced by factors outside of our control.

We could strengthen the connection between the SEP and outcome-based guidance. I like the SEP because it disciplines me to tie my policy prescription to my economic forecast. In times when forward guidance is a crucial component of Fed communications, I think that through very carefully. That said, since the SEP isn't a committee consensus, we could still run into a communication problem where the SEP and policy statement send conflicting messages.

Ultimately, I think the most important thing we can do to build confidence in forward guidance is to cleanly execute. In the early 2000s, the Fed signaled that it would follow a gradual path for rate liftoff and then did so. The so-called "taper tantrum" of 2013 — when long-term bond yields surged suddenly in reaction to an announcement by the Fed that it would soon taper its buying of bonds — was an example of when Fed communications and forward guidance were not so well aligned.

Hopefully, we are executing during the COVID-19 recovery in a way that builds credibility. Regarding our guidance on asset purchases, we have maintained a stable course. In December, we said we would continue "until substantial further progress has been made toward the Committee's maximum employment and price stability goals." In July, we said that "the economy has made progress toward these goals." In September, we said that "if progress continues broadly as expected, the Committee judges that a moderation in the pace of asset purchases may soon be warranted." That is the advance warning we had promised so that no one would be surprised when the time to start tapering came, as it did in November.

That still leaves forward guidance on rates, which is explicitly different. We said in September 2020 that we would keep rates near zero until "labor market conditions have reached levels consistent with the Committee's assessments of maximum employment and inflation has risen to 2 percent and is on track to moderately exceed 2 percent for some time." We have hit 2 percent on inflation, but we still have a lot to learn about whether recent inflation levels will be sustained and how much room we have to run in the labor market until we get to maximum employment. As COVID-19 eases, if all goes well, I expect the answers to these questions to become clearer.

Cleanly executing communication is my goal. Doing so best cements outcome-based guidance as a tool comfortable for us and valuable for the markets and for the public. **EF**

A longer version of this essay was delivered as an address to the Forecasters Club of New York on Oct. 14, 2021.

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"What Does the FOMC's Shift in Fed Funds Rate Target Language Mean?" Economic Brief No. 21-22, July 2021

"How Macroeconomic Forecasters Adjusted During the COVID-19 Pandemic," Economic Brief No. 21-19, June 2021

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