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‘Forward guidance’: new monetary policy instrument or esoteric fad?

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Abstract

In August 2013, the Bank of England adopted a new monetary policy known as ‘forward guidance’. This article sheds light on this landmark moment and rather obscure policy instrument. We pursue this endeavour by unpacking the rationale of this policy, its implementation modality and the international evidence on its impact. We then raise important questions about whether this policy is needed in the UK, and about the downsides of this seemingly innocuous monetary experiment.

Keywords: Bank of England; forward guidance; monetary policy.

Forward guidance (henceforth, FG) is the term used to describe the practice of central banks of announcing, often through a verbal statement, the path of future interest rates. In a nutshell, this unconventional monetary policy, which could be said to rest on an esoteric communication strategy, aims at influencing future interest rates via pledges to keep them low. It is, essentially, a last resort measure called upon when the official Bank Rate (the base rate) hits or is close to zero. The Bank of England’s (BoE) Monetary Policy Committee (MPC) had previously decided that in the UK the base rate would not go lower than 0.5%, the rate in place since March 2009. Hence, unable to lower further the current base rate because of this floor, FG seeks to reduce

future rates by inducing the expectation that the base rate will not rise above 0.5% for longer than might have been anticipated by the markets.

At its meeting on the 1st of August 2013, therefore, the MPC agreed to leave the base rate unchanged at 0.5% at least until the unemployment rate has fallen to 7% (from the 7.7% level of August 2013), provided this does not pose risks to inflation or financial stability. The details of this new monetary policy stance reached the markets on August 7, when FG was announced as part of the BoE quarterly Inflation Report press conference (Bank of England, 2013a).

The adoption of the latest fashion in monetary policy by the BoE, of course, owes a great deal to Mark Carney, the former Bank of Canada (BoC) governor who took over at the BoE in July 2013. Whether Carney's appointment by the UK Government (which was eager to see more monetary stimulus to boost growth) had anything to do with his well publicised support for FG since introducing it in his role as Canada's chief central banker, remains a matter of speculation. However, what is clear is that the Government is set to benefit from the BoE's new policy stance given that monetary policy by the BoE, unlike the Government's fiscal policy, can be changed at any time, without having to wait for budgets. Budget deficits and fiscal measures are always politically sensitive, particularly at times of austerity, and voters reward politicians who do not mess up the government budget.

Whatever the actual degree of political influence on the monetary policy orientation of the allegedly 'independent' BoE, in the absence of evidence to the contrary FG must be seen as a BoE-inspired policy initiative which some commentators even take to signify a consolidation of BoE independence following the Government's regulatory reforms that came into force in April 2013 (which resulted in the BoE gaining significant new responsibilities). Either way, the

adoption of FG undoubtedly marks a significant shift in UK policy behaviour. Carney's arrival in the summer of 2013 had market participants speculating as to whether he would be able to persuade other MPC members over the implementation of FG, especially given MPC members' well known scepticism towards this policy and their loyalty to the renowned motto of Carney's predecessor, Sir Mervyn King, who always insisted that decisions of a given month's interest rates should only be taken in that month. Indeed, ever since the BoE was granted independence in 1997, this was the guiding principle of the MPC: no pre-commitment to any future interest rate decisions.

Forward guidance explained

Given its relative novelty, FG is still perceived by most as a rather obscure instrument in the toolkit of policy makers; a 'black box' whose workings are not understood by or accessible to the wider audience of non specialists. Standard textbooks are of little use in this case, as there is a shortage of textbooks that can be of help on this new topic and even if such textbooks did exist, much like the few academic articles on FG, they would probably be more concerned with examining the technical complexities of the 'flat end of a yield curve' (the typical graphical depiction of yields or interest rates across different contract terms or 'maturities') rather than clarifying, in clear and simple terms, what FG is really about.

The idea underlying FG is that lowering forecasts of the future base rate will reduce the rates paid on fixed interest longer-term loans (which feed into aggregate spending mainly through durable consumption and investment), and will give those considering taking out a loan on variable rates, confidence that rates will stay put in the short term, thus encouraging more

consumer spending. This is expected to provide more effective support to the recovery since the longer the central bank credibly commits to maintaining its policy rate, the larger the effect on longer-term rates (Woodford, 1999). The logic of this transmission mechanism stems from ‘expectations theory’ of the term structure of interest rates (see seminal work by Wood, 1964), which suggests that long-term interest rates are determined by markets’ expectations of short-term rates (controlled by the central bank via the base rate), plus a risk premium. This link between short- and long-term rates is said to exist because trading in financial markets removes arbitrage opportunities across securities with similar risk profiles and different maturities. As a consequence, returns are expected to equalise across the term structure (except for premia accruing to investors holding longer term securities). It is through this process aimed at influencing expectations about the evolution of interest rates in the predictable future that this new policy communication strategy attempts to impact decisions about borrowing, investing and spending.

According to the BoE, providing guidance is about clarity and transparency; helping people better understand the future path of interest rates, and how such a path could help the MPC respond more effectively to the challenges posed by “*the current exceptional economic circumstances*” (Bank of England, 2013b). Specifically, the BoE’s normative register attributes to FG three merits:

- It provides greater clarity about the MPC’s view of the appropriate trade-off between how quickly to return inflation to target and how much stimulus to provide to the recovery in terms of growth and employment;
- It reduces uncertainty about future interest rates as the economy recovers;

- It gives the MPC a measure of how much the economy can expand without causing inflation or risks to financial stability.

In recent years, several central banks around the world have adopted FG. As outlined by Carney (2013) himself, there are three main modalities of implementation. The first is known as ‘open-ended guidance’ (as provided by the Bank of Japan since 1999, the Federal Reserve in 2003, 2008 and 2009, and the European Central Bank in 2013). Open-ended FG provides qualitative information about the expected future path of policy – for example, stating that the base rate is expected not to rise above its current level for an unspecified ‘extended period’. This communication strategy affords flexibility in responding to unanticipated developments but provides a vague policy statement that remains open to misinterpretation.

Time-contingent guidance (as adopted by the BoC since 2009, and the Federal Reserve in 2011, and January and September 2012) provides a clear indication of when monetary policy is likely to change by pre-announcing that the base rate is expected not to rise above its current level until a specified future date. This approach is generally thought to remove at least part of the ambiguity embedded in open-ended guidance but at the cost of the ‘hostage to fortune’ posed by changes to the wider economic outlook or, alternatively, at the cost of serious damages to the credibility of the central bank should it revise its guidance (thus renegeing on its policy announcement) in response to such unanticipated developments. Moreover, market participants might still overreact to unanticipated changes in economic conditions, with a consequent change in expectations about the actual path of interest rates irrespective of the time-contingent FG announcement.

Finally, state-contingent, threshold guidance (as adopted by the Federal Reserve in December 2012, and now the BoE) specifies the future economic conditions that might prompt a change in monetary policy, for example, stating that the base rate will not rise above the current level until a particular economic variable reaches a certain threshold. By linking the path of monetary policy to economic conditions rather than to a pre-announced date, state-contingent FG is believed to help people understand how and why the central bank will respond to unanticipated developments, and to update their expectations about the future policy path.

Yet, this FG modality too, has disadvantages. First, it is itself susceptible to misinterpretation. Moreover, financial market participants as well as ordinary people may have their own view about how the selected variable(s) are likely to evolve over time. Furthermore, linking the path of monetary policy to only one or few variables could also lead to ‘expected’ rises in the base rate that were not warranted by the broader economic conditions. That said, the policy can specify that instead of triggering an automatic rise in interest rates, meeting the threshold can trigger a reassessment of the policy stance.

This is indeed the FG model adopted by the BoE. At its meeting in August 2013, the MPC agreed not to raise the base rate from the 0.5% floor at least until the Labour Force Survey headline measure of unemployment had fallen to a ‘threshold’ of 7%, subject to the conditions outlined below. The policy statement added that the MPC stands ready to undertake further asset purchases via quantitative easing (currently at £375 billion) while the unemployment rate remains above 7% if it judges that additional monetary stimulus is required, but it will not consider selling any such assets unless those conditions are met. (Bank of England, 2013b)

The BoE FG announcement further noted that provided such an approach remains consistent with the primary objective of price stability (as defined by the Government’s 2%

inflation target), the unemployment threshold would cease to hold if any of the following three ‘knockouts’ (conditions) were breached. The first condition is if the MPC expects that inflation (as measured by the consumer price index) will rise to more than 2.5% in the next 18 to 24 months. The second is if the MPC believes that medium-term inflation expectations “*no longer remain sufficiently well anchored*” (Bank of England, 2013b); BoE language for inflation ‘spinning out of control’. The third is if the BoE believes that the current monetary stance poses a “*significant threat*” to financial stability (ibid).

The above explanation should suffice in highlighting that, in many ways, the significance of FG goes far beyond the three technical merits the BoE attributes to it to justify its adoption. First, the implementation of FG signals an important shift in BoE’s internal decision-making and the power of the Governor since it undoubtedly affirms Carney’s influence on the MPC despite substantive internal disagreements on this new policy.

Second, given the extraordinary and historically unique character of contemporary monetary policy (0.5% since March 2009), it is of course reasonable that the BoE seeks to rationalise criteria for any future interest rate increase. However, what is rather puzzling is that the BoE chose unemployment as a sort of policy goal as well as an indicator. Macro-economic policy over the past three decades has downgraded unemployment, and it is unclear, therefore, whether by choosing unemployment the BoE is re-emphasising its importance as a policy goal, or it is merely adopting this indicator as an unambiguous (inverse) correlate for growth.

Finally, FG has far reaching implications that extend well beyond the MPC’s activities. For example, FG is likely to affect financial management in the public sector (which involves government spending, revenue raising, and borrowing) alongside the open market operations carried out by government in order to change the composition of the outstanding stock of

government-issued debt instruments (public debt management). Indeed, although FG does not directly alter the ‘size’ of the debt, the ‘composition’ of the debt is typically characterized by the outstanding debt's maturity structure, itself dependent upon future rates, which is what public debt management is mainly concerned about to minimise the cost of such debt.

Evidence from the international experience of FG

As argued by Contessi and Li (2013), the empirical literature on the efficacy of FG is still in its infancy, still leaving open even the question of how its impact should be measured. That said, the few studies that have examined the international experience of FG appear to have taken as their yardstick the extent to which the forward announcements actually changed expectations of interest rates.

Starting with Japan’s experience of (open-ended) FG, the evidence available is mixed. For example, Okina and Shiratsuka’s (2004) findings suggest that the guidance stabilised financial agents’ expectations about the path of short-term interest rates thereby also reducing longer-term rates. On the other hand, Bernanke *et al.*’s (2004) ‘event studies’ of the movements in three market-based indicators of the private sector’s monetary policy expectations during the periods surrounding the Bank of Japan (BoJ) decisions, do not provide much evidence that the BoJ was successful with FG in 1999, and similar guidance issued in 2001, with no noticeable effects on market expectations.

Studies of Canada’s time-contingent FG provide equally contrasting evidence. For example, contrary to the findings by Chang and Feunou (2013) who showed that FG reduced uncertainty about the future path of interest rates in Canada, Chehal and Trehan (2009) found

that while the BoC's commitment affected interest rates initially, the effect was short-lived. Moreover, in comparing the BoC's time-contingent guidance of 2009 with the Federal Reserve's open-ended guidance of 2008 in the US, they took the close correlation between Canadian and US forward rates either side of the expiry date of the BoC's guidance in mid-2010 as an indication that the announcement of a fixed policy end date did not, by itself, significantly affect expectations of monetary policy in Canada differently from the announcement of open-ended guidance in the US. This evidence would suggest that agents are cognisant that FG, whether open-ended or time-contingent, would ultimately be influenced by the economic outlook, whose changes already form the basis for updating their expectations. Woodford (2012) examined Canada's FG experience of 2009, and found that it had an immediate effect on market expectations across all term lengths of the 'yield curve', particularly over the longer-term.

The evidence relating to the US experience too is anything but convergent. Kool and Thornton's (2012) analysis of the 2003-2005 period indicates that FG in the US did not improve market participants' ability to forecast future short- and long-term rates. Campbell *et al.* (2012) estimated the effects of unexpected FOMC's policy announcements (taken as shocks to the stance of monetary policy) on Treasury security and corporate bond yields containing an expectation component. They obtained a significant effect for the 1990-2007 period but mixed estimates for the 2007-2011 period. Finally, Raskin (2013) focused on the extent to which the time-contingent guidance altered perceptions of the change in policy for a given change in economic conditions between August 2011 and December 2012. He found that the FOMC's time-contingent FG "*did more than signal a weaker outlook - it altered perceptions of the Committee's likely reaction to evolving conditions*" (Raskin, 2013: 30).

Although, to date, there has been no appraisal in the literature of the more recent Federal Reserve's 'state contingent threshold-based' FG (issued in December 2012), it is worth highlighting that there was little response of interest rates on the day that the FOMC's guidance was announced. One may take this as evidence that it did not affect expectations at least in so far as the change from the previously adopted time-contingent variant of FG is concerned.

Overall, therefore, the evidence-base available on the effectiveness of FG is at best contradictory with no consensus from which to discern a conventional wisdom that would have supported the adoption of such a policy initiative also in the UK.

Effective monetary policy instrument or esoteric fad?

Probably owing to the recentness of the FG implementation by the BoE, intellectual engagement in the UK over its alleged merits is still scant, and the concerns surrounding the usefulness of this esoteric monetary experiment have, to the best of our knowledge, not yet been raised in the pages of scholarly journals. Our focus here is to begin to address this gap, by raising a few but nevertheless important questions, if not reasoned objections, which can provide a platform for future scrutiny and debate.

Is this further monetary stimulus really needed in the UK?

A low interest rate environment for the foreseeable future is arguably a good thing (though not for all, as savers, insurers, and pension funds are hit hard by a regime of low interest-rate returns, which also discourages savings). Hence it is all the more telling that the FG promise of low rates for longer – which should have been welcomed by financial markets – was met with scepticism

since after the BoE press conference in August 2013 the FTSE 100 recorded a sharp fall of 1.4% and longer term gilt yields, far from falling as a result of the FG pledge, actually rose (see Roland and Martin, 2013). In October 2013, Stewart (2013) also observed that sterling had appreciated by almost 4% against the US dollar since Carney had taken the helm, hitting a nine-month high at the end of September 2013 – evidence which further suggests that markets expected interest rates to rise sooner than the BoE is indicating.

One reason for the less than enthusiastic reaction of the markets might be that FG was fraught with so-called ‘knockouts’, that effectively offered wide get-out clauses allowing the BoE to change interest rates even if the unemployment threshold is not reached. This, in effect, increases the very uncertainty the policy intends to reduce.

Another possible reason for the markets’ response, might relate to the issue of whether the markets perceived such a (presumed) monetary stimulus as called for. Carney’s conference speech (see Carney, 2013) outlined a fairly gloomy assessment of the UK economy, noting that unemployment would not fall below 7% until 2016 and that UK output was still 3% below its peak. Yet several positive data in the weeks preceding the FG announcement (relating to higher consumer confidence, rising house prices, increased service sector activity, higher manufacturing output and a doubling in the rate of GDP growth between the first and second quarters of 2013) suggested a better than expected recovery of the UK economy which was confirmed in October 2013, when the Government’s Office for National Statistics (ONS) released data indicating strong GDP growth of 0.8% in the third quarter of 2013 compared to the second quarter.

This begs the question of whether the circumstances the BoE faced were really so “exceptional” as to warrant a further expansionary monetary measure. After all, the UK has had above target and fairly stable inflation since 2008. This would suggest that there is no gap

between actual output-employment and the level at which monetary policy should intervene. Whilst there is, doubtless, still a considerable misalignment between the level of current activity and that which prevailed up to 2007, it is certainly not the remit of monetary policy to fill the gap of the residual consequences of supply side shortfalls stemming from the dysfunctionalities of the financial sector.

Furthermore, a monetary stimulus, especially of this esoteric kind, would at best lead to an expectations-fuelled, short-term surge in activity which would inevitably be followed by further uncertainty and - possibly a few quarters later - by higher inflation, with non-trivial implications for the real economy. Sustaining the short-term surge in activity, would then require additional expansionary measures later on, creating a spiral of ephemeral short-term stimuli of little benefit to a sustainable long-term recovery of the real economy. Real supply side problems, if they are indeed still being experienced to an extent deemed worthy of intervention to strengthen what the BoE perceives as an anaemic recovery, would require real not monetary solutions, and the vague *verba volant* of the MPC's FG announcement seem to be no match for firm policy action.

Does FG have a 'credibility' problem?

Having acknowledged that the UK economy was already picking up at the time FG was issued, and assuming the policy is at least to some extent effective, then the unemployment level should be expected to fall even faster than the MPC anticipates but – possibly with a few temporal lags to account for the timing of transmission effects - at the cost of rising inflation later on. This means that - as illustrated by the 'rules rather than discretion' literature on the inconsistency of

optimal monetary policy – the policy is not credible, or, put it in economic jargon, ‘time consistent’ (Kydland and Prescott, 1977; Barro and Gordon, 1983).

Remaining with the theoretical literature, one can find – of course - also the fairly isolated support to the idea of holding interest rates lower for longer, guided by thresholds (see Eggertsson and Woodford, 2003), but there are significant differences between the outcomes of a theoretical model (usually fraught with numerous convenient assumptions) and the practical optimality of policy making during changing conditions. Indeed, should a sustainable recovery take hold in the UK in the near future, it will no longer be optimal for the BoE to honour its commitment even if the unemployment threshold has not been yet reached, prompting the BoE to realign monetary policy on the basis of what is best for the time, namely, raising rates promptly when inflation and output start to firmly pick up. Since the optimality of BoE’s policy preference will inevitably change over time, such a preference for FG now is bound to be inconsistent with a preference at a future date.

In effect, the unemployment threshold coupled with the many ‘ifs’ of the ‘knockout’ clauses of the FG announcement, will force the MPC, even if successful, to lose credibility one way or another either by honouring its FG commitment with respect to unemployment (irrespective of keeping the inflation ‘knockout’ in check), or by pursuing its remit of preventing too high inflation (thereby starting realigning rates sooner than promised). Furthermore, if the BoE chooses to alter the FG itself as events unfold (e.g., by resetting the threshold level), everyone will be left even more puzzled. And what if, at that point, the economy shifts gear yet again and the MPC has to backtrack again on their pledge? (‘time inconsistency’ argument again). How could agents be expected to believe such announcements ever again?

The BoE states that FG tries to provide clarity (through an easily observable state-contingent unemployment threshold) but in fact it breeds more confusion, especially since the unemployment threshold alongside the inflation and financial stability ‘knockout’ clauses are not automatic triggers, they are merely ‘staging posts’ for the BoE to start reassessing its options; which doesn’t say much about the future policy path. This cannot but increase uncertainty over when rates might eventually rise. In the meantime, as recently reported by Giles (2013), the BoE’s chief economist Spencer Dale (a BoE’s executive director who is also a member of the MPC), has himself argued that the BoE’s FG “*is not well designed for an economy moving to recovery and will need to be modified, if it is retained at all*”.

At end of January 2014 unemployment fell to 7.1%, just above the 7% threshold the MPC had set as a cue for thinking about raising interest rates, and despite a concomitant improvement in economic growth, rates were kept at their 0.5% historic low. FG advocates might take this single-quarter data as an indication that FG is already working, while other commentators, including many market analysts, are already administering FG ‘the last rights’ arguing that after only six months since inception FG is ‘dead’. Evidently Carney is hardly going to abandon the tool but he has already announced that it might need to be adapted given that the jobless rate is already within a whisker of 7% (back in August 2013 this was seen as unlikely until early 2016 according to Carney). Whilst we would caution against drawing quick conclusions from these latest data, we take Carney’s recent calls for the need to make urgent and unanticipated adaptations to FG as evidence confirming our more substantive concerns over both the credibility of this policy (‘time consistency’ argument), and the uncertainty that the original FG announcement alongside its recent calls for amendments create. Indeed, at present, no one is even able to speculate as to how FG will actually evolve to changing circumstances, which are

the range of options to be considered for updating FG, whether such updates will entail changes in thresholds and/or changes to altogether different indicators, and – most importantly – which ‘escape velocity’ Britain needs to achieve before interest rates will actually rise.

Are the assumptions underlying the models informing FG tenable?

Underlying the logic of any new economic policy is always a set of models and associated assumptions. FG is no exception. It relies heavily on ‘rational expectations’ to justify the mechanism that sees private-sector expectations become a major conduit through which monetary policy affects, ultimately, aggregate demand. Indeed all academic work on FG is set in the context of the assumption that agents in the model know all there is to know about the model.

It is possible, of course, that some financial market participants will take an attentive and forward-looking look at what the MPC’s FG announcements say about the future path of monetary policy. However, even such a small sample of the population lacks – like the rest of us, including members of the MPC - a full understanding of the precise workings of the economy. There are, surely, many other agents in the economy whose expectations of the future are formed in a much simpler way, perhaps just projecting forwards what they see happening to their household finances, their local market or the factory in which they work. Others still, may be just confused about how the economic recovery will pan out, and how effective interest rate changes (or otherwise) really are. Or they may be suspicious and uncertain, especially about the BoE’s precise intentions, even more so after FG announcements. In this ‘real’, somewhat imperfect, very varied and perhaps a little ‘irrational’ world, the MPC intention to manage expectations through FG not only assumes the way in which agents form forecasts of the BoE’s reaction

function but also how such agents respond to events as they will unfold and, most importantly, how they respond to the announcements of the MPC's own intentions.

Another unconvincing feature of the models that inform FG is the way in which prices and wages are assumed to be 'sticky', meaning that a probability is assigned to a fixed (yet randomly selected) percentage of firms changing prices in each period. This assumption helps the models 'fit the data' better as it permits assigning a weight to the way in which both the general price level and output relate to this quantum of (assumed) price stickiness, thus providing a rationale for an active central bank's stabilisation policy.

The problem with this approach is that it is too often forgotten that in conducting research the 'sticky prices' assumption is made for technical simplification, as a matter of mathematical convenience. This raises serious doubts on the extent to which such models could accurately predict the true impact of FG. Moreover, as demonstrated by Carlstrom *et al.* (2012), sticky-price models that are used to inform monetary policy are not reliable when interest rates are at the zero lower bound or have been fixed for a long period and, as noted above, the UK base rate has now been fixed at 0.5% since March 2009. This evidence raises further doubts on such models' usefulness in informing policy, especially at times marked by a significant shift in policy behaviour (as exemplified by the prominence FG gives to employment vis-à-vis the MPC's primary inflation remit).

The problem of the poor reliability of these models, particularly during times characterised by a shift in policy stance, resonates strongly with the Lucas' critique. Lucas' classic (1976) paper, arguably one of the most influential economics articles ever written, taught us that the relationships between economic variables investigated in econometric models designed to fit the data, would break down in the presence of policy shifts. Such work concluded

that policy makers, in formulating a policy for the future, could not rely on such models once a policy aiming to exploit those relationships is adopted. A consequence of the Lucas' critique was a surge in macroeconomic models that in an attempt to redeem themselves, displayed pseudo 'microfounded' features designed to account for the behaviour of firms and consumers. Somewhat ironically, however, such behaviour is modelled through the very assumptions discussed above (e.g., sticky prices), taking us back to the problems of getting economic models to fit the data.

Conclusion

Quite how effective FG will prove to be in the UK is, of course, open to debate. Yet, it is legitimate to at least be dubious about the impact that the BoE attributes to FG announcements, particularly so when the models and assumptions underlying the logic of FG are subjected to closer scrutiny. The international evidence is also fairly ambiguous as to the efficacy of various variants of FG, and the state-contingent variety adopted by the BoE's MPC seems to compound the hostages to fortune that the announced policy path entails.

Of course, a fervent advocate of this kind of monetary policy might still argue that there is no harm in trying FG, particularly if persuaded by Carney's idea that "*The crisis has reinforced the fundamental importance of effective communications*" (Carney, 2013). Yet, the greatest irony about FG is that it may well end up producing the very uncertainty it is supposed to curb. On this account, it is worth noting that this latest fad - that aims to stimulate more borrowing and spending by managing expectations of future rates - just like the quantitative easing experiment that preceded it, is likely to carry considerable costs in credibility, particularly

in the long-term, especially when considering that excessive debt and over-borrowing were the root cause of the crisis in the first place (De Vita and Abbott, 2011).

In this sense, despite its esoteric connotations, FG is anything but neutral since it has clear implications for the overall management of the relationship between fiscal and monetary policies. It is apparent that monetary policy, particularly of this unconventional variety, is called on to do too much, thus detracting attention that ought to be devoted towards fiscal, structural, and further financial sector reforms which are essential to ensuring macroeconomic stability and entrenching the recovery.

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