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Buiter on forward guidance, or, paging Sumner / Krugman / Woodford / Eggertsson / Svensson

Cardiff Garcia Sep 27 20:49 8 comments

> 'Forward guidance' had a poor start in life. It was born as a pleonasm – afflicted with a severe case of redundancy. 'Guidance' would have sufficed, as all guidance relates to the future and is therefore inevitably forward. Perhaps some idiosyncratic historians call their subject 'backward guidance', and maybe the odd tourist has signed up for instantaneous or simultaneous guidance around some ancient site, but we doubt it. Redundancy as a rhetorical device tends to be used when it is deemed desirable to inflate the importance of someone or something beyond what is fundamentally warranted. Our view is that this also is the case with forward guidance.

That's the opening to Willem Buiter's enticingly aggressive and highly readable 17-page note, available ungated at this link.

His main points are roughly these (note that this is our summary and not from the note):

- Time-contingent forward guidance (the central bank will hold rates at X through Y date) can't be taken seriously by market participants or economic agents because of the potential for future conditions to change, thereby rendering the earlier commitment irrelevant.
- Only state-contingent forward guidance (the central bank will hold rates at X until unemployment is below Y or inflation is above Z) can be taken seriously.
- Credibility for state-contingent policy requires, as Buiter writes, that "the contingencies that could lead to central bank to act in a way that is different from its unconditional central projection, be observable. The markets and the public at large must be able to verify whether the central bank acted according to the conditional rule or instead either acted opportunistically or indeed deceitfully, or made a 'fat finger' error."
- Monetary policy decision-making by committee is sensible. But, other than formal statements, communication of monetary policy to the public should be done by one person

or none at all.

- State-contingent forward guidance is ineffective when it is well understood that the costs to monetary policymakers of future deviations from their guidance are mild. This is largely the situation in which the Fed, ECB, and BOE now find themselves. Forward guidance right now is just "cheap talk".
- The most appropriate way to impose these future costs is for the central bank itself to have skin in the game. Buiter gives two examples:

  1) The Fed can make a collateralised fixed rate loan, or go through longer-term repo markets, setting the loan's interest rate or the repo rate *higher* than the Fed's projection for rates in the time period that covers the maturity of the loan, which would be no less than two years. If rates climb above the Fed's forecast during that period, the Fed will incur a loss.

  2) The Fed can buy Treasuries, just as it does now in QE, but paying more than their current market value, instead paying at yields "implied by and consistent with its forward guidance"....

  (Buiter recommends consolidating the accounts of the Fed and Treasury to make it clear that the taxpayer would not lose money; remember that the repo or secured loan would be collateralised against Treasuries.)
- And, he writes, "the range of financial instruments that can be used to put the monetary authority's money where its forward guidance is can be extended in many directions beyond the long-term fixed rate repo...". The paper offers several more examples of how financial derivatives can be used the Fed to offer the markets "hostage" financial instruments.

And here's how Buiter closes:

> The best approach to signaling longer-term policy intentions in an operational manner typically has three components.
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> First, commit to the regular publication and updating of longer-term forecasts of the target variables, of any additional nominal or real thresholds, knockouts or triggers that define the central bank's reaction function for each of its instruments, and of the instruments themselves.
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> Second, reach an agreement that at most one member of the monetary policy making committee, presumably its chair, speaks or writes publicly about the likely future paths of the policy instruments – rates, QE, or whatever. The other members can of course still discourse in public about the principles of monetary policy and the history of central banking.
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> Third, give the central bank skin in the game by requiring it to issue or purchase material amounts of financial instruments on which it will lose money if interest

> rates depart from the forward guidance-consistent levels – financial hostage instruments. If possible, link the pay of the monetary policy makers at least in part to the performance of these instruments.

(That last line would be a scorcher of a policy proposal.)

It's a fun weekend read, and we recommend combining it with Scott Sumner on NGDP futures markets and the scepticism of Gavyn Davies.

This entry was posted by Cardiff Garcia on Friday September 27th, 2013 20:49. Tagged with Forward Guidance.