Forward Guidance: Communication, Commitment, or Both?

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What is the paper about

Is Forward Guidance a useful and beneficial policy tool?

Alternative interpretations of Forward Guidance (FG):

- Odyssean: FG as a commitment technology
- Delphic: FG as a communication technology

This paper focuses on Delphic FG: cheap talk
- FG does not directly affect future outcomes/payoffs
The framework: Barro-Gordon

CB objective: \[ E \sum_{t=0}^{\infty} \beta^t [(y_t - y_t^* - \kappa)^2 + \alpha (\pi_t - \pi_t^*)^2] \]

Equilibrium output-gap: \[ y - y^* = (1 - \theta) (y^e - y^*) + \lambda (\pi - \pi^e) \]

CB has information advantage on (current) \( y^* \) or \( \pi^* \)

\[ \pi_t^*, y_t^*, F_t, G_t \]
\[ \text{realized} \]

CB sends \( m_t \)

\[ y_t^e = E[y_t|F_t, m_t] \]
\[ \pi_t^e = E[\pi_t|F_t, m_t] \]

CB set \( \pi_t \)

\( y_t \) determined

Notice: if \( \kappa = 0 \), then \( m_t \) s.t. \[ E[y_t^*|F_t, m_t] = E[y_t^*|G_t] \& E[\pi_t^*|F_t, m_t] = E[\pi_t^*|G_t] \text{ even if } \beta = 0 \]
Main results

Under relatively mild conditions (e.g. CB patient enough):

▶ FG can credibly provide information and $m$ affects outcomes

▶ FG is beneficial

FG most effective when information advantage is about $\pi^*$
Comment #1: Odyssean or Delphic?

"The FOMC has not been clear about the purpose of its forward guidance. Is it purely a transparency device, or is it a way to commit to a more accommodating future policy stance to add more accommodation today?" (cit. Charles I. Plosser, March 6, 2014)
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Argument in favor of Odyssean interpretation:

▷ FG announced at ZLB, when indeed commitment is valued the most

Arguments in favor of Delphic interpretation:

▷ FG did not affect possibility of FED to deviate from announced path
  (Marco’s argument)

▷ "Forward guidance aims to ensure that market expectations on future monetary policy are indeed consistent with the policy intentions of the respective central bank.....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." (cit. Benoit Coure, ECB Executive Board, Sep 26, 2013)
Comment #2: FG in the data

FG did impact expectations

Disagreement about future variables: 1Q (black); 1Y (red); 2Y (blue)

Source: Andrade, Gaballo, Mengus and Mojon (2014)
Comment #3: FG welfare improving?

Is Delphic FG welfare improving? Under what conditions?

- Paper argues it is when $\beta$ and $\bar{\pi}$ high enough

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Consider, instead, a framework with markup type shock:

- output-gap: $y - y^* = (1 - \theta) (y^e - y^*) + \lambda (\pi - \pi^e) + \mu$
- CB has private information also on $\mu$; agents have no information on $\mu$

Then communicating information on $\mu$ is welfare decreasing

- example: CB cannot perfectly distinguish or communicate separately $y^*$ and $\mu$
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Other (cheap) comments and conclusion

1. CB has more precise information than individual agent, but still aggregating individuals info. may be valuable
   ▶ CB info. provision may reduce private incentives to "produce" information

2. FG effective if agents can punish CB for misreporting
   ▶ CB private information verifiable ex posts
   ▶ In reality, CB information hard to verify, e.g. large revisions of GDP

Concluding remarks:

▶ It’s a simple but yet very insightful framework to think about the working and implications of FG!

▶ Looking forward to see more.