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Forward guidance is dead; long live forward guidance

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In a shock-prone world, forward guidance may be harder to finesse, but it is not dead yet. The public needs to understand the logic of central bank decision-making now more than ever.

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The South African Reserve Bank (SARB) and the US Federal Reserve (Fed) both increased their policy rates at their most recent monetary policy committee meetings. But that's not the only thing they have in common. Both are also changing how they communicate about the future, although in quite different ways.

The Fed has been overtly trimming its forward guidance about the likely future path of interest rates ever since Kevin Warsh took over as chair in May this year. The SARB has been quietly reducing its use of forward-looking language in policy statements ever since the Covid pandemic (see graph).

What appears to be disappearing is the old form of forward guidance that sought to steer expectations towards a particular path for interest rates. What is replacing it is more conditional communication about how policy will respond as the economy evolves

According to **the IMF**, it is only natural - in a shock-prone world where markets react instantly - that central banks are reassessing how best to communicate. Their challenge is less about telling the public where interest rates are going than helping it understand the logic of central bank decision-making (their reaction function) and how policy is likely to respond as economic conditions change.

The art of central bank communication has been evolving ever since inflation targeting was introduced in the early 1990s. Initially, banks' communication was deliberately opaque. Alan Greenspan, Fed chair between 1987 and 2006, famously once said, "If I seem unduly clear to you, you must have misunderstood what I said".

Yet, over time, it became clear that transparency and credibility were two ingredients essential to the successful implementation of inflation targeting. Clear communication helps us understand why a central bank has acted in a certain way. If a bank's response to

inflation pressure remains consistent over time, this builds its credibility as an inflation fighter and can help anchor inflation expectations, which is central to keeping inflation low and stable.

To improve their transparency, central banks started explaining their policy decisions in the form of monetary policy statements and press conferences. The Fed is one of roughly 20 central banks that also publishes the formal minutes and voting records of its monetary policy committee meetings.

Forward guidance can take two broad forms, sometimes described as Odyssean and Delphic. The former is commitment-based: the central bank signals that it intends to keep policy on a particular path, often to influence financial conditions when rates are near zero. The latter is information-based: the bank explains its outlook and how policy is likely to respond as conditions evolve, without making a binding promise. The distinction matters because commitments can be useful when conventional policy is constrained but become costly when circumstances change.

In recent years, as one economic shock has followed another, central bank communication has shifted toward explaining how policy will respond as economic conditions evolve and new data becomes available, the goal being to help the public understand the logic that guides bank decision-making.

But Warsh is insistent that “my business is not to give forward guidance”. At his first Federal Open Market Committee (FOMC) meeting in June, the statement was only 129 words, less than half of what it was a year earlier. The brevity was deliberate, but it left markets with less information about how the Fed was weighing the outlook and what might cause it to change course.

So, what was Warsh trying to accomplish?

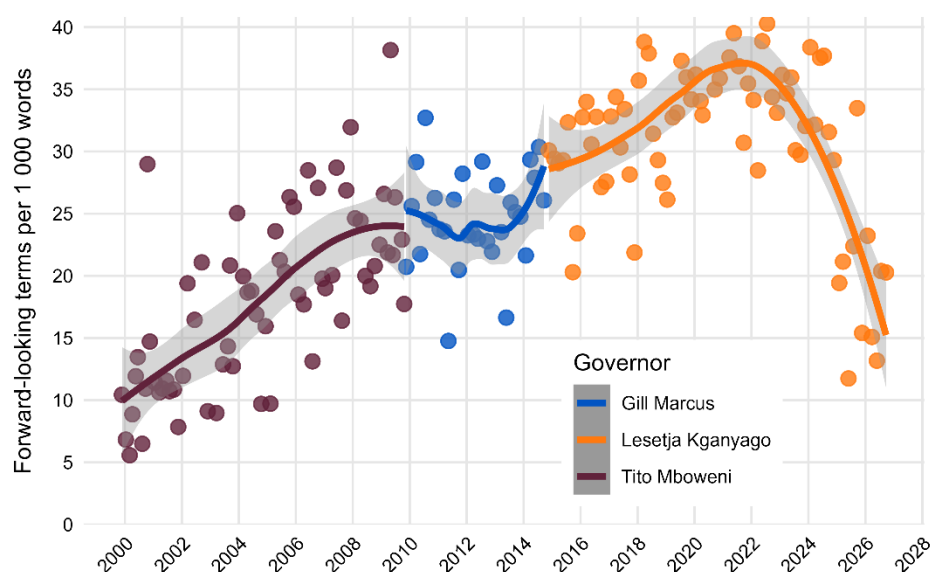
Warsh wants to dismantle what he calls the “hall-of-mirrors” relationship between the Fed and financial markets. His argument is that instead of markets focusing on real-time economic data and making independent economic calls, investors simply trade based on what the Fed says it will do. So, when the Fed looks at the markets for information, it risks seeing its own views reflected back at it.

The deeper concern is therefore not simply that forward guidance may turn out to be wrong, but that it can degrade the information-signalling power of market prices.

However, while Warsh may have a point, his early communication gave markets little sense of which indicators, trade-offs and risks would cause the Fed to change course. The heightened uncertainty helped push long-term US Treasury yields to their highest levels since 2007.

Since then, Warsh has partially recalibrated. At the September FOMC meeting, he described the reasons for the Fed’s 25bp rate hike and, as before, released the Summary of Economic Projections, a quarterly report which contains economic and inflation forecasts from each FOMC member. However, he again did not share his personal forecasts.

Fig 1: Forward-looking language in SARB MPC statements over time



Note: Each dot represents the count of forward-looking words that appear in MPC statements per 1,000 words. While the direction of the decline from 2022 is clear, the steepness of the fall may be overstated due to the measurement method used.

Source: K. Smuts own estimates in "An evaluation of various channels of information influencing inflation expectations in South Africa"

The change in the SARB's communication has been more subtle. It has generally avoided Odyssean, or commitment-based, guidance. Yet it still publishes a model-implied policy-rate path, forecasts, risk assessments and alternative scenarios. In other words, it rejects promises about the future path of rates while still communicating a great deal about how policy is likely to respond under different conditions.

The graph shows how its use of forward-looking language in MPC statements has steadily increased over the past two decades under three consecutive Bank governors – Tito Mboweni, Gill Marcus, and Lesetja Kganyago - before dropping off steeply after 2022.

Though the exact reasons for this shift are unclear, it has coincided with a period of increased global economic uncertainty - from Covid and the Ukraine war to the recent oil price shock. This has, understandably, led to a wave of central banks adopting a more data-dependent approach, South Africa's included.

A more prosaic reason may be that shorter MPC statements simply leave less room to be discursive. South Africa's MPC statements each averaged 1,880 words in the 2000s, rose to 2,700 words between 2010 and 2017, but since 2018 have fallen back to just 1,650 words on average.

According to the IMF, successful central bank communication depends on fostering a better understanding of the bank's policy framework, its objectives, reaction function, and forecasts. It also means, given the high degree of global uncertainty at present, being explicit about the risks, humble about what cannot be known, and clear about how policy may respond under alternative economic scenarios.

The bottom line, it seems, is that central banks are moving away from pretending they can map out the future with precision. But the backlash against Warsh's opacity suggests there are limits to how far they can retreat. Markets may no longer need an Odyssean promise about where rates are going, but they still need to understand what would make a central bank change course. In a shock-prone world, forward guidance may be harder to finesse, but it is not dead yet.

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