

Macroeconomic Effects of FOMC Forward Guidance

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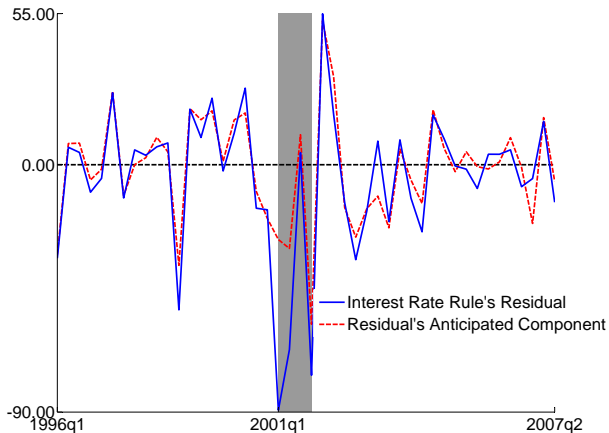
March, 2012

FOMC Experience with Forward Guidance

- ▶ Experience before the crisis
 - ▶ Kohn and Sack (2003)
 - ▶ Bernanke, Reinhart, and Sack (2004)
 - ▶ Gürkaynak, Sack, and Swanson (2005)
- ▶ Experience since the crisis
 - ▶ Gagnon, Raskin, Remache, and Sack (2010) (QE1)
 - ▶ Krishnamurthy and Vissing-Jorgenson (2011) (QE1 & QE2)
 - ▶ Our extension of Gürkaynak, Sack, and Swanson.

Do Markets Hear the Oracle of Delphi or Odysseus?

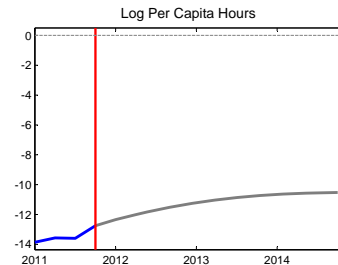
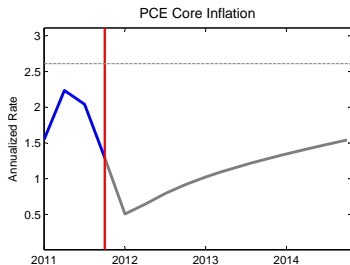
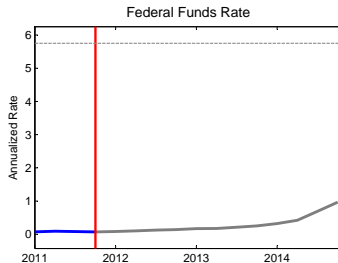
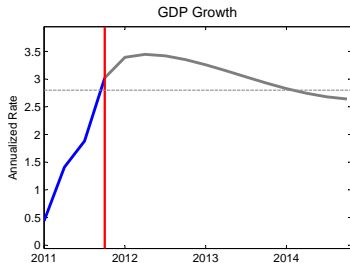
$$FF_t = g(\text{Current Economic Conditions}) + \sum_{j=0}^4 \nu_{t-j,j}$$



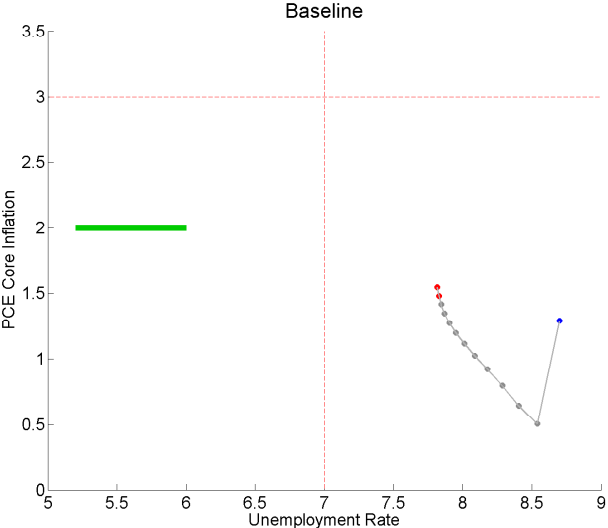
Forecasts from FRB Chicago New Keynesian DSGE Model

- ▶ Adaptation of Justiniano, Primiceri, and Tambalotti (2011).
- ▶ Business cycles are primarily demand determined.
- ▶ Continue 2012 with unusually patient households. (Asset accumulation/Deleveraging)
- ▶ Odyssean forward guidance delays lift-off until late 2014.

Forecast for Baseline Scenario



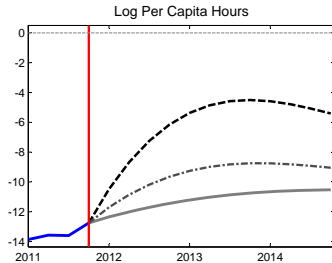
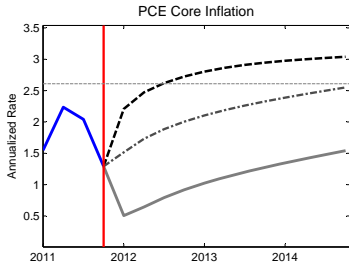
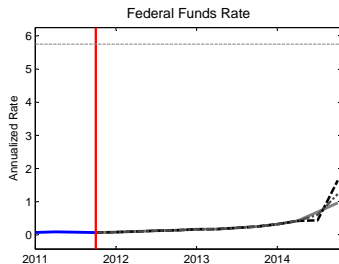
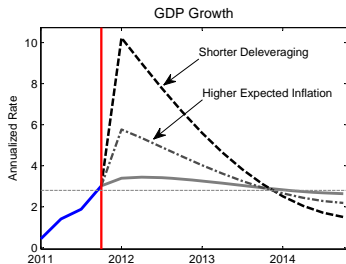
Inflation and Unemployment in the Baseline Scenario



Risk Assessment

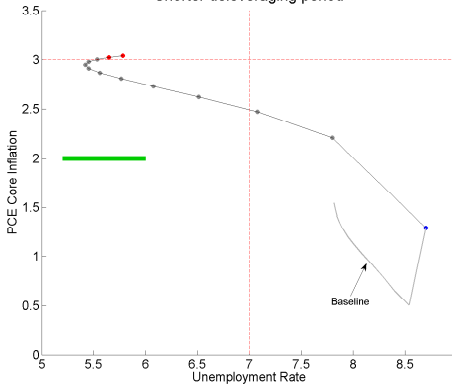
- ▶ Assess upside risks to the outlook with the “late 2014” guidance in place.
 - ▶ Shorter deleveraging period
 - ▶ Higher expected inflation
- ▶ Compare outcomes with 7/3 thresholds for launch from ZLB.

Shorter Deleveraging or Higher Expected Inflation

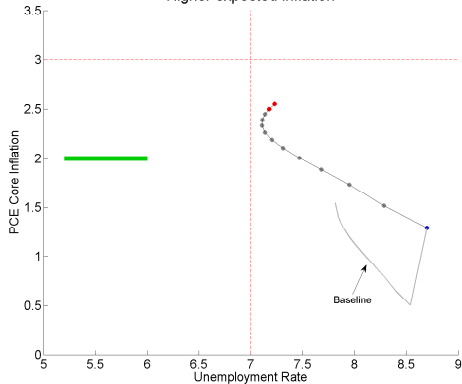


Inflation and Unemployment in the Alternative Scenarios

Shorter deleveraging period



Higher expected inflation



Takeaways

- ▶ Odyssean forward guidance delivers beneficial accommodation.
- ▶ Conservative central bankers will be tempted to renege on promised stimulus once its desired (anticipatory) effects have been achieved.
- ▶ Bright-line economic thresholds, like the 7/3 rule, provide conditions for an extended period of exceptionally low federal funds rates while providing some insurance against unfavorable outcomes and risks.