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Publishing Central Bank Interest Rate Forecasts

Over the past two decades, the Federal Reserve has made significant strides toward greater transparency in the conduct of monetary policy. Most recently, last November, Federal Open Market Committee (FOMC) participants—that is, the Federal Reserve Presidents and Governors—started to release their projections for output growth, unemployment, and inflation to the public more frequently and with greater detail than before (Rudebusch 2008). Such transparency can illuminate the FOMC’s policy strategies and goals and help inform the public’s expectations about future economic developments. Of course, the release of other forward-looking indicators could also be informative. For example, a few central banks release short-term interest rate forecasts along with their economic projections to help guide expectations of future policy. However, the FOMC participants decided against taking this step and will not release the expected policy rate paths that underlie their economic projections (Kohn 2008). This *Economic Letter*, which draws on Rudebusch and Williams (2006), describes some of the pros and cons of revealing future policy inclinations, including the publication of central bank interest rate forecasts.

Policy communication by central banks

Despite a general recognition of the value of communication as an accompaniment to monetary policy actions, most central banks have been reluctant to reveal any information about their expectations for future policy. However, over the past decade, some central banks have started to provide signals about their future policy inclinations. This communication has taken three different forms—indirect signals, direct qualitative signals, and direct quantitative signals—and it is useful to examine each in turn.

Indirect signals provide implicit information about the future policy path via the release of information about something other than that path. For example, a central bank could release a price forecast that shows that inflation will rise sharply if the policy rate is left unchanged. Such a projection is often used as an indirect signal that policy is likely to be tightened. In a similar spirit, from 2000 to 2003 and in-

termittently thereafter, the FOMC provided indirect “balance of risks” signals of expected policy. Specifically, in the post-meeting statements, the risks to the outlook were assessed as either “balanced,” weighted toward “heightened inflation pressures,” or weighted toward “economic weakness.” These three indirect balance of risks signals were readily mapped by observers into future policy options of unchanged, higher, or lower rates, respectively, although the timing and magnitude of any expected changes remained indeterminate.

While indirect signals are quite common, at times a few central banks, including the Federal Reserve and the Bank of Japan, have found it useful to be more explicit and give direct, albeit qualitative, signals of the likely path of future policy. For example, in 1999, the FOMC released the expected direction of future changes in the policy rate—the so-called policy “bias”—immediately after its policy meetings. Specifically, the policy statement released after the October 5, 1999, meeting noted that the FOMC “adopted a directive that was biased toward a possible firming of policy going forward.” In addition, from 2003 through 2006, the FOMC issued direct qualitative statements about its future policy inclinations in various verbal formulations, including “policy accommodation can be maintained for a considerable period,” “the Committee believes that it can be patient in removing its policy accommodation,” “policy accommodation can be removed at a pace that is likely to be measured,” and “some further policy firming is likely to be needed.”

A third type of policy signal is direct and quantitative, as exemplified by the signals currently given by the central banks of New Zealand, Norway, and Sweden. Along with their economic projections, these central banks provide explicit quarter-by-quarter numerical projections of their policy interest rates. These quantitative policy rate forecasts represent a dramatic departure from the communication practices of other central banks; however, these three central banks believe that regularly publishing policy rate forecasts is a significant step toward greater transparency.

Pros and cons of communicating policy inclinations

There is an ongoing debate about the value of communicating policy inclinations, especially releasing projections of the central bank's expected interest rate path, and it is useful to consider both the advantages and disadvantages.

The advantages appear to be similar to those provided by other types of transparency. In particular, the advantages attributed to the FOMC's recent enhanced output and inflation projections appear equally applicable to interest rate forecasts. These include improving the accountability of policy decisions, providing insight into the FOMC's views about the economy, and helping the public better understand and anticipate how policy decisions respond to incoming information (Rudebusch 2008). A key argument in favor of explicitly communicating the central bank's view of the most likely future policy path is based upon the benefits of sharing central bank information with the public (Ólafsson 2007). Monetary policy is in large part a process of shaping expectations about the future path of short-term interest rates in order to achieve various macroeconomic objectives (McGough, Rudebusch, and Williams 2005). As Bernanke (2004) has stated, "FOMC communication can help inform the public's expectations of the future course of short-term interest rates, providing the Committee with increased influence over longer-term rates and hence a greater ability to achieve its macroeconomic objectives." Of course, this leaves open the question of which type of central bank communication can best guide the public's expectations, but interest rate projections would seem to be a natural, even obvious, tool to use. In particular, coupled with output and inflation projections, interest rate forecasts can illuminate likely policy reactions to new information as well as the role of policy in influencing the economy.

The desire to help shape expectations of future policy appears to have prompted the episodes of direct qualitative signaling by the FOMC noted above. Specifically, in 2003, with worries about inflation falling so low as to raise the possibility of deflation, the FOMC decided that explicit statements about its future policy inclinations would help guide interest rate expectations. These direct qualitative signals may have helped boost the economy when the policy rate was close to its lower bound of zero by providing assurances that future interest rates would also be kept low. However, after the fears of a deflationary slowdown ebbed, the explicit signals ended. Indeed, recent FOMC statements as well as the enhanced FOMC projections contain no direct or indirect characterizations of future policy.

More generally, the widespread reluctance of central banks to reveal their views about the likely future path of the policy interest rate suggests that such signals are perceived to have significant disadvantages. Indeed, there are two key arguments against providing central bank interest rate projections (and giving, more generally, indirect and direct policy signals of any kind). The first argument is that central banks typically do not know very much about future policy interest rates and so have little information to communicate. The second is that, to the extent that central banks do try to communicate something they know, the public may very often misinterpret that communication.

The first argument is often made by policymakers who assert that there is too much uncertainty about the future path of rates to give a useful public projection. As Federal Reserve President Poole (2005) noted, "most of the time the FOMC cannot provide accurate information to the market as to the probable course of the target fed funds rate, in terms of a specific path measured in basis points. The future path will be conditional on future information that cannot itself be predicted." And Federal Reserve President Plosser recently warned that even the implicit balance of risk signals in past FOMC statements may convey too much confidence about the future path of interest rates (Ip 2007). However, although the information content of central bank interest rate projections may appear low, it appears hard to argue that it is lower—relative to publicly available forecasts—than that supplied by central bank output growth, unemployment, and inflation projections (see Reifschneider and Tulip 2007).

A second objection is that the public—particularly financial market participants—will misinterpret the central bank's signals of policy inclinations and regard them as essentially promises of future policy action. Indeed, the perceived confusion in financial markets caused by the release of the forward-looking policy bias statements in 1999 caused the FOMC to discontinue these direct signals. In addition, the fear of such confusion induced the FOMC to avoid including interest rate projections along with the recent enhanced projections. As Kohn (2008) noted, "The FOMC decided against reporting a range or histogram for participants' assumptions about appropriate policy, because it was concerned about the potential for unintended consequences of such a publication. Specifically, it worried about a tendency for the public to infer more of a commitment to following the implied path than would be appropriate for good policy. In that circumstance, deviating from the path would risk market instability, and concerns

about such dynamic responses would complicate already difficult policy choices.”

Given the sophistication of the financial system, it may seem hard to accept claims about the inevitable breakdown of communication between central banks and financial markets. Indeed, in practice, financial markets appear to have appreciated the central bank interest rate forecasts provided in New Zealand, Norway, and Sweden and understood their conditional nature. However, because much is still unknown about the relationship between the revelation of information and market pricing, this black box, with its potential for investor herding behavior, information cascades, multiple equilibria, and other problems, continues to worry many central bankers. Although economic researchers have shown that transparency can increase welfare, these conclusions often depend on the exact specification of the theoretical models. For example, Rudebusch and Williams (2006) examine the macroeconomic effects of revelation of a central bank's expectations about the future path of the policy rate in a small theoretical model in which private agents have imperfect information about the determination of monetary policy. In their model, publication of interest rate projections usually, though not always, better aligns the expectations of the public and the central bank and helps the central bank achieve its policy goals.

Conclusion

In the past, one of the strongest central banking taboos was talking publicly about future interest rates. The underlying fear was that financial markets would tend to interpret central bank statements about the likely future path of policy as commitments to action, as opposed to projections based on existing information and subject to considerable change. In order to retain a plausible deniability in case markets are disappointed as the future unfolds, it is fairly rare for central banks to give direct signals about policy inclinations. However, three central banks do publish numerical interest rate forecasts and may be pioneering a path in transparency that others will follow.

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