



Research Working Papers

Should We Be Puzzled by Forward Guidance?

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Forward guidance that lowers the expected path of policy continues to stimulate economic activity and prices.

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Although a growing literature argues output is too sensitive to future interest rates in standard macroeconomic models, little empirical evidence has been put forth to evaluate this claim. In this paper, we use a range of vector autoregression models to answer the central question of how much output responds to changes in interest rate expectations following a monetary policy shock. Despite distinct identification strategies and sample periods, we find surprising agreement regarding this elasticity across empirical models. We then show that in a standard model of nominal rigidity estimated using impulse response matching, forward guidance shocks produce an elasticity of output with respect to expected interest rates similar to our empirical estimates. Our results suggest that standard macroeconomic models do not overstate the observed sensitivity of output to expected interest rates.

JEL Classification: E32; E52

Additional Files

[Appendix](#)

Article Citations

- Bundick, Brent, and A. Lee Smith. 2020. "Should We Be Puzzled by Forward Guidance?" Federal Reserve Bank of Kansas City, Research Working Paper no. 20-01, April. Available at <https://doi.org/10.18651/RWP2020-01>

Related Research

- Bundick, Brent, and A. Lee Smith. 2019. "The Dynamic Effects of Forward Guidance Shocks." Federal Reserve Bank of Kansas City, Research Working Paper no. 16-02, June. Available at <https://doi.org/10.18651/RWP2016-02>

- Bundick, Brent, Trenton Herriford and A. Lee Smith. 2019. “Forward Guidance, Monetary Policy Uncertainty, and the Term Premium.” Federal Reserve Bank of Kansas City, Research Working Paper no. 17-07, December. Available at <https://doi.org/10.18651/RWP2017-07>
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Andrew Lee Smith is a Senior Vice President and Economist at the Federal Reserve Bank of Kansas City. In this role, Lee has oversight of macroeconomic research and serves as an advisor on monetary policy matters. Lee's research has focused on the effects of expanding and unwinding the Federal Reserve's balance sheet, the impact of forward guidance on financial markets and the economy, and, more generally, how central bank communication can influence expectations and economic conditions. Prior to joining the Bank in 2014, Lee received a Ph.D. in economics from the University of Kansas. He also holds a B.A. in economics and mathematics from Drury University in Springfield, Missouri.