Forward Guidance with Unanchored Expectations

Bruce Preston (University of Melbourne)
Stefano Eusepi (University of Texas, Austin)
Chris Gibbs (University of Sydney)

Abstract

We study zero interest-rate policy in response to a large negative demand shock when long-run inflation expectations can fall over time. Because falling expectations make policy less effective by raising real interest rates, the optimal forward guidance policy makes large, front-loaded promises to stabilize expectations. Policy is too stimulatory in the event of transitory shocks but provides insurance against persistent shocks. The insurance property distinguishes our paper from other bounded rationality papers that solve the forward guidance puzzle and generates important quantitative differences. Indeed, those models predict optimal policy that is almost indistinguishable from the rational expectations optimal commitment policy.