Central Banks' Policy Signals in Informational Noise

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Some views from the market on dissecting signals in interest rate markets

- Key challenges identified historically in dissecting signals have been reduced.

- However, new challenges have emerged.

Making progress in signal extraction

Paraphrasing Blinder (2008): If the economic environment is stationary, the Central Bank is credibly committed to an unchanging policy rule, expectations were rational and CB's and markets have the same information set, markets could perfectly forecast policy decisions.

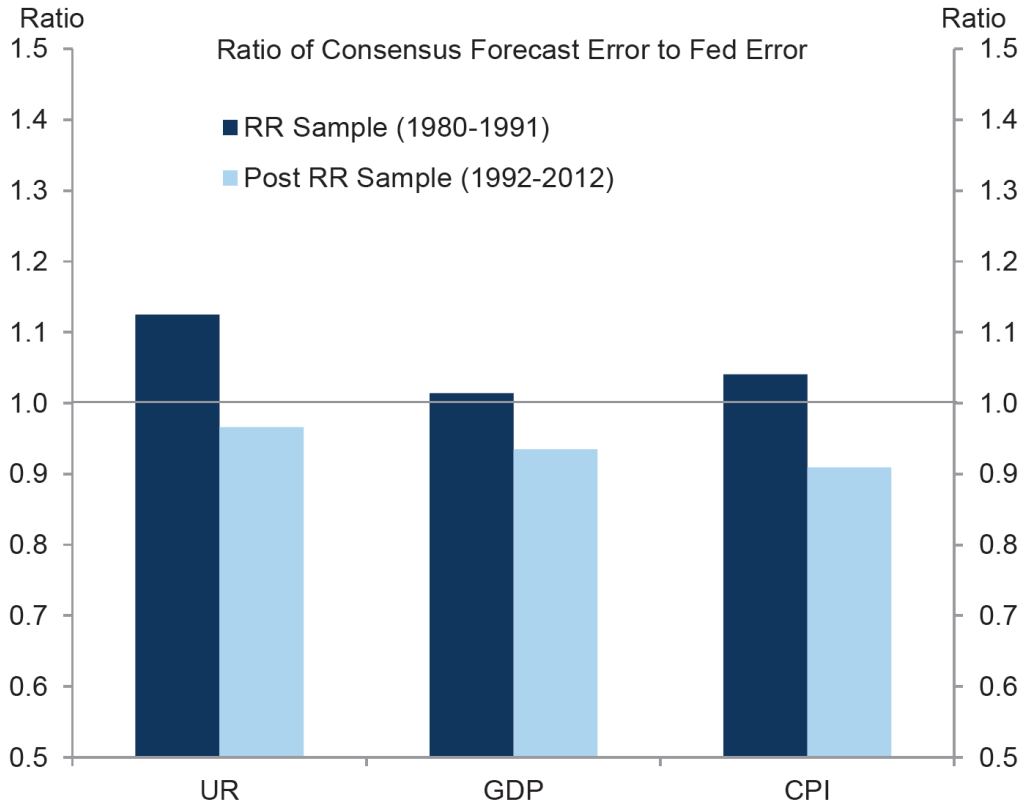
In practice, none of the above holds exactly but progress has been made on many of the constraints historically raised.

- CB's at least in DM but also increasingly in EM are generally perceived as independent,
- their targets are well understood, their communication strategies codified and their decision making has become generally more transparent.
- The market appears to have caught up with the CB's in forecasting the economy.

The Fed's information advantage has declined

- Romer and Romer (2000): FED's forecast more accurate than those of private forecasters.
- Choi (GS 2019) shows that this is not the case in the post R&R period.

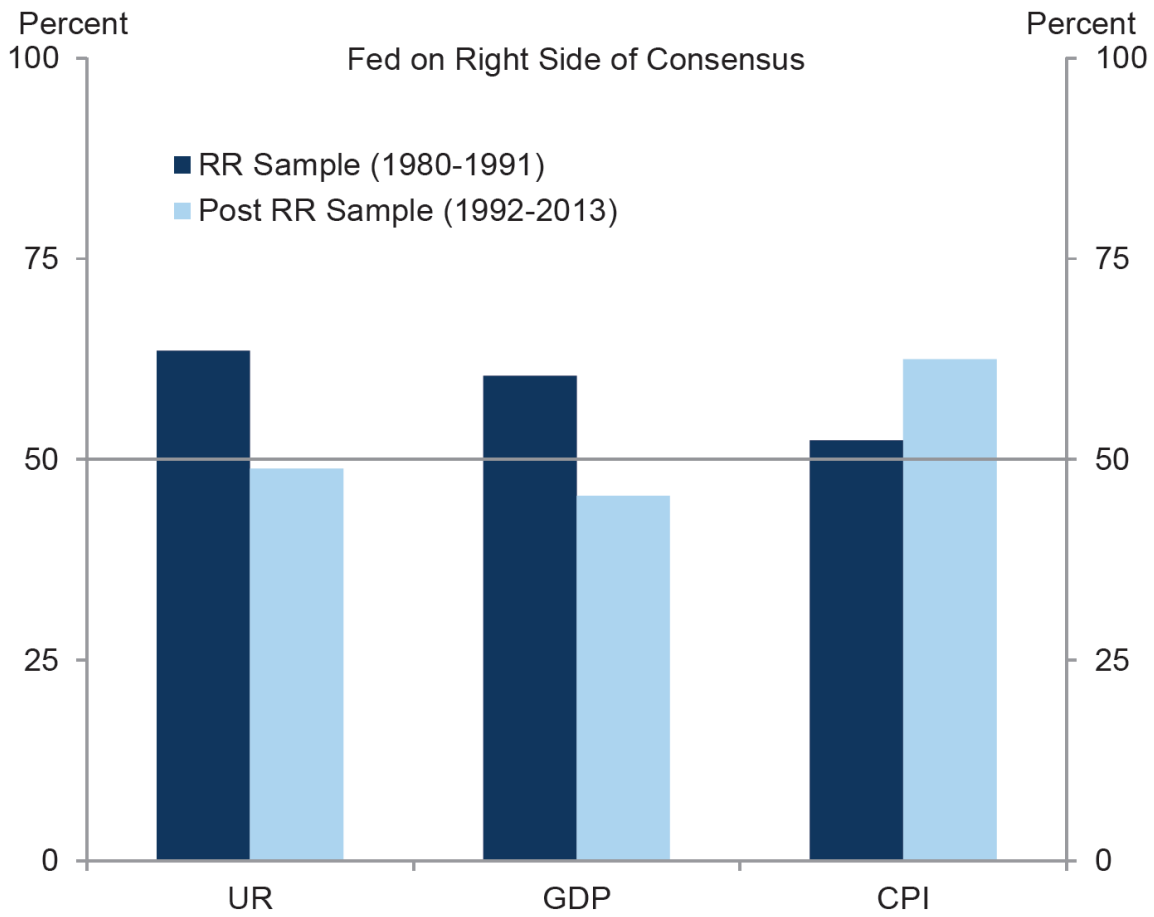
Consensus Forecast Errors are lower than those of the Fed in the RR period



Source: Federal Reserve Bank of Philadelphia, Goldman Sachs Global Investment Research

Study compares Tealbook (formerly Greenbook) with Survey of Professional Forecasters

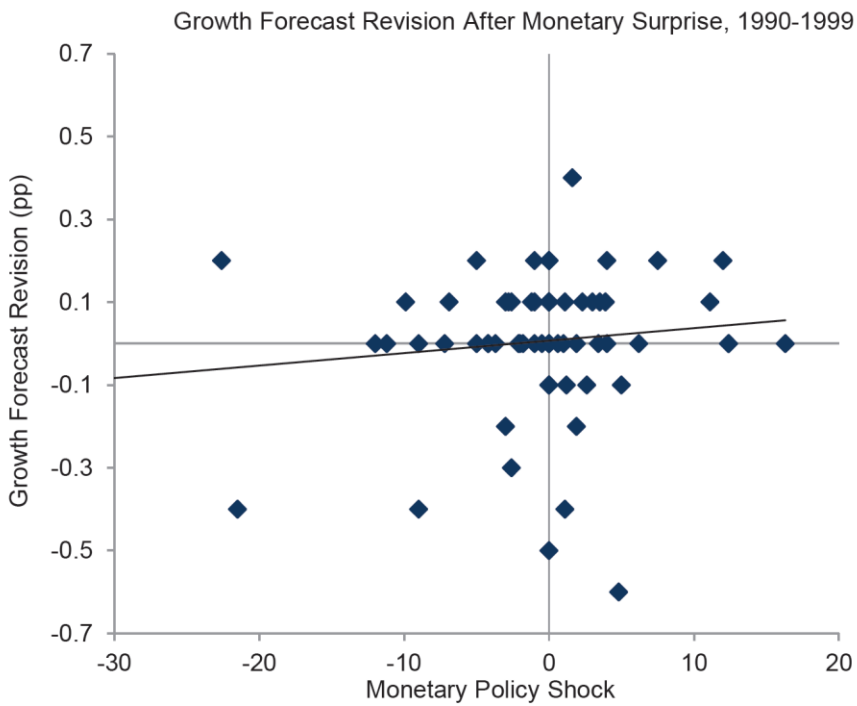
Fed more often on right side of consensus on inflation and hence still one of the better forecasters

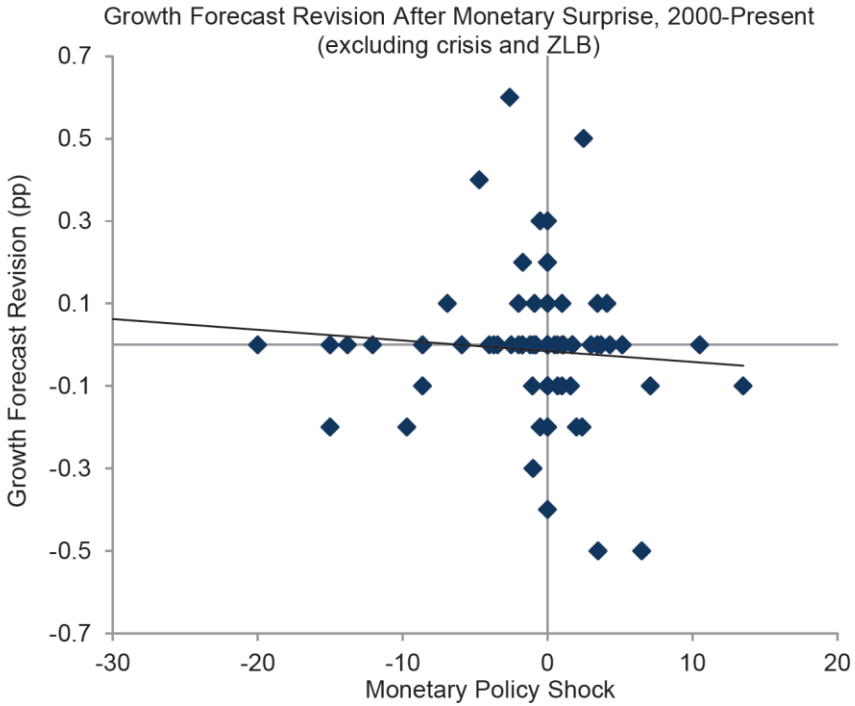


Source: Federal Reserve Bank of Philadelphia, Goldman Sachs Global Investment Research

There is evidence that the market agrees with the finding

- Growth used to be revised upwards after hawkish FED surprises in 1990-99…
- …but is revised downward since.

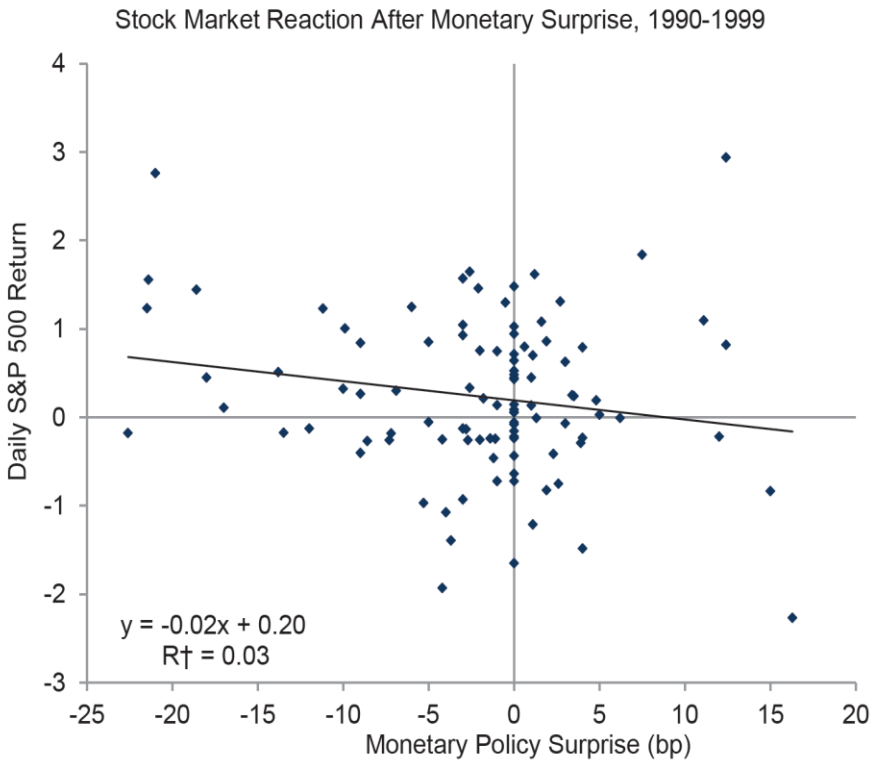


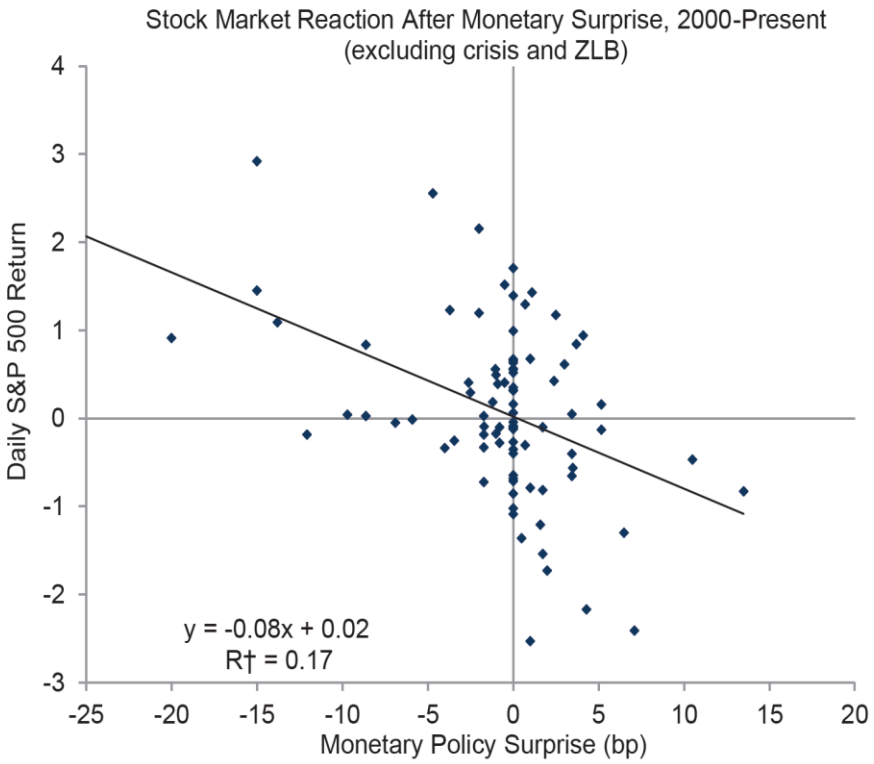


Source: Blue Chip Publications, Goldman Sachs Global Investment Research

Equity investors appear to agree as well

- Negative reaction of stock markets to hawkish surprises have increased quite sharply.





Source: Goldman Sachs Global Investment Research

New issues arise, some unavoidable, some self imposed

- The economy has structurally changed, R* appears to have fallen
- CB innovation (QE, forward guidance etc.) lower relevance of standard policy rules.

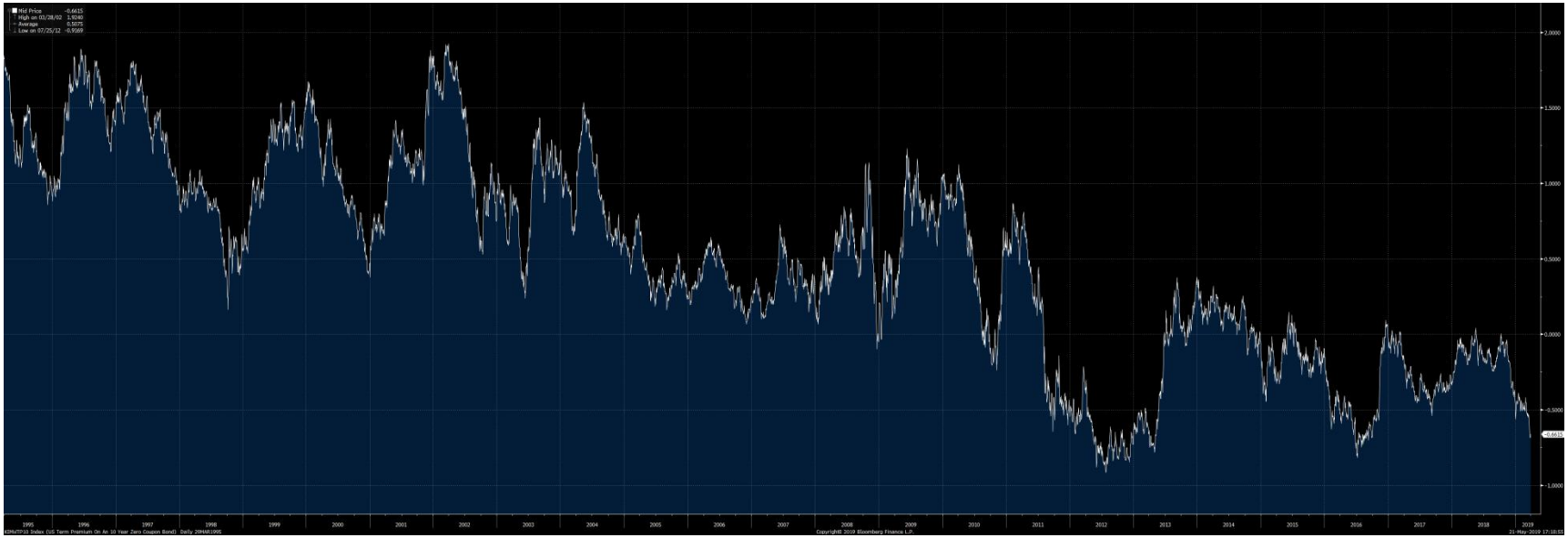
Overlearning from the last crisis

- QE etc. were effectively used in the crisis to overcome the lower bound.
- However, employing those policies comes at a cost, that away from that bound might outweigh the benefits.
- Transmission of these policies to the economy is not well understood, raising the risk of unintended consequences of communication (taper tantrum)
- Extracting market expectations from yield curves has become more difficult. Term premia have become non stationary and more volatile complicating the extraction of market expectations from yield curves and raising the risk of circularity for the CB.

Signal extraction in reverse. Extracting market interest rate expectations has become difficult given the non stationary and volatile term premia.

Non conventional policies like QE and forward guidance impact term premia in ways that are not well understood, making it difficult to extract market expectations both for market participants and CB's

Term Premium on a 10 year zero coupon US government bond since 1995

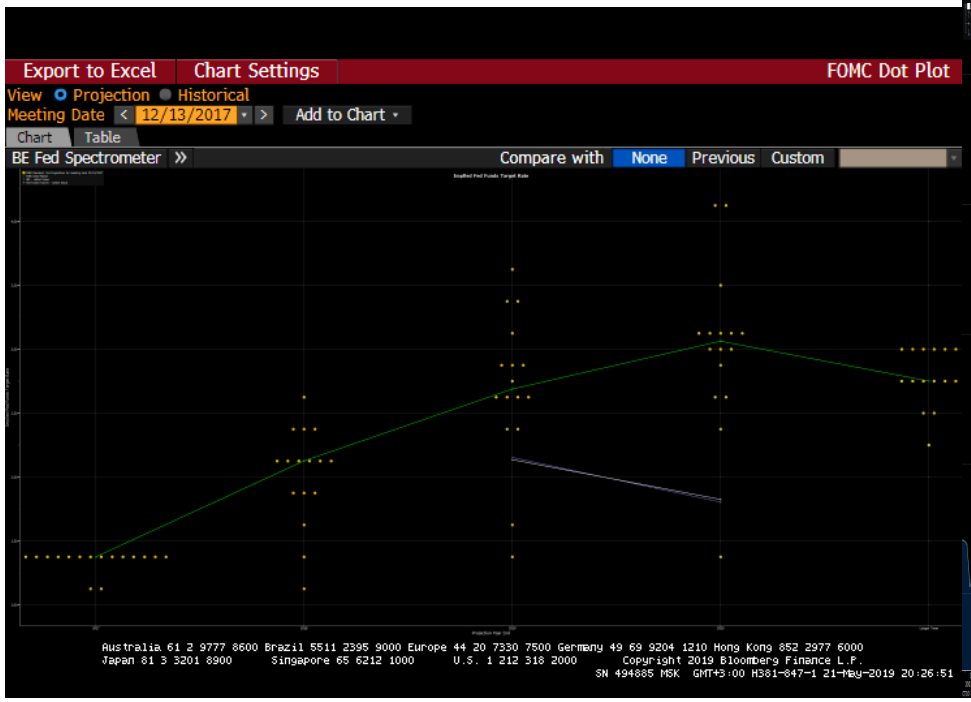


Federal reserve, Bloomberg, Goldman Sachs International

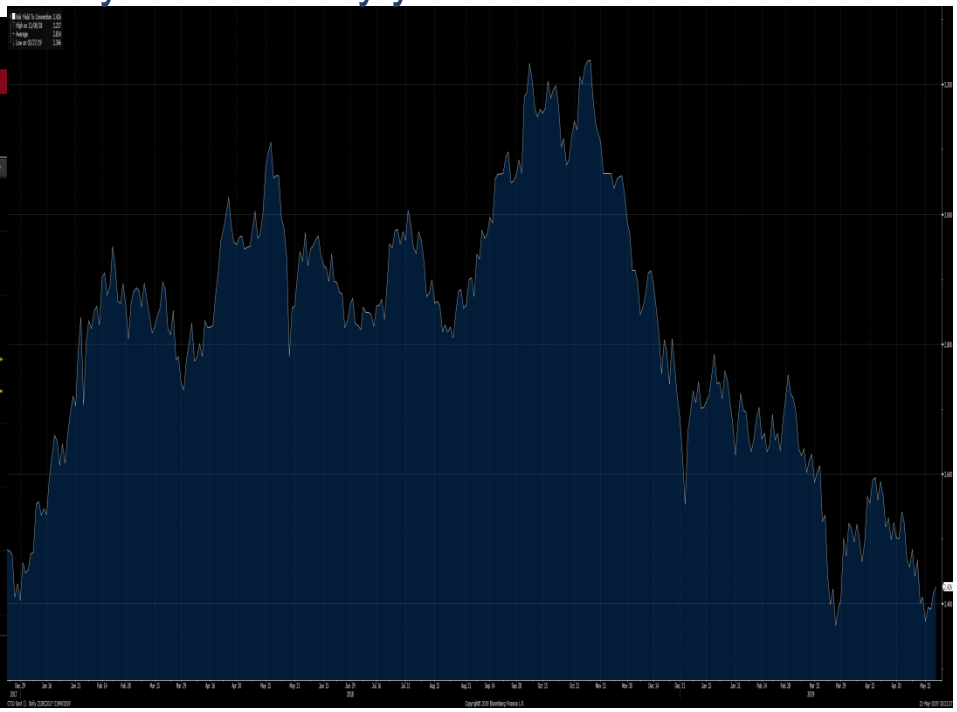
The repricing of the curve in 2018 despite actions being largely in line with analysts' and Fed forecasters

- Dec-17: Median Fed Dot chart was showing 75bps of hikes in 2018 and a similar number in 2019 and 2020. However, 10 year treasuries were at 2.40.
- Similarly consensus forecasts were for 75bps of hikes as well.

Fed Dot's as of Dec-2017 showing tightening



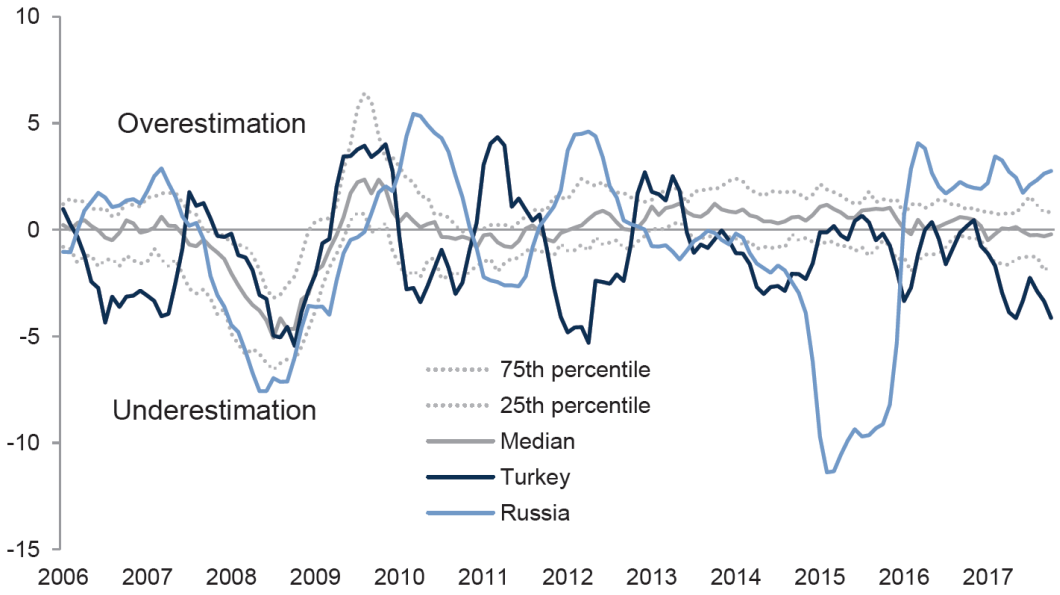
10 yr US treasury yields since end 2017



Bloomberg, Goldman Sachs Global Investment Research

More mundane issues in many emerging countries

Ex post mistakes in forcasting inflation in Turkey and Russia



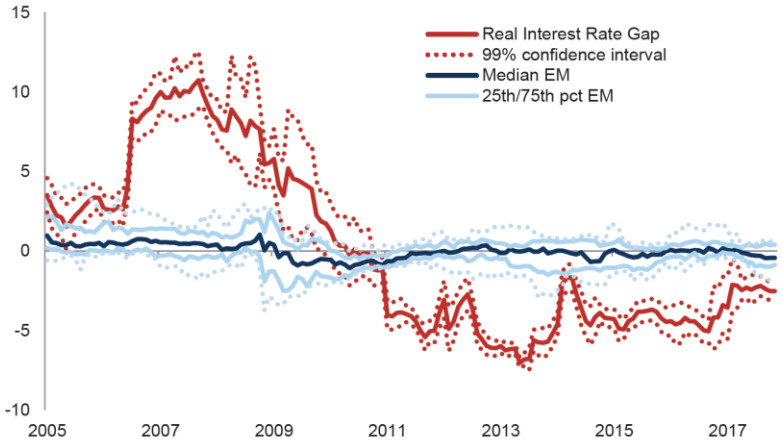
Source: Haver Analytics, Consensus Economics

12-month lagged 12-month-forward inflation expectations minus realised yoy inflation for Russia, Turkey, the median among EM and its 25th and 75th percentiles respectively

At least ex post there is little mystery why Turkish inflation consistently overshot

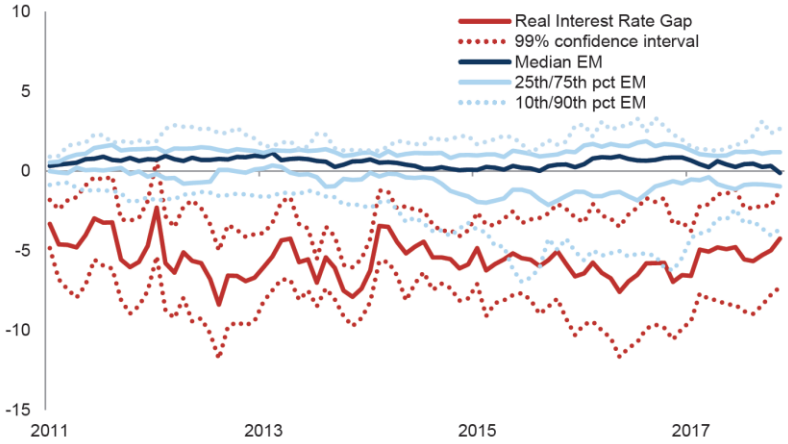
- Simple Taylor rules show that rates were too low
  - No matter if benchmarked vs other EM's
  - Or against Turkey's own history.

Exhibit 3: The cross-sectional approach reveals how the interest rate gap in Turkey has remained extremely low compared with other EMs throughout the post-2011 period ...



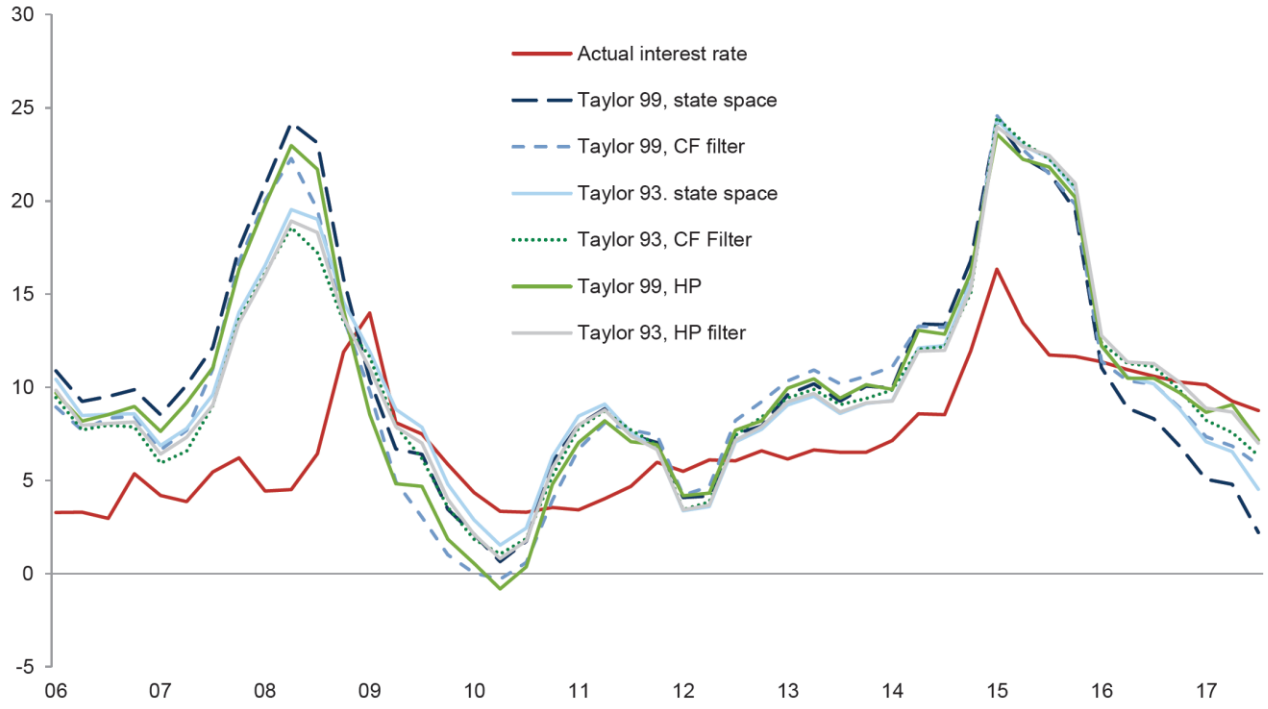
Source: Goldman Sachs Global Investment Research

Exhibit 4: ... and the time-series approach yields even larger estimates of Turkey's real interest rate gap in the out-of-sample post-2011 period



Source: Goldman Sachs Global Investment Research

CBR instead kept rates above the level of standard Taylor rates



Source: Haver Analytics, Goldman Sachs Global Investment Research

Disclosure Appendix

April 23, 2019

Disclosure Appendix

Reg AC

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