



STABILIZATION AND EXPANDED COMMITMENT: A THEORY OF FORWARD GUIDANCE FOR ECONOMIES WITH RATIONAL EXPECTATIONS

Andrew Hughes Hallett¹
Nicola Acocella²

ABSTRACT

In this paper we construct a general theory of forward guidance in economic policy making, in order to provide a framework to explain the role and strategic advantages of including forward guidance as an explicit part of policy design. We do this by setting up a general policy problem in which forward guidance plays a role and then examine the consequences for performance when that guidance is withdrawn. Following results in Acocella et al (2013), who extend the theory of economic policy to a world with rational expectations, we show that forward guidance provides enhanced controllability and stabilizability – especially where such properties have not been available before. As a by-product we find that forward guidance severely limits the scope and incentives for time inconsistent behaviour in an economy whose policy goals are ultimately reachable. It can therefore add to the credibility of a set of policies.

Classification JEL: E42, E58, E61, E63

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¹ Department of Public Policy – George Mason University – 3351 Fairfax Drive, Arlington, VA 22201, USA (ahughesh@gmu.edu).

² Department of Methods and Models for Economics, Territory and Finance, MEMOTEF. – Sapienza University of Rome. – via Castro Laurenziano, 9 00161 ROMA (e-mail: ✉ nicola.acocella@uniroma1.it).