Forward Guidance as a Policy Rule

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Keynote Speech

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Outline

- Recent revival of policy rules research
  - Recent papers
  - Fed publications
  - New measures of discretion versus rules
  - Instrument rules rather than forecast targeting
- Explanations
- Implications
  - Need for robustness to different models and parameters
  - Need for international models to evaluate rules
  - Need research with QE as an instrument in a rule
- Conclusions

Revival of Research on Monetary Policy Rules

- Bernanke, Kiley and Roberts (2019) examine ten different monetary policy rules using the FRB/US model
- Mertens and Williams (2019) evaluate different monetary rules with new Keynesian model; present results in May.
- Sims and Wu (2019) evaluate different monetary policy rules with new structural model; present results in June.

Example: 10 policy rules studied by Bernanke, Kiley, Roberts (2019)

$$i_t^{Tay} = r^* + \pi_t + 0.5(\pi_t - \pi^*) + \hat{y}_t$$

Taylor rule

$$i_t^{iTay} = \rho i_{t-1} + (1 - \rho)[r^* + \pi_t + 0.5(\pi_t - \pi^*) + \hat{y}_t]$$

$$i_t^{FPLT} = r^* + \pi_t + 0.5(\pi_t - \pi^*) + \hat{y}_t + P_t$$

$$i_t^{iFPLT} = \rho i_{t-1} + (1 - \rho)[r^* + \pi_t + 0.5(\pi_t - \pi^*) + \hat{y}_t + P_t]$$

$$i_t^{FTPLT} = \rho i_{t-1} + (1 - \rho)[r^* + \pi_t + 0.5(\pi_t - \pi^*) + \hat{y}_t + \alpha TP_t]$$

$$\boxed{TP_t = \sum_{j=t1}^{m}(\pi_j - \pi^*)}$$

$$i_t = \max\{0, i_t^{Tay} - \sum_{j=t1}^{t-1}(i_j - i_j^{Tay})\}$$

Reifschneider-Williams

$$i_t^{KR} = i_{t-1}^{KR} + \alpha[(\pi_t - \pi^*) + \hat{y}_t]$$

Plus 3 TPLT rules, which are like iTay except for an ELB threshold

A Recent Revival of Research on Monetary Policy Rules

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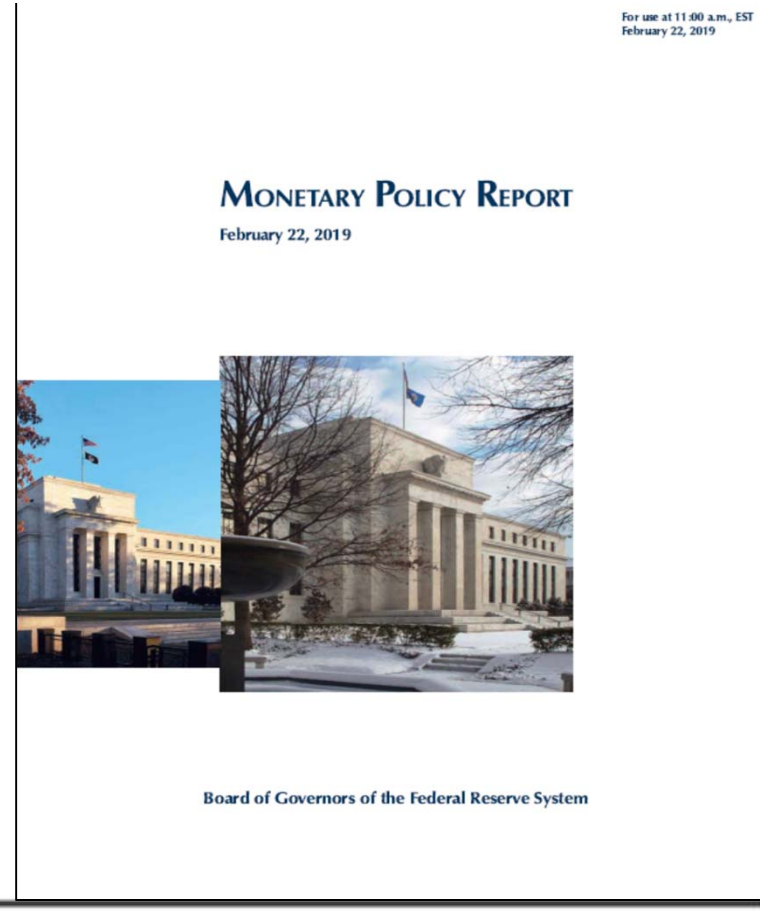
- Whole new section on monetary policy rules in last 4 of Fed's *Monetary Policy Reports* (2017-19) with five different policy rules presented & compared with actual policy.
  - Cochrane, Taylor and Wieland (2019) and Eberly, Stock and Wright (2019) evaluate monetary policy rules in the *Report*

Publications: Rules Are In

Monetary Policy Reports, Fed (2019)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February 22, 2019

MONETARY POLICY REPORT

February 22, 2019

Board of Governors of the Federal Reserve System

A. Monetary policy rules

Taylor (1993) rule	$R_t^{T93} = r_t^{LR} + \pi_t + 0.5(\pi_t - \pi^{LR}) + (u_t^{LR} - u_t)$
Balanced-approach rule	$R_t^{BA} = r_t^{LR} + \pi_t + 0.5(\pi_t - \pi^{LR}) + 2(u_t^{LR} - u_t)$
Taylor (1993) rule, adjusted	$R_t^{T93adj} = maximum\ \{R_t^{T93} - Z_t, 0\}$
Price-level rule	$R_t^{PL} = maximum\ \{r_t^{LR} + \pi_t + (u_t^{LR} - u_t) + 0.5(PLgap_t), 0\}$
First-difference rule	$R_t^{FD} = R_{t-1} + 0.5(\pi_t - \pi^{LR}) + (u_t^{LR} - u_t) - (u_{t-4}^{LR} - u_{t-4})$

A Recent Revival of Research on Monetary Policy Rules

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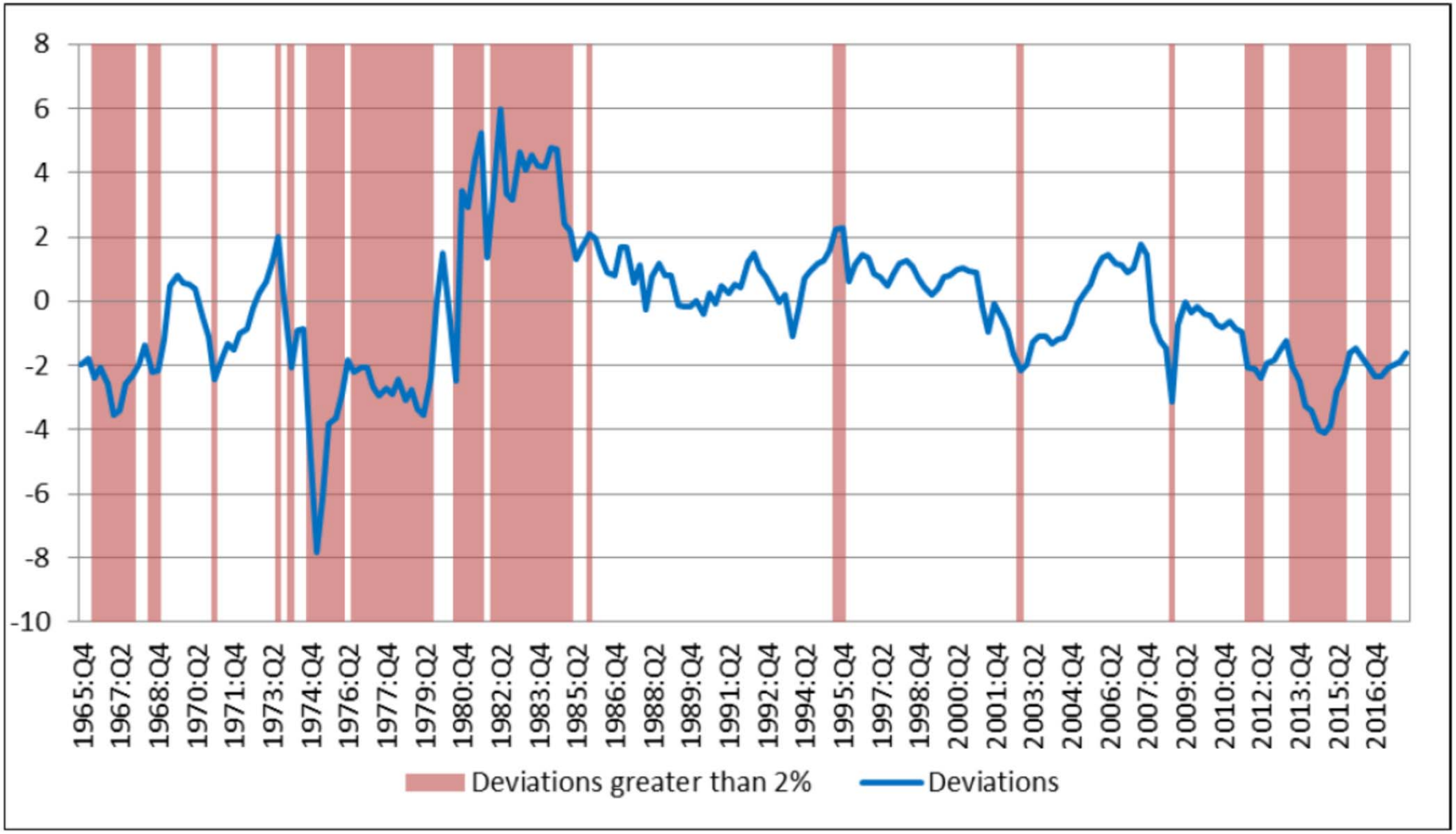
  - Cochrane, Taylor and Wieland (2019) and Eberly, Stock and Wright (2019) evaluate monetary policy rules in the *Report*
- New measures of discretion versus rules
  - Nikolsko-Rzhevskyy, Papell and Prodan (2018) compare policy rules with discretion historically using new econometric techniques

New Measures of Discretion

- Nikolsko-Rzhevskyy, Papell and Prodan define
  - Rule: specific policy rule for the interest rate
  - Discretion: deviation of actual interest rate from that rule.
- US economic performance was worse in periods of discretion (see time series chart)
- Calculations repeated for 400 rules of same form with φ_y and φ_π taking 20 different values between 0.1 & 2.0.
  - Discretion to Rules Loss Ratio: the average loss in high deviation periods divided by the average loss in low deviations periods.
  - Loss ratio is greater than one for all rules (see color chart)
  - "Inflation-tilting" rules result in better performance.
    - Fed's *Monetary Policy Report* should include such rules.

Figure 6. Deviations from the Original Taylor Rule



Source: Nikolsko-Rzhevskyy, Papell, and Prodan (2018)

Discretion to Rule Loss Ratios with Different Rules

Panel B: Inflation Gap α and Output Gap γ Coefficients Range [0,2]

Inflation gap coefficient, α \ Output gap coefficient, γ	0.1	0.2	0.3	0.4	0.5	0.6	0.7	0.8	0.9	1.0	1.1	1.2	1.3	1.4	1.5	1.6	1.7	1.8	1.9	2.0
2.0	6.66	5.68	6.56	7.14	7.53	7.06	7.41	7.97	7.68	8.20	7.96	7.91	7.19	6.67	5.08	4.65	4.31	3.00	2.38	2.09
1.9	7.04	5.84	6.62	7.25	7.50	7.00	7.38	7.91	7.90	8.10	8.38	7.91	7.19	6.23	5.01	4.08	3.41	2.68	2.30	2.12
1.8	4.98	6.08	6.75	7.11	7.41	7.03	7.18	8.07	7.87	8.24	8.36	7.80	5.86	5.05	4.42	3.59	2.77	2.51	2.21	2.16
1.7	5.14	4.75	6.47	6.90	7.30	6.96	7.05	8.03	7.87	8.43	7.35	6.41	5.91	4.40	3.95	3.16	2.96	2.51	2.07	2.10
1.6	5.34	4.87	5.22	7.24	7.47	6.86	7.16	8.19	7.27	6.76	6.92	6.64	4.82	4.32	3.73	2.81	2.40	2.32	2.08	1.73
1.5	5.33	4.91	5.13	7.24	6.95	7.00	6.45	7.60	6.97	6.78	6.17	5.79	4.18	3.70	2.92	2.53	2.49	2.09	1.78	1.61
1.4	4.35	5.10	5.39	5.46	6.50	6.64	6.77	7.34	5.77	5.66	5.49	5.04	4.18	3.17	2.79	2.30	2.21	1.95	1.82	1.72
1.3	3.47	3.45	5.23	5.59	5.27	5.96	5.64	6.01	5.78	5.66	5.49	4.85	3.25	2.80	2.38	2.46	2.14	1.93	1.82	1.80
1.2	3.38	3.62	3.65	4.25	4.91	5.58	5.64	6.22	5.79	5.17	4.87	3.86	3.13	2.76	2.75	2.14	2.14	2.05	1.87	1.79
1.1	3.24	3.43	3.59	3.64	3.91	4.07	5.66	5.59	5.36	4.91	4.54	3.87	3.01	2.84	2.22	2.06	1.96	2.09	1.75	1.61
1.0	3.29	3.17	3.33	3.46	3.44	3.87	3.84	4.33	5.59	4.79	3.86	3.51	2.67	2.24	2.29	1.97	1.86	1.71	1.65	1.64
0.9	3.04	3.11	3.11	3.30	3.29	2.96	3.39	3.33	3.63	3.50	3.40	2.75	2.42	2.16	2.04	1.81	1.87	1.86	1.61	1.54
0.8	2.53	2.54	2.63	2.76	3.16	3.10	3.10	3.31	4.12	3.46	2.55	2.20	2.24	2.04	1.98	2.02	1.96	1.68	1.55	1.44
0.7	2.54	2.56	2.67	2.92	3.10	3.27	3.54	2.93	3.06	2.62	2.29	1.91	1.70	1.61	1.63	1.51	1.44	1.41	1.29	1.17
0.6	2.27	2.37	2.54	2.73	3.03	3.06	3.12	2.76	2.25	2.06	2.03	1.78	1.53	1.44	1.34	1.28	1.55	1.39	1.32	1.18
0.5	1.93	2.00	2.07	2.56	2.82	2.93	3.01	2.39	2.15	1.82	1.92	1.83	1.51	1.43	1.33	1.33	1.29	1.20	1.40	1.27
0.4	1.88	2.08	2.11	2.36	2.47	2.40	2.36	2.26	2.23	1.85	1.47	1.63	1.56	1.33	1.23	1.15	1.27	1.17	1.10	1.01
0.3	1.98	1.87	1.82	1.96	1.99	1.97	2.09	1.99	1.95	1.48	1.36	1.25	1.43	1.39	1.36	1.31	1.25	1.13	1.08	1.02
0.2	1.65	1.74	1.75	1.83	1.79	1.80	1.67	1.80	1.75	1.43	1.23	1.10	1.06	1.34	1.47	1.35	1.26	1.08	1.01	1.05
0.1	1.13	1.21	1.26	1.26	1.39	1.38	1.28	1.37	1.58	1.31	1.22	1.13	1.06	1.20	1.20	1.17	1.12	1.18	1.18	1.21

Source: Nikolsko-Rzhevskyy, Papell, and Prodan (2018), Figure 8

What Explains the Current Revival?

- Much research for 25 years (70s,80s 90s) less in past 15, why revival?
- Revealed preference:
  - Cecchetti & Schoenholtz (2019) found "The most frequently mentioned topic is the desirability of having a clear understanding of policymakers' reaction function."
  - Raghu Rajan: "what we need are monetary rules,"
  - Mario Draghi: "we would all clearly benefit from…improving communication over our reaction functions…"
  - Jay Powell "I find these rule prescriptions helpful"
- Need to improve monetary policy with concern about ELB
  - Calls for rules to deal with ELB and for their evaluation. Huge motivation, including Lilley & Rogoff (2019) & Bordo & Levin (2019)
- Disappointments with monetary policy leading to great recession with deviation from rules in the 2003-2005 "too low for too long" period
- Recognition that we need rules to evaluate QE
  - Brian Sack (2019), "'Talking more about the policy rules…is appropriate' to guide future bond purchase programs and improve their impact."
- Concern about Policy Rules Legislation in Congress in 2017-20 18

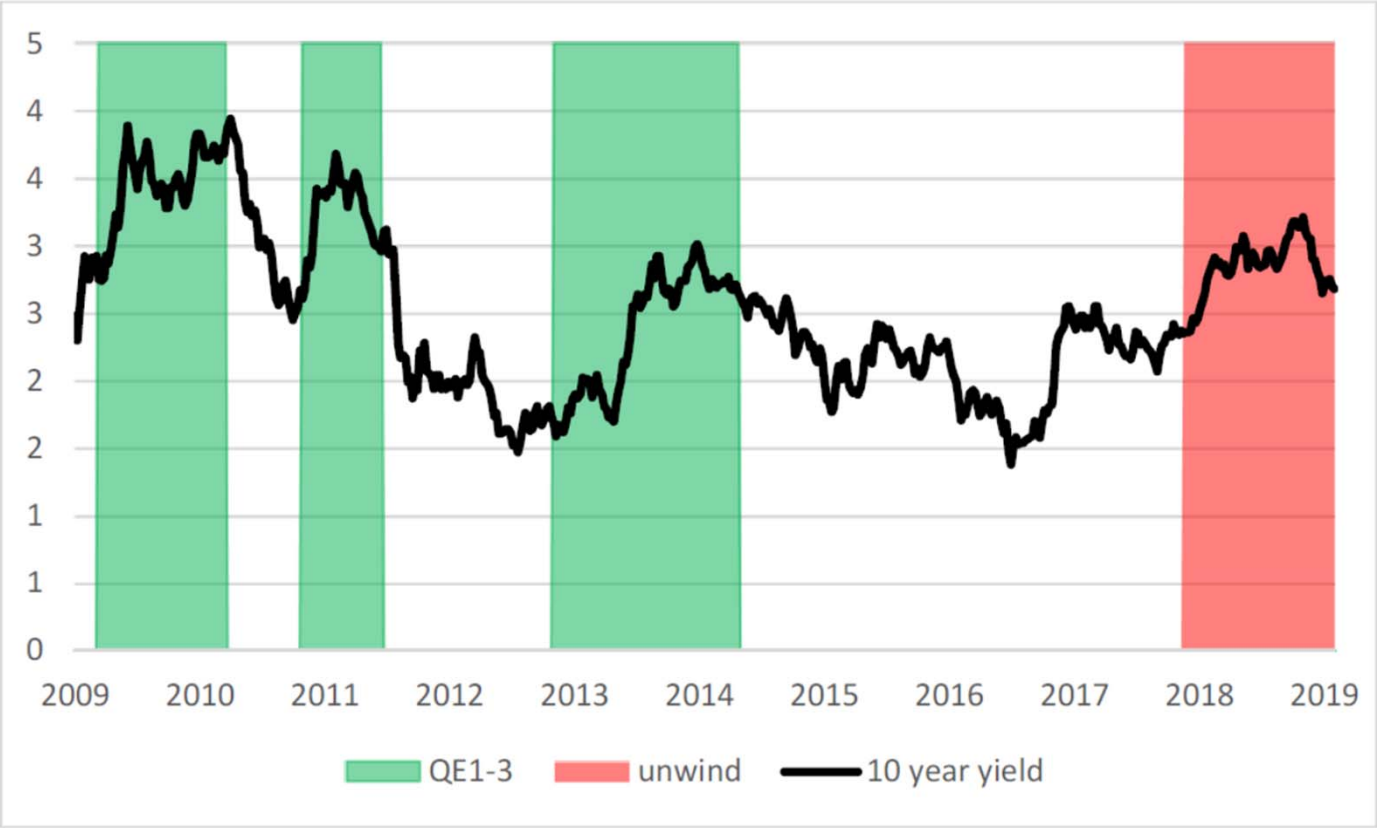
Key Features of Revival

1. Monetary policy rules in revival are in terms of policy instruments
   - Not "forecast targeting" which is specific about the goals, such as 2% inflation, but not about the policy instruments.
   - Other examples: money supply, Belognia & Ireland (2019), or bond purchases, Sims & Wu (2019), as policy instrument
2. Very few rules assume instrument is QE or LSAPs.
   - Exception is Sims and Wu (2019), who propose a Taylor rule for LSAPs
     - Also Gagnon & Sack (2018)
     - Eberly, Stock & Wright (2019) assume that instrument is the slope, but without quantitative model of how instruments affect the slope.
   - Perhaps due to doubts about impact of quantitative easing
     - Bordo and Levin (2019): "OE3 was not an effective form of monetary stimulus"
     - Hamilton (2019): See charts…

Jim Hamilton (2019)

- "On net this rate rose during each of the episodes QE1-3 in which Fed actions were attempting to bring it down, and fell when the Fed was not making new purchases."

Figure 2. Interest rate on 10-year Treasury bond.

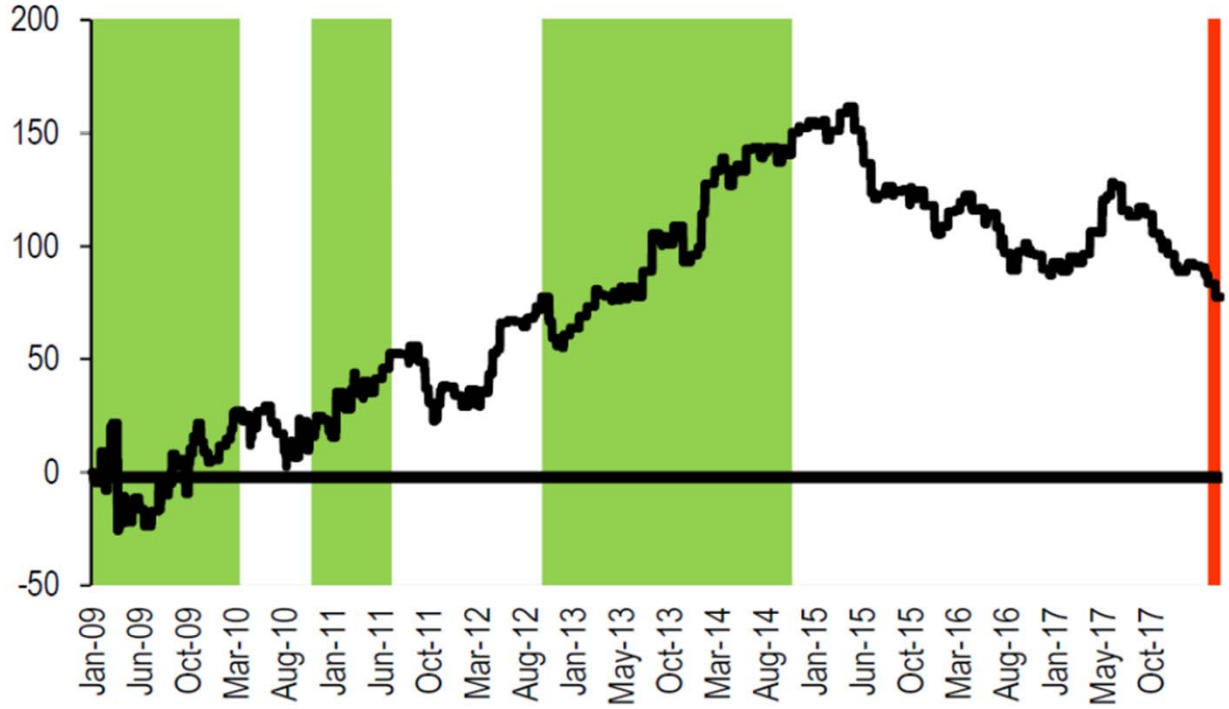


Hamilton (2019) Hoover Monetary Conference *Strategies for Monetary Policy*, May 3

Jim Hamilton (2019)

- "yields on average rose, not fell, during QE1-3, even if we focus on just days in which the Fed made an announcement."

Figure 3. Cumulative change in 10-year yield on Fed Days.



Notes to Figure 3. Cumulative change in interest rate on 10-year Treasury bond on FOMC meeting days days when FOMC minutes were released, or days with speech by Fed chair on economy or monetary policy, Jan 1, 2009 to Dec 29, 2017. Data source: Greenlaw et al. (2018).

Key Features of Revival

1. Monetary policy rules in revival are in terms of policy instruments
   - Not "forecast targeting" which is specific about the goals, such as 2% inflation, but not about the policy instruments.
   - Forecast targeting used by Svensson (2019), critiqued by Taylor (2010).
   - Other examples: papers with money supply, Belognia & Ireland (2019), or bond purchases, Sims & Wu (2019), as policy instrument
2. Very few rules assume instrument is QE or LSAPs.
   - Exception is Sims and Wu (2019), who propose a Taylor rule for LSAPs
     - Also Gagnon & Sack (2018)
     - Eberly, Stock & Wright (2019) assume that instrument is the slope, but without quantitative model of how instruments affect the slope.
   - Perhaps due to doubts about impact of quantitative easing
     - Bordo and Levin (2019): "Our empirical analysis indicates that QE3 was not an effective form of monetary stimulus"
     - Hamilton (2019): See charts…
3. Recent policy rules in Fed's *Monetary Policy Reports* and elsewhere have Taylor principle with coefficient on inflation greater than 1.
   - "One key principle is … the policy rate should be adjusted by more than one-for-one in response to persistent increases or decreases in inflation." – *Monetary Policy Report*
   - Implications for *Forward Guidance Puzzle…*

Definitions of Forward Guidance -- with & without Deviations from Rule

- **<u>Forward Guidance as a Policy Rule</u>**
- Bean (2013): forward guidance "is intended primarily to clarify our reaction function."
- Reifschneider and Williams (2000) embed forward guidance in a "meta rule"
- **<u>Forward Guidance as a Deviation Policy Rule</u>**
- Del Negro, Giannoni, and Patterson (2015) & McKay, Nakamura and Steinsson (2016).
- This is where forward guidance *puzzle* may occur
- *Forward guidance puzzle:* an announcement of a future interest rate increase has a large immediate effect which increases in size with the length of period between announcement and action.

Ruling Out Forward Guidance Puzzles

- Maliar and Taylor (2019) show that forward guidance puzzle does not arise with sensible assumptions about policy rule
  - These assumptions include the Taylor principle.
  - As in Fed *Monetary Policy Reports* and recent research
- In simple NK model these assumptions yield two unstable roots and thus a unique stable solution…

Simple model

$$y_t = E_t[y_{t+1}] - \sigma(i_t - E_t[\pi_{t+1}]) \qquad (1)$$

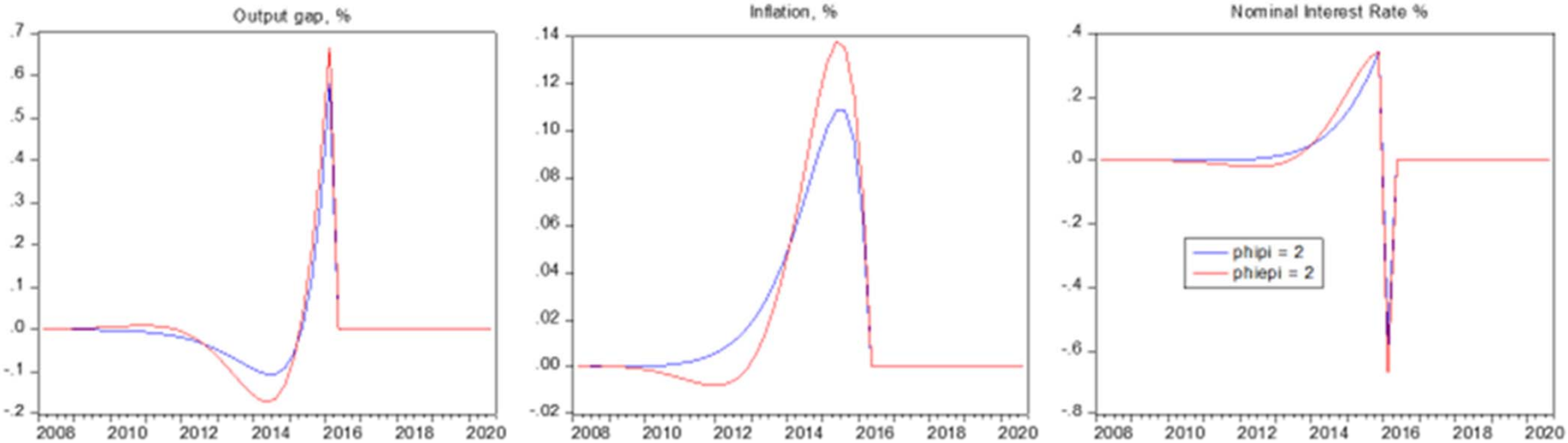
$$\pi_t = \beta E_t[\pi_{t+1}] + \kappa y_t \qquad (2)$$

$$i_t = \varphi_\pi \pi_t + \varphi_{E\pi} E[\pi_{t+1}] + \varphi_y y_t + \varepsilon_t \qquad (3)$$

real output y_t, the inflation rate π_t, and the interest rate i_t

The structural parameters are $\beta = .99$, $\kappa = .11$, and $\sigma = 1$, and the policy rule parameters are $\varphi_y = .5$ and either $\varphi_\pi = 2$ or $\varphi_{E\pi} = 2$. With $\varphi_\pi > 1$ and $\varphi_{E\pi} > 1$ the model satisfies the Taylor principle

Impact on Output and Inflation of an Announced Deviation from the Interest Rate Rule



Simulation of model with equations (1), (2) and (3) with phiy = .5, phipi = 2 or phiepi=2,
kappa = .11, sigma = 1, beta=.99, g= 0, i*=0, i^n =0.
Charts show effects of a one-time shock ε = -1 to the policy rule (3) in 2016.1 anticipated in 2008.1, (T=28).

Need for Robustness Studies

- Bernanke, Kiley and Roberts (2019) look at FRB/US.
- Nikolsko-Rzhevskyy, Papell, and Prodan (2018) look at Smets-Wouters US model and compare.
  - They simulate rules using 100 different values of φ_y and φ_π
- The results are <u>completely opposite in the two models</u>:
  - Smets-Wouters, rule with the lowest loss: $\varphi_y = 0.3$ and $\varphi_\pi = 1.0$.
  - FRB/US model, rule with the lowest loss: $\varphi_y = 1.0$ and $\varphi_\pi = 0.1$.
- An amazingly large difference between policy models

Losses With Different Rules

Figure 12. Smets and Wouters (2007) model

Inflation gap coefficient, α	0.1	0.2	0.3	0.4	0.5	0.6	0.7	0.8	0.9	1
1	29.97	29.45	29.40	29.76	30.46	31.45	32.69	34.15	35.80	37.61
0.9	29.94	29.48	29.58	30.14	31.08	32.36	33.91	35.70	37.68	39.84
0.8	29.95	29.60	29.89	30.72	32.00	33.64	35.59	37.79	40.20	42.78
0.7	30.03	29.83	30.41	31.62	33.34	35.47	37.94	40.67	43.62	46.73
0.6	30.23	30.27	31.28	33.02	35.36	38.16	41.31	44.74	48.38	52.18
0.5	30.62	31.07	32.72	35.27	38.49	42.22	46.32	50.68	55.23	59.90
0.4	31.38	32.56	35.26	39.05	43.59	48.66	54.07	59.69	65.44	71.23
0.3	32.95	35.51	40.06	45.87	52.45	59.49	66.76	74.10	81.41	88.62
0.2	36.69	42.21	50.23	59.51	69.35	79.32	89.17	98.76	107.99	116.84
0.1	48.82	61.39	76.24	91.45	106.16	120.02	132.92	144.85	155.85	165.99

Output gap coefficient, γ

Source: Nikolsko-Rzhevskyy, Papell, and Prodan (2018)

Losses with Different Rules

Figure 13. FRB-US Model: 2

Inflation gap coefficient, α	0.1	0.2	0.3	0.4	0.5	0.6	0.7	0.8	0.9	1	
1	70.54	68.39	66.60	65.14	63.97	63.05	62.36	61.88	61.57	61.44	1
0.9	70.04	67.86	66.05	64.58	63.40	62.49	61.80	61.33	61.04	60.92	0.9
0.8	69.57	67.36	65.52	64.04	62.85	61.95	61.27	60.81	60.53	60.42	0.8
0.7	69.13	66.88	65.02	63.52	62.33	61.43	60.76	60.31	60.04	59.95	0.7
0.6	68.72	66.42	64.53	63.02	61.83	60.93	60.28	59.83	59.58	59.50	0.6
0.5	68.34	65.99	64.08	62.55	61.36	60.46	59.82	59.39	59.15	59.09	0.5
0.4	67.99	65.59	63.65	62.10	60.91	60.02	59.39	58.97	58.75	58.70	0.4
0.3	67.67	65.22	63.25	61.69	60.50	59.61	58.98	58.58	58.37	58.33	0.3
0.2	67.39	64.88	62.88	61.31	60.11	59.23	58.61	58.22	58.02	58.00	0.2
0.1	67.14	64.58	62.54	60.96	59.76	58.88	58.27	57.89	57.71	57.69	0.1
	0.1	0.2	0.3	0.4	0.5	0.6	0.7	0.8	0.9	1	

Output gap coefficient, γ

Source: Nikolsko-Rzhevskyy, Papell, and Prodan (2018)

Example: Checking for robustness

- Cochrane, Taylor, Wieland (2019) rules in Fed *Report*
- Used 7 structural models (Macro Model Data Base)
  - OK: small 3-equation old-Keynesian model
  - NK: small 3-equation new-Keynesian model
  - SW: Smets Wouters (2007) medium-size policy model
  - TMCM: Taylor (1993) multi-country model
  - CCTW10: Cogan, Cwik, Taylor and Wieland (2010)
  - CMR14: Christiano-Motto-Rostagno (2014), adds frictions
  - IN10: Iacoviello and Neri (2010) adds housing market
- Results: rules in Fed *Report* work pretty well.

How model differences affect policy rules?

- If equilibrium interest rate is down by 1%
  - Then reduce intercept in Taylor Rule by 1%.
- If slope of "Phillips curve" is down (curve got flatter, so that gap has a smaller effect on inflation)
  - Then reduce the coefficient on output in Taylor Rule
  - But how much?
    - Bullard (2018) reduced by same amount: factor of 10, from 1 to .1
  - However, the coefficient on output in policy rule is only partly due to the slope of Phillips curve…

Consider a model and a policy rule

Laurence Ball "Efficient Rules for Monetary Policy"

$$y_t = -\beta r_{t-1} + \lambda y_{t-1} + \varepsilon_t$$

Slope changes

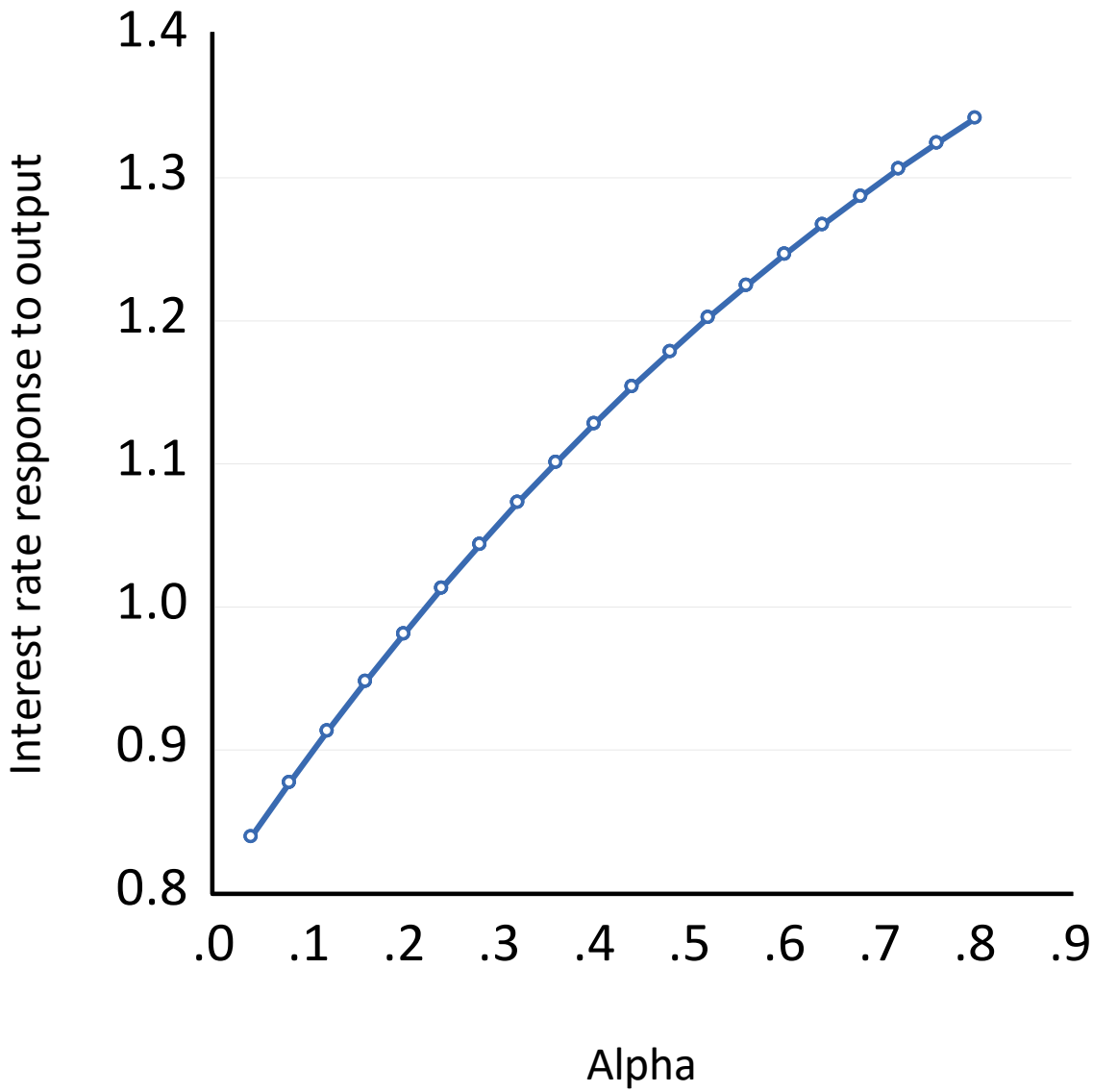
$$\pi_t = \pi_{t-1} + \alpha y_{t-1} + \eta_t$$

$$r_t = [(\lambda+\alpha q)/\beta]y_t + [q/\beta]\pi_t$$

$$\min[\mathrm{var}(y_t) + \mu \mathrm{Var}(\pi_t)]$$

$$q = -\mu\alpha + (\mu^2\alpha^2+4*\mu)^{.5})$$

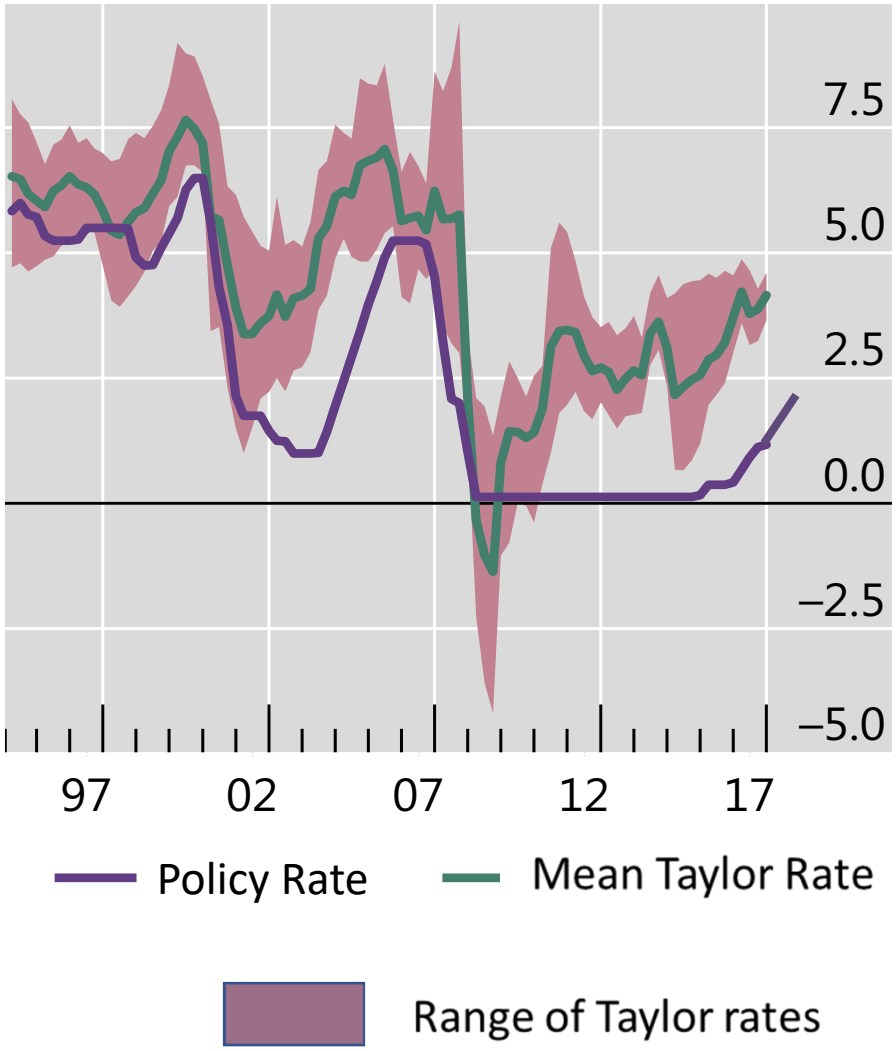
$\beta=1.0$, $\lambda=0.8$, $\alpha = [.04,\ldots,\mathbf{0.4},\ldots,0.8]$


1.4
1.3
1.2
1.1
1.0
0.9
0.8
Interest rate response to output
.0
.1
.2
.3
.4
.5
.6
.7
.8
.9
Alpha

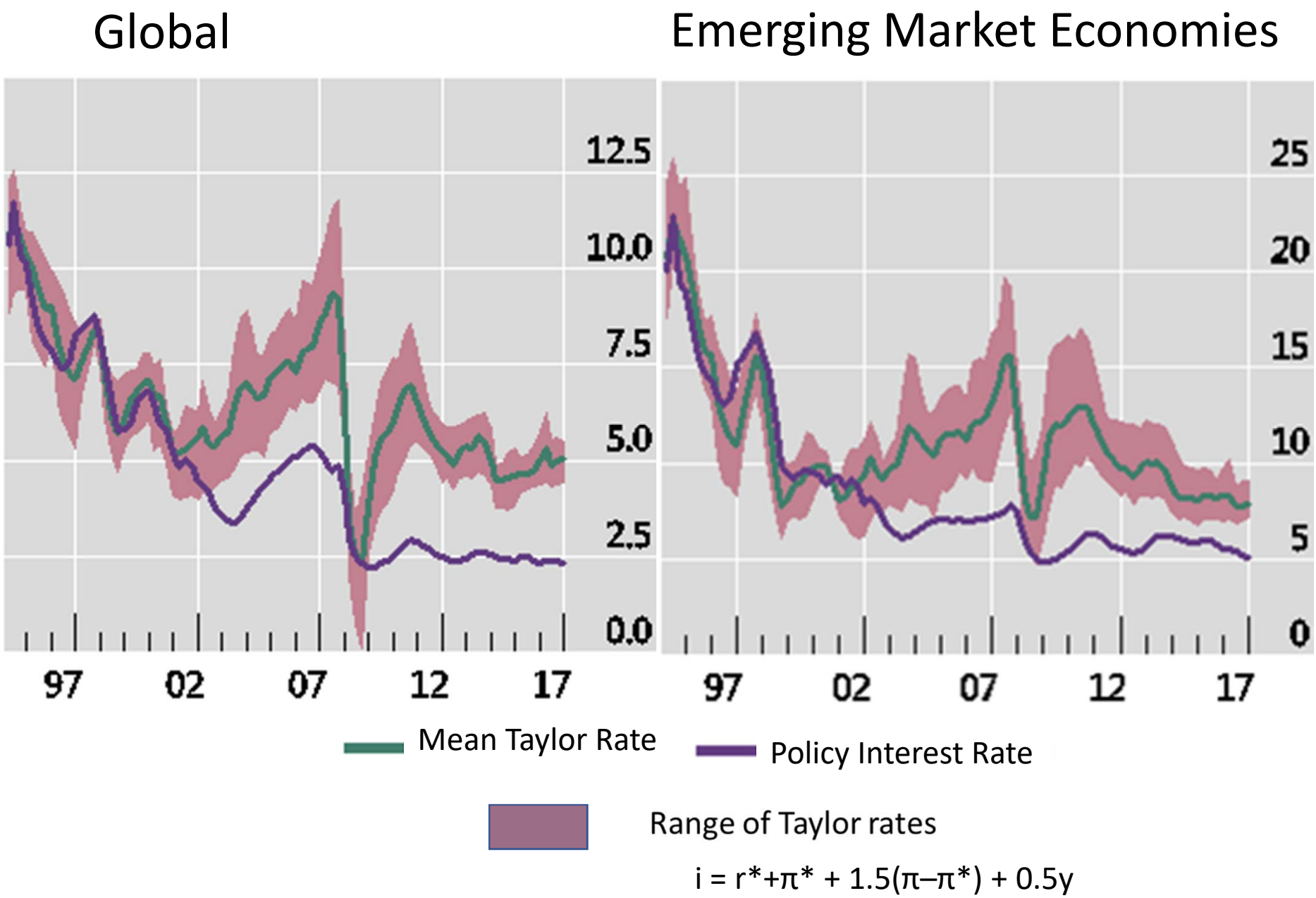
International Monetary Considerations

- Policy rules for international monetary system are a natural extension of the idea of policy rules in each country
  - Though rules will not be the same in each country
- International monetary models can be enormously helpful.
  - For example, can assess if Nash equilibrium is optimal globally
- Yet, little or no revival of policy rule research in global context
  - Research cited at the start of talk is largely single country

United States



Source: Bank for International Settlements, 2018


Global
Emerging Market Economies
12.5
10.0
7.5
5.0
2.5
0.0
25
20
15
10
5
0
97
02
07
12
17
97
02
07
12
17
Mean Taylor Rate
Policy Interest Rate
Range of Taylor rates
i = r*+π* + 1.5(π–π*) + 0.5y

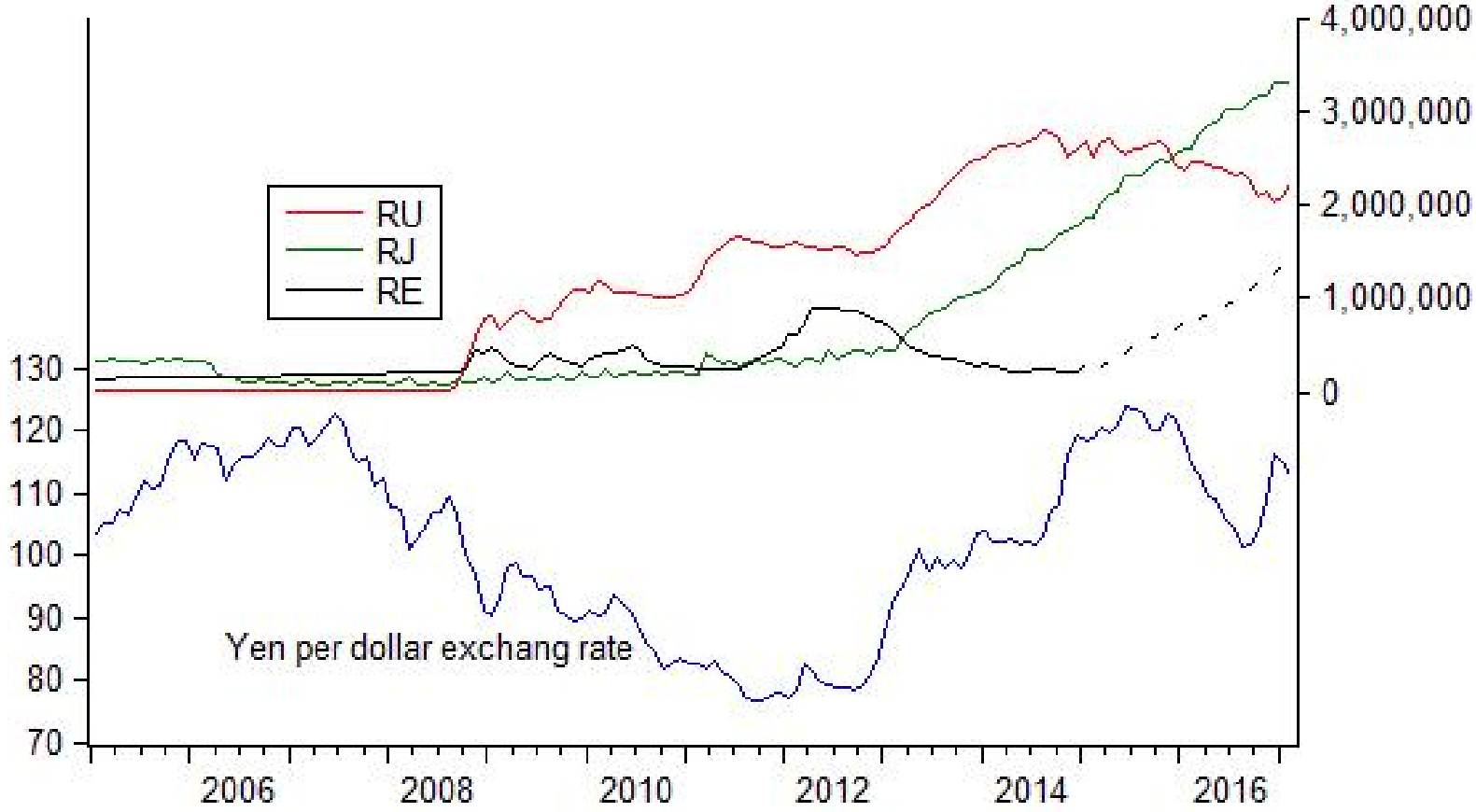
Source: BIS

Correlations Between Reserve Balances and Interest Rates

	R_U	R_J	R_E	R_S	I_U	I_J	I_E	I_S
R_U	1.00							
R_J	**0.72**	1.00						
R_E	**0.49**	**0.64**	1.00					
R_S	**0.89**	**0.85**	**0.69**	1.00				
I_U	**-0.77**	**-0.36**	**-0.44**	**-0.58**	1.00			
I_J	**-0.53**	**-0.45**	**-0.37**	**-0.48**	**0.49**	1.00		
I_E	**-0.81**	**-0.57**	**-0.51**	**-0.71**	**0.76**	**0.87**	1.00	
I_S	**-0.84**	**-0.61**	**-0.59**	**-0.76**	**0.78**	**0.85**	**0.97**	1.00

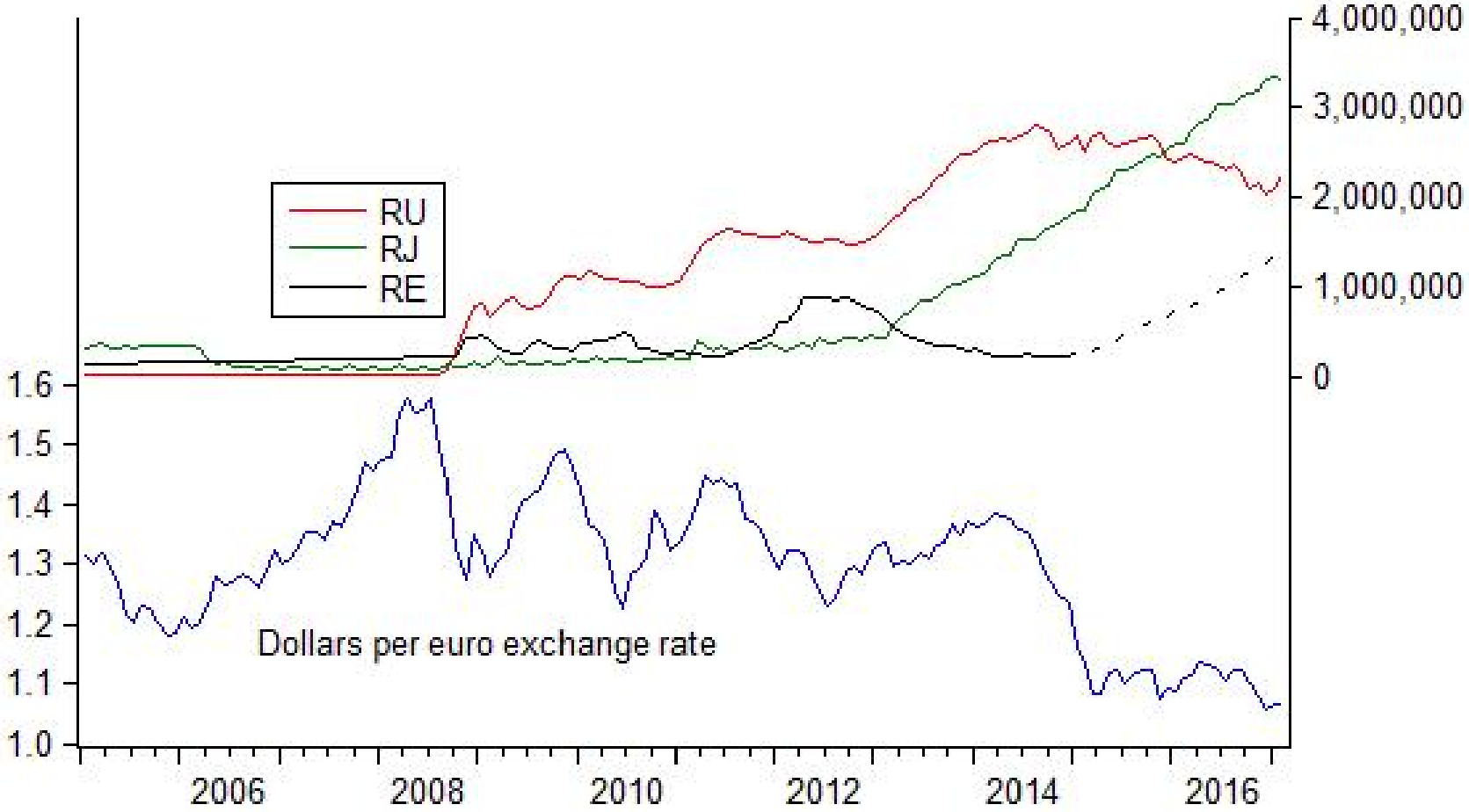
Sample: 2005.1 2017.5

Source: Taylor (2019)



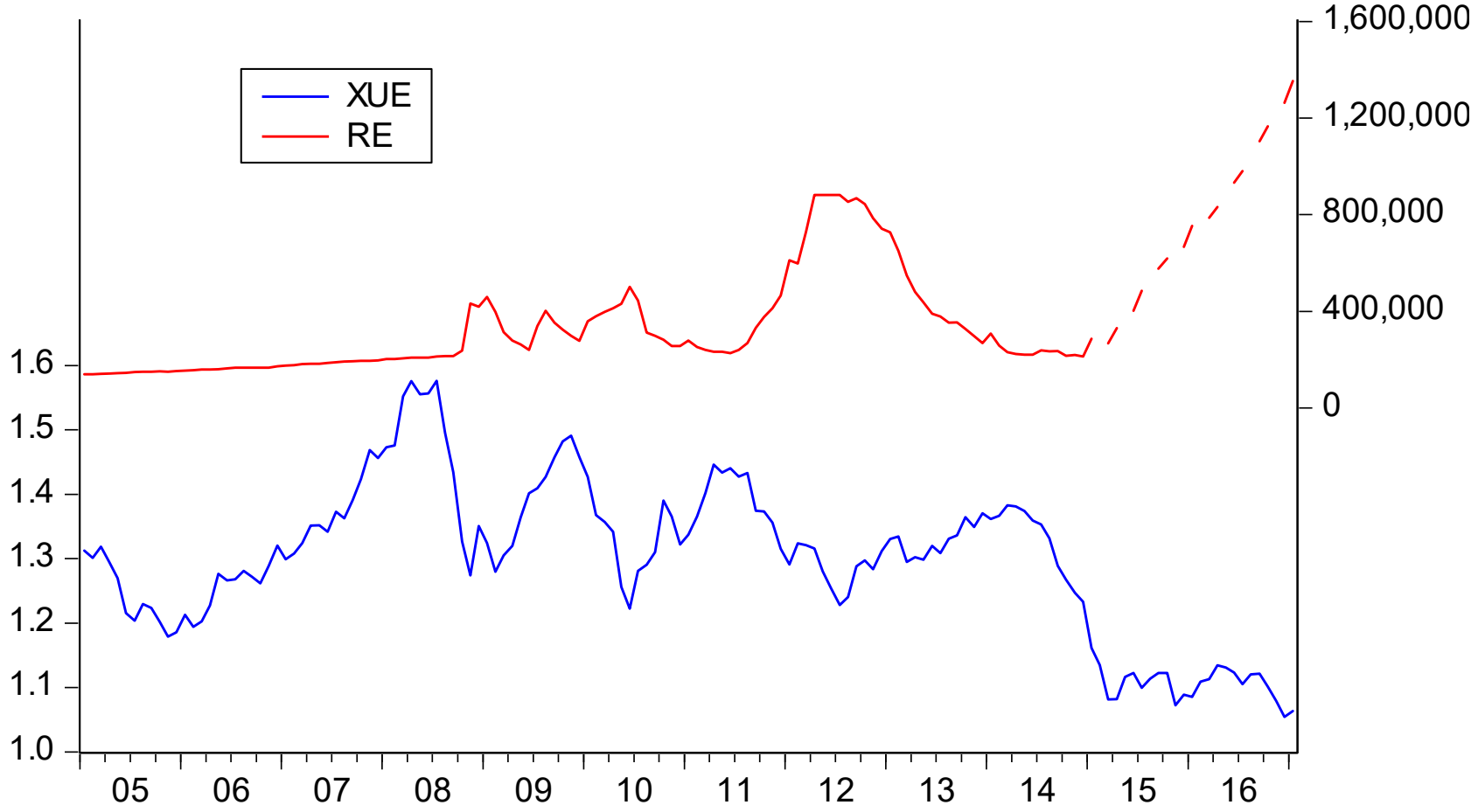
Yen Dollar Exchange Rate & Reserve Balances at Fed(R_U), BOJ(R_J),ECB(R_E)

Source: Taylor (2019)



Euro-Dollar Exchange Rate & Reserve Balances: Fed(R_U), BOJ(R_J), ECB(R_E)

Source: Taylor (2019)



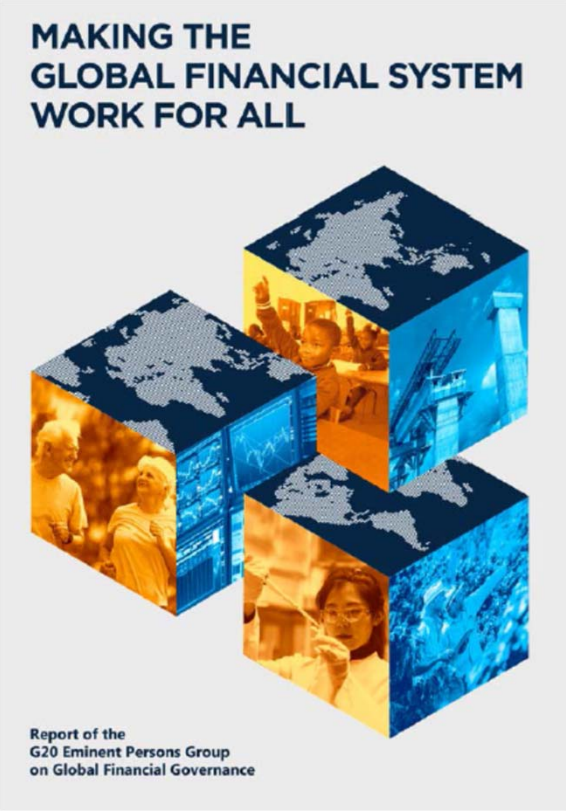
The Euro-Dollar Exchange Rate and Reserve Balances at the ECB

Policy Responses to Increased Volatility of Exchange Rates and Capital Flows

- Capital controls
  - Ghosh, Ostry, and Qureshi (2017): countries re-imposed "capital controls to stem inflows in the wake of historically unprecedented accommodative monetary policies" by Fed, ECB and BOJ"
  - IMF Institutional View
  - However, capital controls can have adverse effects.
- Competitive devaluations
- Political instability due to concerns about "currency manipulation."
- Big balance sheets multiplied, unwinding difficult.

International Monetary Reform

- Principles
  - Open capital markets
  - Flexible exchange rates between countries or blocs
  - Rules-based monetary policy
- Getting from here to there
  - EPG report to G20
    - End capital controls
  - each central bank follows its own rules-based monetary policy and a global rules-based monetary system emerges



With Fed Normalizing, International Monetary Reform Could Follow

- Each central bank would describe & commit to strategy
- Attractive because each country can choose its own strategy and contribute to global stability.
- But more macro model evaluations are essential
  - Macro Model Data Base could play a key role

Conclusion

- Revival of model research on rules for policy instruments
  - Research papers, fed publications, new measures of discretion, instrument rules rather than forecast targeting
- Explanations
  - Revealed preference, need to deal with ELB, disappointments with departures, threats of legislation
- Implications
  - Not much on QE as instrument in rule
  - Need for robustness to models and parameters
  - Need for international monetary models to evaluate rules
  - Forward guidance as a policy rule