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Don’t become dependent on forward guidance

- **Forward guidance has become the latest fashion among central banks**
- **There are advantages**
- **But there are also substantial risks, frequently ignored**

(The following Comment was inspired by and builds on an exchange of emails with John Nugée, Senior Managing Director and Head of Official Institutions Group at State Street Global Advisors.)

Over the past few weeks, we have seen both the Bank of England and the European Central Bank follow in the footsteps of the Federal Reserve and provide ‘forward guidance’, ie more detailed information about the future course of monetary policy. For the Bank of England, this was expected once Mark Carney took over as Governor from Sir Mervyn King. For the ECB the step was not unexpected, although it was quite a break with repeated statements (notably from the previous President M Trichet) that the Bank does not pre-commit.

Central banking has come a long way from the days when changes in Federal Reserve policy had to be inferred from its actions; or when the Bundesbank felt that an unanticipated policy change was a “success”. In one sense, forward guidance is not new; many central banks have given some indication of the near-term and in some cases also medium-term course of monetary policy, from using code words (a specialty of the ECB) to more explicit statements about the suitability or otherwise of current monetary policy (the Reserve Bank of Australia) and outlining an interest rate path (the Riksbank). But recent developments are more detailed. The Fed initially only spoke about keeping monetary policy unchanged for an extended period; this was then qualified to include dates; and finally (at the end of 2012) to involve thresholds that would be reached before monetary policy would change. (Incidentally, although the general impression is that once the Fed’s thresholds – related to unemployment and inflation – are reached, policy will change, this is by no means certain. Janet Yellen, the Vice Chair of the Board of Governors, has implied that it shouldn’t.) For the time being, both ECB and BoE forward guidance is less detailed, although commentators expect that Governor Carney will move towards tying policy to economic indicators in the Fed’s style.

The timing of the ECB and BoE announcements was to some extent guided by the calendar – the July meeting of the BoE Monetary Policy Committee coupled with the change of Governor; and the July meeting of the ECB Governing Council. Both central banks were also keen to distance themselves from the Fed in the wake of Chairman Bernanke’s June statements about the possibility of an imminent taper of the Fed’s quantitative easing, and make it clear that neither of them was in the process of changing monetary policy. From this perspective, the policy was successful, in that both euro and sterling markets calmed down; and commentators generally saw the change in policy as a Good Thing.

However, is more forward guidance really an unalloyed good? Yes, it increases the transparency of monetary policy. But, there may be occasions when surprise will add potency to a policy move.

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In addition, forward guidance is – and must always be – conditional. Although central banks do not necessarily spell it out, forward guidance is only valid as long as nothing happens beyond what they except to happen; ceteris paribus, to use that term so beloved by economists. But 'ceteris' are not always 'paribus' – in fact, it's probably safe to say that they never are. If circumstances change, so will policy. So, forward guidance is in some ways really just a safety blanket to calm markets and pretend that nothing will change. Since that doesn't hold true, it can be misleading and even potentially harmful. For one thing, forward guidance promising to keep monetary policy ultra-loose for the foreseeable future risks giving the impression that things are much worse than they are – 'the central bank knows how bad it really is' – thus underpinning pessimism and fears of deflation.

But even without going this far, there are other risks with too much forward guidance. Once you start guiding the market, it merely changes the pressure point at which you have to tell the market that you are changing direction. Previously, when central banks changed policy, markets had to adjust and that was that. Now, by announcing under what circumstances and potentially when policy will change, markets are given the opportunity to adjust in advance – which may be good – but also the time to marshal their arguments against the indicated policy change. This is most likely one of the causes behind the recent seeming flip-flops from the Fed, where a fairly hawkish statement from the June FOMC meeting was followed by an astonishingly dovish statement form Mr Bernanke in July.

Also, the more central banks practice forward guidance, the more markets will come to depend on their soothing statements and the more aggrieved they will become if circumstances and thus also policy change. It is also likely that they will become more volatile, as textual exegesis will reach new heights of absurdity, where every single nuance change in a central bank statement will potentially be taken as a signal to act upon. In essence, the danger is that instead of complementing economic analysis as a key input in investment strategy, central bank guidance will replace it. This is silly.[1]

Forward guidance can play a constructive role. At a time when both the economy and monetary policy are sailing through unchartered waters, it can be useful, particularly the Fed style with its economic development thresholds for action. But the risks involved, including making it more difficult for central banks to exit from ultra-loose monetary policies and entrenching market dependence on central bank guidance, are such that it should be employed much more sparingly than the current debate suggests. Of course, in a world where most investors rely heavily on central bank statements, those who actually analyse the development of the economy will be able to spot trend changes much quicker than others and profit thereby.

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[1] Here I have to declare an interest: Stein Brothers (UK) provides economic analysis to use as an input in investment strategy.

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