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Ending central bank forward guidance: What it means for the markets

Statements from central bankers about future decisions are creating considerable uncertainty on the markets, which is in fact the exact opposite of what this policy intended to achieve

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Since the onset of the financial crisis in 2008, central banks around the world have been relying on a new trick: forward guidance. The Federal Reserve, the Bank of Japan, the Bank of England, the European Central Bank and the Bank of Canada have all started providing the public with some form of guidance about future policy rates, through either qualitative arguments (e.g., to keep rates steady as long as inflation expectations remain well anchored), quantitative targets (e.g., as long as the unemployment rate remains above 6.5 per cent), or even by referencing specific economic developments.

This relatively new approach to central banking (the Bank of Japan actually started using it in the late 1990s, when it promised to leave rates at zero "until deflationary concerns subside") was truly useful coming through the Great Recession, as it helped make policy intentions clearer in a rather uncertain economic environment.

As central banks pushed their leading rates lower and lower, they one by one started hitting the zero lower bound (ZLB). This meant that they could no longer use their main policy tool to further ease monetary conditions and get businesses to invest and hire again as well as households to borrow and spend.

When the ZLB is reached, new tools are needed. Of course, the biggest one to come out of the bag was quantitative easing, or "QE," where the central bank prints new money to buy assets on the secondary market as a way of pushing longer maturity rates lower. This tool was used by each of the main central banks listed above, except for the Bank of Canada.

Our central bank did follow suit in resorting to forward guidance as a way to push rates in the direction it wished along the yield curve, but while mostly every other major central bank vowed to keep rates lower for longer, the Bank of Canada did just the opposite. Under Mark Carney, as the bank was mostly concerned by booming household debt and rising housing prices, the guidance was to the upside, with the bank repeatedly stating that rates could be going up at any time. The Bank of Canada's guidance has since shifted to neutral, then negative, following Stephen Poloz's arrival at the helm. Indeed, the bank was quick to warn that the next move might be a rate cut, as weak global growth was delaying the pickup in exports and inflation remained persistently below target.

The dark side of forward guidance

As we get further into the business cycle and the weight of the ZLB is becoming less of a constraint, forward guidance should be phased out for a few reasons.

First, in the U.S., there is a case to be made about how wrong it is that the bond and stock markets are hanging on the withdrawal of one or a few words from the statement put out every six weeks by the Fed. Not only does it create considerable uncertainty on the markets (which is in fact the exact opposite of what this policy intended to achieve), but it also keeps the market's focus on a single aspect of the global picture instead of the overall balance of risks.

We should also not neglect that when the path looks like it has already been traced, it gets harder and harder for central bankers to adapt their guidance as the economy evolves. As Mr. Poloz put it last October: “The problem with having given the ultimate conclusion is it’s very difficult to unwind it. You end up explaining every little detail in order to maintain it.”

Second, and most importantly, it leads to excessive risk-taking as markets become numbed by their expectations that the punch bowl will remain on the table all night and that it is safe to reach for yield in risky asset classes such as high-yield bonds. It is not desirable for markets to make one-way bets –we had a good example in the previous decade when everyone was betting on ever-expanding housing prices south of the border. Artificially low volatility creates a false sense of security, sowing the seeds of significant turbulence when the economy ends up taking an unexpected turn, or even simply when guidance shifts.

The Bank of Canada has been emphasizing these points since last fall, and we agree: forward guidance 1) has run its course, and 2) is now causing more harm than good. Markets need some volatility to operate correctly and to ensure that excessive risk-taking does not become the norm. You know that something is off when the mere possible exclusion of the word “patient” on a statement from the U.S. Fed’s policy-making committee becomes the most important market mover across the globe. The return to more general language from global central banks would be a step forward in ensuring that the current long-winded bull market in bonds doesn’t wind up in a catastrophe.

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