Interest-rate predictions – a recipe for trouble?

Forward guidance has provided a useful tool for central banks, but there is a good chance it will be misunderstood, says Kallum Pickering

Central banks in the developed world argue that the achievement of low and stable inflation for nearly 30 years is down to hard-won credibility. Credibility helps central banks to do their job; a lack of it has been the perpetrator of some of the worst episodes of hyperinflation in history.

What does credibility mean in practice? Central banks are considered credible when financial markets, businesses and households trust the central bank to achieve its mandate and know why and how it is likely to react to certain economic conditions. Over time, credibility grows if a central bank reacts consistently to changing economic conditions in a way that is in accordance with its target. In the developed world, where central banks have adopted a fairly simple policy framework, the most common target is some annual rate of inflation, usually 2%.

All else being equal, interest rates can be expected to increase if inflation rises above the target and decrease if inflation falls below the target. This is known as the reaction function. We have become so accustomed to this reaction function and hard-won credibility that low and stable inflation is almost taken as given. Even as central banks have undertaken a once unthinkable amount of monetary stimulus since 2008, inflation has remained largely well controlled.

Why is credibility at risk? Amid the post-Lehman recession and recovery, central banks have been the only game in town. Burdened with the unprecedented task of single-handedly nursing the global economy back to health, central banks broadened their arsenal. One tool, forward guidance – using forecasts to influence market expectations of interest rates – proved somewhat useful during the expansionary phase. But for the two central banks that are now using it during their tightening cycle, the US Federal Reserve and the UK's Bank of England, it might be a recipe for trouble.

Forward guidance, like many other ideas in economics, finds its roots in academia. As such, it has a solid theoretical basis. The argument goes that, by offering lots of information about future policy intentions, central banks can help to make the transition smoother, especially in an already volatile world. In practice, however, forward guidance can be risky business. What if the guidance is not properly understood? And what if the world does not turn out as expected?

There is a good chance that recent communications from the Fed and Bank of England have been misunderstood. Both central banks have frequently used the words "slow" and "gradual" to describe the likely paths towards more normal interest rates. The trouble is, this guidance has largely been taken as a promise that interest-rate hikes will be slow and gradual. But that is not quite right. A nuance has been overlooked. In reality, the Fed and the Bank of England have announced that they think future economic conditions will only warrant a slow and gradual hiking cycle. However, the future often does not develop in line with economic forecasts. As a result, these policy predictions may not become a reality.

Central bankers have little more information about the economy than anyone else. That is part of the reason why monetary policy works the best when a simple, interpretable reaction function is applied that central banks can lean on and market participants can understand. If central banks' predictions of slow and gradual rate hikes do not materialise, because economic conditions turn out to be much better or worse than expected, that could create an adjustment problem if rates do not follow the predicted path.

To avoid a hit to credibility, central bankers ought to gradually inch away from complicated policies that rest too much on the abilities of forecasters. The chance of this happening is low. Even with hikes, central banks will remain the guardians of the recovery. At the very least then, they ought to be more explicit about the possibility of big surprises, even if they don't happen.

Kallum Pickering is senior UK economist at Berenberg Bank

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