Tying monetary policy to unemployment: Is the game worth the candle?

Last week, the Bank of England (BoE) conditionally committed not to raise its key rate until British unemployment fell to 7.0%. This approach, similar to one previously instituted by the Federal Reserve (Fed), is somewhat surprising from a central bank whose fundamental mandate is inflation control. It may be appropriate for central banks to signal how they plan to change their monetary policy in the future. However, in our view, the use of thresholds that are based on economic variables seems to have few advantages over a date-based commitment. Moreover, this approach opens the door to a lot of confusion and, in the end, could affect central bankers’ credibility.

The 2008 financial crisis had significant consequences for several aspects of the global economy and international financial system. In particular, the crisis brought on a transformation in monetary policy. Pre-crisis, the role of central banks was mainly limited to adjusting their policy rates to keep inflation close to a desired level, frequently 2%. In 2008, the growing consensus on the restricted role of central bankers led David Dodge, former Governor of the Bank of Canada (BoC), to ask “Are we at the end of monetary policy history?”

However, the financial crisis forced central banks to take a much more active role. They ended up on the front lines in the fall of 2008, when the Lehman Brothers bankruptcy was threatening to trigger a collapse by the financial system and another economic depression. Without abandoning their primary objective, inflation control, a number of central banks stressed the fact that this objective needed to be pursued with some flexibility, to take other factors into account.

The magnitude of the crisis and ensuing recession also confronted central bankers with another sizable issue. Even after having lowered their key rates to their floors, some central banks deemed that more expansionary monetary policy was needed to stimulate economic activity and stave off a widespread drop in prices. The major central banks primarily resorted to two unconventional mechanisms. The BoE, Fed and Bank of Japan (BoJ) used quantitative stimulus measures, buying huge amounts of financial securities. Several central banks also turned to forward guidance to signal future monetary policy movements.

WHY FORWARD GUIDANCE?

Even before the crisis, central banks were giving some hints about future monetary policy trends. A few decades ago, there were two contrary visions on this matter. For some, monetary policy action was more effective if it was not expected; for others, it was better if investors could, in general, predict central banks’ decisions. The second vision clearly took hold since the early 1990s, as “research and experience demonstrate that clear and open communications are critical to both the effectiveness and the accountability of monetary policy.”

A transparency revolution has occurred over the last few decades, with central banks starting to regularly release statements explaining their decisions, along with, in some cases, the minutes of their meetings. Some banks even go so far as to publish key rate projections.

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2 Mark Carney, “Monetary policy after the fall” Edmonton, May 1, 2013
The importance of forward guidance on monetary policy increases once key rates have been taken to their floor. The logic is simple: key rates at a floor ensure that short-term interest rates remain very low. To provide further economic stimulus, the next step is to try to lower medium- and long-term rates by convincing investors that key rates will stay near zero for an extended period.

A MATTER OF CREDIBILITY
At first glance, the use of forward guidance may seem simple. A central bank only has to promise to keep key rates at the floor for 10 years to bring yields on bonds with maturities of 10 years or less to close to zero and thus provide strong stimulus for the economy. In reality, this exercise is more complicated: to be effective, forward guidance must be credible and consistent with the other monetary policy objectives. It is therefore difficult for a central bank whose main mandate is to keep inflation under control to commit for more than a few quarters without jeopardizing its credibility as a guardian of price stability. Accordingly, central banks that have used forward guidance to date have done so on the condition that there is no inflation risk. However, this substantially increases the risk that the forward guidance will not be respected, reducing its impact on the markets and the economy. From the start of the 2000s, research has shown that central bank commitments can be very effective monetary policy tools, but their credibility is essential.

FORWARD GUIDANCE IN PRACTICE
Unsurprisingly, forward guidance was first used by a central bank that had already taken its key rate to its floor. In 1999, the BoJ decided to indicate that its key rate would stay at zero until fears surrounding deflation dissipated. After lowering its key rate to 1.00% and judging that the recovery was still too soft, the Fed used forward guidance for the first time in 2003, adding the following remark to its statement: “the Committee believes that policy accommodation can be maintained for a considerable period.” The Fed again resorted to this tool at the end of 2008, specifying that “the Committee anticipates that weak economic conditions are likely to warrant exceptionally low levels of the federal funds rate for some time.”

In early 2009, “for an extended period” replaced the qualifier “for some time.” The first generation of forward guidance was very vague and did not tie central bankers’ hands. It essentially involved another effort at transparency, to narrow the gap between market expectations and those of central bankers.

The BoC went further in April 2009. In announcing that it was lowering its main policy rate to a floor of 0.25%, it also committed to keeping it there, subject to the inflation outlook, until the end of the second quarter of 2010. In using the word “commitment,” the BoC was clearly trying to make its forward guidance more effective. However, it was not a firm commitment, as it was conditional on the inflation outlook. In fact, the BoC dropped its commitment in April 2010 and raised its key rate in June 2010, to deal with the emergence of certain inflation risks.

In turn, the Fed began to use date-based forward guidance in August 2011, stating that “the Committee currently anticipates that economic conditions (...) are likely to warrant exceptionally low levels for the federal funds rate at least through mid-2013.” When the U.S. economic recovery remained disappointing, the Fed pushed back the date of its forward guidance, going so far as to signal that the key rate should not change before mid-2015.

Forward guidance appeared to be effective at managing investor expectations, but some Fed leaders seemed uncomfortable with this new tool. In particular, they thought that the changes to dates were not a clear enough signal of the economic conditions the Fed wanted to achieve, and that it was hard for the public to know whether pushing back a date signalled a change in monetary policy or a change in the economic outlook.

This is why the Fed again modified its communications in December 2012, replacing the date concept with a remark that its key rate should stay where it is as long as the jobless rate remains above 6.5%, one- to two-year inflation outlooks are below 2.5%, and long-term inflation expectations remain well anchored. Once again, this is not a firm commitment, but rather a kind of highly conditional promise.

Finally, last week, the BoE adopted a framework similar to the Fed’s by committing not to raise its key rate until British unemployment reaches 7.0%. This commitment is void, however, if the BoE expects inflation to exceed 2.5% in the next 18 to 24 months, if it thinks medium-term inflation expectations are insufficiently anchored, or if a committee deems that the monetary policy poses a substantial risk to financial stability.

IS AN ECONOMIC FIGURE TIED TO SEVERAL CONDITIONS CLEARER THAN A DATE?
In using forward guidance based on economic variables, the Fed and BoE are striving to communicate their reaction function so that the public can automatically adjust its expectations when economic statistics are released. This is an interesting idea in theory but, in our opinion, in practice...
it is really hard to do as the major central banks do not follow a simple reaction function. In fact, central bank leaders base their decisions on dozens of economic and financial statistics, as well as on several factors that are hard to quantify, for example, financial stability and the presence of risks. The recent move toward a more flexible monetary policy partially reflects this reality.

In the case of the Fed, which has a dual mandate targeting price stability and maximum employment, it may seem normal to use forward guidance based on inflation outlooks and the jobless rate. However, the use of the jobless rate remains debatable, as movement by this variable is not always a good reflection of the job market’s health. A major flaw in the jobless rate is that it is dependent on the participation rate, which could mean that, even when no jobs are being created, the jobless rate could fall if discouraged workers stop looking for work and leave the workforce. This issue becomes especially important at this point, when the U.S. labour force participation rate is falling steadily (graph 1). Experts therefore agree that movement of the jobless rate is not enough to assess the health of the job market.

For a central bank like the Bank of England, which has no price stability mandate, using inflation as a forward signal is even more surprising. In short, BoE leaders’ reasoning is as follows: they were looking for a variable that 1) provides a good idea of overall economic conditions, 2) does not pose a risk of sending false signals, 3) is regularly released without too many changes or volatility and 4) is easy to communicate. The unemployment rate seems to have been primarily chosen because GDP data was deemed too volatile and subject to revision. We can wonder, however if this variable respect the first two conditions.

PROBLEMS WITH A THRESHOLD BASED ON THE UNEMPLOYMENT RATE

Major risk of false signals. As movement by the unemployment rate is not always a good reflection of the overall economic outlook, there is a substantial risk that this threshold will send the public false signals. For example, let’s assume that the unemployment rate drops substantially in the United Kingdom over the next six months, but the economy slows and leading indicators soften. In this case, some agents could erroneously start to anticipate early monetary firming. What has happened in the United States since December 2012 reflects this problem. Although, overall, the economic outlooks have moved in a manner fairly consistent with what Fed leaders anticipated, the unemployment rate fell more quickly than forecast (graph 2). Chair Ben Bernanke clearly indicated at his June conference that this drop by the jobless rate should not influence market expectations for monetary policy and he was even considering lowering the threshold for the jobless rate. We can thus conclude that the jobless rate failed its first test as a forward signal.

Central banks’ work and communications become more onerous. Fed and BoE leaders must now meticulously predict the jobless rate in addition to forecasting how inflation pressures and the overall economy will move. They must also make sure that their own jobless rate forecast sends the message they want to send the public on future rate movements. With this proliferation of factors to predict and communicate, the risks of confusing the public and the financial markets increase a lot.

Graph 1 – U.S. participation rate has been dropping for several years

Graph 2 – The unemployment rate went down faster than Fed officials were expecting

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1 Labour force/Working age population
Confusion about the central bank’s mandate. Given all of the focus on the unemployment rate, the public could be led to think that the BoE has adopted a twin mandate, like the Fed. This, combined with the major risk of forecast errors and non-compliance with commitments, in our view represents a risk to the bank’s credibility.

CONCLUSION: A LOT OF RISK FOR LITTLE GAIN
Beyond the specific problems associated with using the unemployment rate, it is hard to imagine that a movement by one or two economic variables would be determinant for monetary policy over the medium term. However, this is the assumption behind using forward guidance based on economic variables. Central bankers’ main argument for using forward guidance based on economic variables rather than on dates is that the public could misinterpret a change of date. In our opinion, this is only a hypothetical problem, as central banks already have the required tools (statements, press conferences, speeches by leaders) to explain the reasons behind a change of date. This is exactly what the BoC did when it dropped its commitment in April 2011, and the message was fairly well received.

In our opinion, the Fed and in particular the BoE have gone too far in establishing forward guidance based on economic variables. Note that forward guidance is simply a communications tool that is used to influence expectations surrounding future monetary policy. If a central bank wants to signal that it don’t expect raising its key rate before some date, let it simply say so, rather than trying to signal it indirectly and making its job and communication process more onerous. Regardless of what type of conditional forward guidance is used, the risk it will not be respected will always be with us.

In all cases, the impact of these kinds of conditional commitments could be relatively small (graph 3). If a central bank really wants to make its monetary policy much more expansionary, it should resort to firm commitments. In that case, it would have to agree to assume an additional risk to price stability. Once again, there are no free lunch.

Graph 3 – Forward guidance immediate effects on bond yields have been limited

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