Mark Carney: Guidance

Remarks by Mr Mark Carney, Governor of the Bank of Canada and Chairman of the Financial Stability Board, to the CFA Society Toronto, Toronto, Ontario, 11 December 2012.

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Introduction

It is a pleasure to be here today to discuss guidance.

Guidance is fundamentally about managing expectations, so let me manage yours up front. This speech is primarily *about* policy guidance; it will not itself provide *new* policy guidance.

We all need guidance from time to time – we look to our parents, teachers, partners and peers for their help to make life, career or major financial decisions. Ultimately, though, these decisions are ours to make, and the consequences ours to bear.

Taking responsibility is why you became Chartered Financial Analysts: to learn how to analyse information, to make difficult valuation and credit decisions, and to bear the risks and reap the rewards that result. You rely on accurate and full disclosure by the companies you analyse. Without it, you could not do your jobs; and, indeed, financial markets could not do theirs of bringing together savers and investors to allocate capital efficiently. With more CFA Charter holders per capita than any other major jurisdiction, Canada is favoured by such an emphasis on fundamental analysis at the core of our system.

Beyond disclosure, what else can be usefully conveyed? Does the communication of companies' expectations of performance serve a purpose? What about central bank expectations about future policy?

In my remarks, I will discuss where such guidance can be effective and when it may be warranted. My main message is while transparency is critical to well-functioning capital markets and effective monetary policy, forward guidance of policy is best used sparingly in normal times. In extraordinary times, however, conditional guidance can be used to resolve time inconsistencies and achieve a better path for the economy.

First, allow me to address the private sector use of guidance and its impact on the financial markets.

Company disclosure

An ongoing focus of regulators is ensuring that company disclosure is full, fair and timely.

The crisis demonstrated the need for better disclosure by financial institutions. Insufficient and inconsistent disclosure by financial institutions contributed to uncertainty and eroded market confidence. This led to a withdrawal of market liquidity, depressed valuations and increased funding pressures.

Regulators and market participants are addressing these shortcomings. An Enhanced Disclosure Task Force was formed last May at the initiative of the Financial Stability Board. This private sector Task Force is a unique undertaking that brings together senior officials from the banking sector, investors, analysts, rating agencies and audit firms, in consultation with international standard-setting bodies and national regulators. In its October report, the Task Force outlined principles and recommendations for improved risk disclosures that are better aligned with banks' risk management and business strategies. Together with regulatory initiatives and capital increases, these measures will contribute to improved market confidence in financial institutions.

Earnings guidance

That companies should communicate material facts about their businesses, and do so to everyone at the same time, is no longer controversial.[1] There are, however, differing views as to whether companies should also provide their expectations of how their businesses will perform.

Most research finds little evidence that earnings guidance systematically improves company valuations, increases shareholder returns or reduces market volatility.[2] Some even argue that forward earnings guidance can be harmful, focusing both financial market and company management attention on a short-term "numbers game" at the expense of long-term business fundamentals.[3] Accordingly, a number of companies have stopped providing earnings guidance, with research finding that these companies do see a subsequent increase in analyst forecast dispersion and a decrease in forecast accuracy – but no change in actual market volatility.[4]

Is central bank communication different?

First and foremost, central banks pursue transparency to be accountable in democratic societies. Moreover, research and experience demonstrate that clear and open communications also enhance the effectiveness of monetary policy. In particular, successful monetary policy requires transparency around two aspects of the policy approach – what we are trying to achieve and how we go about achieving it.

With respect to the former, Canada has benefitted from a clear objective for monetary policy since the adoption of an explicit inflation target in 1991. As Canadians have come to understand the Bank's policy objective and have gained confidence in its attainment over time, inflation expectations have become firmly anchored around the 2 per cent target.

This confidence allows households and firms to make longer-term plans with greater confidence, aligning their savings, investment and spending decisions with a common inflation-control objective. These actions collectively serve to make the inflation target self-reinforcing. They also give the Bank greater latitude to respond aggressively to economic shocks without fear of dislodging longer-term inflation expectations. In short, the common understanding of our monetary policy objective makes its attainment easier.

Of course, it would be quite remarkable if simply communicating the monetary policy objective were sufficient to ensure its achievement. The conduct of policy obviously matters as well. The Bank of Canada implements policy through changes in the target overnight interest rate, which has a limited direct impact on saving, investment and spending decisions. Far more important is the impact the Bank's actions have on the broader spectrum of market interest rates, domestic asset prices and the exchange rate.

What matters to these asset prices, however, is not so much the current setting of the policy interest rate but, rather, its expected path over time. Thus monetary policy affects the

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[1] Regulation Fair Disclosure was adopted by the U.S. Securities and Exchange Commission in 2000 to address the problem of selective disclosure of information by publicly traded companies and other issuers. Regulation FD provides that when an issuer discloses material non-public information to certain individuals or entities, the issuer must make full public disclosure of that information.

[2] J.L. Rogers, D.J. Skinner and A. Van Buskirk, "Earnings Guidance and Market Uncertainty," *Journal of Accounting and Economics 48*, no. 1 (2009): 90–109.

[3] P. Hsieh, T. Koller and S.R. Rajan, "The Misguided Practice of Earnings Guidance," Perspectives on Corporate Finance and Strategy, *The McKinsey Quarterly*, No. 19 (Spring 2006).

[4] S. Chen, D. Matsumoto and S. Rajgopal, "Is Silence Golden? An Empirical Analysis of Firms that Stop Giving Quarterly Earnings Guidance," *Journal of Accounting and Economics* 51 (2011): 134–50.

economy primarily through policy-rate expectations.[5] The more those expectations are aligned with the policy path necessary to achieve the policy objective, the higher the probability the policy objective will be achieved.[6]

The Bank of Canada has become significantly more transparent. We now explain our decisions eight times a year and provide rich supplemental detail in our quarterly *Monetary Policy Report*.[7] These communications are designed both to report the Bank's views on the forces at work on the Canadian economy and to help households, firms and financial market participants understand how the Bank will respond to those forces over time. The goal here is, in effect, to allow markets and the public to "think along with us," not only promoting the appropriate formation of policy expectations given current information, but also allowing those expectations to evolve efficiently as new information is received.

We would have an easy time communicating our "reaction function" if we followed a simple mechanical rule. Life would indeed be easier if we could be so rigid. But achieving our target requires that we take a flexible policy approach, one informed by considered analysis and judgment. That is one reason why transparency – and occasionally guidance – matters.

Guidance in normal times to help achieve the monetary policy goal

In a perfect world, guidance would be unnecessary. The inherent uncertainty in economic outcomes and thus in the policy path would be widely understood. With full information and efficient markets, monetary policy expectations would effectively take care of themselves – knowing a central bank's inflation objective and its reaction function would be sufficient for markets and the public to form and evolve their expectations, without the need for any direct guidance from the central bank.

In the real world, monetary policy guidance can be useful in providing additional information. But this is not assured. How to get guidance right remains a subject of considerable debate.

One approach is to provide advance signals to markets, using stock phrases or code words. Not surprisingly, this sort of signalling helps market participants predict policy decisions in the near term.[8] But it is not clear that fulfilling promises helps market participants understand *why* those decisions are taken.[9] Without this understanding, market participants may be even less able to form efficient expectations over time, thus increasing their reliance on explicit guidance from the central bank. Ultimately, the risk is that markets turn into an echo chamber, to the benefit of no one.

Some other central banks directly disclose their policy interest rate forecast. "Putting it all out there" is, on its face, an appealing approach. It avoids the challenge of trying to perfectly

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[5] J. Boivin, "How People Think and How It Matters," a speech delivered to the Canadian Association for Business Economics, Kingston, Ontario, 23 August 2011.

[6] Note the contrast here to company earnings guidance, where expectations are essentially irrelevant to how the business actually performs, except indirectly through their effect on valuations and, thus, company funding conditions.

[7] J. Murray "Monetary Policy Decision-Making at the Bank of Canada," a speech delivered to the Mortgage Brokers Association of B.C., Vancouver, British Columbia, 7 May 2012.

[8] See C. Rosa and G. Verga, "The Impact of Central Bank Announcements on Asset Prices in Real Time," International Journal of Central Banking 4 no. 2 (June 2008): 175–217.

[9] C. Fay, T. Gravelle, "Has the Inclusion of Forward-Looking Statements in Monetary Policy Communications Made the Bank of Canada More Transparent?" Bank of Canada Discussion Paper 2010–15, November, 2010.

calibrate verbal guidance. It also makes it easier to illustrate how monetary policy interacts with the economy.[10]

In practice, however, it does not appear that markets take systematic account of the guidance offered by a published path beyond the very near term. Overall research has not generally found that publishing a path leads to better outcomes.[11]

At the Bank of Canada, we take a different approach. We seek to provide the appropriate degree of transparency regarding how we intend to achieve our policy objective by regularly reporting on the forces we see at work on the economy and helping markets and the public understand how policy responds.

The Bank occasionally provides guidance in normal times to give some sense of the imminence and degree of prospective policy action. We seek to place that guidance in the context of the most important economic and financial factors that will determine whether it is prophetic. This guidance is never a promise, however. Actual policy will always respond to the economic and financial outlook as it evolves. Market expectations of policy should do the same, reflecting differences in perspectives amid a common understanding of our objective.

Let me offer some specific examples where the provision of additional guidance in normal times on the path of interest rates might be helpful.

Headwinds and the neutral policy rate

First, through the spring and summer of 2011, it became clear that some Canadian market participants were making the short-hand assumption that the policy interest rate needed to be at neutral when inflation was on target and the output gap was closed.[12] It was not fully appreciated that, in an environment of material headwinds, the last two conditions would only be satisfied if the policy rate remained at a more stimulative level to offset the impact of weaker foreign demand on the domestic economy. To clarify our approach and guide market participants, we inserted a Box in our July 2011 *Monetary Policy Report* (***Charts 1*** and ***2***). This helped reduce unrealistic views of the pace of future tightening.

Communicating the links between price stability and financial stability

A second example concerns the links between price stability and financial stability. Our flexible inflation-targeting framework requires that we re-evaluate – and communicate – the optimal path for returning inflation to target, taking due consideration of the consequences for volatility in output and financial markets. The variation in that optimal path has resulted in an inflation-targeting horizon as short as 2 quarters and as long as 11 quarters since the Bank began publishing its projections for inflation in 1998.

The global crisis was a stark reminder that economic stability and financial stability are inextricably linked, and that pursuing the first without due regard for the second risks

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[10] Publishing the policy rate forecast path corresponding to the central bank's forecasts of growth and inflation helps to communicate both the central bank's prevailing views on the economy and its policy reaction function, which in turn should help policy expectations evolve efficiently as new information arrives.

[11] 11. See, for example, M. Andersson and B. Hofmann, "Gauging the Effectiveness of Quantitative Forward Guidance Evidence from Three Inflation Targeters," European Central Bank, Working Paper No. 1098, October 2009; C. E. Walsh, "Optimal Economic Transparency," *International Journal of Central Banking* 3 no. 1 (March 2007): 5–36; and G.-A. Detmers and D. Nautz, "The Information Content of Central Bank Interest Rate Projections: Evidence from New Zealand," Reserve Bank of New Zealand Discussion Paper No. 2012/03.

[12] level of the neutral rate itself is, of course, subject to some debate. For example, see D. Laidler, "Natural Hazards: Some Pitfalls on the Path to a Neutral Interest Rate," Backgrounder No.140, C.D. Howe Institute, July 2011.

achieving neither. While the primary tools to deal with financial stability are micro- and macroprudential regulation and supervision, it may be appropriate in some circumstances for monetary policy to contribute to financial stability directly by complementing macroprudential policy.[13]

More specifically, because the consequences of financial excesses may be felt over a longer horizon than other economic disturbances, the potential may exist for tension between price and financial stability considerations over the typical monetary policy horizon. In current circumstances, the Bank may want to set interest rates higher than would otherwise be warranted to bring inflation back to target within the typical six- to eight-quarter time frame.

But that flexibility does not exist in a vacuum, and should never be used by stealth.

The most recent *Financial System Review* elaborates on risks related to household imbalances in Canada. Their evolution may be a factor affecting the timing and degree of any withdrawal of monetary stimulus. If the Bank were to lean against such imbalances, we would clearly say we are doing so, and indicate how much longer we expect it would take for inflation to return to the 2 per cent target.

Our current guidance is that "some modest withdrawal of monetary policy stimulus will likely be required, consistent with achieving the 2 per cent inflation target. The timing and degree of any such withdrawal will be weighed carefully against global and domestic developments, including the evolution of imbalances in the household sector."

Our current guidance indicates that some policy action may be necessary, encouraging a degree of prudence in household borrowing. The share of new fixed rate mortgages has almost doubled to 90 per cent this year, reflecting the combination of attractively priced fixed-rate mortgages and the tightening bias of the Bank of Canada.

Guidance as an unconventional policy tool

While the Bank believes it appropriate to be sparing in forward policy guidance under ordinary circumstances, the calculus changes under extraordinary ones. When conventional monetary policy has been exhausted at the zero lower bound (ZLB) on nominal interest rates, the additional stimulus that is likely to be called for is impossible to achieve using the conventional interest rate tool. Extraordinary forward guidance is one unconventional policy tool, along with quantitative easing and credit easing.[14]

The Bank of Canada used extraordinary forward guidance in April 2009, when the policy interest rate was at its lowest possible level and additional stimulus was needed. At the time, we committed to holding the policy rate at that level through the second quarter of 2010, conditional on the outlook for inflation. In effect, we substituted duration and greater certainty regarding the interest rate outlook for the negative interest rate setting that would have been warranted but could not be achieved. The Bank's conditional commitment succeeded in changing market expectations of the future path of interest rates, providing the desired stimulus and thereby underpinning a rebound in growth and inflation in Canada (***Chart 3***).[15] When the inflation outlook – the explicit condition – changed, the path of interest rates changed accordingly.

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[13] Bank of Canada, Renewal of the Inflation-Control Target, November 2011.

[14] Bank of Canada, "Framework for Conducting Monetary Policy at Low Interest Rates," MPR, April 2009.

[15] See Z. He, "Evaluating the Effect of the Bank of Canada's Conditional Commitment Policy," Discussion Paper No. 2010–11, Bank of Canada, 2010; and M. Woodford "Methods of Policy Accommodation at the Interest-Rate Lower Bound," paper presented at the Jackson Hole Symposium, "The Changing Policy Landscape," 31 August – 1 September 2012.

Our conditional commitment worked because it was exceptional, explicit and anchored in a highly credible inflation-targeting framework. It also worked because we "put our money where our mouths were" by extending the almost $30 billion exceptional liquidity programs we had in place for the duration of the conditional commitment. And it worked because it reached beyond central bank watchers to make a clear, simple statement directly to Canadians.

Obviously the optimal policy path will differ for central banks, depending on their circumstances and mandates. For example, the Federal Reserve indicated at its September meeting that its policy rate could be expected to remain at exceptionally low levels until mid-2015, and provided additional certainty with respect to its reaction function by linking future unconventional monetary policy to substantial improvements in the outlook for the U.S. labour market. Further, it indicated that it will leave highly accommodative policy in place "for a considerable time after the economic recovery strengthens." The Fed also expanded its large-scale asset purchases, dubbed "QE3," consistent with this enhanced forward guidance.[16]

Guidance and time inconsistency

Doing more may require overcoming the familiar monetary policy challenge of time inconsistency – but not as it has been conventionally understood.[17]

Today, to achieve a better path for the economy over time, a central bank may need to commit credibly to maintaining highly accommodative policy even after the economy and, potentially, inflation picks up. Market participants may doubt the willingness of an inflation-targeting central bank to respect this commitment if inflation goes temporarily above target. These doubts reduce the effective stimulus of the commitment and delay the recovery.

To "tie its hands," a central bank could publicly announce precise numerical thresholds for inflation and unemployment that must be met before reducing stimulus.[18] This could reinforce the central bank's commitment to stimulative policy in the future and thus enhance the stimulative impact of its policies in the present, helping the economy escape from the liquidity trap.

Further enhancing guidance may require a change in framework

From our perspective, thresholds exhaust the guidance options available to a central bank operating under flexible inflation targeting.

If yet further stimulus were required, the policy framework itself would likely have to be changed.[19] For example, adopting a nominal GDP (NGDP)-level target could in many respects be more powerful than employing thresholds under flexible inflation targeting. This is because doing so would add "history dependence" to monetary policy. Under NGDP

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[16] U.S. Federal Reserve, Federal Open Market Committee Press Release, 13 September 2012.

[17] In the days before independent central banks, governments could not credibly commit to maintaining low and stable inflation, since they subsequently had the incentive to violate that commitment by engineering a growth-boosting inflation surprise. This time inconsistency led to the unfavourable stagflation equilibrium of the 1970s, and ultimately resulted in the widespread operational independence of central banks. See F. Kydland and E. Prescott, "Rules Rather Than Discretion: The Inconsistency of Optimal Plans," *Journal of Political Economy* 85 (3) (1977): 473–92.

[18] See, for instance, C. L. Evans, "Perspectives on Current Economic Issues," a speech delivered to the Bank of Ann Arbor Breakfast, Ann Arbor, Michigan, 18 September 2012.

[19] In most jurisdictions, including Canada, a change in the policy framework would require the approval of the political authority. In some others, it would require a change in the constitution.

targeting, bygones are not bygones and the central bank is compelled to make up for past misses on the path of nominal GDP (***Chart 4***).

Bank of Canada research shows that, under normal circumstances, the gains from better exploiting the expectations channel through a history-dependent framework are likely to be modest, and may be further diluted if key conditions are not met. Most notably, people must generally understand what the central bank is doing – an admittedly high bar.[20]

However, when policy rates are stuck at the zero lower bound, there could be a more favourable case for NGDP targeting. The exceptional nature of the situation, and the magnitude of the gaps involved, could make such a policy more credible and easier to understand.[21]

Of course, the benefits of such a regime change would have to be weighed carefully against the effectiveness of other unconventional monetary policy measures under the proven, flexible inflation-targeting framework.

Conclusion

Companies can talk about their future performance, but cannot guarantee its delivery.

Central banks can talk about the future path of policy, and we can, at least on the surface, deliver.

However, in ordinary times, achieving our objective will mean delivering a path of policy that adjusts as economic circumstances evolve. Therefore, that path cannot be predicted with certainty in advance. In the Bank's view, this limits the effectiveness of policy guidance to relatively special circumstances.

In extraordinary times, policy guidance may be more appropriate, and, as the Bank has demonstrated with its conditional commitment, it can be highly effective. But, in more extreme circumstances, even such a conditional commitment may prove insufficient. In order to provide even greater stimulus when at the ZLB, central banks can further "restrain" their future policy path through pre-commitment or history-dependence.

In all cases, central banks must be mindful of the impact on financial stability of what amounts to a "low for long" interest rate environment. This puts a premium on co-ordination among the relevant authorities to provide active macroprudential management.

Our goal, as always, is to ensure that households, firms and investors can make their decisions in a stable macro environment.

That will ensure that the fundamental analysis that CFAs perform every day plays a central role in capital allocation, business investment and ultimately jobs and growth.

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[20] In particular, for the benefits of a history-dependent monetary policy framework such as NGDP targeting to be realised, people must be forward-looking, fully conversant with the implications of the regime and trust policy-makers to live up to their commitment. As Bank research has shown, if these conditions do not fully hold, these approaches could in fact prove destabilising to the economy and damaging to the central bank's credibility.

[21] 21. Depending on the depth and duration of the ZLB episode, our calculations suggest that the adoption of a (temporary) price-level target, if well understood and credible, could eliminate more than half of the losses associated with the impossibility of providing additional monetary stimulus through a lower policy rate. See R. Amano and M. Shukayev, "Monetary Policy and the Zero Bound on Nominal Interest Rates," Bank of Canada Review, Summer 2010 and C. I. Evans, "Monetary Policy in a Low-Inflation Environment: Developing a State-Contingent Price-Level Target," remarks delivered before the Federal Reserve Bank of Boston's 55th Economic Conference, Boston MA, October 16, 2010.

Chart 1: Impact of foreign demand headwinds with a simple rule

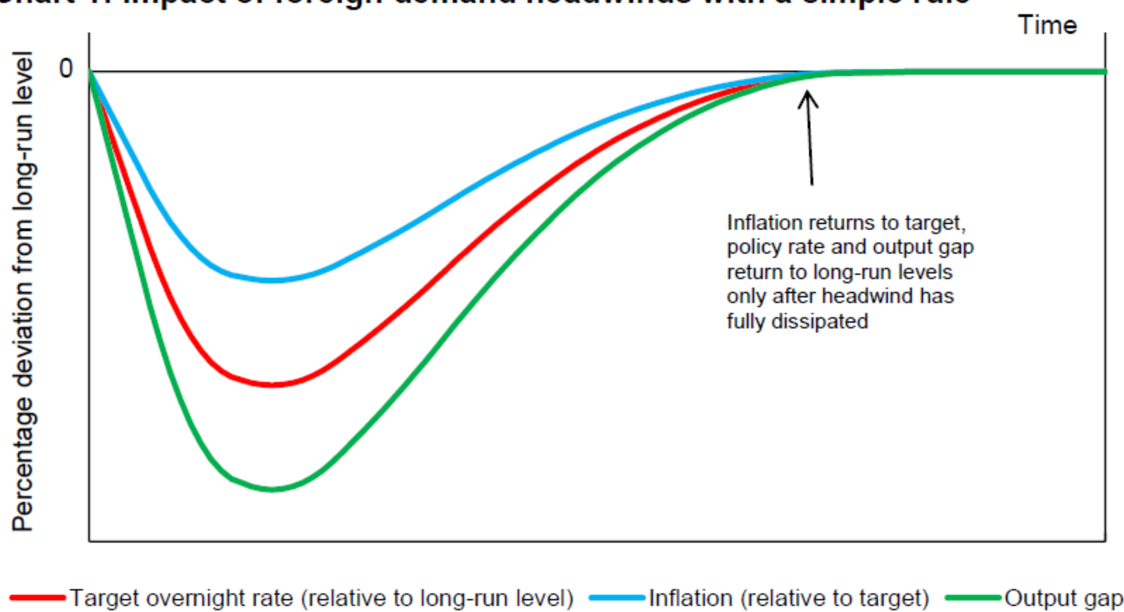


Chart 2: Impact of foreign demand headwinds with a more appropriate policy response

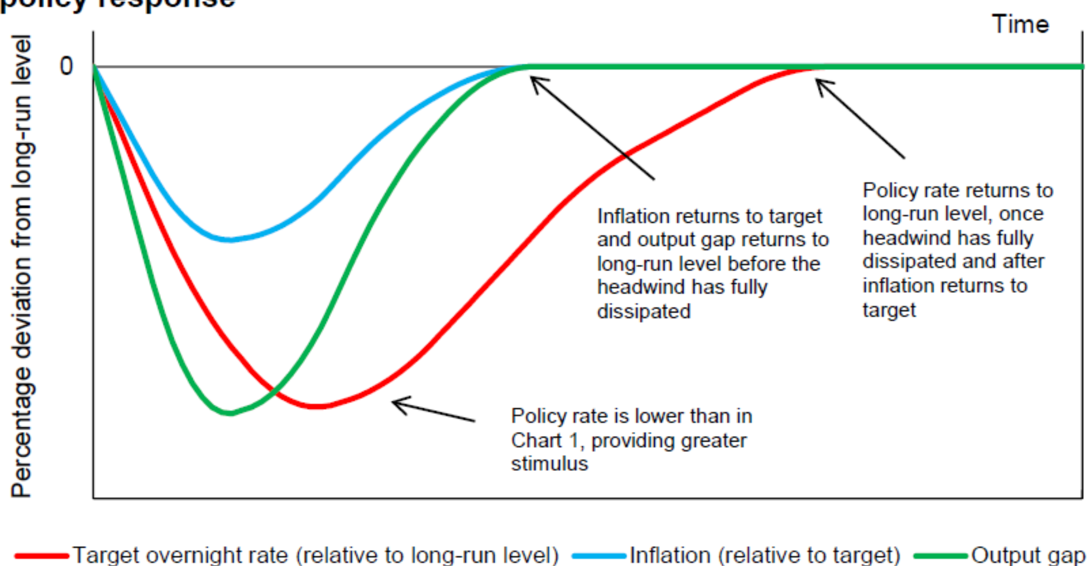
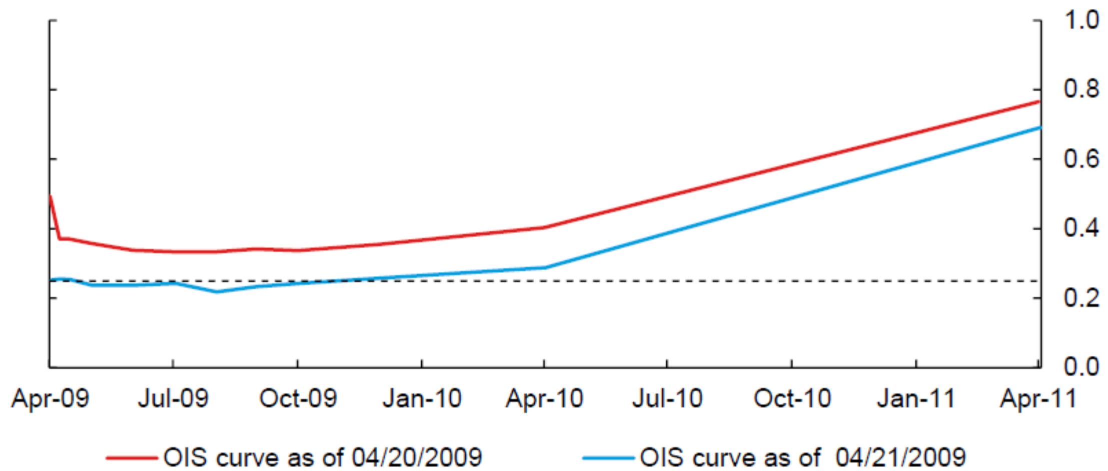


Chart 3: Bank of Canada yield curve expectations declined after conditional commitment was announced (on 21 April 2009)

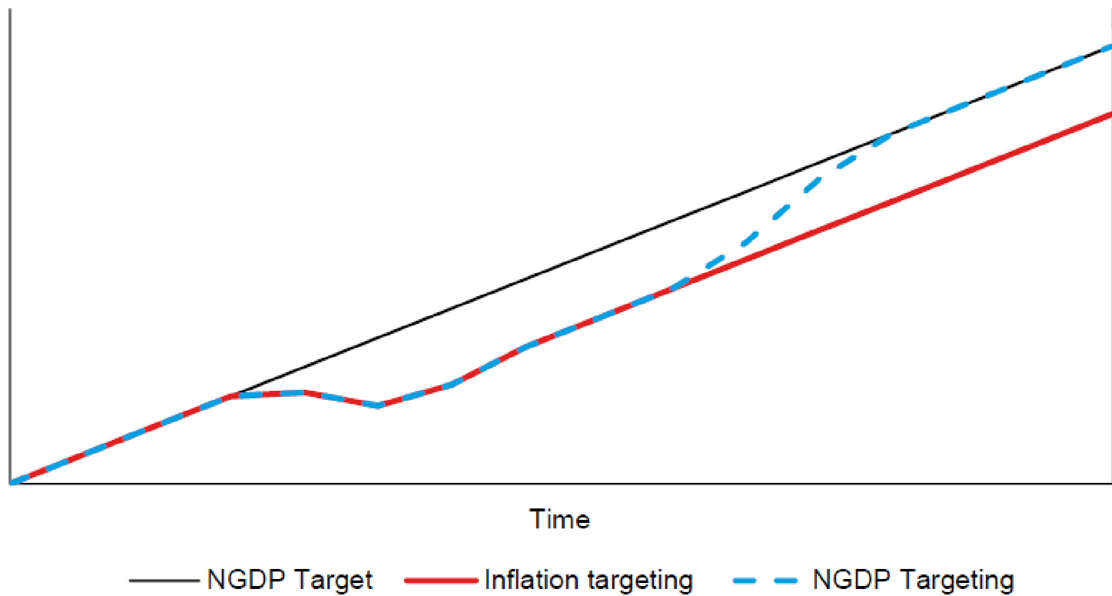
OIS curve 0 to 2 years the day before and day of the announcement of the conditional commitment %



Note: On April 21, 2009, the Bank of Canada announced commitment to hold the policy rate at 0.25% until the end of Q2 2010.
Source: Bloomberg

Last observation: April 2009

Chart 4: Bygones are not bygones under nominal GDP targeting



Source: Bank of Canada calculations