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Buttonwood's notebook
Financial markets

Monetary policy
The old guy behind the curtain

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THE more transparent central banks become, the less credible they seem. That's the view of Eric Lascelles, chief economist of RBC Global Asset Management, and after recent events it seems very pertinent. Back in 2013, the Bank of England announced a policy of "forward guidance" that was designed to reassure markets that interest rates were not set to rise any time soon. Initially, it said that rates would not rise until unemployment fell to at least 7%. The implication was that unemployment would take time to fall, probably a couple of years. Instead, joblessness fell rapidly and is now 6.6%. So a bit of adjustment was needed; low unemployment was a necessary but not sufficient condition for a rate rise. Forward guidance, mark two, came out earlier this year and our leader in February (http://www.economist.com/news/leaders/21596522-bank-england-doing-better-job-explaining-its-intentions-federal) praised the Bank saying that

> Financial markets now expect interest rates to start rising in April 2015. Without forward guidance they would have expected a move far sooner.

But the Bank is now saying that instead of a triumph, this was a mistake. The markets are placing too low a probability on a rate rise this year. Now, of course, there is a simple explanation for this; the UK economy has performed better than most people forecast. But it is also performing better than the *Bank of England* forecast. It has no monopoly on wisdom.

The same goes for inflation. The Bank consistently forecasts that inflation will be on target within two years; after all, if it did not believe that, it should change policy. But inflation was above target for four years and is now below it. So the Bank is not good at forecasting growth, or unemployment, or inflation.

Forward guidance was always a tricky policy, given that background. We can probably all agree that the Bank should change policy if the facts change. But since that is the pragmatic approach, the only way forward guidance would have credibility would be if the Bank were a great forecaster. Which it isn't.

Mr Lascelles's point is useful at this stage. In the old days, we did not know what the central bank was up to, and it was easy to believe that it had access to information of which we are not aware. Now it publishes all the numbers and we can see it's often wrong. Dorothy has found out that the Wizard of Oz is an old man behind the curtain.

The same goes for the Fed. Remember that Alan Greenspan, the doyen of central banking, believed that the financial markets would be self-regulating only to admit in 2008 that

> Those of us who have looked to the self-interest of lending institutions to protect shareholders' equity, myself included, are in a state of shocked disbelief

Yesterday, the Fed cut its growth forecast (in both the short and long term) and left its inflation forecast unchanged. Was it right to do so? Maybe but we shouldn't have excessive faith in its wisdom; after all, by cutting its forecast, it admits its previous estimate was wrong. Central bankers aren't supermen (or superwomen). The trouble is our entire economic policy seems to be built on the assumption that they are.

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