Comment on Ed Green's "Some Economic Observations Regarding Communication About Policy"

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Outline

The main points

What do policy-makers see as advantages and drawbacks of transparency and targeting?

Why is transparency and targeting seen as emerging now, and not before?

Is there something missing from policy-makers' thinking about transparency?

Comparison to Morris and Shin

Time consistency's place in monetary policy formulation

The paper's framework

- Agents are fully rational, in the sense that they optimize continuously, making full use of all available information at every instant.
- The central problem of monetary policy is that good policy might involve occasionally surprising the public, or equivalently delaying the release of some information to the public. Transparency, if it eliminates this possibility, entails losing a possibly important policy tool.

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- But as a framework for thinking about transparency and inflation targeting, it misses the most important issues.

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- For central banks at the frontier, like the Riksbank, describing projected time paths for the policy rate along with those for inflation and output.
- Whether the 2-year target inflation rate remains fixed may not be essential to the benefits of this regime. (This is my opinion.) For example, a small open economy might find it beneficial to vary the target as the market for a primary export fluctuates — not as a surprise, but as a systematic policy response.

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Policy-makers' views of drawbacks

These apply mainly to policy-makers in banks that are not in an inflation-targeting regime.

- Worries that they will be locked in to a course of action they project, *despite stating clearly that their projections are contingent, and will likely change*.
- Worries that, since policy actions and statements are already often misintepreted, producing undesirable gyrations in financial markets, releasing more information will produce more misintepretation.

Drawbacks, continued

- Concerns that reaching agreement in a policy committee will be difficult or impossible when projections of the future as well as current policy actions have to be agreed on. Implicitly, there may be fear that ignorance or disagreement on the committee might become public.
- A few, though I think not many, may have the view that the ability to make surprise changes in the two-period ahead inflation target in response to current shocks is important.

Policy-makers' views of advantages

- Committing to an inflation target over a two-year horizon and publishing a projected distribution for future inflation rates may reduce the public's uncertainty about future inflation and reduce the dispersion in beliefs about it.
- Committing to an inflation target may be easier to maintain than commitment to other types of policy rule, in that it will be plausible, if inflation temporarily deviates from target, that the CB is willing to incur some cost to get back to target — because both the bank and its indirect political constituency actually care about inflation (as opposed to money growth or a Taylor rule coefficient.)

Advantages, continued

- Increased transparency about the CB's reasoning may in itself enhance the ability to maintain commitment.
- E.g., by explaining what the CB believes produced a deviation of inflation from target and how it intends to return to target, the CB may be able to reduce the chance that the deviation is seen as intentional on the part of the CB, or that the CB does not intend to or does not know how to return to target.
- The public may find inflation targeting much easier to understand than an equivalent "rule" formulated as a mapping from the state of the economy to an interest rate.

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Long run output-inflation tradeoffs are seen as weak

- Most monetary economists and policy-makers now think that the cost in possible destabilized output and employment from maintaining an inflation target over a two-year horizon is not likely to be high. This was not always true.
- Most monetary economists and policy-makers now think that staying fairly close to an inflation target over a two year horizon is feasible, given appropriate policy by an independent central bank. This was not always true.
- Modeling, computational, and graphical tools have improved, so that producing fresh forecasts, with credible error bands, several times a year is possible. Committee discussion can explore alternative projections in real time. This was not possible, at least at similar cost, decades ago.

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Do policy-makers understand the game they're playing?

- My view: for the most part, they do.
- The issues we've listed broadly cover the range of real issues, including those of a game-theoretic nature.
- Some of them leave open questions, but in my view the most important ones are not game-theoretic.

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- They involve leaving the framework of continuously optimizing agents, continuously aware of all available signals.
- They involve thinking about why we care about price stability — which in my view requires that we recognize that people are not "rational" in the sense of rational expectations models or game theory.

Rational inattention

- Most people, most of the time, in countries with the best monetary policy, are unaware of policy decisions about interest rates and make no adjustment to, or react very slowly to, shifts in policy stance.
- This is not because there is a significant cost to acquiring the information — people page through newspapers that contain it or channel-hop through news programs that present it, yet don't react to it.
- This can be "rational" if we recognize that processing information to translate it into action is costly, even if the information itself can be observed for free.

Rational inattention and inflation targeting

- Though most people pay little attention to monetary policy, some people — financial market traders, in particular — pay a lot of attention to it. This helps explain why a CB cares about financial market gyrations in reaction to its announcements — they may catch many people by surprise, and if repeated, may force many people to pay the cost of following financial market developments more closely.
- How to explain that CB's worry that announcing a policy rate path would be seen as a commitment to that path, despite their asserting that it is not a commitment? They expect that many people will not pay attention to all parts of their policy message, absorbing only simplified summaries of it.
- How to explain that inflation targeting can be distinctly superior to an apparently equivalent announced "rule" mapping state of the economy to policy action? From the point of view of most people, it is a simpler policy, more easily absorbed in a single announcement.

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Rigorous game theory on casual and fragile empirical foundations

- Morris and Shin's BPEA paper is in some ways similar to this one: an attempt to apply game theoretic thinking to monetary policy, and particularly to issues of transparency.
- Unlike this paper, it does include one explicit model of an economy in which a monetary policy authority appears.
- However, in that model (the Lucas island model) announcing monetary policy actions is clearly optimal, which is not what interests MS. In their other explicit models, money, the price level, and monetary policy are not present.

Morris and Shin/Green continued

- M and S discuss explicitly only Green's first case, where the CB has an information advantage concerning the state of the economy but takes no actions that agents care about.
- In contrast to Green, they think this is the case in which it is most likely that the CB could make things worse by being transparent. Their argument depends on effect that Green does not emphasize: If private agents can obtain information at a cost, they might lose the incentive to do so if the CB announces somewhat accurate information, though the resulting economic equilibrium might be worse.
- My view is that this is relevant to discussion of government publication of weather forecasts or collection and dissemination of data in general, but misses the main issues in monetary policy transparency, because the CB does take actions the public cares about.
- On this, probably Green would agree.

A digression: Have forecasts of prices gotten worse?

- Morris and Shin and Green both cite Stock and Watson for the result that forecasts of inflation have gotten worse. Each paper finds this result supports part of its argument, though in quite different ways.
- This citation is simply incorrect, however. And this is not a difficult econometric point that theorists should be forgiven for missing.
- As SW state in their introduction, "...inflation like many other macroeconomic time series has become much less volatile, so the root mean squared error of even nave or relatively poor forecasts had declined since the mid-1980s. In this sense, inflation has become easier to forecast..."

Digression, continued

- The sense in which inflation has become harder to forecast really matters only to econometricians: even though econometric models have become much better at forecasting inflation, the improvement, relatively, in naive forecasts, has been even greater, so that it is now harder for a fancy model to improve on a naive model.
- This *improvement* in the ability to forecast inflation may indeed be part of the explanation for the recent emergence of inflation-targeting policy regimes: econometric models look more reliable, and policy-makers think they have been able to keep inflation under better control.

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Time consistency

- The simple Lucas supply curve framework in which monetary policy directly produces surprise inflation, and thereby has effects on output, does not fit the data.
- Models in use in CB's today, from structural VAR's to DSGE's, all imply that monetary policy can have fairly prompt effects on output and employment, and then with considerable delay a change in the inflation rate.
- This pattern of effects does not depend on the policy being a surprise. It depends on some form of "stickiness" in the model, usually interpreted as arising from nominal contracting (but in my view possibly also due to rational inattention).
- There can be a question of whether the CB, or more broadly the government and the voting public, are willing to pay the short run output and employment costs of reducing inflation.
- But here I think an inflation targeting regime can only be a help, by making the short vs. long run tradeoffs explicit.

Where the paper's ideas are relevant to policy

- CB policy on regulation, lender of last resort
- Capital taxation
- The inflation tax

Conclusion