Central Bank Communication and the Financial Markets

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Evolving academic attitudes

- **Karl Brunner (1981):** Central bankers refuse to speak in “intelligible words and sentences.”

- **Alan Blinder (1996):** By guiding expectations, greater openness enhances the effectiveness of monetary policy.

- **Michael Woodford (2001):** The view that monetary policy is about managing expectations is “widespread.”
A practical success story

- This is progress!
- It’s a case where academic thinking influenced actual CB practice, mostly before there was any empirical evidence. But there now is.
- Norway and Sweden may now be the transparency leaders.
An important reminder

- The case for openness rests on *two co-equal foundations:*
  1. democratic accountability
  2. monetary policy effectiveness
- I will deal with #2, but #1 is just as important.
CB communications would be superfluous under rational expectations in a stationary environment with a central bank credibly committed to an unchanging policy rule.

**Implication**: CB communications contribute by improving understanding of evolving policy “rules” in a non-stationary environment with asymmetric information and learning.
Can there be too much CB communication?  
Well, I’m skeptical, but…  
✓ Confidentiality and “purdah”  
✓ If it’s only unanticipated policy that matters (Cukierman & Meltzer)  
✓ If CB signals crowd out other valuable information (Morris & Shin)  
✓ the cacophony problem  
Only the last seems important in practice.  
✓ It argues for clarity, not silence.
Prefatory Note 3

- Communication need not imply commitment—unless the CB wants it to.
  ✓ This is a common confusion.
- This point is critical in thinking about publishing interest rate forecasts and other forms of “forward guidance.”
Some key empirical questions
(survey paper by Blinder, Ehrmann, Fratzscher, De Haan, and Jansen)

- **Short term**: Do CB communications (a) make policy more predictable, (b) move financial market prices?
  - Strongly? In the right direction?

- **Long term**: Do CB communications (e.g., a numerical inflation target) anchor expectations and/or reduce inflation?
CB communications and financial market prices: creating news and reducing noise

- Predicting the next monetary policy decision
  - Markets have gotten better at it as communication has increased. The evidence is plentiful and one-sided.
  - There is a little evidence that “cacophony” (dispersed communication) hurts.

- Impacts on interest rates *et al.*
  - Re: which types of communications matter most, there is no clear “winner.”
  - There is some suggestive evidence that greater clarity helps. (next slide)
Clarity and CB communication

1. Fracasso, Genberg, Wyplosz (2003): higher quality inflation reports → smaller policy surprises
2. Ehrmann and Fratzscher (2007): ECB press conferences → more impact on asset prices and less on volatility (than statements)
Anchoring expectations and inflation

- Re: anchoring expectations
  - It’s a prime argument for IT.
  - The evidence here seems one-sided: They do.
- Re: reducing average inflation
  - Here the evidence is far from clear.
  - One reason: There is a two-way causation problem.
  - Another reason: Compared to whom? (Mishkin and Schmidt-Hebbel)
The new frontier: projecting the path of the policy rate (1)

- *For researchers*: How tightly, strongly, and accurately does it condition market expectations (e.g., in NZ, Norway, Sweden)?
  - Three recent papers suggest that it does not crowd out all other ideas.

- *For researchers*: Do markets understand the conditionality of the projections (in NZ)?
  - The same papers suggest that they do.
The new frontier: projecting the path of the policy rate (2)

- *For practitioners*: balancing the pros and cons (and feasibility)
  - Operational feasibility is a serious issue at many CBs.
  - But let’s remember, the “unthinkable” has become “thinkable” many times before.
“Best practice”

- Almost all CBs should communicate more.
  - And more clearly!

- Post a numerical inflation target (≠ IT)
  - Some ITers are less than transparent.

- Statements, minutes, etc. must to tailored to the MPC’s nature and structure.

- Forecasts should be released contemporaneously.
  - Whose forecasts?
  - Does forecast include the future policy rate?

- Collegial committees need “one voice.”
  Individualistic committees need many voices.

- Publish interest rate projections? An open issue