How central banks communicate – II

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Communication contributes to the effectiveness of monetary policy by creating genuine news (e.g., by moving short-term interest rates in a desired way) or by reducing noise (e.g., by lowering market uncertainty). In other words, if communications steer expectations successfully, asset prices should react and policy decisions should become more predictable. Central bank communications ?create news? if the central bank?s pronouncements influence expectations and therefore move asset prices. In extreme circumstances, communication used to anchor and guide market expectations may even become the main tool of monetary policy. Central bank communications ?reduce noise? if such communication increases the predictability of central bank actions, which in turn reduces the volatility in financial markets. The underlying presumption must be that market participants make more efficient decisions when markets can correctly predict central bank actions. In both cases, i.e., when creating news or when reducing noise, the central bank?s presumed objective should be to raise the signal-to-noise ratio. In other words, the objective should be to increase the information content of the communication and reduce the unwanted noise portion.

Over the years, many central bankers and economists have at times confused communication with commitment?or worried out loud that the public might confuse the two. For example, it has been argued that words uttered today might restrict the freedom to manoeuvre tomorrow. For example, then chairman Paul Volcker defended the Fed?s refusal to announce its decisions immediately in 1984 as follows: ?One danger in immediate release of the directive is that certain assumptions might be made that we are committed to certain operations that are, in fact, dependent on future events and these interpretations and expectations would tend to diminish our needed operational flexibility.? In a similar vein, Alan Greenspan opposed immediate disclosure of the FOMC?s decisions in 1989 because ?a public announcement requirement also could impede timely and appropriate adjustments to policy?. Yet less than five years later, he voluntarily did precisely that.

From today?s standpoint, the objections of Volcker and Greenspan to this minimalist disclosure proposal sound quaint, almost scholastic. While there are cases in which saying something does constrain future behaviour?as in ?making a verbal commitment??most central bank communication is not, or need not be, of this nature. In particular, the mere conveyance of information?such as about the policy decision, the inflation target, the forecast, etc?does not commit the bank to any future action or inaction (although it might hint at such). Even the famous published ?forward tracks? of the Reserve Bank of New Zealand, which are conditional forecasts of its own future behaviour, are conditioned on many future variables.

That said, communication is no panacea! As with all human endeavours, there are pitfalls and occasional errors. One famous example came in October 2000, when then ECB President Wim Duisenberg hinted to an interviewer that there would be no further central bank intervention to support the euro. Those words led to an immediate depreciation of the euro and heavy criticism of Duisenberg. Similarly, when a supposedly off-the-record remark made in April 2006 by Fed Chairman Ben Bernanke stating that his recent Congressional testimony had been misinterpreted, was reported, markets reacted strongly?as investors concluded that Bernanke was ?reversing himself? and saying that interest rates could easily go up.

What constitutes ?optimal? communication strategy is by no means clear. And these two examples illustrate that more talk is not always better. No consensus has yet emerged on what communication policies constitute best practice for central banks. Practices, in fact, differ substantially and are evolving. The predictability of monetary policy decisions has improved notably in many countries due to more and better central bank communication that has contributed to ?reducing noise?. That said, the predictability of monetary policy appears to be degraded somewhat when central banks speak with too many conflicting voices. ?Short-run? central bank communication?for example, disclosing central bank views on the outlook for the economy and monetary policy?has a substantial impact on financial markets. Official statements, reports and minutes appear to have the clearest and most consistent empirical effects on financial markets. The evidence on the impact of speeches is more mixed. But it, too, is mainly supportive of the idea that central bank communication ?creates news?. Some studies that assess the directional intent of the central bank?s messages generally find that markets move in the ?right? direction. In other words, often the ?announcement effects? of central bank messages help the central bank rather than hinder it. With respect to ?long-run? central bank communication?for example, disclosing the central bank?s goals and strategies?studies indicate that the effect of announcing an inflation target or a quantitative definition of price stability helps to anchor inflationary expectations. However, the studies do not find compelling evidence that announcing an inflation target or a quantitative definition of price stability leads to lower or less variable inflation.

With RBI receiving many plaudits for the fact that its regulatory management avoided the precipitous financial crisis of 2008 in India, this may be an opportune moment to push the envelope further by utilising effective and transparent communication as an

instrument of monetary policy.

(Concluded)

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