

José De Gregorio: Transparency and communications in modern central banking

Keynote speech by Mr José De Gregorio, Governor of the Central Bank of Chile, at the 10th Annual General Meeting of the Interamerican Economics and Finance Journalist Association (AIPEF), Santiago, 17 July 2008.

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It is a pleasure for me to take part in this event and to have the opportunity of highlighting the importance of communications in modern central banking. Journalists play a fundamental role in transmitting our messages to the general public and that is why we are particularly interested in communicating with you and making ourselves understood to the best of our ability. The time when central banks were opaque is gone. Today, transparency is the key to satisfying the demands that democratic societies make on autonomous institutions like central banks and to achieving monetary policy efficiency. So I would like to talk about transparency with a special focus on monetary policy.

Why the need for transparency?

In recent decades, central banks have become increasingly more transparent. For many reasons, which I will not go into today, they have moved towards a greater degree of autonomy in the conduct of monetary policy. Central banks have been given operational independence and are able to exercise monetary policy using technical criteria with a medium term perspective. Therefore we have the first reason for central banks to be transparent: the legitimacy required in a democratic regime of an autonomous institution whose decisions have important implications for national welfare.

In the case of Chile, this duty to impart information is stipulated in the Central Bank's Constitutional Organic Law which mandates that once a year the Bank must inform the President of the Republic and the Senate about its deliberations and developments. This takes place in September when the Central Bank Board presents its Monetary Policy Report to the Senate. Nevertheless, the Central Bank of Chile goes beyond this requirement and reports not only to the Senate in September but also presents a monetary policy report to the Senate's Finance Committee in January and again in May. The same happens with the Financial Stability Report which is published in January and June each year. Similarly, the Bank gives an account of its management of international reserves once a year as part of its Annual Report.

However, this is not enough. The legitimacy of the Central Bank is upheld by direct, open, and non-excluding communication with the general public and so these documents are uploaded on the Bank's website at the same time as they are being presented. Moreover, the Bank issues other reports, communications, minutes, specialized studies and statistics, all of which are available to the public. There are also press conferences and interviews with Bank board members and staff.

The time when the workings of central banks were something complex and mysterious has also passed. We want the community to understand our work since it consists of providing a public good – stability – which enables the country to progress. It is our concern that people no longer consider us a bunch of technocrats engaged in incomprehensible activities.

Another important reason for transparency has to do with the effectiveness of monetary policy. In recent years, there is a growing consensus towards the idea that monetary policy is better when it is carried out with clarity and predictability and is not a source of noise and

instability. To that end, the monetary authority must communicate clearly its vision of how the economy is working and how monetary policy decisions influence inflation.

With regard to Chile's inflation targeting regime, we aim at keeping inflation most of the time around 3%, with a tolerance range of one percentage point either side. However, given that inflation cannot be controlled in the short term, we implement our policy in such a way that forecast inflation two years ahead is 3%. This requires high and constant degrees of transparency and communication, as I will go on to discuss.

Transparency in inflation targeting

In the past, when monetary policy was implemented in a different way, less information was required. For example, when there was a fixed exchange rate, the public only needed to look at the exchange parity each day to know whether targets were being met. Similarly, if a central bank bases its monetary policy on a certain monetary objective, the public only needs to check the way the figures for that particular aggregate are going to be sure that the objective is being accomplished.

However, in the context of inflation targets, where this variable is not controllable in the short run – and, as we are currently witnessing, it is subject to many shocks – it is important to monitor to what extent targets are met and for that it is not enough to simply monitor inflation figures since the scheme itself allows for deviations. The Central Bank must report these deviations and explain its strategy to correct them.

In an ideal world – without uncertainty and where all agents have the same information and also the same chance of protecting themselves from any contingency – transparency would be unnecessary. However, it is a good exercise to ask oneself what are the frictions that require communication, beyond being accountable to the executive and legislative. Friction in this case is the incomplete information market participants have about the Central Bank so transparency is fundamental to generating credibility, and credibility is at the heart of a good monetary policy.

There are two kinds of asymmetries of information that require communication: one is the uncertainty about the preferences and objectives of central banks and the other is the uncertainty about the central banks' technical ability to achieve their target. By publicly justifying their decisions, central banks enhance their credibility. Moreover, decision-making is improved by ensuring coherence between the decision and the communication and this obliges central bankers to profoundly think upon and evaluate their decisions thereby improving their monetary policy results. Thus, we can claim that greater transparency has led to better economic performance.

As we see in Chile, there is a lot of talk about the decisions and the scenarios of the Central Bank and this is good because it strengthens credibility and keeps authorities committed to their objectives, not only at the moment of communicating but also at the moment of adopting those decisions.

Effectiveness of monetary policy is reinforced by communication with market participants and by some degree of predictability in the Central Bank's conduct of its policies.

Monetary policy affects inflation through its effects on spending (consumption and investment) and on asset prices. The Central Bank controls short-term interest rates but these have only limited effects on the economy; financial market participants base their decisions on the whole term structure. Investment, for example, is fundamentally guided by long-term rates. Nevertheless, expectations about the course of short-term rates naturally are key determinants of the long-term rate and therefore do influence the whole term structure. Thus, expectations about the evolution of monetary policy contribute to its effectiveness. A transparent central bank affects the market's expectations by providing

market participants with information on which they base their vision of the likely course of inflation and monetary policy actions.

The Central Bank of Chile's communication of monetary policy

In the Chilean case, our main vehicles through which we give account for our objectives of price and financial stability are the quarterly Monetary Policy Report and the bi-annual Financial Stability Report.

I would like to describe in more detail our communication strategy for monetary policy. The information provided in our Monetary Policy Report is only part of that communication. The preparation that leads up to its publication is a vital component of our work, demanding great dedication, discussion, interaction and reflection on the current state of the economy and the outlook for inflation. The Board and staff meet at least six times in the course of five weeks and there are presentations of special topics, a great many bilateral meetings and draft reports are revised and discussed at length prior to publication. Therefore in this process the board members form their opinion on the determinants of inflation and how monetary policy should evolve.

This kind of reporting was introduced by the Bank of England in 1993 and is a common practice among central banks that have inflation target regimes. Today a great number of banks publish inflation reports and in a survey carried out by Fracasso et al. (2003) our Monetary Policy Report was classified in 5th place out of a sample of twenty such reports, the Bank of England's being judged the best.

To provide a basis for discussions on monetary policy, the Board decides which are the key variables of the most likely economic scenario. The projections for these variables derive from sources considered to be the most realistic and widely accepted. For example, the outlook for world growth is based on the *Consensus Forecast* and the International Monetary Fund's projections published in its *World Economic Outlook*. The outlook for commodity prices generally follows the futures market prices. Of course, these projections are imperfect – all projections are inherently uncertain – and the Board places particular emphasis on the risks and threats that may cause deviation from the baseline scenario. Thus, while making the baseline scenario as realistic as possible, the important discussion centers on analysis of the deviations from it and, above all, what are the implications for monetary policy that are coherent with our inflation target.

To make this most likely scenario more useful, we need to consider not only the external economy but also discuss the outlook for the key variables of our own economy, particularly exchange rate and interest rate.¹

To project the path of exchange rates, we use the interest rates parity, that is, the exchange rate varies according to interest rate differentials. If the domestic interest rate is lower than the international interest rate (adjusted for risk premiums), the exchange rate can be expected to depreciate. Furthermore, we have to make some assumption about where the exchange rate will be in the long run. For this purpose, we assume that if at the moment of making the forecast the real exchange rate is consistent, within a reasonable margin, with its long-term fundamentals, it will remain at the current levels in the long run. On the contrary, if it is deviated from fundamentals, we assume that the exchange rate will converge to values coherent with its long run levels.² In this way, with interest rate parity and certain

¹ For further details on projection models and as an example of transparency, see Banco Central de Chile (2003). Also Banco Central de Chile (2007) updates the Board's vision of monetary policy and its price stability objective.

² Caputo, Nuñez and Valdés (2008) present the various models normally used to evaluate the real equilibrium exchange rate.

assumptions about the distant future it is possible to have a complete trajectory for the exchange rate.

I must point out that, in a floating exchange regime, this is a working assumption made only to provide a model consistent with projections, even recognizing that the disclosed interest rate parity has little empirical validation. In any case, as our experience early this year has shown, a significant deviation from this path can have important implications for the course of monetary policy. At the beginning of the year, it was thought that rates could go up in the first quarter. However, the Board considered that the downward pressure on inflation generated by a pronounced appreciation of the peso relieved pressure on monetary policy.

One aspect which has received much attention in monetary policy practice and theory is the assumption about future interest rates used in the projections. It is an assumption about the future conduct of the Board itself, because this is the instrument used by monetary policy.

When we began publishing the Monetary Policy Report at the beginning of this decade, like many other central banks we worked on the assumption that the monetary policy rate would remain constant for the whole policy horizon. Even though this was not wholly plausible over a horizon of two years, it did seem to be not far off reality since the monetary policy rate was thought to be around its neutral level.

However, this working assumption became extraordinarily unreasonable when, towards the end of 2002 and early 2003, the monetary policy rate fell well below its neutral level. That is why, since then we have taken as a working assumption a monetary policy rule that adjusts the interest rate in order to meet the target.³ This does not involve a commitment to the future rate path but it serves to organize our discussions and deliberations. We communicate this path by comparing it (saying it is higher or similar, etc) to the implicit path seen in the forward curve and the expectations, and in general we indicate what this means in terms of possible rate changes during the year.

For example, in the latest Monetary Policy Report we stated that “in coming quarters, the monetary policy rate will move along a similar path to the one that can be inferred from the different measures of private sector expectations over the two weeks prior to the statistical closing of this Report.” and in the presentation to the Senate this was clarified in more detail by stating that by the end of the year the monetary policy rate could lie in the range of twenty-five basis points more or less than its current level.

In practice, and only two months after that presentation to the Senate, we have increased the monetary policy rate by one hundred basis points. In the Board’s opinion, this is necessary to prevent the latest news on inflation – both internationally and its passthrough to some domestic prices – from delaying the adjustment of inflation to its target within the policy horizon. The anchor for these decisions was the baseline scenario on which the May Monetary Policy Report was drawn up.

Publication of the Monetary Policy Report is reinforced by the statements released at the end of our monthly monetary policy meetings in which we generally refer explicitly to the baseline scenario. Additionally, three weeks after each meeting takes place we publish the minutes containing the board members’ discussions which again frequently refer to the most likely scenario.

With the objective of acting with the greatest independence possible in the monetary policy meetings and minimizing the risks of introducing unnecessary noise on financial markets, we have a self-imposed period of silence, or *purdah*, in the days prior to the meeting and to the Monetary Policy Report release. Evidence shows that financial markets are much more sensitive to information in the few days prior to a monetary policy meeting (Ehrmann and

³ See Woodford (2007) for recent discussion of the alternatives and coherence with a framework of inflation targets implemented through inflation forecast targeting.

Fratzscher, 2008) and, at the same time, any comment that is misunderstood or confused could influence the position of someone in the meeting.

Are there limits to transparency? The answer is definitely yes. In every democratic society, transparency is a duty. But the limit is to what point an excess of transparency might limit the Bank in achieving its objective which is price stability. For example, we could televise live the monetary policy meetings but that would restrict the open, frank dialogue that goes on. Besides, the discussions could be misinterpreted because they involve much technical jargon and judgments. I imagine that these same reasons prevent court deliberations from being broadcast live.

In other words, since context determines conduct, an excess of transparency can limit the freedom with which we discuss and express our judgments, thereby undermining the capacity to make appropriate decisions on monetary policy. The more transparent, the more cautious board members will be in pronouncing their judgments. That is why we have decided not to reveal board members' names in the minutes, so as not to inhibit an open, technical and independent discussion. In the pursuit of monetary policy effectiveness and predictability, we feel that the discussion itself is more important than names. A recent study by Meade and Stasavage (2008) compared the Fed's Federal Open Market Committee discussions before and after 1993, at which time it was decided to publish detailed records of deliberations of the meetings five years after they had been held. The study concluded that knowing the transcripts were to be made public had made members of a monetary policy committee more reluctant to offer dissenting opinions.

In general, transparency and its limits depend chiefly on the characteristics of the Board. For example, at one extreme we have the European Central Bank which does not keep minutes and dissent is very limited; and at the other extreme we have the Bank of England where each board member has individual responsibility.⁴ Chile, like the United States, takes an intermediate stance. That's why Blinder (2004) says, there is no "one-size-fits-all" approach to communication and transparency.

Communications policy

The Central Bank website carries a document called "Communications Policy" which specifies the principles and norms governing the Bank's communication with the public. It states that the Bank communicates with the public by way of official notices and publications, minutes, previously announced public conferences, interviews or public declarations made by board members. It also says that the Governor is directly responsible for all the information the Bank puts out, except for whatever the individual board members might publish or say in public.

At the same time, the policy rules that the Bank must publish all information or resolution relevant to the market as soon as it has been validated, thus obliging itself to give out all market-sensitive information as quickly as possible.

Whenever a board member or Bank executive gives a talk with information that could be relevant for the market, it is published on the website. Any public presentation given by the Governor is posted on the web as soon as they begin so that the general public has access to the information at the same time as those present. In my own case, and so that there is no discrimination between those who attend the presentation and those who do not, I leave a written text of my speech which is not an easy task to do, but ensures providing a precise message. For you as journalists, this is useful to your work and contributes to avoiding the use of the old excuse "I was misinterpreted", which may occur, but in most cases is the fault

⁴ See Blinder and others (2008) for more details on communication in central banks and relevant references.

of the speaker. Some of my presentations are not accompanied by a written speech in which case your job is to pick up on the fundamental messages and my job is to know how to best transmit them.

Our communications policy requires a fluid relationship with the press. We can hardly amplify our messages if we do not have access to the media. We have a Communications Manager who advises the Bank's board members and executives on the intricacies of this relationship with the press. It is a complex relationship because it has to be carried on within the limitations imposed by the fact that we are a technical institution and our messages are highly sensitive for the market and for the general public.

One principle we rigorously uphold is that all information that is the product of a Board decision or resolution is communicated simultaneously, which means that no media channel can obtain a scoop. There are strict internal rules on this matter and all contacts with Bank executives and staff must go through the Communications Management before following the corresponding course.

We are not prolific in giving interviews, statements or press conferences. We speak little, maybe less than the press would like and, although some of you might disagree with me, we try to maintain equanimity in our dealings with the media.

Just as the press requires us to use clear language in a transparent, timely and fast communication, we must also stress the importance of the media in the economic agents behavior. We certainly do not ask you to restrict or limit the information, nothing could be further from the spirit of free speech we adhere to, but we do request you to be rigorous in your reporting. Overinterpretation of decisions made by the Bank or overemphasis of transient economic indicators that do not mark a trend are situations that regularly influence public sentiments and even behavior. It only remains to me to recommend professional rigor and an adequate appreciation of the evolution of the economy, which are the same demands we at the Bank make upon ourselves.

Chile requires a specialized press that looks at economic events through the perspective of time and avoids being led away by sensations or climates. The economy progresses in long, slow cycles even though the day-to-day events may at times overwhelm us.

We have seen tremendous progress in the Chilean economic press. The specialized journalists have played an outstanding role in contributing to a better informed society, better equipped for decision-making. As in all fields, there is always room for further improvement. From our side, we are always available to contribute to explaining or advising on complex phenomena.

Final remarks

I would like to finish with some comments on a matter that has concerned me for some time which is, on what subjects a Central Bank board member can talk, and in particular the Governor of the Bank who is the official spokesman. There is no formal restriction, but there is a practical limit which is that no board member would like to spoil his professional and communicational reputation by speaking without well-founded arguments. It is true that the Bank has a limited mission but it also has an excellent group of economists. For example, at the request of the Senate Financial Committee, studies have been carried out at the Bank on the long-term growth of the Chilean economy and both myself and my predecessor have written articles on the same topic (Corbo and Tokman, 2007; De Gregorio, 2008). It is possible to speak and research on relevant topics as long as we do not stray far from our fundamental task. A few weeks ago, Ben Bernanke gave a speech on the challenges of health reform in the United States (Bernanke, 2008) and ten years ago Alan Greenspan gave a speech on income distribution (Greenspan, 1998).

Just as the Central Bank asks that its autonomy is respected, which is far from not accepting criticism, the Bank must also respect the decisions of other institutions. Here the balance is certainly tenuous. In any case, as a policy, the Central Bank at the moment of making a decision and defining scenarios takes as given what happens in other spheres of national life.

There is no clear rule, but there are some principles. First, the Central Bank must be rigorous in referring to all matters that have macroeconomic impact and consequently condition its actions. Secondly, when the connection is not so straightforward, we must be particularly cautious, especially when politically controversial subjects are involved. The Central Bank is a technical and autonomous institution and must take great care that the messages it puts out are not used politically. There are some very important subjects requiring discussion in our country, such as the educational reform, but it would not be prudent for the Bank to be affected by approaching any matter in an inadequate or inopportune way. Even more complex would be to discuss a tax reform that changes the composition of taxes or a labor reform that alters the dynamics of the business cycle. Subjects like these have enormous implications for economic efficiency, but they also evoke tremendous political passion.

Since there are no clear rules, and I have no defined position on this matter, I can offer two popular recommendations that I tend to follow: “nothing can be rejected out of hand” which allows an ample degree of flexibility and “when in doubt, refrain,” which is the best advice to prudence.

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