BIS Conference
Lucerne
June 26-27, 2008

MONETARY POLICY AND CENTRAL BANK COMMUNICATION: COMPLEMENTS OR SUBSTITUTES?

Discussion of Alan S. Blinder, "Talking About Monetary Policy: The Virtues and Vices (?) Of Central Bank Communications"

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Alan Blinder's paper offers a great deal of common-sense wisdom about central bank communication, along with a highly useful survey of both current practice and the current state of research on this key aspect of monetary policy. As Alan rightly recognizes, the change in attitudes toward central banks' public discussion of monetary policy in recent decades has amounted to a virtual revolution in how policymakers in this important arena of economic activity behave. Within living memory, many if not most central bankers thought it unwise if not perhaps undignified to explain their policy objectives to the general public except in the most general and abstract terms. Addressing specific policy actions was seen as even more inimical to the accepted norms of professional conduct. Today, as Alan's numerous examples illustrate, the opposite is more nearly true. Central bankers not only speak regularly to the public about both their objectives and their actions, they consider it a virtue to do so.

To be sure, this revolution among central bankers has paralleled broader cultural trends within our society. A generation ago ordinary people did not discuss intimate details of their

personal lives on television, human anatomical nomenclature was not an appropriate mode of naming stage plays and films, nor was the vocabulary of reproductive hygiene an accepted source of titles for books purporting to be serious literature. No doubt future cultural historians will sort out the resonance, and the influence, running from these changes in the popular and artistic worlds to the parallel changes that Alan documents in central bankers' newfound quest for revelation and disclosure. But as Alan persuasively argues, the changes that have occurred in what central bankers say about monetary policy, and in how they say it, are certainly important enough in their own regard.

The developments described in Alan's nicely comprehensive survey raise three logically related questions. The first is whether, from the perspective of the central bankers doing the communicating, monetary policy and communication about monetary policy represent complements or substitutes.

One's immediate reaction, I suspect, is to suppose that they are of course complements in the usual economic sense: If I hadn't drunk a cup of coffee this morning, I wouldn't have needed the milk that I used to dilute it. If central bankers weren't making monetary policy, they wouldn't need to tell anyone about it. The communication can go along with the policymaking or not – nothing dictates that I *must* add milk to the coffee I drink – but it seems clear enough that without the policymaking there would be nothing to communicate.

The modern logic of monetary policy points the other way, however. Even those cental banks that conduct monetary policy according to an inflation targeting regime, or whose public charge places clear primacy on maintaining a low inflation rate, nonetheless seek to achieve that objective at the least possible cost in terms of foregone output and employment. (In Mervyn

King's famous phrase, there are few if any "inflation nutters.") Modern representations of price determination – the various models underlying the New Keynesian Phillips Curve, for example, but by no means those formulations alone – relate pricing decisions to two distinct influences: (1) Price setters will set higher prices, all else equal, if their marginal costs of production are higher, and on average across all producers, marginal costs will be higher if the economy's level of aggregate demand is greater compared to the relevant "natural" or "full employment" output. (2) For given marginal cost, price setters will likewise set higher prices as they expect either prices or inflation to be higher in the future; hence expectations also matter. Both of these influences on price determination are operative, and in exactly this way, in models based on random price flexibility a la Calvo, staggered contracts a la Taylor, convex costs of adjustment a la Rotemberg and Woodford, Ss pricing a la Gertler and Leahy, and, in all probability, many others as well.

In light of this independent role for expectations, central bankers' concern for the public credibility of their commitment to a low-inflation trajectory is readily understandable. The lower is expected inflation, the smaller is the real economic cost – again, foregone output and jobs – required to contain the inflationary consequences of an adverse shock like an increase in oil or food prices. Similarly, the lower is expected inflation, the smaller is the real economic cost of returning to a low-inflation trajectory after some past sequence of events – a series of oil price increases, or perhaps even a period of misguided monetary policy pursued by one's predecessors – has placed the economy on an unacceptable path in this regard. Depending on the relative magnitudes assigned to the two key terms in the aggregate price setting mechanism, it is easy to understand the view, which Alan notes, that "the essence of monetary policy is the art of managing expectations" (pp. 1-2).

To the extent that communication about monetary policy is part of the "management" of the relevant expectations, therefore, communication is a *substitute* for monetary policy in the standard sense of higher or lower interest rates and greater or lesser liquidity of credit markets. For a given adverse supply shock, or a given starting point with unacceptably rapid inflation, there is a continuum of combinations of interest rate increases and inflation expectations that will result in maintaining the central bank's inflation target, or returning to it. More success at persuading the public that future inflation will be low means less need for higher interest rates and depressed aggregate demand. More success by the central bank's press office means less need for reliance on the open market desk. One is a substitute for the other.

The second question, to which this substitutability gives rise, is to what extent central bankers therefore seek to influence expectations independently of their actual conduct of policy. The incentives for seeking to do so are immediately evident. Along the continuum of interest rate and inflation expectation combinations that will produce the desired inflation rate, in the face of a given adverse shock, or initial conditions with inflation unacceptably high, each combination corresponds to a different real economic cost. Specifically, those combinations with lower inflation expectations, and therefore a smaller required increase in interest rates, involve less reduction of output and employment compared to the prevailing full employment levels. In short, disinflation achieved by the open market desk involves real economic cost; disinflation achieved by the press office doesn't.

Incentives of this kind are hardly unique in economic policymaking, or even within the scope of central banking. To cite just the most recent example, market events of the past year have sharply reminded us that in most economies the central bank not only makes monetary

policy but also acts as the lender of last resort. Before a liquidity crisis occurs, any lender of last resort will naturally want the operators of private financial institutions to believe that official assistance will rarely be forthcoming, and even then only on onerous terms. Otherwise the resulting "moral hazard" would create incentives for private parties to game the protective system by taking risks that they would not otherwise assume. But once a crisis is in full swing – for example, if one of the economy's five largest investment banks is threatened with bankruptcy and its numerous counterparties with chaos – a responsible lender of last resort will presumably act promptly and aggressively to effect a rescue, if necessary even on terms advantageous (under the straightened circumstances) to the private parties involved.

It is not surprising, therefore, that in the monetary policy sphere as well, central banks sometimes seek to "manage" expectations without undertaking real monetary policy actions. Alan's paper enumerates many of the rhetorical devices that central banks have used for this purpose, and there are more besides: easing interest rates (or at least not tightening them) but simultaneously issuing a contrasting "bias" or "balance of risk" statement to signal that policymakers' aims nonetheless remain firmly fixed on inflation; issuing a detailed quarterly report on the central bank's monetary policy deliberations and actions but calling it the "Inflation Report," as if inflation were policymakers' sole concern; publishing a description and rationale of the central bank's monetary policy strategy that simply asserts the presumed long-run efficiency advantages of aggregate price stability for aggregate output, while giving no hint of any tension between inflation and output at nearer horizons; and the list goes on.

Alan acknowledges this tendency, but only briefly and only at the end of his survey: "Notice also that the rhetoric of some inflation-targeting central banks, which focuses so single-

mindedly on inflation, does not match their observed behavior, which also displays concern with, say, output gaps. That, to me, is miscommunication and lack of transparency" (p. 27). (Earlier on, Alan uses italics to emphasize that in this paper he is writing about "*honest* central bank talk about monetary policy"; p. 6.) I surely agree. But I think the practice is more widespread than he implies here, in no way limited to the two dozen or so central banks that are self-declared inflation targeters.

I also think the practice is potentially more harmful than Alan's brief mention implies. The damage results in the first instance from undermining the objectives that proper central bank communication is supposed to achieve, namely transparency and accountability. If the central bank regularly *mis*communicates (to use Alan's deft way of putting it), the purported efficiency gains to private sector decision making from greater predictability of future policy actions are obviously nullified. And if the central bank is deliberately obfuscating its policy objectives – or, more likely, if it reveals one among a set of objectives but conceals the others – the purported gains to what Alan calls the democratic accountability of its decision making are precluded as well.

Even apart from problems of deliberate obfuscation and opacity, I think Alan here takes too much at face value the currently commonplace view that certain forms of monetary policy strategy are, per se, clear and transparent for these purposes. He writes, for example, "An independent central bank should have a clearly-defined mandate. The Bank of England's inflation target, for example, comes straight from the Chancellor and is very precise" (p. 8). True enough. But does anyone today, outside the Bank, have any clear or precise notion of how high or how rapidly the Bank's Monetary Policy Committee will decide to raise interest rates in order

to return U.K. inflation to the stated target as decreed by the Chancellor? Or how soon inflation will return to that pace? Or what degree of foregone output and employment the Committee will accept along the way? For the private sector decision makers whose behavior is at issue when we discuss the presumed efficiency gains from greater predictability of monetary policy, these questions too are part of what matters. They also bear importantly on the process of public evaluation that is central to democratic accountability. The idea that simply identifying a numerical inflation target is sufficient to specify a clearly-defined monetary policy strategy for these purposes is one of the commonly accepted fictions of today's monetary economics. But it is just that – a fiction – and a potentially very misleading one too.

The third question, following closely on the second, is to what extent it is *possible* for a central bank to "manage expectations" independently of what actual monetary policy does. Confronted with questions of this generic form, economists normally fall back on the familiar mantra that one cannot fool all the people all the time; and presumably this is so. But the communication policies of many central banks today suggest that policymakers believe it is possible at least to persuade many people (perhaps even including themselves), for at least some period of time, of things that may or may not be true; presumably this is so as well. The practically relevant issues in this regard occupy a portion of the horizon spectrum that plays out long before it becomes necessary to conceive of the central bank governor as the Wizard of Oz. Unfortunately, to date economists have had less to say about what actually happens over such finite periods. There is clearly much useful research to be done.

A final question, not directly linked to Alan's paper, also seems worth raising in conclusion: As time passes, will the world of monetary policymaking eventually outgrow the

legacy of the 1970s, including the fixation on credibility of the commitment to low inflation, and the other well known implications of the time inconsistency literature? Just a year or two ago, an even-handed assessment might well have expressed cautious optimism. Today, under the burden of a lengthening list of new adverse shocks – food, energy, the end of the information technology investment boom, security measures that likewise impinge on productivity gains – it seems more likely that the 1970s will be with us somewhat longer. So will the issues under discussion here.