

WHY SHOULD CENTRAL BANKS COMMUNICATE WITH PUBLIC? "EXPOSURING THE FRAME" VS. "NEVER EXPLAIN, NEVER EXCUSE"

ABSTRACT The ability of a central bank to affect the economy depends on its ability to influence market expectations about the future path of financial indicators. Effective communication with the public increases the transparency of monetary policy. Increased transparency improves the public's understanding and support of monetary policy and the democratic accountability of the central bank, serving to convergence to the rational expectations equilibrium. The paper suggests that, in order to be able to build stable monetary markets against financial crises, communication should be considered as an integral part of the modern day monetary policy.

KEYWORDS

Central bank
Communication
Monetary policy



1. WHY SHOULD CENTRAL BANKS COMMUNICATE WITH PUBLIC? "EXPOSURING THE FRAME" VS. "NEVER EX- PLAIN, NEVER EXCUSE"

There has to be a reason to start communication in the first place. For central banks the motive is generally a way of "exposuring the frame", that is, increasing the transparency of the monetary policy actions. Increased transparency is valuable for improving the public's understanding and support of monetary policy and the democratic accountability of the central bank. It can enhance the effectiveness of policy by fostering behavior in wages and prices and in financial markets that should help the central bank achieve its objectives of stabilizing prices and easing fluctuations in economic activity. Communications have a source who communicates a message through a channel or medium to a destination (audience) that aims at creating the desired effect. As

has Harold Laswell (1948) stated with his contribution to communication theory; verbal communication sketches a pattern in the following form; *Who (says) What (to) Whom (in) What Channel (with) What Effect*. The "Who" is the "Source"; "What" is the message; and "To Whom", is the destination.

The rest of the paper will follow this pattern in an attempt to present an overview on the role of skillful communication in improving the strength of the monetary policy. We suggest that monetary policy is most effective when it is effectively communicated.

2. WHO (SAYS)?: CENTRAL BANK AS THE SOURCE OF COMMUNICA- TION

Central bank communication can be defined as the provision of information by the central bank to the public regarding such matters as the objectives of monetary policy, the monetary policy strategy, the economic outlook, and the outlook for future policy decisions (Blinder *et al*, 2008: 6).

Until the 1990s, monetary policy makers should be secretive and say the least. They believed that they would not need to excuse for their false policy decisions, if they did not explain them to the public *a priori*. When

the essence of managing expectations in monetary policy was understood both in academia and in central banking; however, the influence of communication as a tool to strengthen policy implementations was recognized. Since then, the literature on why central bank communication matters and in which ways it affects macroeconomic variables has extended. This literature mostly consists of empirical studies that focus on how the content of central bank communication influences expectations and how central bank talk increases the predictability of central bank actions, which should in turn reduce volatility in financial markets. The key empirical question here is whether communication contributes to the effectiveness of monetary policy by moving short-term interest rates in a desired way or by lowering market uncertainty.

The first line of research in the related literature focuses on the impacts of central bank communications on financial markets. The basic idea is that, if communications steer expectations successfully, asset prices should react and policy decisions should become more predictable. The second line of research seeks to relate differences in communication strategies across central banks or across time to differences in economic performance.

Blinder (1998) and Bernanke (2004) emphasize the importance of communication as a means for central banks to influence asset prices in the financial markets, provided that the central bank has acquired a credible reputation. In that respect, communication is found as an important tool for the effectiveness of monetary policy implementation (Buiter 1999, Hoerberichts *et al* 2004, Issing 2005). On the other hand, several authors argue that more communication need not always be optimal. King (2000) argues that while a central bank should be highly transparent about its monetary policy, it should avoid “creating” news. Besides, an information bomb induces not more but less clarity and common understanding among market participants, as there are limits to how much information can be digested effec-

tively (Kahnemann 2003, Winkler 2000). This takes us to one of the most important aspects of a central bank’s communication strategy, the extent and content of any information it provides.

3. WHAT (TO COMMUNICATE)?: THE CONTENT OF THE CENTRAL BANK MESSAGES

The information provided by the central bank communication includes the bank’s objectives and strategies, the motives behind a particular policy decision, overall economic outlook, assessment of future indicators and economic activity, and its projections regarding future monetary policy decisions. The strategic importance of the content of each of these possible message topics come from the central bank’s ability to manipulate the economic agents’ actions.

Both Mishkin (2004) and Goodhart (2001) argue against announcing the future path of the policy rate claiming that it may complicate the committee’s decision-making process. On the other hand, there is the possibility that the communication of the central bank containing projections are mistakenly taken as commit-

ments by the public. When the central bank is accepted to be too credible, the public may place more weight on its pronouncements than the central bank intended. In that case, if the projected developments do not materialize, the discrepancy between actual and previously-projected policy might damage the central bank's credibility (Issing 2005). In addition, while forward guidance by the central bank is intended to correct faulty expectations, and thereby reduce misallocations of resources, inaccurate forecasts might actually induce such misallocations. Against these potential pitfalls, all central banks that provide forward guidance on interest rates emphasize that any forward-looking assessment is conditional on current information—and therefore subject to change.

4. WHOM TO COMMUNICATE?: THE AUDIENCE(S) OF THE CENTRAL BANK

The information flow during the central bank communication is targeted at two audiences. The first one is the broad public. Addressing the concerns of ordinary citizens and engaging them in issues are important for broadening awareness and understanding of monetary policy. This broad audience is best reached through the

mass media. At this point, the essence of mass media arises. If the media politicizes the central bank's decisions prejudicedly, overall monetary policy could be adversely affected. Second audience is the financial markets through which the monetary policy is transmitted to the rest of the economy. The central bank needs to enlighten the market operators to think and process information as it does. This implies sharing with the market the broad objectives of the bank's strategy, and even the technical details. By doing so central bank can be predictable in terms of market expectations.

5. WAYS TO COMMUNICATE: THE CHANNELS OF CENTRAL BANK COMMUNICATION

Central banks with similar objectives follow different communication policies, since they face different constraints as they try to achieve efficient monetary policy outcomes. Thus, both the content of messages and the choice of communication channels vary across central banks.

The messages can be sent by the committee or by an individual committee member. When messages are sent by or on behalf of the monetary policy committee, the

appropriate content, timing, and channels must all be chosen. Communication by individuals raises further issues – such as whether one member (e.g., the chairman or governor) should serve as spokesperson for the committee, reflecting a more collegial approach to communication, or each member should present his or her own views, representing an individualistic communication strategy.

SELECTED CENTRAL BANK COMMUNICATION ACTIONS

| | FED | ECB | BOE | BOJ |
|-----------------------------------|-----|-----|-----|-----|
| ACCOUNTABILITY | | | | |
| Quantitative Inflation Objectives | X | | | NO |
| Report to Legislature | | | | |
| POLICY DECISION ANNOUNCEMENTS | | | | |
| Announced immediately | | | | |
| Press Conferences | X | | X | |
| Press Releases | | | | |
| Minutes Published | | X | | |
| Precise Voting Results Published | | X | | |
| ECONOMIC ASSESSMENTS | | | | |
| Report on Monetary Policy | H | M | Q | M |
| Forecasts Released | H | H | Q | H |
| Quantitative Risk Assessments | X | X | | X |

Notes: FED: US Federal Reserve Bank, ECB: European Central Bank, BOE: Bank of England, BOJ: Bank of Japan, H: Half yearly, M: Monthly, Q: Quarterly

Source: EGBUNA, 2008: 16.

According to Blinder (2004), most central banks make decisions by a committee, reflecting an apparent consensus that doing so leads to superior policy. He distinguishes among three types of committees – individualistic, genuinely collegial, and autocratically collegial. Blinder emphasizes that these distinct types of committees need different communication strategies. In the individualistic case, the diversity of views on the committee should be apparent, as a way to help markets understand the degree of uncertainty surrounding monetary policy making. But in the collegial case, a similar diversity of views, if made public, might undermine clarity and common un-

derstanding. Therefore, communication should mainly convey the committee's views.

One difference between communications by individual members and by entire committees is the greater flexibility in timing of the former. Communications by committees are generally pre-scheduled, and thus somewhat inflexible in timing. But changes in the circumstances relevant to monetary policy do not always coincide with meeting dates or testimonies. Furthermore, the central bank might want to provide more guidance to financial markets and the public in times of great uncertainty (Jansen and De Haan, 2005). Occa-

sional speeches and interviews by individual committee members between meetings offer a way to communicate changes in views rapidly.

6. WHAT EFFECT: THE CONSE- QUENCES OF CENTRAL BANK COM- MUNICATION

Central bank communication increases learning both by and about central bank. That is, through open and clear communication with public, not only economic agents adjust their behavior, but central bank itself may develop good skills to evaluate its policy decisions. The bank can correct itself for future actions when needed to achieve a more stable macroeconomic environment. When the public does not know, but instead must estimate the central bank's policy moves, there is no guarantee that the economy will converge to the rational expectations equilibrium because the public's learning process affects the economy's behavior (Bernanke, 2004). The feedback effect of learning on the economy can lead to unstable or indeterminate outcomes—which effective communication by the central bank can help to avoid (Eusepi and Preston 2007).

There is empirical evidence that financial markets react to information on the outlook that central banks provide (Andersson et al, 2006). Investors update their own views in response to the information conveyed by the central bank. Kohn and Sack (2004) argue that private agents may attach special credence to the economic pronouncements of their central bank, especially if the bank has established confidence as an effective forecaster.

As a result of an effective use of communication, it may be possible for central banks to move interest rates with a smaller volume of open market operations, adjust target-deviated asset prices including exchange rates, "reduce noise" by eliminating any mis-forecasts regarding financial markets on the part of the public, and converge the market views to move in the rational direction. Clear communication requires time, money and other resources, thus releasing certain types of information might be costly for the central bank. However, today's modern monetary policy requires developing good communication skills with public, albeit costly, in order to build transparent monetary markets indestructible against financial crises.

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