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Estrategias de Comunicación y Efectividad de la Política Monetaria

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Estrategias de Comunicación y Efectividad de la Política Monetaria*

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Resumen

Los bancos centrales han cambiado drásticamente sus políticas comunicacionales en las últimas décadas. Desde un manejo casi secreto han pasado a la transparencia, con especial énfasis en las comunicaciones. Esto no tiene que ver solo con un cambio cultural en la sociedad como un todo que exige mayor transparencia a sus autoridades o con un cambio tecnológico que permite hacer un escrutinio más profundo de las medidas de las autoridades, sino también con que estas se han convencido de que la política monetaria funciona mucho mejor cuando es abierta y transparente. Por otra parte, en un mundo de bancos centrales autónomos, un mayor grado de apertura y transparencia los protege de la presión política.

La forward guidance (lineamientos hacia adelante) es una forma de comunicación que los bancos centrales han usado por años, pero que cobró importancia y se hizo más explícita con la crisis financiera global. En esta nota se analiza la evolución, los beneficios, costos, desafíos y perspectivas de esta forma de comunicación.

Communication Strategies and Monetary Policy Effectiveness

Summary

Central banks' communication policies have changed dramatically over the last decades. They have moved from being very secretive to much more transparency with a special emphasis on communications. This is not only related to a cultural change in the society at large that demands more transparency from their authorities or to technological changes that allow more scrutiny over policy actions of authorities in general, but also because central bankers have realized that monetary policy works much better when it is open and transparent. In addition, in a world of independent central banks a greater degree of openness and transparency protects them from political pressures.

Forward guidance is a form of communication that has been used by central banks for years, but that became much more relevant and explicit with the global financial crisis. In this note the evolution, benefits, costs, challenges and perspectives of this form of communication are analyzed.

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I. Introduction

Not long ago, the "art" of central banking was covered with mystery. Just twenty-five years ago, a best-seller in economics, "Secrets of the Temple: How the Federal Reserve Runs the Country," came out. Its excerpt read: "This ground-breaking best-seller reveals for the first time how the mighty and mysterious Federal Reserve operates… Secrets of the Temple takes us inside the government institution that is in some ways more secretive than the CIA and more powerful than the President or Congress."

Central bankers would communicate as little as possible with the public and when they did, they would use cryptic and inscrutable words and sentences. They were secretive about their policy targets and even the current stance of their policy instruments.

It is true that central bankers enjoyed a great degree of discretion and flexibility to conduct monetary policy. However, this secretive tactics came at a cost. They created confusion in the public and markets about the goals of monetary policy, and central banks became more vulnerable to political pressures, sometimes running into time consistency problems and ultimately losing effectiveness to achieve their mandate.

Over the last two decades, central banks have learned that monetary policy works much better when it is open and transparent. Transparency enhances markets' and the public's understanding of and confidence in monetary policy. It makes monetary policy more effective to influence financial conditions, the real economy and inflation.

Further, greater transparency about goals, instruments and analysis is a natural consequence of central bank independence and accountability to the political system and the general public. It reduces the scope for external political pressures on monetary policy and it preserves its autonomy over time.

Today, communication is a core and highly demanding task of central banking. Authorities have to clearly spell out their policy and operational targets; regularly release reports about monetary and financial policies, hold press conferences communicating their views on the current and future state of the economy, and their balance of risks; the likely evolution of policy rates in the baseline scenario; and their reaction function under alternative scenarios.

Better communication and understanding of the actions of monetary policy and its future path improves the tune of current financial conditions, including long-term interest rates and exchange rates, with the desired policy stance for monetary policy, enhancing its effectiveness. Words and deeds influence current financial conditions because central banks know first-hand their own intentions for the future. Actually, we can regard this shift of strategy of central banks towards more operational transparency as an early version of *forward guidance*, an issue I will address in more detail in the next section.

II. Forward Guidance

In recent years, challenges for central bank communication policy have multiplied in both advanced and emerging market economies. There is greater uncertainty arising from unusual circumstances, such as the zero lower bound for the monetary policy rate, doubts about fiscal policy sustainability in advanced economies, and large capital inflows into emerging market economies. All these situations have required central banks to deploy new policy tools and explain their goals and expectations about them.

These exceptional circumstances, in particular the zero lower bound constraint, have made traditional monetary policy based on short-term rate setting less effective. Central banks in advanced economies have responded with unconventional monetary policies, including large-scale asset purchases for a wider range of securities, as well as long-term refinancing operations.

Regarding their communication strategies, the major change is an enhanced version of *forward guidance*, by which central banks adopt a stronger commitment to keeping rates exceptionally low for a prolonged period of time. The hope is that this stronger commitment will affect expectations of future interest rates and provide an additional boost to key asset prices, including medium- and longer-term bonds.

What is *forward guidance* in its modern form? Compared with its elder relative, the modern version of *forward guidance* essentially conveys more directly and explicitly the central bank's intentions of keeping interest rates low. This commitment can vary in terms of the specific communication strategy, where we can distinguish roughly three forms of *forward guidance*. *Open-ended forward guidance* is a rather general statement about the future path of short-term rates. For example, "the central bank is likely to keep rates at low levels for an extended period of time." A second strategy, often referred to as time-contingent *forward guidance*, makes a further commitment about a particular date, e.g., "is likely to keep rates low for at least two more years." And yet a third version of the communication strategy is a state-contingent statement, such as: "will keep rates low at least until unemployment falls below 7%, as long as inflation projections and expectations remain anchored at the inflation target of 2%."

The key challenge of *forward guidance* is trying to shift expectations about future interest rates, while at the same time allowing significant flexibility to central banks to change course in light of changing economic conditions. Indeed, promising "low rates for an extended period of time" is a convenient way of not tying the Central Bank's hands to a particular date, but for the same reason, it is unlikely to be received as significant news by the market. Conversely, a strong commitment to keeping rates close to zero for at least two years is not a promise financial markets are likely to forget or misinterpret. But such promise exposes the monetary authority to an uncomfortable situation if, say, six months ahead, improved conditions call for a retreat of the expansionary policy sooner than expected.

As economic conditions remain sluggish and deflation becomes a more palpable threat, central banks have moved progressively towards stronger forms of time- and state-contingent *forward guidance* communication strategies. A good case study in the evolution of forward guidance is the Japanese experience. In 1999, the BoJ announced to maintain low rates until "deflation concerns are dispelled." Because the commitment was rather vague about the precise inflation goal or date to achieve it, it is regarded —in retrospect— as open-ended by current authorities at the BoJ.[1] In its second "round" of *forward guidance* between 2001 and 2006, aside from changing the operational target to the money supply, the language was further refined to a state-contingent guidance, stating that "monetary easing would continue to be in place until the core CPI registers stably zero percent or an increase year on year." Later, in January 2013, the guidance was further strengthened: "the Bank will achieve the price stability target of 2% at the earliest possible time, with a time horizon of about two years." Seeking a stronger response in the expectations of the public, the BoJ has issued monetary policy communiqués that are increasingly specific about the particular inflation goal, and the time frame in which it expects to achieve it.

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[1] Shirai, Sayuri (2013), "Monetary Policy and Forward Guidance in Japan." Speeches at the IMF and Board of Governors of the Federal Reserve System. September.

The evolution of the Federal Reserve's communicational strategy is also illuminating in this respect. In December 2008, it stated: "the Committee anticipates that weak economic conditions are likely to warrant exceptionally low levels of the federal funds rate for some time." Later, in August 2011, the language became closer to calendar-based *forward guidance*: "…are likely to warrant exceptionally low levels for the federal funds rate at least through mid-2013." And later still, in December 2012, it introduced state-contingent guidance by stating that the Committee: "… currently anticipates that this exceptionally low range for the federal funds rate will be appropriate at least as long as the unemployment rate remains above 6-1/2 percent, inflation between one and two years ahead is projected to be no more than a half percentage point above the Committee's 2 percent longer-run goal, and longer-term inflation expectations continue to be well anchored."

This state-contingent version of *forward guidance* also shapes the current communicational strategy at the Bank of England, where the August 2013 communiqué read "…keep monetary policy rate at 0.5% until unemployment has fallen below 7%, as long as certain scenarios, or knockouts, do not materialize. These include i) The MPC views as more likely than not, that CPI inflation 18 to 24 months ahead will be 0.5% or more above the 2% target, ii) medium-term inflation expectations no longer remain sufficiently well anchored; and iii) the financial policy committee judges that the stance of monetary policy poses a significant threat to financial stability…"

The Central Bank of Chile also used *forward guidance* in the past, although implemented in a very different economic scenario compared to most developed economies in recent years.

Mostly due to commodity and agricultural shocks, 12-month inflation rose to more than 9% in the second half of 2008. As a result, and for the first time since inflation targeting was adopted in the early 2000s, inflation expectations threatened to lose anchor from the 3% target. Besides a significant hike in the policy rate (325 bp in 14 months to September), statements began incorporating an additional "upward bias." For example, in August 2008, it stated: "in the most likely scenario, further adjustments will be necessary to ensure the convergence of inflation to the target."

In January 2009, four months after the financial tsunami of September, monetary policy rates in Chile began their downward trend. Here, and for a brief period, the economic situation became more aligned with the world contraction. June 2009 marks the beginning of our rather brief implementation of *forward guidance*, as currently understood in the countries referred to above. The communiqué read: "the Board considers that, in the most likely scenario, it will be necessary to maintain the monetary stimulus for a longer period than the one implicit in financial asset prices." Interestingly, while open ended, the communiqué made explicit reference to the objective of affecting the yield curve beyond the traditional policy horizon. This message was further strengthened in the next meeting, in which concrete quantitative easing measures were adopted. These included direct lending facilities for loans up to six months, to commercial banks at the current policy rate.

Open-ended *forward guidance* continued until December 2009, when it was changed briefly to time-contingent guidance by stating that macroeconomic conditions would be consistent with current rates for at least the next six months. By February 2010, economic activity had slightly recuperated, and the stage seemed ripe for commencing the normalization of rates.

This is where the Chilean experience departs once again from the general trend. In February 2010, another tsunami hit our country, but this time a real one. Together with the largest earthquake in half a century, the natural catastrophe actually accelerated the economic recovery by boosting investment and employment, particularly in (re)construction. This episode also marks the end of time-contingent *forward guidance* at the Central Bank of Chile. Since then, our communiqués sometimes suggest that further rate movements could follow the recent direction of changes being implemented, but always leaving ample discretion to adjust to changes in the economic outlook. In this sense they again became traditional communiqués and in the same sense the exit of our country from quantitative easing and from *forward guidance* was rather easy.

III. Problems and Challenges of *Forward Guidance*

While stronger commitments to future monetary policy can perhaps impact medium- and longer-term rates more than open-ended messages, they present numerous challenges for monetary authorities across the world.

The first of these problems is time-consistency. As pointed out by Michael Woodford in a recent paper,[2] *forward guidance* can affect the yield curve only to the extent that central banks can credibly commit not to raise interest rates in certain scenarios where ex-post, and conditional on economic recovery, it would be tempting for them to do the opposite. Quoting from his paper, "… the future policy that one wishes for people to anticipate is one that the central bank will not have a motive to implement later, if it makes its decisions then in a *purely forward-looking* way, on the basis of its usual stabilization objectives."

How can central banks escape this apparent conundrum? This is not an easy question. One possibility is to accept higher inflation in the future as a natural outcome of the ex-ante commitment that the central bank needed to pledge in order to reach economic recovery sooner, rather than later. Another is to simply renege on this promise, and start raising rates as soon as economic conditions advice (ex-post) to do so, accepting the reputational costs of the public embarrassment and the virtual elimination of this possibility for future use.

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[2] Woodford, Michael (2012). "Methods of Policy Accommodation at the Interest-Rate Lower Bound." Paper presented at the Jackson Hole symposium, August.

Yet another way is to condition that all monetary policy decisions will always prioritize the anchoring of expectations, and subject to this constraint, monetary policy will be as lax as possible. But isn't this behavior already incorporated in the current yield curve? If it is, then this third choice is not really a choice, and central bankers who wish to bring further down the long-end of the yield curve will have to choose from some combination of the previous two, rather painful, possibilities.

Historically, however, the problem of monetary policy has been precisely the opposite: the inflationary bias of discretionary policies, and how to overcome it through better institutions. This puts central banks in a position in which there is little or no theory, and no actual experience, to provide guidance.

A second problem is that a richer contingent plan necessarily comes at a cost of more communicational complexity. This is a fine and difficult balance to achieve. Indeed, greater complexity will allow for a more robust state-contingent plan, but it will undoubtedly create more confusion among the public. A recent example that underscores this tension is the experience of the Bank of England over the last nine months. In August 2013, the BoE announced the state-contingent *forward guidance* policy referred to above. In particular, it chose the unemployment rate as an operational target to assess the state of slack in the economy because, among other advantages, it is a simple target that the public can easily understand; it is available in a timely fashion for policy decisions; and it is a relatively stable indicator. In its August 2013 *Inflation Report*, the Bank also hinted that the likely horizon by which unemployment would fall from the 7% threshold would be in the neighborhood of two years. Five months down the road in January, and with the unemployment rate about to cross the threshold, the Bank had to modify its statement. According to its authorities —and in all probability, rightly so— the fall in the unemployment rate due to discouraged workers exiting the labor force does not reflect a reduction in the amount of slack in the economy, and the BoE would therefore consider broader indicators to assess the output gap.

It is important here to mention that, if one reads the August 2013 *Forward Guidance* document carefully,[3] it is actually quite explicit about leaving the door open to such a broader interpretation of the state of slack in the economy, were the unemployment rate deemed as unfit (if, for instance, it fell due to lower participation rates!). But this does not change the fact that the modification in the operational target created confusion and opened up lines of criticism in numerous financial blogs and in the general media.

A third problem inherent in making stronger commitments about future policies is that our knowledge of the future is very limited, and we may need to change course as new information arrives. Macroeconomics deals with essentially complex phenomena for which we have limited data and not necessarily the most relevant. As Friedrich von Hayek stated 40 years ago in his Nobel lecture: "To act on the belief that we possess the knowledge and power which enable us to shape the process of society entirely to our liking, knowledge that in fact we do not possess, is likely to do us much harm."[4] There is danger in presuming a precision and degree of knowledge we do not have. We must leave ample room for the unexpected. Giving too much detail and precision about the future policy path may reduce the ability of central banks to re-optimize as new information arrives or delay actions to avoid creating financial turmoil.

We must also recognize that our disclosures are likely to impact the broader information set that economic agents act upon, particularly in financial markets. Indeed, von Hayek's insight has been formalized and further studied in a number of

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[3] Monetary Policy Trade-offs and Forward Guidance. Bank of England. August 2013.

[4] Von Hayek, Friedrich A. (1974). Prize Lecture: The Pretense of Knowledge". Lecture in memory of Alfred Nobel, December.

important contributions. For instance, in the highly influential piece of Grossman and Stiglitz,[5] whose analysis reveals a simple yet powerful message: financial markets gather knowledge about the prospects of the economy that is eventually expressed in the form of prices, and through prices, guide the allocation of resources. Naturally, this process of information discovery is not without its costs. What determines then how much information financial market participants will choose to collect? Among other things, certainly their alternative sources of information. The worry here is that by communicating a stronger commitment towards a particular path of the economy, we may be affecting the very essence of the process by which markets discover information by themselves.

I want to remark here that this is not merely an "academic" concern. The financial crisis of 2008 is a vivid reminder of the dangers of asset concentration in the balance sheets of financial intermediaries: when the time comes to sell these assets to face liquidity needs, who will you sell to, if all your peers are holding the same assets, and for that very reason, are all in dire need of liquidity as well? This is not meant to say that central banks' communication policies in the past have put us in the line of fire (nor fire sales!). But the natural outcome of a financial market in which participants act on similar beliefs is precisely the concentration of risks, and these are not risks we want to turn a blind eye upon.

We must communicate clearly and actively the uncertainties surrounding our projections because there is the danger that the public and market participants may rely too much on the forecasts of central banks, not preparing themselves for the unexpected.

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[5] Grossman, Sanford J., and Joseph E. Stiglitz (1980). "On the Impossibility of Informationally Efficient Markets." The American Economic Review 70(3): 393-408.

It is well known from behavioral sciences that people have a poor understanding of probability and uncertainty. Specialists and the general public get confused between point predictions and accurate predictions. Overconfidence leads to bad financial and economic decisions. Central bankers need to be humble about their ability to make predictions about the future, about exogenous variables, and even about their own policy decisions, so that they and the public may better plan for the future.

One corollary is that transparency and openness of the decision-making process is important. Differences of opinions should be candidly informed to the public so they can form their own views on how likely the central bank is to maintain the stated course or change it under alternative scenarios. Greater transparency and openness about these differences may come at the cost of losing clarity and policy traction in the baseline scenario but it will probably improve performance under the alternatives.

A final concern about *forward guidance* relates to the exit strategy from it. As economic conditions improve and rates begin their path towards normality, this will naturally shift the whole yield curve upwards. Just as stocks are traded mostly by professional fund managers nowadays, fixed-income securities are also traded by professional investors, for whom relative performance with respect to their peers is a key determinant of compensation. This opens the door for strategic interactions, by which each fund manager tries to sell off securities before their peers in order to preempt the price decline. This "herd" behavior can introduce non-trivial volatility in medium and long term rates as the period of monetary easing comes to an end. Morris and Shin[6] nicely illustrate this point in a recent article.

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[6] Morris, Stephen, and Hyun Song Shin (2014). "The risk taking channel of monetary policy: A global games approach." Working paper, Princeton University.

IV. Emerging Market Economies, Capital Flows and Communication

Central banks in emerging market economies have also confronted an unusual policy environment requiring them to enhance their communication efforts. They have received large capital flows and experienced greater exchange rate volatility. Many emerging economies (and recently some advanced economies too) have intervened exchange rate markets to dampen potentially damaging fluctuations in the currency value. Others have adopted nonstandard macroprudential measures to tame credit growth, or capital flow measures to slow down the pace of capital inflows. To the extent that these interventions are exceptional, their implementation requires a special communication effort to explain their objectives, the reaction function of the central bank and their interaction and coordination with monetary policy.

Furthermore, central banks have encouraged going beyond their traditional price stability objective to give more prominence to financial stability and exchange rate concerns, and to use all instrument simultaneously to achieve all policy targets. For example, use simultaneously monetary policy and macroprudential tools to lean against the economic and financial cycle. Sometimes, macroprudential policies may lack flexibility because of political or institutional constraints, so monetary policy may lean against the financial cycle, in addition to targeting price stability. On other occasions, monetary policy may be constrained to do this job due to exchange rate concerns, so macroprudential policies may be used to moderate the business cycle, in addition to financial stability, and so on. In a second-best world, where all policy instruments face constraints and have costs and unwanted spillovers, this may be the optimal solution. However, the communication challenges they impose on central banks are enormous. There is a real danger that greater activism in these areas and the mingling of policy targets and instruments will create confusion about the goals of the central bank and lead to underperformance in all policy goals.

V. Final Remarks

Central banks' communication policies have changed dramatically over the last decades. They have moved from being very secretive to much more transparency with a special emphasis on communications. This is not only related to a cultural change in the society at large that demands more transparency from their authorities or to technological changes that allow more scrutiny over policy actions of authorities in general, but also because central bankers have realized that monetary policy works much better when it is open and transparent. One reason is that this enhances the markets' understanding and confidence in monetary policy.

In addition, in a world of independent central banks a greater degree of openness and transparency protects them from political pressures. Only with a large degree of transparency in terms of policy goals, instruments, analysis and actions, an institution such as a central bank can gain prestige and support from the public that allows them to avoid or to be well prepared to face political pressures without risking its independence.

Forward guidance is a form of communication that has been used by central banks for years, but that became much more relevant and explicit with the global financial crisis. Its objective is to communicate to the market the likely evolution of monetary policy in the future so as to influence not only short term but also long term interest rates. It is also used as a means to provide the market with a more specific view on how the central bank sees the economy. After the global financial crisis (and before that in the case of Japan) central banks around the world have used *forward guidance* in a much more explicit way to convey the message that rates are going to remain low for an extended period of time. We have discussed in this paper the benefits and costs of this more direct form of communicating future policy actions. The question that remains is whether *forward guidance* in its current more explicit version will survive after central banks have normalized their monetary policies. Although it is difficult to know the answer to this question, my view is that the costs in normal times of this form of *forward guidance* are quite high in terms of the time inconsistency, communication complexity and the effects on markets expectations that we have addressed in this paper. If this is the case the explicit forms of *forward guidance* that have been used during the crisis will not be needed any more. Chile is a case in point.

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