Volume Title: NBER International Seminar on Macroeconomics 2007

Volume Author/Editor: Richard Clarida and Francesco Giavazzi, organizers

Volume Publisher: University of Chicago Press

ISSN: 1932-8796

Volume URL: http://www.nber.org/books/clar07-1

Conference Date: June 15-16, 2007

Publication Date: January 2009

Chapter Title: Comment on "Interest Rate Signals and Central Bank Transparency"

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Chapter URL: http://www.nber.org/chapters/c2998

Chapter pages in book: (52 - 54)

Comment

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Is more central bank transparency a good thing? In the bad old days, central bankers saw themselves as guardians of the inner sanctum; mystique was everything. Today, transparency seems to be the norm. But exactly how far should that transparency go? Standard macroeconomic models appear to imply that central banks should reveal everything that they think they know in order to anchor private expectations. But following the work of Stephen Morris and Hyun Shin (2005), a little literature has developed that questions whether full transparency is indeed optimal. Morris and Shin showed that in a world where agents need to form a view about the price expectations of other agents, undue weight will be placed on any central bank (CB) signal of the overall price level, because it acts as a focal point around which these expectations can coalesce. The CB will be better off not revealing its signal if the precision of the CB's information is low and the common knowledge distortion is large.

The present clever, though rather complex, chapter by Pierre Gosselin, Aileen Lotz, and Charles Wyplosz (GLW) represents a useful extension of that literature. While at one time the Federal Open Market Committee (FOMC) did not reveal its target for the Federal Funds rate, most CBs usually reveal their policy rate and therefore necessarily reveal something about their perceptions of the economy in the process. The question is how much further the CB should go. Gosselin, Lotz, and Wyplosz allow for this and more, by generalizing the Morris-Shin framework for both the number of underlying fundamentals and the nature of the uncertainties that are present.

In the basic model, partial transparency—in the shape of revealing the interest rate—dominates both opacity and full transparency. Why is that? Revealing something increases the information available to the private sector but simultaneously generates a common knowledge effect. But the interest rate—the route whereby CB information is revealed in the partial transparency regime—is a manipulable signal. So the CB

can always choose a reaction function that reveals enough information to dominate opacity, but not so much that the common knowledge effect becomes dominant (i.e., it can lean against the common knowledge effect).

In the basic model, the signals of the fundamentals are privately observed but the precision of those signals is common knowledge. In the second half of their chapter, GLW drop that assumption and instead assume unknown precisions, which they describe as generating a fog effect in which the quality of the information transmitted is lowered. Now full transparency on the part of the CB may be optimal if the fog is thick enough, essentially because the ability of the CB to manipulate private sector beliefs through its use of the interest rate signal is impaired.

What should we make of these results? First, I should say that I find it very difficult to map the analysis of the chapter across to what CBs actually do. A key assumption is that the interest rate only functions as a signal in the model and plays no role whatsoever in affecting aggregate demand or supply. Even though the policy rate may be of negligible direct importance to private agents, it is the fulcrum around which all the other interest rates and asset prices in the economy revolve. So any aiming off on the part of the CB in order to manipulate its signal and offset a beauty contest effect carries a potentially significant macroeconomic cost. I am therefore somewhat doubtful that policymakers would ever actually want to choose a reaction function in which such considerations loomed large. That is especially the case when one views this as a repeated game in which a sequence of interest rate decisions help the private sector to learn about the CBs reaction function and thus help to condition future expectations.

A second observation is that this chapter, like its predecessors in this literature, assumes that agents observe private and noisy indicators of the true state of the economy and that the structure of the economy is well known. But CBs' information sets are very largely comprised of macroeconomic indicators that are certainly noisy, but are also published and therefore common knowledge. If there is an information difference, then it largely resides in differences in view about the structure of the economy. Gosselin, Lotz, and Wyplosz suggest that one could just flip the interpretation of A and θ, so as to make A the state and θ the structure of the economy, in which case all the results go through. However, communicating beliefs about economic structure is in practice rather harder than measuring and communicating information about the state.

Third, the literature inspired by Morris and Shin seems to me rather to

miss why CBs aspire to greater transparency and as a result focuses attention on peripheral rather than central issues. Central Banks aspire to transparency for essentially two reasons. The first is an economic one, namely to better condition expectations, something that the New Monetary Economics, exemplified by Mike Woodford's magisterial tome (Woodford, 2003), puts right at center stage. In particular, policymakers want the private sector to understand how they are likely to respond to data news so that market interest rates, asset prices, and expectations respond appropriately. That is, they want private agents to understand the policy reaction function. As the reaction function is a complex beast—*no* central bank actually follows a Taylor Rule—this is something that is very difficult to do and requires a lot of explanation. This communication problem is absent in most academic analyses, which simply assume that private agents know, or can easily calculate, the CB's reaction function. (In passing, I might also note that publishing a CB's expected future interest rate path, as recommended in some of the recent academic literature, falls well short of communicating a reaction function, which is all about what happens if shocks push an economy *off* its expected path.)

The second reason that CBs pursue transparency stems from political considerations, in that the Bank of England simply could not have been given operational independence in 1997 without simultaneously being made accountable to Parliament; that was essential for democratic legitimacy. Indeed, all CBs, even the most independent, are accountable in some form or other to both the government and the people. A reasonable degree of transparency on the part of the CB is necessary if it is to be held to account effectively. The issue is how best to do it. For instance, the Bank of England's Monetary Policy Committee is legally required to publish minutes, including individual votes, and a quarterly *Inflation Report* that explains our thinking. These are not optional extras!

I conclude that until the academic literature engages properly with *why* CBs seek transparency, it is unlikely to be of much help in considering the practical question of what is the optimal nature and degree of that transparency. But I greatly enjoyed reading the present chapter nevertheless!

References

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