BANK OF ENGLAND

Speech

Central Bank Communications: Best Practices in Advanced Economies

Speech given by

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It is fair to say that communication is an integral part of monetary policy".[i]

These words of Jean-Claude Trichet, president of the European Central Bank, are the context for my remarks this morning on best practice in the advanced economies. I have four broad objectives in mind:

* I'll try to explain how and why the world's leading central banks have been willing to open their front doors and let in a little sunshine over the last decade or two.
* I will argue that there is no single best practice in central bank communications. Policies which are appropriate for one type of monetary policy authority may not be suitable for another. So this is not a case where one size fits all.
* I will emphasise that central banks must communicate for a purpose. There is no virtue in general transparency for its own sake and it's important to be clear about why and to whom the messages are being addressed. In other words, monetary policy makers must adopt a strategic approach to communications.
* Finally, I will suggest that although central banks have come a long way in the way they communicate over recent years, they are nowhere near the Promised Land. There are serious communications challenges ahead, for which policymakers need to be preparing themselves today.

I should make clear at the outset that these views are my own: I'm not speaking for my colleagues on the Monetary Policy Committee or for the Bank of England.

From where we stand now, it is hard to remember that only a dozen years ago, Federal Reserve Board Alan Greenspan was arguing against the FOMC making any public announcement of its interest rate decisions.

"Immediate release of the directive could threaten to roil markets unnecessarily," he stated. "And concern about market reaction could reduce flexibility in decision-making."[ii]

Little by little, the veil was lifted in the years that followed. At the end of 1995, the Fed officially adopted the policy of announcing all its decisions immediately. Four years later, it took to issuing statements after every meeting, and in 2002 it began announcing the vote, with names attached, at the end of the meeting.

And it was only last year that the Fed went another step down the road by releasing the minutes of its meetings in a much more timely fashion – around three weeks after the meeting in question. Instead of being ancient history, the publication of this information is now something that can move markets.

In one way or another, all the developed world's central banks have marched along this path to greater transparency. As a financial journalist, I banged my head for many years on the famously thick walls of the Bank of England. The job of its press officer was explicitly to keep the Bank out of the press, and the press out of the Bank. Now it is among the most transparent of such institutions in the world, publishing full accounts of its policy meetings and detailed analyses of its views on the inflation outlook, as well as submitting the Governor and his colleagues to all kinds of public interrogation.

The President of the European Central Bank walks directly out of its policy decision meetings into a press conference. The Bank of Japan has been extremely open about the economic circumstances in which it would start to tighten policy.[iii] The Norwegian and New Zealand central banks have started to publish their assumptions about how market interest rates might unfold in the years ahead.[iv]

The list goes on. There are two broad reasons for this general trend towards greater openness and transparency.

The first stems from the fact that central banks throughout the developed world have been given a much greater degree of autonomy over the conduct of monetary policy over the past twenty years. As Federal Reserve Board Governor Donald Kohn explained in a speech last year:

"Greater support for independent central banks with goals set by the political process was one of the results of the lessons of the great inflation of the 1970s. But an arms-length distance from immediate political pressures requires accountability and reporting to elected representatives."[v]

Of course accountability means different things in different systems. The Bank of England is set an inflation target each year by the UK's finance minister: if inflation were to deviate from the target by more than 1 percentage point on either side, we would have to explain ourselves publicly – and the finance minister's response would also be public.

By contrast, the European Central Bank – not the Commission or the parliament – sets its own policy goals. And although Chairman Greenspan is accountable to the Congress, he has always shunned rules and exercised the maximum discretion possible within the Fed's legal mandate.

But although the regimes are different, the important point is a political one: that if unelected policymakers are to be allowed to make decisions that affect everyday lives, then they need to take some trouble to explain what they are up to. It's a question of legitimacy. As I shall suggest later on, the political pressures on central bankers could well increase in the years ahead, which is why they are going to have to pay more attention to this part of their communications strategy.

A second reason for greater transparency is entirely about economics. Again to quote from Governor Kohn's speech:

"A basic tenet of economics is that markets work better – reflect underlying economic forces, efficiently allocate resources – with more information. Because central banks are key players in financial markets, a better understanding of central bank behavior should improve pricing in those markets."

In normal circumstances, monetary policymakers only have a single policy instrument to play with: the ability to influence very short term interest rates. But the big decisions that affect supply and demand in an economy – and which determine price developments over the medium term – are shaped much more by medium and longer term interest rates, over which central banks have little direct control.

The markets and the public have to understand how the bank is likely to react in response to new information. They also have to be convinced that the monetary authority can be trusted over time to take whatever steps are necessary to maintain price stability. This means that they must have confidence that a temporary shift in inflation – the result, for example, of a jump in oil prices – will not be allowed to pass through into higher inflation over the longer term.

The key to maintaining low and stable inflation over time lies in public expectations about the likely future path of wages and prices. And communications must play a central part in managing those expectations. Policy must be well understood if it is to be effective, as well as consistent, systematic and reasonably predictable.

How central banks go about their approach to communications depends very much on the way that they are structured. Part of the fun of the job is the polite point-scoring that goes on between different institutions – each of which can prove beyond any doubt that its strategy is more transparent than its peers.

But such comparisons are irrelevant. The reality is that different decision-making systems call for different approaches. There are two key determinants for a central bank's communications strategy. The first is the structure of its decision-making system. And the second is the monetary framework within which it operates.

The different systems and frameworks also reflect historical experience. The basis for the present arrangements in the United Kingdom can be traced back to our experience in the European Exchange Rate Mechanism. The reforms in the aftermath of our withdrawal from the Mechanism in 1992 saw the introduction of an inflation target and increased transparency of monetary policy, including an Inflation Report, culminating in operational independence in 1997.

In a paper published just over a year ago, Alan Blinder and Charles Wyplosz suggest that there are four archetypical systems for setting interest rates.[vi]

In the first, the individual central bank governor takes the decision: New Zealand is the obvious example. Since only the Governor makes the interest rate decision, there's no vote and no minutes to report. It's up to the Governor to explain as fully as possible why he has taken the decision he has: it may be no coincidence that the New Zealand gives more information than just about any other institution on one very sensitive subject - its assumptions about the future path of interest rates.

The second category of decision maker is described as the autocratically-collegial committee, of which the best example, certainly under Mr Greenspan, has been the Federal Reserve Board. In this system, the chairman more or less dictates the group consensus. In his entertaining account of his term as a Fed Governor, Laurence Meyer confessed: "I ended my term not sure I had ever influenced the outcome of an FOMC meeting." He went on:

"Once the majority view (which, as I've mentioned, is always that of the Chairman) is apparent at FOMC meetings, the Committee is expected to rally around it."[vii]

Such has been the credibility and authority of Mr Greenspan, built up over a period of 18 years, that he is the dominant figure in the communications process. The FOMC is in a position to issue a substantive statement at the end of each meeting, since the chairman may well have started the discussion with a draft in his pocket, and his testimonies on policy have turned into major news events.

Blinder and Wyplosz's third category of decision maker is the genuinely collegial committee, such as the European Central Bank. Here, the president's job is to arrive at decisions by consensus – and to avoid any discussion of dissent. Above all, the ECB is anxious to avoid any suggestion that individual governors may have been driven by national – as opposed to euro area – considerations.

This is why the ECB does not publish minutes, or the votes of its committee members. To do so, it thinks, might impair its ability to project a sense of consensus. It's also why the president feels able to walk straight out of the meeting into a press conference. His role there is to reflect the consensus, not to pick out the subtle nuances of the different arguments heard around the board table. For this reason, the conference is often not very exciting. But it is an important form of transparency.

The fourth decision making system is the genuinely individualistic committee, like that of the Bank of England. The Bank of England Act makes us individually accountable to Parliament for our decisions. So at our meetings, the Governor does not try to reach a consensus. Instead, he chairs a sometimes vigorous discussion about the economic conjuncture, and then asks us to express our individual vote for the policy rate: he normally votes and speaks last, and the simple majority wins.

Last summer, Governor King chose to put himself in the minority by voting against an interest rate cut. This had not happened since the Bank was given independence in 1997, and the news was received with something like amazement by my friends in the US. But for me it showed that our system was working well, and I admired the Governor for his decision. Each member of the committee is held personally responsible for his or her vote – and it would be absurd if the one person on the committee who could not freely exercise this responsibility would be its most senior and experienced member – the Governor.

An individualistic committee like ours would find it difficult to agree on a substantive statement in the tight time frame available immediately after each meeting. And it would be very difficult for the Governor to hold an immediate press conference on the decision, since at that short notice he couldn't be expected to reflect the sometimes highly nuanced tone of the policy discussion. We do tend to put out a short statement when we've changed the rate, or made an unexpected decision – but even this can be quite hard to agree on in time for the announcement deadline.

So for us the minutes, which appear a couple of weeks after each meeting, are a crucial part of the communications effort. They are intended to capture the different arguments, and give a clear sense of what shaped the conclusion and any dissension. They also disclose the vote of each member.

Of course, there is plenty of room for argument about which broad category of committee is likely to produce the best decisions. As you would expect, I believe strongly in the virtues of a committee made up of informed people from somewhat different backgrounds, each voting according to his or her individual judgment. There is some evidence to suggest that such a group is more likely to come up with good decisions than is a single powerful individual – however brilliant – or than a consensus-driven group.[viii]

But the important point so far as our debate today is concerned is that it's this choice of system that determines how the communications policy should be shaped. If you go for a bunch of strong-willed individuals, like the Bank of England, you are going to have to communicate your views in a different way than you would if you opted for a consensus-driven body like the ECB.

The nature of a bank's communications also depends on the framework within which it operates. Again, this varies from country to country. At one end of the spectrum are banks with a statutory responsibility to meet a set inflation target.

A number of such institutions – like the Reserve Bank of New Zealand, the Swedish Riksbank or the Bank of England – have developed another important tool for communicating their ideas and shaping inflation expectations.[ix] Regular inflation reports – at the Bank of England, we are required to produce one every three months – are intended to explain the analysis that has led to policy decisions, and to bring the public up to date with the bank's latest thinking about the prospects for demand and inflation.

By putting this information in the public domain, the bank is providing context for its present and future decisions. It also provides a clear framework for its own internal discussions. One of the questions we at the Bank of England ask ourselves about any significant new piece of economic information is: how does this compare with our assumptions in the most recent Inflation Report? If you have a set inflation target, then a regular inflation report is a good way of explaining your thinking, of shaping inflation expectations, and of benchmarking your performance.

At the other extreme come banks like the Fed, which has considerable room for discretion within its broad mandate. This has been especially true under Chairman Greenspan, thanks to the extraordinary reserves of trust and credibility that he has built up over time. The result is that he has no great incentive to strive for transparency – indeed, he sometimes takes a pleasure in expressing himself in a way that can leave his audiences bewildered.

As he famously remarked when a congressman once said that he now understood what the Chairman had been saying: "If that's the case, then I must have misspoken."[x]

This is not an approach that would work for anyone without his long established reputation, and his successor, Mr Ben Bernanke, has already made it clear that he intends to communicate with his different audiences in something nearer to the English language.

But whatever their differences, central banks all need to have a *strategic* approach to communications. That is to say they need to be clear about whom they are talking to and why. And they have to work out what their different audiences need to know, and how best to tell them. Without this disciplined framework, they would risk confusing the public by sending out inconsistent or irrelevant messages, and they could constrain their own freedom of action by linking themselves to a particular policy line. In either case, their credibility would be damaged and with it the effectiveness of their policy making.[xi]

There are at least two broad audiences to be addressed. One consists of the financial markets and economic commentators. They are interested in the numbers and in the minutiae of policymaking. The other consists of the public and the politicians, intermediated by the media. They are more interested in words, and in the big picture: they don't care about the shape of the Phillips curve, but they do want to know if their mortgage payments are going up. The overall message to both audiences must be consistent, but it is important to remember that they are not interested in the same things and they don't have the same understanding of what is important.

In order to shape expectations about inflation, monetary policymakers need to be clear about their objectives. They have to explain the thinking that has gone into their decisions, and the reasons for their successes or failures. They also need to be frank about the limits of their knowledge – resulting from their uncertainty about both the data and the future path of the economy.

A good example of the benefits of credibility is to be found in the response to last year's oil price shock. Although the initial impact was to drive up the headline rate of price inflation in all the developed economies, there have so far been few signs of this flowing through into a more generalised upturn in inflation and the impact on economic growth rates has also been remarkably modest.

Credibility also makes it easier for monetary policy committees to exercise judgement. We at the Bank of England raised interest rates in 2004 even though inflation at the time was running below the target, and we cut them modestly last summer when inflation was actually well ahead of the set figure. The public understood that interest rate policy has to be forward looking, and broadly agreed that our judgments made sense.

All central banks in the developed economies invest a great deal in explaining their views about the economic outlook, focusing on the outlook for potential supply and demand, and for inflation. But for understandable reasons they tend to be much less happy about discussing the likely future path of interest rates. They worry that the markets will place too much weight on any comments about future actions, however much they hedge their remarks with conditions and health warnings. And they fear that their future decisions might be constrained by concern about creating confusion and upsetting the marketplace if they change their mind.

However, there have been circumstances in recent times when policy committees have been willing to disclose their views on the likely direction of policy. At the end of 2003, the Bank of England signalled that other things being equal interest rates could be expected to rise gradually over the following months.[xii] The reason for being frank was that this followed a long period in which interest rates had been going down and we wanted consumers to be aware that economic conditions were changing, but we did not want to cause unnecessary alarm.

A much bolder example of policy signalling came from the Federal Reserve Board in the summer of 2003. The fed funds rate had been reduced to just 1 per cent, but inflation remained low and some Fed members were concerned that a period of disinflation might be in the offing. The Committee wished to maximise the transmission of policy into long-term rates and they did not want people to assume that a pick up in activity would be followed by a rapid tightening of monetary policy. In this sense, its reaction to a strengthening economy was likely to be different from that at many previous periods of expansion,

Accordingly, the policy statement in August concluded with a new type of comment – maybe even a commitment: "In these circumstances, the Committee believes that policy accommodation can be maintained for a considerable period."[xiii] And that type of language, with subtle variations, was repeated all the way through to the end of last year.

These were unusual circumstances. As Governor Kohn wrote in a paper with Brian Sack two years ago, "Shaping accurate expectations about the economy and policy inclinations might be especially important when the nominal policy rate is very low and the central bank remains concerned about inadequate demand." [xiv] It's no coincidence that these are also the circumstances in which the Bank of Japan has been very open about how economic conditions will need to develop before it starts to tighten policy in the future.

So in more normal circumstances I don't think this marks the start of a new trend of openness about the likely future direction of policy. Central bankers just don't know enough to be confident about where interest rates are likely to be heading. But what is clear is that central bank communications is a work in progress in the developed economies. What lies ahead?

The matter of most immediate interest, of course, is the way that the Fed might develop under its new leadership. Mr Bernanke has suggested that over time he would be in favour of releasing more information about the FOMC's economic projections, and about its medium-term inflation objectives.

But there are other issues to be considered. Should policymakers condition their economic projections on the basis of their own interest rate expectations - and then publish those expectations, as do New Zealand or Norway? David Archer, formerly of the Reserve Bank of New Zealand, admits that his bank's interest rate projections do not significantly outperform a random walk, but argues that publishing them enhances transparency and reinforces credibility.[xv]

Should the views of individual committee members be attributed to them in the minutes of policy meetings? That's a question that occasionally arises in the UK.

Generally speaking, though, I think it would be fair to say that although there is plenty of room for improvement around the margin, the major moves towards greater transparency have already taken place at central banks in the developed world. We are going to discuss tomorrow the question of whether there are limits to transparency: for the record, I think there are.[xvi] There is a risk that too much talk could cause confusion. In any event, it is hard to imagine that the steps to greater openness in the next 20 years will be as big as those in the last.

But this does not mean that these banks do not face major communications challenges in the future. The past years have been remarkably benign for the economies of the developed world. In the eighteen years of Mr Greenspan's term of office, the US has suffered only two mild recessions, the second of which – in 2001 – was so mild that it disappears altogether when the quarterly data are aggregated into years.

History suggests that this period of great stability will - sooner or later - come to an end. And when it does, the task of the monetary policy maker will become a great deal more challenging. There is now a whole generation of voters around the Western world who have never known anything other than low and stable inflation. They have also come to attribute at least part of this success to the wisdom of central bankers, as opposed to luck or any other of the many possible explanations. It seems to me that's why monetary policymakers in general tend to be treated with almost exaggerated respect by the media, as compared to the way they handle finance ministers or business leaders.

There are two big problems with the idea that central bankers can manage economies along a path of smooth expansion. The first is that it's not true: they have neither the knowledge, the tools, nor the authority to make this possible. And the second is that unless these perceptions are changed, monetary policymakers are going to get a good part of the blame when the great stability eventually comes to an end. That would be a threat to their credibility, and so to their ability to do their job.

This suggests that central banks need to be reaching out to a wider audience than they do at present, in order to reinforce their public legitimacy and explain what can - and cannot - be reasonably expected of them. While they have all got much better at explaining their regular policy decisions, they have much further to go in terms of communicating their strategic aims. And they need to be thinking creatively about new ways of getting their messages across - online and through broad or narrow cast, as well as through the printed word. New media have become an essential part of any successful media strategy today, and there is no obvious reason why this should not apply to monetary policymaking.

Two final points. What might seem like an outrageously risky communications policy today will almost certainly seem like a routine part of the process tomorrow. Just consider what Fed insiders would have said 20 years ago about the degree of openness with which it now operates.

Most central banks have had a relatively easy ride over that period. The climate is probably going to get rougher, in which case excellent external communications will become even more important than they already are today.

[i] Jean-Claude Trichet "Communication, transparency and the ECB's monetary policy", January 24, 2005.
[ii] Quoted by Alan Blinder and Ricardo Reis in: "Understanding the Greenspan Standard", CEPS Working Paper No. 114, September 2005.
[iii] See, for example, Toshiro Muto, Deputy Governor of the Bank of Japan, "Price Stability and Central Banks' Responsibility", December 2, 2005.
[iv] See, for example, Inflation Report 3/2005, Norges Bank.
[v] Donald Kohn "Central Bank Communication", January 9, 2005.
[vi] Alan Blinder and Charles Wyplosz "Central Bank Talk: Committee Structure and Communication Policy", December 2004.
[vii] Laurence Meyer "A Term at the Fed: An Insider's View", HarperBusiness, 2004.
[viii] Alan Blinder and John Morgan "Are Two Heads Better Than One?: An Experimental Analysis of Group vs. Individual Decisionmaking", NBER Working Paper No. 7909, September 2000. Clare Lombardelli, James Proudman and James Talbot "Committees versus individuals: an experimental analysis of monetary policy decision-making", Bank of England Working Paper No. 165, 2002.
[ix] See Michael Woodford "Central Bank Communications and Policy Effectiveness." NBER Working Paper No. 11898, December 2005.
[x] See Laurence Meyer, *ibid*.
[xi] See, for instance Paul Jenkins, Senior Deputy Governor, Bank of Canada, "Communications: a vital tool in the implementation of monetary policy", September 30, 2004.
[xii] See, for instance, MPC minutes, December 2003.
[xiii] FOMC statement, August 2003.
[xiv] Donald Kohn and Brian Sack "Central Bank Talk: Does It Matter and Why?" FEDS Working Paper No. 2003-55, August 25, 2003.
[xv] David Archer, formerly of the Reserve Bank of New Zealand, "Central bank communication and the publication of interest rate projections", Stockholm, June 2005.
[xvi] See, for instance, Frederic Mishkin "Can Central Bank Transparency Go Too Far?" NBER Working Paper No. 10829, October 2004.