Bulletin
de la Banque de France
226/2 - NOVEMBER-DECEMBER 2019

BANQUE DE FRANCE
EUROSYSTÈME

Economic research

Trends in central bank communication: from secrecy to transparency

Over the past 25 years, central banks have undergone a revolution in the way they interact with the public: from secrecy to extensive communication. Transparency is not only a democratic imperative: it also improves the efficacy of monetary policy. Since the financial crisis, communication about future policies – known as forward guidance – has become a key policy tool. It requires central bankers to weigh each word in order to ensure that the economic players, markets and the public do not misinterpret forward guidance announcements as a sign about the future state of the economy. In the future, central bank communication must be ready to evolve in order to address monetary policy challenges arising over the long run.

Jean Barthélemy, Stéphane Dupraz, Gaetano Gaballo and Klodiana Istrefi
Monetary and Financial Analysis Directorate
Monetary Policy Research Division

Codes JEL
E52, E58

Engaging with the public for a central bank is a means to

i) answer for its actions (democratic imperative)
ii) best achieve its objectives

Forward guidance announcements

The efficiency of this announcement crucially depends on the interpretation by the public

Communicate more with the general public

i) to fulfill the demand for more accountability
ii) to strengthen public support for independent central banks

Over the past 25 years, central banks' relationship with the public has undergone a radical reversal from secrecy to extensive communication. In the late 1980s, the Federal Reserve (Fed) did not explicitly communicate its target for the Fed Funds rate and Fed chairman Alan Greenspan warned that anyone who found him clear had probably misunderstood what he had said.[1] Today, most central banks of developed countries hold press conferences after policy decisions, where they explain present policy and provide indications as to its future evolution.

This revolution in communication was initiated by the central banks of small open economies, such as the Reserve Bank of New Zealand and the Bank of Canada. In the 1990s, these central banks adopted inflation targeting, a policy framework that gives a central role to the communication of their objectives and the rationale behind their policy decisions. Although major central banks such as the Fed and the European Central Bank (ECB) did not explicitly adopt inflation targeting, they followed a similar trend. As of the 1990s, the Federal Reserve started publishing statements on the state of the economy, the rationale for policy decisions and the target range for the Fed Funds rate (1994), the votes of individual members (2002), and the minutes of the Federal Open Market Committee (FOMC) meetings (2005). As for the ECB, it has held press conferences after monetary policy decisions since its inception in 1998, including a Q&A with journalists. Since 2015, it publishes accounts of monetary policy meetings.

1 Why communicate?

Two major motives for communication justify this reversal. First, communication is essential to transparency and accountability. These duties fall on any public institution charged with a mission of public interest. But they are all the more important for central banks. Since the 1990s central banks have been granted greater independence to pursue price stability and economic stabilisation. It comes with a greater duty to explain monetary policy actions and how these actions serve the objectives with which they have been entrusted.

Second, communication is also an instrument to enhance the efficacy of monetary policy. Most central banks have objectives for inflation or economic activity, but price-setting, production and consumption decisions are ultimately made by firms and households. The control of the central bank on the economy is only indirect: it uses its control over a few instruments – mainly the overnight interest rate and the size of its balance sheet – to influence households' and firms' decisions. Radical changes in economists' and central bankers' understanding of the way central banks affect these decisions have brought communication from a second-order consideration or undesirable guest to a primary policy tool.

Prior to the 1990s, it was common to believe that the efficacy of monetary policy depended on taking markets by surprise (Cukierman and Meltzer, 1986). But central banks gradually realised that to influence households' and firms' decisions, it is better to engage with them rather than surprise them. This is because firms' and households' economic decisions depend very little on what the central bank does today – for instance, the level it sets for the overnight interest rate until the next monetary policy meeting. Instead, most spending and borrowing decisions depend on long-term interest rates. In turn, long-term rates depend on banks' expectations of overnight interest rates in the future, i.e. on their expectations of what the central bank will do in the future.

Monetary policy therefore exerts most of its influence on the economy by making its own future decisions predictable. By enhancing the predictability of policy decisions, communication greatly increases the control of monetary policy on the economy. In influential papers, Kohn and Sack (2004) and Gurkaynak, Sack and Swanson (2005), although writing just a few years after

1 Greenspan made the quip on June 23, 1988, as part of the informal remarks before a dinner meeting of The Trilateral Commission: "Since I became a central banker I have learned to mumble with great incoherence. […] I might add that on the issues of foreign exchange and interest rates this evening, if you think what I said was clear and unmistakable, I can assure you you've probably misunderstood me."

the Greenspan-chaired Fed started providing indications as to the future path for the Fed Fund Rate in the early 2000s, already found that the reaction of long-term interest rates to the Fed's statements was much stronger than their reaction to the Fed's policy actions. Yet, a central bank's words and actions are best seen as complementary: words have power only because the public trusts that they will be followed by actions. Credibility is therefore paramount to communication. Without it, central bank communication is powerless to affect the public's expectations, and the central bank therefore loses most of its power to steer the economy in the direction it desires.

Being predictable does not mean committing unconditionally to future policy. Unconditional commitment to a future policy is hardly recommendable since the appropriate policy tomorrow will depend on the economic conditions at that time. Yet, avoiding unconditional commitments is a case for more communication, not less. Giving indications dependent on a few main scenarios, as well as stressing the conditionality of future policy decisions on the occurrence of a given scenario, can greatly enhance the predictability, and therefore the effectiveness, of monetary policy.

Nevertheless, it is possible for a central bank to communicate too much, precisely at times when over-communicating would harm predictability: either by overloading the public with too many details over too many contingencies, or by providing indications whose conditionality would be missed by the public. In addition, monetary policies are taken by committees and the multiplicity of voices can create cacophony when too many voices offer too much diversity of views about the likely path of policy (Blinder, 2004). In attempts to minimise the unintended effects of communication, several central banks practice purdah, a self-imposed guideline of abstaining from communication around policy meetings, to avoid creating excessive market volatility and unnecessary speculation (Ehrmann and Fratzscher, 2009, Powell, 2019).

2 Communication in unconventional times: the forward guidance example

The recent financial crisis has led major central banks to move toward more active communication - more frequent and longer official speeches.[2] Following the onset of the crisis, central banks introduced many unconventional monetary policies (e.g., quantitative easing). Central banks had to explain the rationale for and the functioning and expected impacts of these policies to ensure both their accountability and the efficiency of their policy. In a highly uncertain economic environment, more active communication was needed to guarantee a high degree of predictability of monetary policy actions and limit the additional noise that an unexpected policy decision could generate.

The crisis has also led major central banks to communicate more about future policies. Due to the effective lower bound on the nominal interest rate, central banks could not cut interest rates as much as they would have liked to in order to stimulate the economy. To loosen financial conditions further, central banks have communicated about future interest rates to steer expectations about future policies. This policy is known as forward guidance.[3] The table below reports the three main forms of forward guidance used in practice by central banks. However, these three forms are not exclusive; for instance, the current forward guidance by the ECB as of July 2019 is best described as a mix of date-based and state-based statements.

A central bank may use forward guidance as a policy tool and announce that it intends to keep its interest rate low in the future for at least two main reasons. Forward guidance is said to be "Delphic" when it concerns a release about the future path of rates consistent with the future outlook expected by the central bank. In this case, the main information content is the central bank's expectations of the duration and severity of the crisis. It is said to be "Odyssean" when it is a promise that rates will initially rise slower in reaction to inflationary

2 Coenen et al. (2017) show that the lengths of monetary policy minutes published by the Fed, the Bank of Japan, the Riksbank and, to a lesser extent, the Bank of England increased during the crisis.

3 See Drumetz et al. (2015) for a simple presentation.

pressures, allowing for temporary deviations from target in normal times.[4]

Ambiguity about the motives for a forward guidance announcement may unintentionally signal a worse outlook, potentially leading to a further deterioration of the economy, while the initial intention of the central bank was to signal further accommodation. Even if the central bank achieves consensus on the future path of rates, market operators may interpret a forward guidance announcement as rather Delphic or Odyssean. In the former case, they will attribute the announced path of low rates as a signal that the central bank has received unexpected bad news on the severity of the crises; in the latter, they will interpret the announced path of low rates as a period of extra accommodation and lower long-term real interest rate (see Andrade et al., 2019).

To prevent such an ambiguity, the central bank can design the announcement in such a way that observers can disentangle the central bank's perception of the economic outlook (the Delphic part) and the change in the policy stance (the Odyssean part) by choosing the best form of forward guidance.

The forward guidance is likely to be considered as purely Delphic – and hence not effective – if observers believe that the central bank is not able to tolerate an overshooting of inflation from its target and anticipate that inflation will always converge to the target from below.[5] This risk is less pronounced (i) in a state-based statement including an explicit reference to overshooting (see the example above of the FOMC in December 2012); (ii) if the central bank emphasises the symmetric nature of its target suggesting that it will not overreact to overshooting (as in the July 2019 introductory statement by the ECB); (iii) if the central bank has already tolerated temporary overshooting in the past (Barthélemy and Mengus, 2018).

Finally, empirical evidence suggests that state-based forward guidance is one of the most effective for reducing interest rate volatility (Ehrmann et al., 2019)

The three main forms of forward guidance used by central banks

Forward guidance form	ECB	US Federal Reserve
Open-ended statement on the period during which rates are expected to remain at the effective lower bound.	"The Governing Council expects the key ECB interest rates to remain at present or lower levels for an extended period of time". European Central Bank (ECB), 4 July 2014.	"The Committee […] anticipates that economic conditions are likely to warrant exceptionally low levels of the federal funds rate for an extended period." Federal Open Market Committee (FOMC), 18 March 2009.
Date-based statement on the period during which rates are expected to remain at the effective lower bound.	"We expect them to remain at their present or lower levels at least through the first half of 2020 […]." ECB, 25 July 2019.[a]	"The Committee […] anticipates that economic conditions […] are likely to warrant exceptionally low levels for the federal funds rate at least through mid-2013". FOMC, 8 August 2011.
State-based statement specifying the conditions for rates to remain at the effective lower bound.	"We now expect the key ECB interest rates to remain at their present or lower levels until we have seen the inflation outlook robustly converge to a level sufficiently close to, but below, 2% within our projection horizon, and such convergence has been consistently reflected in underlying inflation dynamics." ECB, 12 September 2019.	"The Committee […] anticipates that […] the federal funds rate will be appropriate at least as long as the unemployment rate remains above 6.5 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 will continue to be well anchored". FOMC, 12 December 2012.

a) At this date, the forward guidance by the ECB was also state-based. The end of the quote is: "and in any case for as long as necessary to ensure the continued sustained convergence of inflation to our aim over the medium term."

4 This terminology was introduced by Campbell et al. (2012).

5 Eggertsson and Woodford (2003) indeed show that forward guidance has an effect on the real economy only if inflation is expected to exceed the target.

and the most often interpreted by the public as Odyssean (Andrade et al., 2019). By contrast, some forms of forward guidance (e.g. date-based forward guidance with a short-term horizon) are sometimes found to be less efficient than no forward guidance at all.

3 What future challenges for communication?

As the economy returns to normal times and policy normalises, the level of communication could normalise as well. However, looking forward, central bank communication should be ready to evolve in order to address challenges that will be faced in the long run.

In the immediate future, a return to the normal should be a return to a period when rates are no longer constrained by the zero lower bound. Yet, many economists argue that the long-term new normal will be one where the frequency of recessions that cause the zero lower bound to bind is greater. Monetary policy needs to adjust to this possibility and communication can be a significant part of this adjustment. Several options are discussed in the literature, from clearer formulations of central bank objectives to adopting strategies that make the central bank's behaviour at the zero-lower bound as predictable as it is away from it (i.e. price-level targeting, where a central bank tries to keep the level of prices on a steady growth path).

Regardless of what the new communication framework entails, recalibrating communication is generally easier done under blue skies than during the next storm. First, making important changes to communication after the recession has hit loses some of the predictability benefits that communication precisely intends to reap. Second, making changes in turbulent times runs the risk of being interpreted as panic and impotence, rather than a shift to more control over the economy.

Communication to the public

Central bank communication has been calibrated mostly for experts and financial market participants. However, it is also important that central banks communicate more with the general public as well. First, households' decisions to invest and to consume are central for economic growth and inflation. Thus, central bank communication should reach this group in order to steer their individual decisions in the direction it desires.

Second, communication to a broader public contributes to the demand for more accountability from central banks, thus strengthening the support of the public for independent central banks. This is especially important in an environment of rising populism. To succeed, central bank communication should be clear, simple and relate more to the everyday lives of people they serve.[6]

6 Bholat et al. 2019 provide evidence that public comprehension can be improved by making monetary policy messages relatable to people's lives. They use an experimental design on different versions of the summary of the Bank of England's Inflation Report on a representative sample of the population in the UK.

References

Andrade (P.), Gaballo (G.), Mengus (E.) and Mojon (B.) (2019)
"Forward guidance and heterogeneous beliefs", *American Economic Journal Macroeconomics*, Vol. 11 No. 3, pp. 1-29, July.

Barthélemy (J.) and Mengus (E.) (2018)
"The signaling effect of raising inflation ", *Journal of Economic Theory*, Vol. 178, pp. 488-516.

Bholat (D.), Broughton (N.), Ter Meer (J.) and Walczak (E.) (2019)
"Enhancing central bank communications using simple and relatable information", *Journal of Monetary Economics*.

Blinder (A.) and Shiller (R.) (2004)
The quiet revolution: central banking goes modern, Yale University Press.

Coenen (G.), Ehrmann (M.), Gaballo (G.), Hoffmann (P.), Nakov (A.), Nardelli (S.), Persson (E.) and Strasser (G.) (2017)
"Communication of monetary policy in unconventional times", *Working Paper Series*, No. 2080, European Central Bank, June.

Cukierman (A.) and Meltzer (A. H.) (1986)
"A theory of ambiguity, credibility, and inflation under discretion and asymmetric information", *Econometrica*, Vol. 54, No. 5, pp. 1099-1128.

Drumetz (F.), Pfister (C.) and Sahuc (J.-G.) (2015)
Politique monétaire, 2e édition, De Boeck.

Eggertsson (G. B.) and Woodford (M.) (2003)
"The zero bound on interest rates and optimal monetary policy", *Brookings Papers on Economic Activity*, Brookings Institution Press, Vol. 34, No. 1, pp. 139-235.

Ehrmann (M.) and Fratzscher (M.) (2009)
"Explaining monetary policy in press conferences", *International Journal of Central Banking*, Vol. 5, No. 2.

Ehrmann (M.), Gaballo (G.), Hoffmann (P.) and Strasser (G.) (2017)
"Can more public information raise uncertainty? The international evidence on forward guidance ", *Working Paper Series*, No. 2263, European Central Bank.

Gürkaynak (R. S.), Sack (B.) and Swanson (E. T.) (2005)
"Do actions speak louder than words? The response of asset prices to monetary policy actions and statements", *International Journal of Central Banking*, Vol. 1, No. 1, pp. 55-93.

Kohn (D. L.) and Sack (B. P.) (2004)
"Central bank talk: does it matter and why? "at the conference *Macroeconomics, monetary policy, and financial stability*, June 2003, Bank of Canada.

Powell (J. H.) (2019)
"Opening remarks" at the conference *Monetary policy strategy, tools, and communications practices*, sponsored by the Federal Reserve and the Chicago Fed, Chicago, Illinois.

Williams (J. C.) (2019)
"Living life near the ZLB", Remarks at 2019 Annual Meeting of the Central Bank Research Association (CEBRA).

Published by
Banque de France

Managing Editor
Gilles Vaysset

Editor-in-Chief
Françoise Drumetz

Editor
Caroline Corcy

Translator
Anthony Dare

Technical production
Studio Creation
Press and Communication

ISSN 1952-4382

To subscribe to the Banque de France's publications
https://publications.banque-france.fr/en
"Subscription"