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Central Bank Communication: Never excuse, never explain

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Introduction

For most of the 20th century and earlier, central banks went about their business without ever feeling the need to communicate what they were doing to the financial markets or the general public. Then from around 1990 onwards, central banks became ever more transparent, trying to make clear to the markets and the public what they were doing and why. The purpose of this review essay is to understand why this change came about and how successful it has been. I start with a brief history of central banks and their (lack of) communication with the public. I then move on to discuss what information central banks need to transmit to financial market participants and the general public and why they might want to do this. I then discuss 'forward guidance' as a potential policy tool before evaluating the success (or otherwise) of the increase in central bank communication. I finish by concluding that clear central bank communication is important for both democratic accountability and monetary policy effectiveness.

A brief history of central bank communication

The Bank of England was founded in 1694 as a private bank whose main purpose was to fund the government when at war. Over time, the Bank of England developed into the United Kingdom's central bank, acting as the banker for the banks and thus forming the centre of the payment system. This was formalised in the Bank Charter Act of 1844, which granted the Bank of England a monopoly on note issue. Similarly, the Federal Reserve Act of 1913 established the Federal Reserve System 'to furnish an elastic currency, to afford means of rediscounting commercial paper, to establish a more effective supervision of banking in the United States, and for other purposes'.

After World War I, both the Bank of England, under Montagu Norman, and the Federal Reserve, led by Ben Strong, the Governor of the New York Fed, increasingly pursued active monetary policies, seeking to stabilise prices while supporting the economy. But, neither felt any need to communicate what they were doing with the general public. Montagu Norman, in particular, worked according to the maxim 'Never excuse, never explain'. He, and other central bankers of his time, regarded central banking as something that the general public could not understand and that would only be negatively affected if they tried to intervene or comment on it.

[1] Prepared for the 'MPC at 25' conference held at Gresham College, 30 March 2022.
[2] 'Know thyself': One of three maxims inscribed on a column in the pronaos (forecourt) of the Temple of Apollo at Delphi.

And this view of central banking held until relatively recently. Alan Greenspan (2007), for example, noted that at the Federal Reserve 'you soon learn to mumble with great incoherence'. Goodfriend (1986) describes the Federal Reserve's arguments at the time for pursuing monetary policy in secret. They argued that disclosure would lead to unfair speculation, since only large speculators were able to use the information to their benefit, the wrong reaction from the market, the possibility that the market might react in a way that would raise the cost of issuing debt for the government, the possibility that agents in the economy would think the Federal Open Market Committee (FOMC) had pre-committed to a particular path for rates and problems smoothing interest rates.

The first modern move towards transparency in the central banking community came in 1989 with the Reserve Bank of New Zealand Act. This instituted an 'Inflation Targeting' regime, where the Reserve Bank had a clear role, viz. to operate an independent monetary policy so as keep inflation within a target band set by the government. And, in particular, the Governor *was obliged* to start communicating with the markets and the general public. The main argument for imposing this was one of democratic accountability; in other words, voters had a right to know what their central bank was up to and why. But it could also be argued that monetary policy itself was more effective if *financial market participants* understood what central banks were up to and why as then financial markets would move in a predictable way for central banks.

Canada and the United Kingdom soon followed with inflation targets and communication was also a key part of the regime in these cases. In particular, the Bank of England started publishing its *Inflation Report* in 1993 and was given the ability to set monetary policy independently in 1997. The Federal Reserve, however, was much slower in adopting this framework. It was only in 1994 that the Federal Reserve started announcing its target Federal Funds interest rate and make press statements, and it was only in 2012 that they officially announced an inflation target of 2% (though it was widely understood that they had been targeting inflation at 2% prior to that date). Interestingly, the ECB provided press conferences right from the start of its Governing Council meetings in June 1998.

When the Bank of England was first charged with producing an *Inflation Report* the goal was 'to provide a regular report on the progress being made towards the Government's inflation objective'. The first *Inflation Report* came out in February 1993 and contained four sections: recent price developments, recent cost developments, the outlook for inflation and a conclusion. In other words, 'where we are now' and 'where might we be going'. What was missing was 'what this means for policy', perhaps unsurprising given that the Government (specifically, the Chancellor of the Exchequer) was still setting monetary policy at that point based partly on advice from the Bank of England (what was known as 'The Ken and Eddie Show').

What should central banks communicate and why?

In order to carry out effective monetary policy, a central bank needs to understand the degree of inflationary pressure in the economy. This implies a need to understand where the economy is now and what this means for the future evolution of the economy. Given this understanding, the central bank can adjust monetary policy in order to affect the future evolution of the economy in a way that ensures inflation is on target in the medium term. But the transmission of monetary policy through the economy will depend on the responses of households and firms and these responses, in turn, will depend on the beliefs of households and firms about where the economy is now as well as their expectations about the future path of the economy and monetary policy.

Given that, if the central bank wants its policy to have predictable effects, it needs to 'steer' the beliefs of households and firms about the current state of the economy and its future path into line with the central bank's own beliefs. And then, it needs households and firms to expect the same path for monetary policy as would be implied by the central bank's reaction function. So, the central bank needs to communicate 'where we are now', 'where might we be going' and 'what this means for policy'.

From the start, the Bank of England's Inflation Report (as was then) provided an authoritative analysis of the current state of the UK economy and a forecast for where GDP growth and, most importantly, inflation was headed. But turning to 'what this means for policy' it was thought that simply providing the inflation forecast would be enough: if inflation is likely to be above target in the medium term, absent a policy intervention today, then policy needs to be tightened whereas if inflation is likely to be below target in the medium term, absent a policy intervention today, then policy needs to be loosened.

But, maybe it's not as simple as that. Where the forecast is conditioned on the assumption of constant interest rates (as was the case in the *Inflation Report* until May 2004), the central bank has a choice between adjusting policy a little today versus adjusting policy by more at a point later in the future. Adopting the latter approach creates a communication issue as it would involve showing inflation away from target in the medium term at the same time as no policy change had taken place, begging the question: why not?

When the forecast is conditioned on the market curve, a forecast of inflation away from target in the medium term suggests that the financial markets are expecting a different path for monetary policy to that expected by policy makers. This may be because the markets disagree with the policy makers' assessment of current inflationary pressure or because the markets do not understand the policy makers' reaction function. Either way, in this case there is a clear need for communication between the policy makers and the markets in order that the market curve may move in line with what is needed to ensure inflation is on target in the medium term.

But why not simply communicate the expected path of interest rates and/or QE in the first place? Some central banks such as the Norges Bank and the Svergies Riksbank produce a forecast for the path of interest rates as part of their overall forecast. But others, including the Bank of England, have argued strongly against doing this using the Federal Reserve's argument reported in Goodfriend (1986), viz. they did not want to be taken as precommitting to a particular path for interest rates lest agents should take them to task were the actual path different. Of course, this changed in 2013 with the arrival of Mark Carney as Governor and the advent of 'forward guidance' by the Bank of England.

Communicating future policy: Odyssean vs. Delphic communication

In the wake of the Global Financial Crisis, central banks worldwide cut interest rates to levels close to (or in some cases at or below) the zero lower bound. At the same time, many adopted so-called 'unconventional' monetary policy including asset purchases and – most important for our story – 'forward guidance'. In its policy statements from December 2008 onwards, the Federal Reserve made a series of statements about it expecting low interest rates to prevail 'for some time', eventually changing the language to 'at least until *xx*', ie, putting specific dates on the earliest time at which interest rates might increase. In August 2013, the Monetary Policy Committee of the Bank of England committed to holding interest rates at 0.5% at least until the unemployment rate had fallen below 7%, subject to the inflation forecast remaining lower than 2.5%, inflation expectations remaining anchored, and there being no risk to financial stability.[3]

The basic idea behind forward guidance is relatively simple: commit to holding nominal interest rates at a low level into the future, which raises inflation expectations, and so lowers real interest rates today. That way, central banks can loosen monetary policy despite nominal interest rates being at their lower bound.[4] But, as noted by Campbell *et al.* (2012) such a policy prescription may not be 'time consistent' in that once the central bank arrives at the point where it had committed to holding interest rates low, it has no incentive to follow through with the commitment. Rather it will set interest rates at that point based on economic conditions at that point. Campbell *et al.* referred to this type of forward guidance as 'Odyssean' because it involved the central bank tying its hands in the same way that Odysseus was tied to the mast of his ship by his crew so that he would not be drawn to his death by the sirens' song. The difference is that he could not untie himself whereas central banks clearly can.

But is this how central banks have actually used forward guidance? An alternative approach sees announcements about future policy as providing information to the markets (and the general public) about the central bank's policy reaction function, i.e., how it would respond if the economy evolved in a particular way. This could be particularly useful if the central banks wanted to convey a change in its policy reaction function, e.g., that it would pursue 'looser' policy than might have been expected given its past policy movements. Campbell *et al.* (2012)

[3] As it was the Bank Rate remained at 0.5% until August 2018, by which time the unemployment rate had fallen to 4.1%! As discussed later, this turned out to be a classic example of 'Delphic ambiguity'.
[4] See Krugman (1999), Eggertsson and Woodford (2003) and Werning (2011) for more sophisticated versions of this argument.

refer to this as 'Delphic' forward guidance, after the famous oracle at Delphi. Specifically, they state that 'Delphic forward guidance publicly states a forecast of macroeconomic performance and likely or intended monetary policy actions based on the policymaker's potentially superior information about future macroeconomic fundamentals and its own policy goals'. This is, of course, nothing more than the communication of where the economy is now, where it's expected to head, and what the policy implications of this are, exactly what I discussed earlier!

Campbell *et al.* (2012) note that the Oracle at Delphi was famed for making prophecies that could easily be misinterpreted but state that they merely refer to central banks making statements about the future. To my mind, however, it is worth thinking about the extent to which central bank 'Delphic' forward guidance is as clear and unambiguous as assumed by Campbell *et al.* Indeed, much of the recent literature on central bank communication has asked exactly that question.

Evaluation

Are central banks clear in their communication or are they 'Delphic' in the sense of being open to misinterpretation?

One way of testing this is to examine what happens in response to monetary policy decisions. On the assumption that the central bank has communicated to the markets exactly where the economy is now and where it thinks the economy is going, as well as its monetary policy reaction function, then there should be no market response to a monetary policy announcement. Rather, data surprises should provoke a market reaction reflecting its knowledge of the central bank's reaction function. Unfortunately, Lasaosa (2005) found that the increased communication and transparency of the Monetary Policy Committee in the United Kingdom, post Bank of England independence, did not lead to a smaller response of financial markets to interest rate announcements. Indeed, Chadha and Nolan (2001) found that the volatility of market interest rates actually increased on monetary policy announcement days, and this could be seen in the market reaction to the MPC decision to leave rates unchanged in November 2021. The Monetary Policy Committee were 'Delphic' in the sense of being open to misinterpretation.

Haberis *et al.* (2017) start from the position that 'Delphic' forward guidance *creates* uncertainty. In particular, forward guidance along the lines of 'interest rates shall remain fixed at least until unemployment falls below *x*%' (eg, the MPC Forward Guidance of 2013 discussed earlier) leaves the public uncertain about whether interest rates will rise at that point or, instead, 'lift off' continues to be delayed. In addition, where the guidance is not 'time consistent' (in a way, the whole point of it), the public will remain uncertain about whether it will be followed through. Again, the argument is precisely that forward guidance is 'Delphic' because it is open to misinterpretation.

Conclusion

In this review essay, I have discussed how and why central banks started communicating their actions with the financial markets and the general public. I have argued that not only does democratic accountability demand that independent central banks explain their actions but that monetary policy itself will be more effective if financial market participants understood what central banks are up to and why. More specifically, if the central bank wants its policy to have predictable effects, it needs to bring the beliefs of agents in the economy about 'where we are now', 'where might we be going' and 'what this means for policy' close to the central bank's own beliefs. That is, it needs to communicate in a way defined by Campbell *et al.* (2012) as 'Delphic'. Unfortunately, central banks – like the oracle at Delphi – are still often misunderstood, with sometimes negative (economic) effects resulting.

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