Comments on: "Transparency, uncertainty and monetary policy"

Hans Dillén and Johnny Nilsson

Comments by Andreas Fischer, Swiss National Bank and CEPR

Transparency has become the panacea for central bank aliments. It is offered as a cure-all solution for deficiencies in accountability, credibility and communications. The paper by Jonny Nieson and Hans Dillon follows this line of argument. The authors define transparency in the context of Sweden's experience with inflation targets around two central issues. Transparency is first defined as a communications device to spell out publicly the Riksbank's intentions. The cloudy operating links of monetary policy are explained through the instruments of openness (forecasts, inflation report, instrument path, etc.). Transparency's second function in this paper is credibility enhancement. The authors argue that through the central bank's openness and rhetoric, the Riksbank eliminates the potential inflation biases, expectations are altered and policy becomes more effective. Below I will offer some remarks on the slippery concept of transparency and its role in monetary policy.

1.0 Transparency

Is transparency always needed? I would argue that different types of monetary regimes require different levels of transparency. Monetary rules based on outcomes (inflation or nominal income targeting) require a greater degree of transparency as opposed to rules based on instruments (exchange rate and monetary targeting). Under exchange rate targeting, for example, the goal and intermediate target is continuously observed. As long as the spot and the forward rates are consistent, greater levels of transparency are not required.

A good inflation record and the public's acceptance of the goal of price stability do not require a central bank to be as open and transparent as a central bank operating under a new monetary regime. Once the monetary regime becomes more successful - its reputation grows - transparency becomes less of an issue, because of the public's acceptance and awareness of the central bank's norms, rules and procedures. The hallmark of the Bundesbank's and the Swiss National Bank's success of monetary targeting since the mid 1970s, for example, does not rest on their ability to communicate their policy.

One may also ask whether all forms of transparency work equally well? The authors cast their primary credibility arguments in terms of disclosing the Riksbank's projected instrument path. Based on these projections, forward-looking agents will attach certain probabilities to the possible outcomes and undertake decisions conditional on their beliefs. If the agent's expectations are in line with the central bank's projection, openness makes policy more predictable and the incentive for the central bank to operate through monetary policy shocks is reduced. However, not all forms of openness lead to forward-looking behaviour. The release of the Governing Board's minutes could result in adaptive expectations on the part of the public. Past information on central bank behaviour in this case would be used to extrapolate future voting patterns.

1.1 Openness and transparency in Sweden[1]

The authors discuss Swedish monetary policy in terms of a multi-step strategy with a single policy objective that of price stability. In this case, the inflation bias is absent because the central bank has no incentive to raise output through surprise expansionary policies. The drawback is that it precludes monetary policy responses to supply shocks, which will result in higher output variability.

An alternative means of making inflation targets credible is to announce both inflation and output targets, assuming they are consistent. In this set-up, the central bank's incentive to raise output through surprise inflation is eliminated. Svensson (1997) and Green (1996) note that if the output target is set equal to that consistent with the natural rate of unemployment, the policy conflict and the inflation bias are resolved. Green (1996) takes the argument one step further, in that output targets could be signalled implicitly as part of an effort to make policy more open and transparent. In general, central banks (including the Riksbank) publish assessments of prospects for output relative to its potential. By making known its views on inflationary pressures in this context, the central bank signals an implicit output target. Ideally, the central bank states that the policy stance will be tightened if inflation is likely to rise above the announced target.

2.0 The modelling of transparency

Transparency is modelled in the following manner:

$$p^e(t) = (1-\alpha)p^e{}_{BL}(t) + \alpha p^e{}_{MC}(t) \qquad (1)$$

where expectations are a weighted average of backward-looking and model-consistent expectations. The authors assume that greater openness results in a larger weight for the model-consistent component. Although this assumption is not testable in this framework, backward-looking expectations generate higher output costs when the Riksbank is trying to disinflate. The authors do not define an optimal degree of openness as in Cukierman and Meltzer (1986) or Stein (1989) and hence one can only assume that $\alpha = 1$ is the preferred result.

1 Svensson (1995) in his critique of inflation targeting in Sweden mentioned that the lack of transparency was a problem. More specifically, during the initial stages of the new regime Svensson (1995) claims that the Riksbank did not clearly state what it intended to do and therefore the inflation targets were not regarded to be credible.

Much of the analysis seeks to show the benefits of openness through forward-looking expectations. What happens when inflation is increasing? Output costs may be lower if inflationary expectations are backward looking. Equation (1) is also defined in terms of the first moments. The variances for backward-looking and model-consistent expectations may differ and may not be constant over time. Hence, the optimal level of transparency may be time varying. Also, multiple equilibria cannot be excluded in this set-up. The level of can take on any value whenever inflation is constant.

References

Cukierman, Alex and Allan H Meltzer, (1986). "Theory of Ambiguity, Credibility, and Inflation under Discretion and Asymmetric Information," *Econometrica* 54(5), 1099-1128.

Green, John H, (1996). "Inflation Targeting: Theory and Policy Implications," *IMF Staff Paper* 43(4), 779-795.

Stein, Jeremy C, (1989). "Cheap Talk and the Fed: A Theory of Imprecise Policy Announcements," *American Economic Review* 79(1), 32-42.

Svensson, Lars E O, (1997). "Optimal Inflation Targets, "Conservative" Central Banks, and Linear Inflation Contracts," *American Economic Review* 87(1), 98-114.

Svensson, Lars E O, (1995). "The Swedish Experience of an Inflation Target," in Inflation Targets, editors Leonardo Leiderman and Lars E. O. Svensson, CEPR. 69-89.