Speaking, listening and understanding: The art of monetary policy communications.

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Introduction

Tēnā koutou katoa – good morning, everyone.

My thanks to the Commonwealth Bank of Australia for inviting me here today. It’s a pleasure to take part in this conference and connect with so many global investors in the New Zealand fixed interest market – some familiar faces, some new.

It’s great to see that Kim Martin, Acting Director of Capital Markets at the New Zealand Treasury, is a fellow presenter today. We attended Rangiora High School together. It’s a small world.

Today, my speech is going to focus on the communications approach we take at the Reserve Bank of New Zealand – Te Pūtea Matua – given the mandate we have to serve all New Zealanders.

Two-way communication is crucial for effective relationships. To emphasise what I mean by that, I’ll take you through the changes we are making and how we are trying to improve the quality of information that we share with financial markets – the ‘speaking’. I’ll also explain how we interpret information from financial markets – the ‘understanding’ and ‘listening’.

One challenge we immediately face is that the role of the Reserve Bank of New Zealand, like many other central banks, is often misunderstood or unknown to the general public. To help clarify the Bank’s role, we are using Māori mythology and the story of Tāne Mahuta, the kaitiaki (guardian) of the forest.2 This metaphor draws a comparison to our role as the kaitiaki (guardian) of the financial system, and helps us in our ongoing conversations with New Zealanders.

A big focus of our communication at the Reserve Bank this year has been on reaching our broader stakeholders in a variety of new ways. A recent example of this is our Future of Cash programme to better understand how people use cash and its relevance in our society. On a personal note, I am very proud that this conversation about cash generated around 2400 responses – many from organisations, communities, iwi and individuals that had not engaged with the Reserve Bank before.3

The focus of my comments here today are for our traditional audiences, like you. As financial market participants, you already have a strong understanding of our role as a central bank. But, it is important not to forget to communicate to all of our audiences in a way that is easily understood.

Looking back over the last twenty years that I have worked in financial markets, it was clear to see that fixed interest and foreign exchange markets hung on every word of key central bank governors. This seems to have intensified even further since the global financial crisis (GFC).

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2 Orr (2019). Tāne Mahuta is believed by Māori to be the god of the forest and birds, and who separated his parents – the earth mother (Papatūānuku) and the sky father (Ranginui) so that the sun could shine in and the forest life could flourish.

3 Reserve Bank of New Zealand (2019b).
The reality is that central banks are grappling with uncertainty about economic developments and dynamics in financial markets, just like you. We are susceptible to the same vulnerabilities and challenges in understanding the world around us.

So, what do we do when we are faced with this uncertainty? I'll talk today about the benefits of transparency from central banks, but also its limitations and pitfalls, and how this influences our approach to communication and decision-making in an uncertain world.

**Benefits of central bank transparency**

Firstly, it’s important to understand some history.

Andy Haldane (2017) provides an excellent historical description of central bank communication. For many centuries central banks were effectively mute. Even into the 1980s and early 1990s central bankers remained ‘deliberately opaque’.

During this later period, former United States Federal Reserve Governor Alan Greenspan was celebrated for his ‘constructive ambiguity’. One of his most famous quotes gives a fairly good idea of how difficult it was to interpret central bankers in those days: “I guess I should warn you, if I turn out to be particularly clear, you’ve probably misunderstood what I said.” Former Governor of the Bank of England, Mervyn King, described monetary policy over these times as “a dark art, practised by magicians, and wrapped in secrecy.”

Since the mid-1990s central bank communications have undergone a major revolution.

There is a greater expectation from the public that information is easily available and understandable. This has seen a wider and deeper engagement with financial markets and society as a whole. And, as a result, speeches and official publications have become more frequent, and central banks have increasingly used these approaches to deliberately convey their perspective on the state of the economy and the outlook for interest rates.

Measuring the transparency of a central bank is not an exact science. However, the Reserve Bank of New Zealand was an early adopter of a more transparent approach, and have consistently ranked towards the top of transparency league tables; the most widely used measure, the Dincer-Eichengreen index, placing the Reserve Bank of New Zealand third, behind only the Riksbank and the Czech National Bank (Figure 1).

A key way we have been transparent with financial markets since that late 1990s is by publishing projections for the future path of short-term interest rates. Today, only a handful of central banks do this.

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4 Haldane (2017).
6 King (2000).
7 The Dincer-Eichengreen index is a measure of the sum of responses to fifteen questions regarding the political, economic, policy and procedural transparency of central bank operations.
8 The other central banks to publish similar projections include the Czech Republic, Israel, Norway and Sweden.
We see three main benefits of publishing a full set of projections for the economy, including our policy interest rate.

Firstly, by sharing our research and expertise on our expectations for the economy and monetary policy, we can give individuals and businesses more information that helps them make more educated economic decisions.

Secondly, publishing our future interest rate path can move medium-and-long-term interest to a level that is consistent with our policy objective. This is significant since the entire yield curve, rather than just the short-term Official Cash Rate, has an impact on economic activity.

Thirdly, our projections convey our internal view of the significant factors for monetary policy, and how these can change as new information becomes available. By stating these views publicly, markets and the general public can hold us to our word and keep us honest. Repeating this process through time can also help us illustrate how we are learning from past experiences. This ultimately builds trust.

Over time, we expect a combination of transparency and a consistent approach will help markets understand how the Reserve Bank reacts to new data and economic developments. If we communicate effectively and markets are able to anticipate the policy implications, markets should then respond to information on the economy from new economic data as it occurs, rather than waiting for us to make a policy announcement.

You can think of this as a central bank’s objective for monetary policy communications to financial markets. As a result, interest rates should naturally adjust to levels consistent with
medium-term price stability and maximum sustainable employment without the need for constant talking and intervention from the central bank.

Research tells us that the countries that are most effective in this practice tend to experience less interest rate volatility and smaller reactions to monetary policy changes.\(^9\)

In New Zealand, the evidence over a long period suggests that our communication has been relatively effective in conveying our approach to financial markets. As an example, Figure 2 shows the change in market expectations for 90-day interest rates between our Monetary Policy Statements,\(^{10}\) compared to the change in the Reserve Bank’s own 1-year ahead interest rate projections.\(^{11}\) As you can see, the two track reasonably closely.

**Figure 2: Changes in 1-year ahead interest rates between Monetary Policy Statements**

![Graph showing changes in interest rates](image)

**Limits to central bank transparency**

While transparency has many benefits, it is also important to understand the limitations, as well as some potential costs and unintended consequences, of providing the market with too much information.

Firstly, publishing projections can portray a false sense of precision.

In reality, the uncertainties inherent in forecasting mean that the economy will almost always evolve differently to our expectations (Figure 3). The only certainty when making a forecast, is that it is unlikely to be exactly right. It is therefore extremely important that market

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\(^9\) See for example Blinder (2008).

\(^{10}\) The change in market pricing is measured from the day after a Statement to the day before the next Statement to eliminate the impact of the Monetary Policy Statement on market pricing. Prior to November 2016, the Reserve Bank published projections for 90-day interest rates, which move closely with the OCR.

\(^{11}\) These two changes represent how market participants have interpreted economic developments and believe the Bank will respond, compared to the actual interpretation of these events by the Reserve Bank.
participants understand our interest rate projections are conditional on a number of assumptions and our understanding of the economy at the time the projections were made. As these change, our view of the economy will need to change.

**Figure 3: Actual 90-day interest rates versus projections**\(^{12}\)

A second limitation of publishing projections is that it can create a disincentive for policymakers to change their view and adapt even as new economic data and developments emerge.\(^{13}\)

In recent years, the Reserve Bank of New Zealand was challenged over whether it was a mistake to start a hiking cycle in 2014.\(^{14}\) In my view, the case at the time was compelling, and the Bank had waited patiently to begin a tightening cycle. I think the more interesting question is whether publishing a projection with a very strong tightening bias over the period ahead had an influence on how long it took to adjust once the global outlook and domestic data weakened quickly through 2014.

A third limitation of transparency is the noise that it can create – an example of this is how to capture the diversity of views of individual members of a committee tasked with setting interest rates.

An example of this is how to capture the diversity of views of individual members of a committee that sets interest rates. Each individual member regularly sharing their views on the economic and policy outlook can make it harder for financial markets to interpret the

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\(^{12}\) The Bank changed from publishing the forward path for the 90-day interest rate to the OCR in November 2016. All OCR projections subsequent to November 2016 have been adjusted to a 90-day basis by applying a constant assumption for the spread between the 90-day rate and the OCR.

\(^{13}\) For further discussion on this idea see Mishkin (2004); Orphanides, Dale, & Österholm (2008).

\(^{14}\) See for example Dann (2017).
reaction function of the collective group. While I worked at the Bank of England, I always remember the head of communications bemoaning the *cacophony of voices*. More transparency around the perspectives of individual members could also create incentives for those individuals to hold on to a previously published position even as new information emerges, for fear of being seen as ‘conceding’ their position.

A paradox of these limitations is that greater transparency does not necessarily equate to increased clarity for market participants and the general public. Just because more information is available does not necessarily mean the audience will have a greater understanding of how and why central banks make decisions.

In a recent review of the United States of Federal Reserve communications, Stephen Cecchetti illustrates a general trend in monetary policy statements and media releases becoming longer and more complex, to the point where the reader requires a university-level education to properly understand the content.

In his excellent speech on central bank communications, at 11,500 words, Andy Haldane acknowledged the irony and difficulty of keeping things simple and accessible.

We’ve made some progress in making our monetary policy communications simpler and easier to understand, including the addition of the *MPS* in pictures and using language that is as plain as possible. We also webcast our media conferences, and speak with audiences around New Zealand to explain our thinking and to listen to their perspectives.

**Central banks' listening ear**

Listening is an invaluable part of communicating and learning, but is sometimes overlooked in our haste to say something and be a part of the conversation.

At the Reserve Bank, we consider it to be an important part of our role to listen to others so we can learn and extract information from financial markets. And, of course, to improve what we do.

However, there is a significant trade-off we face. The more we communicate and try to influence market pricing of future OCR decisions with strongly signalled messages, the more market pricing can merely reflect what we have said. When we are too explicit in our communications, market pricing can fail to be a useful signal in itself. As discussed by Shin (2017), we run the risk of finding ourselves “in an echo chamber of our own making, acting on market signals that echo our own pronouncements.”

It can be easy to fall into the trap of delivering on market pricing out of fear of creating significant market volatility. However, this does not recognise how dependent markets have become on the communications from central banks in setting their own expectations.

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16 Cecchetti (2019).
17 Cecchetti (2019).
18 Haldane (2017).
As former Federal Reserve Governor Jeremy Stein described it, the close attention of markets creates an incentive for central banks to speak in a whisper, since they know their comments will reverberate loudly around financial markets. However, the issue this creates is that "the softer [the central bank] talks, the more the market leans in to hear better and, thus, the more the whisper gets amplified".\textsuperscript{20}

In this scenario there is a danger that markets end up paying too much attention to our communications for what we have said ‘we will do’, leaving no one left to analyse the incoming economic data for what ‘we should do’. As a central banker, I am far more interested in listening to what ‘we should do’.

When private sector economists, analysts, commentators or bloggers don’t agree with our policy decisions or our projections for the economy, it can be an uncomfortable message to hear. But it is an invaluable exercise to test our assumptions and reasoning, even if we don’t agree with their conclusions, we inevitably learn something along the way and strengthen our analysis of the issues.

**Our evolving approach**

The creation of the Monetary Policy Committee (MPC) in April this year has given us a great opportunity to reflect on how we communicate with financial markets and the general public.

To support the transition to the new monetary policy framework, we published a *Monetary Policy Handbook*.\textsuperscript{21} The Handbook explains the new framework and sets out key assumptions about how the economy operates, the contribution of monetary policy to New Zealand’s economy, and how to design processes to optimise the benefits provided by a legislated MPC. It is intended as a living document and will evolve over time with input from the MPC.

A principle underlying our communication approach is that we want the market to use the information we publish in a way that is consistent with the way we use it ourselves. This is the overriding objective behind the key elements we made available in our recent *Monetary Policy Statements*.

**OCR projections**

As I mentioned earlier, we have been publishing projections for short-term interest rates since the late 1990s, and we continue to believe that they convey valuable information to financial markets – but only if they are interpreted correctly.

The purpose of our OCR projections is to serve as a signal from our modelling of the macroeconomy that informs our monetary strategy. Internally, our MPC use these projections as a signal of the broad amount of stimulus required over the next 6 to 12 months. That is, the published projections are not designed as a precise signal of our expectations for the OCR at every single meeting date over the horizon of our projections.

\textsuperscript{20} Stein (2014).
\textsuperscript{21} Williams et al (2019) provides further information on our framework for monetary policy communication and implementation.
In addition to our monetary strategy, the exact timing of OCR changes will also take into account tactical considerations not captured by a macroeconomic model. I’ll come back to these tactical considerations of timing later, when I talk more about our decision in August 2019. 

**Alternative scenarios**

For many years we have also published so-called ‘alternative scenarios’ for the OCR, as shown below in the February MPS (Figure 4). These were designed to provide an insight into how our monetary policy outlook might alter, given specific changes in our central assumptions about the economic outlook.

**Figure 4: Alternative Scenarios from the February 2019 MPS**

These scenarios also have their limitations.

The most important of these is that each scenario merely represents just one of the possible paths that could occur in the future, subject to a number of simplifying assumptions. Of course, in practice, there are a multitude of possible scenarios that could play out in the future.

By publishing just a couple of alternative scenarios, we felt we were portraying an overly-binary view of our decisions making process, and gave a false impression that we had a playbook to switch to at our next decision – when in practice, there would always be a range of new information and assumptions to incorporate into our next projections.

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22 For further discussion of these factors see Hawkesby (2019); Reserve Bank of New Zealand (2019a).
With financial market participants placing more weight on these alternative scenarios than the MPC were using in its own deliberations, we decided that, for now, we will not publish alternative scenarios routinely in our Monetary Policy Statements.

Instead, we have used other approaches to communicate the uncertainty we face.

Record of meeting

While there is a temptation for financial markets to be drawn to the appeal of precise numbers, Haldane reminds us all that "story-telling is the ultimate communication device".23

Since the May 2019 Monetary Policy Statement, in addition to a media release, we have published a summary record of the meeting to provide a richer story behind the decisions we make.

This record is published at the same time as the OCR decision and is owned and affirmed by the entire MPC. Even if we make a consensus decision about where to set the OCR, the record will capture the dispersion of views and difference in emphasis across the members of the committee. It is this rich discussion that gets us to the final decision and our collective outlook.

We feel this is a better way to capture the uncertainties and risks to our objectives that the members of the committee are grappling with, and sharing those insights with financial markets and the public in a coherent way.

A distinguishing feature of the summary record of meetings is that they are short and easy to read. Each record is written largely from scratch. This is designed to help avoid the trap of the markets leaning in to over-analyse changes in ‘code words’ from one meeting to the next; or the trap of the committee feeling like it has to whisper any changes in the story for fear of rattling markets.

I expect over time the Record of the Meeting will become the go-to for readers trying to quickly understand our decisions.

Our monetary policy decisions in 2019

At face value, having delivered a few ‘surprises’ this year (Figure 5), it may appear as if we are failing in our own objective for communications to the financial markets – that market movements are driven by data outturns and not central bank decisions.

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23 Haldane (2017).
I would like to conclude my remarks today by illustrating how our decision to cut by 50 basis points in August drew on some of the themes on communication that we have discussed so far.

For context, leading into the decision, market pricing pointed to an expectation that we would lower the OCR by 25 basis points at the August meeting, and another 25 basis points by around the November meeting, to deliver a total of 50 basis points of stimulus. Our own economic projections, captured in OCR projection that we would publish, suggested that around 60 basis points of stimulus was required some time over the next 12 months (Figure 6).
A key consideration in our eventual decision to deliver 50 basis points of stimulus at the August meeting was our need to listen to market signals – not just market expectations of how we would use our policy tool (the OCR), but market expectations our ability to achieve our objective (the inflation target).

There are pros and cons of different types of market measures of inflation expectations.

Survey measures of economists are informed by professional analysis, but may include only a small handful of submitters. Market measures of inflation expectations (such as so-called inflation-breakevens), are derived from markets with far more participants, but can be influenced by other factors such as risk premia and illiquidity discounts.

Both market measures (Figure 7) and survey measures (Figure 8) had been drifting lower through the year.

Figure 7: 10-year break-even inflation rates
A key part of the *tactical* decision to front-load the 50 basis points of stimulus in August was that it would give inflation the best chance of meeting our policy objectives. In particular, it would demonstrate our ongoing determination to ensure inflation increases to the mid-point of the target. We felt this commitment should support a lift in inflation expectations and an eventual lift in actual inflation.

On balance, our ‘regret analysis’ was that we judged that it would be better to do too much too early, than do too little too late.

The alternative approach risked inflation remaining stubbornly below target, with little room to lift inflation expectations later in the face of any downside shock. By contrast, we judged that bringing the timing of the stimulus forward – taking more decisive action – gave inflation the best chance to lift earlier, reducing the chance of inflation expectations continuing to drift lower, and creating an even more challenging task to achieve our objectives.

Put simply, our communication signal to the market was our determination to do what is required to achieve our mandate. It was a reminder to the market to focus first and foremost to analyse the incoming data and information for ‘what we should do’.

**Conclusion**

I hope these remarks help deepen the understanding of our approach.

Central bankers are subject to the same uncertainties and vulnerabilities as other market participants.

There is little doubt that communication is key to the successful delivery of our mandate. The environment we work in is not straightforward, and so additional transparency can bring clarity – if used appropriately.
Our approach to communications and transparency is an important part of our how we deliver on our mandate.

We need to continue to broaden our reach with the public to help everyone understand what we are responsible for achieving, and the reasons we make decisions that impact on all of New Zealand society. The language we use, not only to financial markets, matters.

There are plenty of communication challenges ahead, especially if monetary policy in New Zealand moves into a less conventional territory, and we end up adopting new tools and approaches.

These will need to be explained clearly to both financial markets and the people of New Zealand.

Nō reira,

Nau te rourou, naku te rourou, ka ora ai te iwi.

With your contribution, and my contribution, the people will prosper.

Tēnā koutou, tēnā koutou, tēnā tatou katoa.
References


