

Monetary policy transparency

In monetary policy, a trend towards greater transparency has been apparent in recent years. This article first of all sets forth the principal reasons for this development. It is shown that the openness and reconstructability of monetary policy decisions are basically in the best interests of all parties concerned. However, uncertainty about the monetary transmission mechanisms and differences in perception between central bankers and the markets set limits to the efforts to achieve full transparency. The crucial elements of a transparent monetary policy are: a clear definition of the ultimate goal, the announcement of the monetary policy strategy, the publication of the data relevant to decision-making and the consistent substantiation of policy decisions. On the other hand, it seems to make little sense to measure the degree of openness and comprehensibility solely in terms of the use of specific means of communication, such as the publication of the minutes of meetings. Any verdict on the transparency of monetary policy should, rather, be based exclusively on a comprehensive analysis of all the relevant criteria. Moreover, on some occasions there may be an incompatibility between the call for greater clarity and the criterion of monetary policy efficiency that must be taken into account when deciding for or against specific transparency-promoting measures.

The benefits of transparency

*Trend towards
greater
transparency
apparent*

Many central banks have made considerable efforts in recent years to disclose and explain their objectives, their strategy and the background to their interest-rate-policy decisions. This trend owes something, on the one hand, to the need to meet prescribed disclosure requirements and, on the other, to the intention of exploiting information channels so as to influence market participants' expectations.

*Extension of
disclosure
requirements as
a consequence
of greater
independence*

Accountability is, as it were, the consequence of the greater independence that has been granted to central banks in many countries. In a democracy, the independence of an executive body cannot be seen in isolation from its mandate. An independent central bank should therefore have a clearly defined objective and be accountable for its actions. For this reason, the Maastricht Treaty provides for extensive reporting requirements for the European System of Central Banks (ESCB). For example, the European Central Bank is required to submit to the European Parliament, the ECOFIN Council, the EU Commission and the European Council an annual report on the activities of the ESCB and on the monetary policy pursued in both the previous and the current year. Moreover, the President of the ECB and the other members of the Executive Board may be heard by the European Parliament and the appropriate committees. In addition, the statute of the ESCB and ECB provides for the publication of quarterly reports on their activities.

The actual information policy of the Eurosystem is, however, much more comprehensive. For instance, the Governing Council of the ECB decided to provide a quantitative definition of the ultimate objective and to announce the benchmarks of its monetary policy strategy. The ECB's decision to publish Monthly Bulletins and hold regular press conferences likewise goes beyond the requirements of the Maastricht Treaty. Other central banks, too, have extended their information policy beyond their official reporting commitments in recent years. The reason for this is that they wish to lessen market players' uncertainty about the future policy stance of the central bank, and to anchor inflation expectations as firmly as possible at the low level envisaged. Central banks are therefore themselves interested in making their monetary policy actions as transparent as possible.

The perception that optimum anti-inflationary solutions may founder on the lack of confidence of the private sector has determined the monetary policy debate of the past twenty years, just as much as the search for ways out of this dilemma.¹ The credibility problem is particularly pressing for central banks which, on account of a regime shift (such as the granting of independent status or the establishment of a monetary union), initially have to act without a relevant "track record". The option of gaining the confi-

*Use of
information
policy for
influencing
inflation
expectations*

*Transparency
as an approach
to solving the
credibility
problem*

¹ Guides in this debate were the papers by Kydland/Prescott (1977) and Barro/Gordon (1983). See Kydland, F.E. and E.C. Prescott (1977): Rules rather than discretion: The inconsistency of optimal plans; in *Journal of Political Economy* 85, pp. 473–91 and Barro, R.J. and D.B. Gordon (1983): A positive theory of monetary policy in a natural rate model; in *Journal of Political Economy* 91, pp. 589–610.

dence of the private sector by scoring successes with respect to the ultimate goal is not available to them until a few years have elapsed because of the long time-lags in the transmission process. They are therefore obliged to offset their lack of reputation by means of enhanced communication. Transparency here plays the part of self-imposed commitment: by disclosing the basis of its policy decisions, the central bank enables the general public to assess their adequacy and impose a sanction, if appropriate. At the same time, the central bank forfeits the option of pursuing a policy other than what it has announced.²

Transparency hampers employment-oriented ...

The benefits of transparency are, however, not independent of the target function of the central bank. Quite a number of academic studies come to the conclusion that central banks are supposed to have an interest in keeping information secret because being better informed enables them to raise output and employment, at least in the short run, above the levels planned by the private sector. Since, however, enterprises and households cannot be deceived indefinitely, but will take due account of the central bank's behaviour in their plans, the possibility of exerting temporary employment effects has to be bought in such models at the price of a permanent increase in trend inflation above the level actually aimed at – the so-called "inflation bias".³

... and facilitates stability-oriented monetary policy

As can easily be seen, the validity of this scenario is confined to central banks in whose target function stimulating economic activity has a similar ranking to safeguarding price

stability. In contrast to this, if a central bank is committed by law to the ultimate objective of price stability, it is in its best interests to communicate its intentions clearly and convincingly from the very outset. For it is only if economic agents are confident that the central bank will do all it can to discharge its mandate successfully that the full welfare-enhancing effects of a stability-oriented monetary policy will be unleashed. If, on the other hand, the central bank fails to convince the general public of the anti-inflationary thrust of its monetary policy, it will have to counteract the "overshooting" inflation expectations by pursuing a correspondingly more restrictive policy. In this case, longer-term interest rates, too, will contain no-confidence premia which will have an adverse impact on investment activity and real growth, and thus jeopardise the acceptability of a monetary policy geared to price stability.

The limits to transparency

The above considerations suggest that transparency is basically desirable, and especially crucial when the aim is to build up credibility as fast as possible. This raises the question of what a central bank can best do to make the monetary decision-making process transparent to outsiders. The fact that this question is

Approaches to creating transparency controversial

² See Briault, C., A. Haldane and M. King (1996): Independence and Accountability, Bank of England Working Paper, p. 34f.

³ See, for example, Cukierman, A. and A. Meltzer (1996): A Theory of Ambiguity, Credibility and Independence under Discretion and Asymmetric Information, *Econometrica* 54, pp. 1099–1128, or Faust, J. and L. E. O. Svensson (1998): Transparency and Credibility: Monetary Policy with Unobservable Goals, NBER Working Paper 6452.

far more difficult to answer in practice than in the context of simple theoretical models is illustrated not least by the strong differences of opinion about whether a particular monetary policy strategy or particular measures, such as the publication of the minutes of meetings, are apt to enhance the transparency of monetary policy decisions.⁴

Assumptions in the literature not fulfilled in practice

In the theoretical literature, it is mostly assumed that the way in which monetary policy measures work (the underlying structural relationship) is known to all those involved. On this assumption, the generation of full transparency is not difficult: it merely requires the publication of the data and forecasts available to the central bank at the time the decision is taken.⁵ Unlike this simple scenario, however, practical monetary policy is faced with a much higher degree of uncertainty. One key factor of uncertainty is the time-lags arising in the transmission of monetary policy stimuli to the demand for goods, output and prices. As interest-rate changes as a rule have their main impact on the inflation rate only after one to two years, all central banks have to rely on indicator variables which signal the price trend and the impact of monetary policy measures as early and reliably as possible. In order to create transparency, the monetary policy-makers must announce the indicators they rely on and must convince the general public that using these variables as a guideline is a suitable means of achieving the announced objective within the time horizon relevant to monetary policy.

However, the central bank cannot provide full transparency about the transmission mechan-

isms and the reliability of the indicators used, as knowledge of both is but limited within the central bank system as well. It is not clear, in particular, how far laws and behaviour patterns that were valid in the past can be extrapolated into the future. For instance, in the wake of a change of regime, such as the launch of a monetary union, structural breaks must be expected whose implications for the monetary transmission process are difficult to gauge at first. Another example of the possibility of fundamental structural changes is provided by the current debate in the United States on the pace of real growth that is durably consistent with price stability.

Moreover, the very data base available to the central bank for analytical and forecasting purposes is subject to considerable uncertainty. For example, data from the real sector undergo frequent and sometimes considerable revisions. The central bank can, however, generate transparency only with respect to facts which it knows itself. The limited scale of knowledge in turn narrows the overall scope for creating transparency.⁶

In practice, transparency can therefore only ever be partial, and never perfect, in the sense of theoretical models. It should also be borne in mind that more information does

Uncertainty about the transmission of monetary stimuli ...

... and about the data impedes the creation of transparency

Not necessarily more clarity owing to additional information

⁴ A good case in point is the controversy between Buiters, W.H (1999): Alice in Euroland, CEPR Policy Paper No. 1, and Issing, O. (1999): The Eurosystem: Transparent and Accountable, CEPR Policy Paper No. 2.

⁵ See, for instance, Geraats, P. (1999): Transparency and Reputation: Should the ECB Publish Its Forecasts?, Working paper for the ECB and CFS conference on "Monetary Policy-Making under Uncertainty" in Frankfurt am Main on December 3/4 1999.

⁶ See Remsperger, H. and A. Worms (1999): Transparency in Monetary Policy, Center for Financial Studies Working Paper No. 1999/16.

not necessarily result in greater clarity. In view of the complexity of monetary policy transmission mechanisms and the uncertainties specified above, additional information may even lead to more confusion if it is presented to the general public without corresponding elucidation. It is therefore important that the central bank should structure the wealth of information relevant to its decisions, and provide the public not only with the "bare" figures but also with its interpretation of them. This task is greatly facilitated by announcing a monetary policy strategy, which is then available as a frame of reference for interpreting the mass of information.

Assessment depends partly on the observer's vantage point

Whether the thrust of the central bank's argumentation, and its actual arguments, are felt to be transparent also invariably depends to some extent on the observer's vantage point. In this respect, the Governing Council of the ECB is in a particularly difficult position: it must convince a public that is characterised by differences in its way of thinking and by divergent national experience of monetary policy of the appropriateness of its decisions.⁷

Ways and means of creating transparency

Possible starting points

In view of the problems mentioned, it comes as no surprise that no agreement has been reached so far about the measures that are suitable for enhancing the transparency of the monetary decision-making process. However, a number of criteria can be derived from what has been said above, and may be used as a starting point for assessing the information policy of individual central banks. These

starting points include, besides the announcement of the ultimate goal, the formulation of a consistent monetary policy strategy, the publication of, and comments on, the data basis and the detailed substantiation of decisions. The table overleaf provides an overview of the ways and means chosen by the Eurosystem and other major central banks for enhancing the transparency of their policies in the fields mentioned.

Setting the monetary policy objectives

A clear definition of the ultimate objectives is obviously an essential prerequisite of the transparency of decisions. As far as the number of objectives is concerned, it may be said that a central bank's commitment to more than one objective is transparent only if unambiguous weights are assigned to the different objectives at the same time. Monetary policy decisions are even easier to reconstruct if central banks have a clear primary objective, as has increasingly been the case in recent years. One exception to this continues to be the United States. There, the Federal Reserve System is committed to promoting stable prices, maximum employment and moderate long-term interest rates, with no clear ranking being prescribed. In contrast to that, the Maastricht Treaty and the new Japanese and British Central Bank Acts of 1998 unambiguously lay down safeguarding price stability as the overriding ultimate goal of monetary policy.

Unambiguous primary objective conducive to transparency

⁷ See Winkler, B. (1999): Which kind of transparency? On the need for clarity in monetary policy-making, Working paper for the ECB and CFS conference on "Monetary Policy-Making under Uncertainty" in Frankfurt am Main on December 3/4, 1999.

Monetary policy transparency *

	US Federal Reserve	Bank of Japan	Eurosystem	Bank of England	Memo item: Bundesbank
Objectives					
Specification of an overriding ultimate goal	No	Price stability	Price stability	Price stability	Price stability
Quantification of ultimate goal	No	No	Quantitative definition by Governing Council of the ECB	Inflation target of the government	Medium-term price assumption ¹
Strategy					
Announcement and substantiation of monetary policy strategy	No	No	Two-pillar strategy	Inflation targeting	Monetary targeting
Announcement of an intermediate target	No	No	No	Inflation projection as intermediate target proxy	Monetary target
Announcement of prominent indicators	Monitoring ranges for money and credit growth ²	No specific indicators	Reference value for M3 growth	No specific indicators	–
Data and forecasts					
Publication of data on intermediate targets/ indicators and explanation of possible deviations	Yes ²	No	Yes	Yes	Yes
Publication of an inflation forecast and explanation of deviations from target	Twice a year ³	No	Under discussion	Quarterly	No
Decisions					
Announcement of monetary policy decisions	Yes	Yes	Yes	Yes	Yes
Statements concerning direction of future interest-rate policy	Interest-rate bias of the FOMC; meanwhile superseded by risk assessment	No	Occasionally	No	No
Means of communication					
Parliamentary hearings	At least twice a year	At least twice a year	At least four times a year	Regularly ⁴	No
Reports on economic conditions and monetary policy ⁵	Semi-annual report (Monthly report)	Monthly report	Monthly Bulletin	Quarterly Inflation Report	Monthly Report
Press conferences on economic conditions and monetary policy	No	Monthly ⁶	Monthly ⁷	Quarterly, on Inflation Report	On specific occasions ⁸
Publication of minutes of meetings	After six to eight weeks	After about one month	No	After two weeks	No
Publication of voting behaviour of individual members	After six to eight weeks	After about one month	No	After two weeks	No

* Similar tables have been published in: BIS (1998): Annual report 1997–8, p. 79 and by: Bini Smaghi, L. (1998): The democratic accountability of the European Central Bank, Banca Nazionale del Lavoro Quarterly Review, No 205, June 1998, pp. 128–9. — ¹ As part of the derivation of the monetary target. — ² Prescribed by law, but now of minor relevance to practical monetary policy (see text). — ³ As part of reports which the chairman of the Federal Reserve Board has to make to Congress under the Humphrey-Hawkins Act. — ⁴ In addition,

reporting requirement of the Central Bank Governor to the government if inflation leaves the target band. — ⁵ All the central banks specified here also publish an annual report. — ⁶ On the second working day after the first Policy Board meeting each month. — ⁷ Immediately following the first meeting each month of the Governing Council of the ECB. — ⁸ To announce and review the monetary target and after major monetary policy decisions.

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*Quantification
of the ultimate
objective by the
Governing
Council of the
ECB*

The clarity of the target definition can be increased by quantifying the concept of price stability or by setting an "inflation target". However, the quantification of price stability involves a conflict between the desire for as precise a definition as possible and the not inconsiderable problems posed by the exact measurement of inflation. The Governing Council of the ECB therefore decided to define price stability as an increase of less than 2% against the previous year in the harmonised consumer price index of the euro area as a whole. As this definition is intended to exclude both a decline in, and an increase in consumer prices of 2% and more, it can be interpreted as a range of between slightly over zero and just under two percent. One reason why the target has been set slightly above the zero line is that the measured inflation rate presumably overstates the actual inflation rate.⁸ Another point arguing in favour of a range is that, in the short run, inflation also owes something to factors beyond the control of the central bank, such as wage and fiscal policies or external influences. In order to emphasise its responsibility for the longer-term inflation trend, the Governing Council of the ECB has clearly based its quantitative definition of price stability on the medium term.

*Inflation target
of the Bank of
England*

In the United Kingdom, the government specifies an inflation target for the central bank. The present government has opted for a single-figure target of 2.5% per annum for the rise in the consumer-price index RPIX (which excludes mortgage rates). If the current inflation rate moves more than one percentage point above or below the prescribed inflation

target, the Governor of the Bank of England must explain the reasons why to the Chancellor of the Exchequer and spell out the requisite monetary policy measures. This arrangement likewise takes explicit account of the fact that inflation cannot be controlled in the short run. The central bank is, however, deemed accountable if the current inflation rate deviates from the specified range of the inflation target. Hence, the time horizon of the target is distinctly shorter than that in the Eurosystem. This strictness appears to be not unproblematical, as it might force policy-makers to respond to temporary price shocks, and, given the existing time-lags, might thus be counterproductive.

Defining the monetary policy strategy

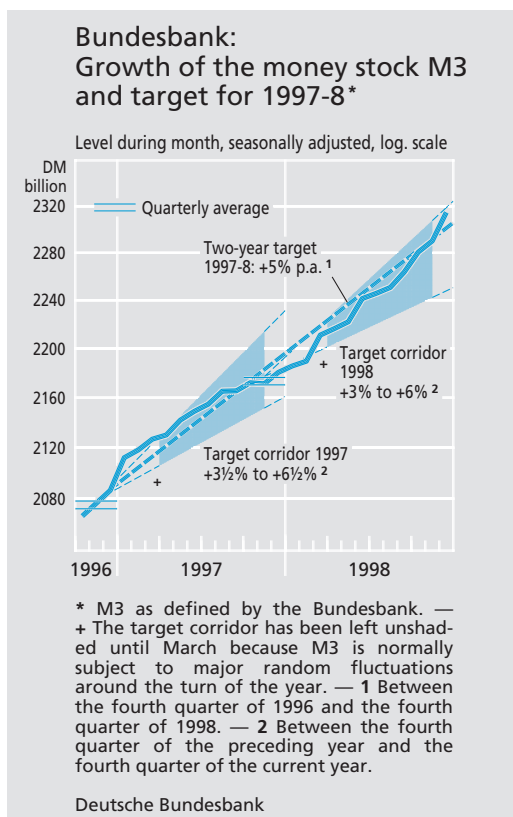
In order to create transparency, the policy-makers also have to disclose how they intend to achieve price stability or the announced inflation target, and they must convince the general public that the strategy chosen is suitable for the purpose. Here, too, there is a potential trade-off between the desire for clarity, which would suggest announcing a decision rule that is as simple as possible, and the existing uncertainty about the "true" transmission mechanism, which tends to advocate the use of as large a number of indicators as possible.

If a variable can be found which, on the one hand, can be controlled by the central bank with sufficient accuracy and, on the other,

*Transparency by
announcing the
monetary policy
strategy*

*Preconditions
for a strategy
using an
intermediate
target*

⁸ See Hoffmann, J. (1998): Problems of Inflation Measurement in Germany, Discussion paper 1/98, Economic Research Group of the Deutsche Bundesbank.



has a stable correlation with the ultimate target variable, that variable can be used as an intermediate target. A "classical" strategy using an intermediate target is the specification of a monetary target. In a strategy of monetary targeting consistent with production potential, such as was pursued by the Bundesbank between 1975 and 1998, the basic idea is to manage the supply of money in such a way that production potential is fully utilised without generating any inflationary pressures. The target set is therefore composed of the growth rate of potential output plus the medium-term price assumption. In addition, any trend decline (or increase) in the velocity of circulation of money must be taken into account by incorporating a corresponding add-on (or discount).

Gearing monetary policy to an intermediate target not only affords the central bank scope for responding to undesirable developments at an early date, but also makes it easier for all economic agents to assess monetary policy. However, a number of central banks had to relinquish the use of intermediate monetary targets because formerly stable relationships between the money stock and prices had become much looser. A case in point is the United States. There, the Humphrey-Hawkins Act of 1978 requires the Federal Reserve System to announce annual targets for money and credit growth and explain any failures to meet those targets to Congress and the general public.⁹ Frequent and unforeseeable deviations of the velocity of circulation of money from its historical trend have, however, considerably reduced the importance of these targets for US monetary policy and led to the Federal Reserve System pursuing, in effect, a purely discretionary policy.

Gearing monetary policy to an intermediate target

A number of other countries, including the United Kingdom, have adopted a strategy of direct inflation control – known as "inflation targeting". Central banks using this strategy base their assessment of future inflation trends on a large number of indicators from the real and monetary spheres. In order to enhance the transparency of the inflation assessment, some of them publish quantitative inflation forecasts for the time-horizon of two years that is relevant to monetary policy. In this case, the inflation forecast of the central bank practically performs the role of an inter-

The role of inflation forecasts in direct inflation targeting

⁹ The current target ranges are 1% to 5% and 2% to 6% for the growth of M2 and M3, and 3% to 7% for credit growth.

mediate target: if the forecast overshoots the official inflation target, that signals a need to raise interest rates, and vice versa. The reconstructability of monetary policy decisions as part of this strategy is thus subject to the condition that the central bank discloses how the inflation forecasts are made.

*Two-pillar
strategy of the
Eurosysteem*

The Eurosystem decided to adopt a two-pillar strategy. The first pillar of this strategy assigns a prominent role to the money stock, which is emphasised by setting a quantitative reference value for the growth of the broad money stock M3. The empirical foundation is provided by a number of studies which have found that, in the past, there has been a stable long-term relationship between the money stock M3 and the price level in the euro area.¹⁰ Since, on the other hand, it was not impossible that the move to monetary union would change the payment and investment patterns of households and enterprises, the Governing Council of the ECB decided to announce a reference value, which is less binding, rather than a monetary target. It also decided to supplement the use of monetary growth as a guideline by a second pillar, in the form of a broadly-based assessment of the outlook for prices.

*Increased
uncertainty
requires
flexibility*

The two-pillar strategy of the Eurosystem has been criticised by many observers as being non-transparent. This criticism is understandable insofar as drawing on two criteria – monetary developments and the outlook for prices – basically involves the risk of conflicting signals being received. On the other hand, the decision of the Governing Council of the ECB must be seen against the back-

ground of the particular uncertainty surrounding the change in the monetary policy regime. In these circumstances it is not impossible that a primary gearing to the money stock might lead to wrong decisions in some situations, nor does it seem safe to assume that assessing the outlook for prices solely on the basis of other indicators would ensure appropriate reactions in all cases. Hence policy-makers must have the discretion to weight contrasting signals on an ad hoc basis. This discretionary latitude, however, places heavier demands on the central bank's information policy. So as to ensure that the decisions are reconstructable by outsiders, the assessment of prevailing conditions and the background of the adopted monetary policy stance must be communicated at an early date, on a regular basis and in a comprehensible manner.

Publishing the data and forecasts

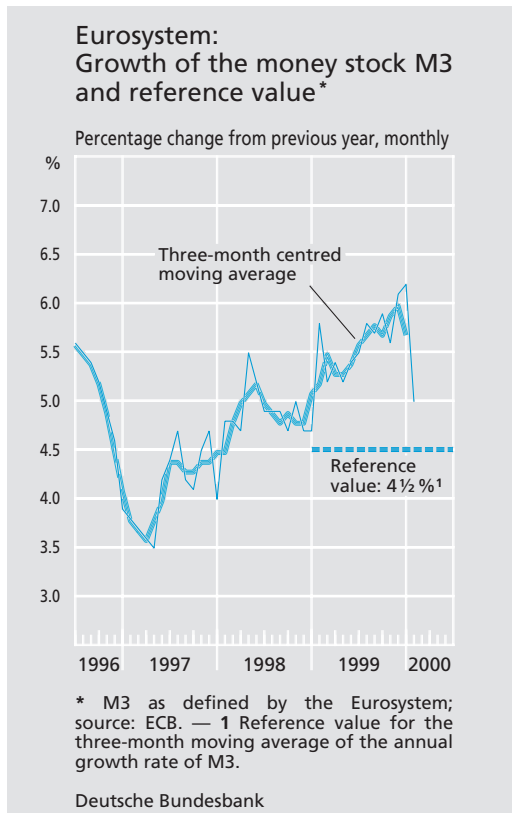
A basic prerequisite of a transparent policy is the disclosure of the data basis available to the central bank at the time decisions are taken. However, what matters is not so much the publication of all the information available as the selection and explanation of those factors which are relevant to the decision-making process.

Consequently, the contribution made to the transparency of policy decisions by the publication of forecasts depends on the monetary

*Disclosure of
the data
relevant to
decisions*

*Monetary
growth
observable,
but may need
interpretation*

¹⁰ See Fagan, G. and J. Henry (1998): Long-run money demand in the EU: Evidence from the area-wide aggregates, in *Empirical Economics*, 23, pp. 483–506, and the studies cited there.



policy strategy. If a monetary targeting strategy is pursued, the central bank's and general public's interest focuses on the movement of the monetary aggregate serving as the intermediate target. As far as reviewing compliance with the target is concerned, this strategy has the advantage that the money stock figures are realised statistical variables which can be observed unambiguously by the general public. The full benefit of this advantage can be enjoyed, however, only if the correlation between the money stock and prices is sufficiently stable, so that direct conclusions about the outlook for prices can be drawn from the observation of a target deviation. If, however, the basic relationships are temporarily distorted by other factors, the general public has to base its assessment also on the interpretation supplied by the central bank of

monetary developments and of other indicators considered to be relevant.

If direct inflation targeting is practised, the assessment of future price movements is of primary interest. In this case, the publication of a quantitative inflation projection provides a central reference point for the debate, and therefore basically enhances transparency. Projections, however, need much elucidation. This applies, firstly, to the estimation methods used in making the projection. Secondly, the assumptions about the development of major exogenous variables, such as exchange rates, commodity prices etc., must be disclosed. Thirdly, the question of whether the projection is based on the assumption of constant central bank interest rates or whether any need to adjust interest rates has already been taken into account is of key importance. Fourthly, the projection must also include information on the degree of uncertainty and the distribution of risks around the central projection value. Fifthly, it must be clear who is responsible for the projection.

In its quarterly Inflation Reports, the Bank of England publishes inflation projections based on the assumption of unchanged central bank interest rates as well as projections based on market expectations of the future stance of monetary policy. To present the forecasts, so-called fan charts are used, which illustrate the degree of uncertainty and the distribution of risks around the central projection. The effects of alternative assumptions about the development of major exogenous variables on the central projection value are quantified in a supplementary table.

Great need for elucidation of published inflation projections

Projections of the Bank of England carefully presented

*Forecasting
method
difficult to
reconstruct in
detail, however*

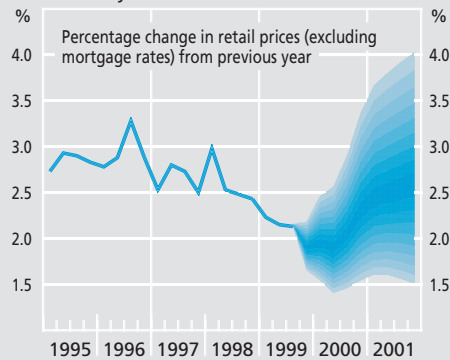
Despite the careful presentation of the projections, however, it is difficult for outsiders to reconstruct the forecasting method in detail. Although the macroeconomic models which provide the starting point of the projections were published by the Bank of England, a large number of additional influences not incorporated in the models are included in the forecasting process, alongside the results generated by the models. Assessment of this "off-model" information, of the degree of uncertainty and of the distribution of risks is effected by the members of the Monetary Policy Committee, who are also responsible for the "end-product". The general public has no means of knowing, however, which factors are included in the inflation projection, and how they are weighted. The publication of the projections therefore does not substantially reduce the discretionary scope available to the policy-makers. This applies all the more, given the magnitude of the forecasting uncertainty applying to the forecasting horizons that are relevant to monetary policy. Thus the band into which the future inflation rate falls with a 90 % probability already covers about two percentage points for the one-year horizon. For a two-year horizon it increases to 2½ percentage points and more.¹¹

*Survey among
policy-makers
at the Fed*

In the United States, the members of the Federal Reserve Board and the Federal Reserve Bank presidents come up with quantitative growth and inflation forecasts twice a year. Information on the range and central tendency of these projections is published as part of the reports on monetary policy which the Chairman of the Federal Reserve System

Bank of England: Inflation projection based on constant nominal interest rates at 6%

February 2000



The fan chart depicting the probability distribution for inflation is rather like a contour map. At any given point during the forecast period, the depth of the shading represents the height of the probability density function over a range of outcomes for inflation. The darkest band includes the central (single most likely) projection and covers 10% of the probability. Each successive pair of bands is drawn to cover a further 10% of the probability, until 90% of the probability distribution is covered. — Source: Bank of England, Inflation Report, February 2000, p. 55.

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presents to Congress in February and July of each year. These figures, too, suggest a considerable degree of uncertainty surrounding the projections. For example, the views regarding the inflation prospects for a time horizon of 1½ years ranged from 1.5 % to 2.75 % in July 1999, and thus covered a band of distinctly more than one percentage point.¹²

In its publications, the ECB has so far confined itself to qualitative descriptions of inflation prospects. At present, the production of inflation forecasts for the euro area is being hampered above all by the lack of reliable

*Inflation
forecasts for
the euro area
under
discussion*

¹¹ See Bank of England, Inflation Report, November 1999, p. 57 f, and Inflation Report, February 2000, p. 55 ff.

¹² See e.g. Board of Governors of the Federal Reserve System: Federal Reserve Bulletin, August 1999, p. 531.

US Federal Reserve: Economic projections for 1999 and 2000 *

July 1999; %

Indicator	Federal Reserve governors and Reserve Bank presidents	
	Range	Central tendency 1
1999		
Change, fourth quarter to fourth quarter		
Nominal GDP	4 3/4–5 1/2	5 – 5 1/2
Real GDP	3 1/4–4	3 1/2–3 3/4
Consumer price index	1 3/4–2 1/2	2 1/4–2 1/2
Unemployment rate 2	4 – 4 1/2	4 – 4 1/4
2000		
Change, fourth quarter to fourth quarter		
Nominal GDP	4 – 5 1/4	4 – 5
Real GDP	2 – 3 1/2	2 1/2–3
Consumer price index	1 1/2–2 3/4	2 – 2 1/2
Unemployment rate 2	4 – 4 1/2	4 1/4–4 1/2

* Source: Federal Reserve Bulletin, Monetary Policy Report to the Congress, August 1999, p. 531. — 1 Extreme values at the top and bottom edge are eliminated when calculating this variable. — 2 Average level in fourth quarter.

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data. Moreover, the occurrence of structural breaks or structural adjustment processes cannot be ruled out in the first few years of monetary union. Forecasts, however, are based on econometric models reflecting laws and behaviour patterns observed in the past. If presumptions about structural changes at the end of a series are to be included in the forecasts, this requires discretionary intervention in the models, which is hardly reconstructable by outsiders. Hence inflation forecasts for the euro area are subject to even greater uncertainty than usual. Even so, the President of the ECB has publicly advocated the publication of union-wide forecasts later this year. If the ECB were actually to take this step, the particular uncertainty surrounding the nature and scale of the figures published would have to be borne in mind. Moreover,

the (limited) weight of the forecasts in the monetary decision-making process would have to be explained by an active communication policy.

Announcing the interest-rate decisions

Other approaches to generating transparency are the announcement of current monetary policy decisions and, if appropriate, the preparation of the markets for future interest-rate moves. The immediate announcement of monetary policy decisions is now a matter of course in most countries. Thus all the central banks listed in the table on page 20 inform the general public immediately after meetings of the decision-making bodies whether a decision to change official interest rates has been taken.¹³

Announcement of current decisions common practice

Central banks are less inclined to inform the general public about their assessment of the need for future interest-rate adjustments. One exception here is the Reserve Bank of New Zealand, which publishes in its Monetary Policy Statements not only other forecasts but also the interest-rate path which would bring down inflation to a level of 1.5 % (the middle of the target range) over a time horizon of one to two years.¹⁴ The reason for the restraint on the part of other central banks is their fear that such statements might be interpreted by the markets as an announce-

Less openness about future interest-rate moves

¹³ This has not always been the case. The US Fed has been announcing its target for the Federal Funds Rate on the day of the FOMC meeting only since February 1994.

¹⁴ See Reserve Bank of New Zealand: Monetary Policy Statements, and Mayes, D.G. and W.A. Razzak (1998): Transparency and accountability: Empirical models and policy making at the Reserve Bank of New Zealand, Economic Modelling, 15, p. 380, footnote 6.

ment of forthcoming interest-rate decisions. Policy-makers would then run the risk of being forced to act, since correcting the assessment, once it has been announced, might call into question their credibility and competence.¹⁵

Bias announcement and risk assessment of the FOMC

Recent experience of the US Federal Reserve System of making statements about the thrust of future interest-rate policy (known as "bias announcements") shows that this concern is not unwarranted. In an effort to increase transparency, the US Federal Open Market Committee (FOMC) had decided in December 1998 to announce in future, immediately after the meetings, how the majority of members viewed the likely direction of the next movement in rates (tightening, loosening or neutral bias). When it turned out in the course of the year, however, that the bias announcements tended to provoke more confusion than clarity, the FOMC commissioned a working party to look at alternatives. Following the latter's suggestion, the FOMC decided at the beginning of this year to replace the bias statements by an assessment of the risks to balanced economic growth, explicitly covering the foreseeable future – and thus a much longer period than that up to the next meeting. The FOMC members have a choice between three standard formulae: the risks are weighted mainly toward conditions that may generate heightened inflation pressure, or mainly toward conditions that may generate economic weakness, or the risks are balanced.¹⁶

The new system is intended to make it clearer than before to the markets that, given the

great uncertainties surrounding future trends, the Fed can do no more than assess risks, and that those risks have to be reassessed as soon as more information becomes available. This new system of announcements gives the Fed greater latitude again without exposing it to the criticism that it has abandoned its efforts to enhance transparency.

In line with the Fed approach, the ECB, too, has recently been pointing out that the risks to price stability are rising in the medium term. Moreover, a growing tendency is discernible in many countries towards preparing the markets for forthcoming interest-rate moves by including hints to that effect in speeches and publications. The intention is to reduce uncertainty and to steer market expectations in the direction desired by the central bank. This does not imply, however, that every monetary policy measure can be prepared a long time in advance and be fully foreseeable. Instead, situations are conceivable in which surprise monetary policy decisions are required – for instance, to arrest undesirable developments in the financial markets. Policy-makers must therefore preserve the freedom to disagree with the views of the markets, and to take market participants by surprise, if necessary.

Possibility of surprise decisions

Means of communication

Monetary policy-makers have a variety of means of communication at their disposal for

Significance of individual means of communication varies

¹⁵ See Goodhart, C. (1999): Central Bankers and Uncertainty, Bank of England Quarterly Bulletin, Volume 39, February 1999, p. 104ff.

¹⁶ See Federal Reserve Board, Press Release of January 19, 2000.

explaining their views on economic conditions and the reasons for their decisions. The extent to which the various instruments are used depends, among other things, on the given institutional framework and on tradition. It is therefore hardly surprising that the significance of individual means of communication differs from central bank to central bank.

US Federal Reserve

In the United States, the reports on monetary policy which the Fed Chairman delivers to Congress twice a year are traditionally a major instrument of communication policy. Current monetary policy decisions are elucidated mainly by the publication of the minutes of meetings which both reflect the discussions in the FOMC (without giving any names) and disclose the voting by individual members. The minutes are not published, however, until some days after the following meeting, i.e. with a time-lag of six to eight weeks. Moreover, it is a controversial point whether the disclosure of differences of opinion in the committee increases the transparency of monetary policy decisions. This is suggested by the fact that it gives markets an idea of the uncertainty and risks involved in assessing economic conditions. On the other hand, there is a risk of too much attention being paid to the views of individual members and less to the committee's overall assessment.

Bank of Japan

The Bank of Japan has likewise been publishing minutes of its meetings since 1998, with a time-lag of about one month. A more timely means of communication are the monthly reports, which are published after the first

monthly meeting of the Policy Board and include an introductory statement by the Board on the latest economic and financial developments. In addition, once a month – always two days after the first monthly meeting of the Policy Board – a press conference is held at which the Governor explains the current policy stance.

Bank of England

At the centre of the Bank of England's information policy are the quarterly Inflation Reports, which contain both an in-depth analysis of monetary and real economic trends and the inflation and growth projections of the Monetary Policy Committee. Background information on monetary policy decisions is also imparted to the general public by the publication of the minutes of meetings, which are made public two weeks after each meeting.

Eurosystem

The President of the European Central Bank presents the Annual Report of the ECB to the ECOFIN Council and the European Parliament; in addition, he appears before the Economic and Monetary Committee of the European Parliament four times a year. The ECB addresses its Monthly Bulletins to the general public; in them, it analyses monetary and economic conditions in the euro area and describes the background to its monetary policy decisions. Great value is also attached to the press conferences, which are held regularly immediately after the first monthly meeting of the Governing Council of the ECB. At those press conferences, the President of the ECB analyses monetary and overall economic conditions and – if appropriate – elucidates the monetary policy decisions, and thereafter

answers journalists' questions. The Governing Council of the ECB has decided not to publish the minutes of its meetings, primarily because of the special features of the Eurosystem as a supranational institution. In view of the European mandate assigned to the Governing Council, this decision was motivated chiefly by the desire to preclude any possible re-nationalisation of monetary policy by the publication of the voting behaviour of individual members, and to enhance the collective responsibility of the Governing Council of the ECB.

Outlook

Efforts on the part of the Bank of England and the Eurosystem to ensure a high degree of transparency

The object of the above analysis was to give an overview of possible approaches to, and instruments for, creating transparency in monetary policy. All the central banks analysed here have attempted in recent years to communicate, on a regular and comprehensive basis, their views on economic conditions and the background to their monetary policy decisions. This applies with particular force to the Bank of England and the European Central Bank, whose main aim has been to build up credibility as fast as possible after a change in the monetary policy regime.

Even so, in recent months both central banks have had to grapple with criticism of a lack of transparency. The Bank of England, for example, was faced with the reproach that the credibility and transparency of its inflation forecasts had diminished as a consequence of the independence granted to it.¹⁷ The Eurosystem, by contrast, was chiefly criticised for the monetary policy strategy it chose, and also for its failure to publish the minutes of its meetings. This criticism was not altogether surprising, it is true, as new ground was broken by the adoption of the two-pillar strategy. On the other hand, the advocates of the two alternative proposals – monetary targeting or inflation targeting – have so far failed to prove that a one-dimensional strategy is not only more transparent but also promises to be more successful with respect to the ultimate objective of price stability. However, in view of the change of regime and the uncertainties involved, the two-pillar strategy at present continues to appear superior to both alternatives. Its complexity makes heavy demands, though, on the Eurosystem's information policy.

Complex strategies make heavy demands on communication policy

¹⁷ See Martijn, J.K. and H. Samiei (1999): Central Bank Independence and the Conduct of Monetary Policy in the United Kingdom, IMF Working Paper 99/170.