The importance of central bank transparency in establishing central bank communication strategies

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Abstract: - In recent years, many central banks around the world have undertaken reforms to refine the communication channels regarding the assessments of economic conditions and their decisions related to the monetary policy stance. This shift towards enhancing communication skills has two main underlying factors: first, greater central bank autonomy has been accompanied by a corresponding demand for greater democratic accountability and transparency; second, there can be identified an international consensus among central bankers and economists that better communication about central bank actions is essential in reducing uncertainty facing economic agents. In our opinion, a high level of central bank accountability and improving the expectations’ management are both facilitated by a more transparent decision – making process. The main problem that is emphasized in the economic literature regards the optimal way of gaining such central bank transparency. In this paper we focus upon the central bank transparency trends in establishing the most comprehensive communication strategies for the central banks.

Key-Words: - Central bank accountability, communication channels, central bank independence, credible expectations, market efficiency, monetary policy committee, central bank autonomy and flexibility

1 Introduction

In the past, central banks used to be very reserved regarding their activities, strategies and monetary policy decisions and actions. As central banks become more and more independent, transparency gained importance based upon accountability arguments. An important fact for adopting an increasing central bank transparency lies in its importance for influencing the development of expectations. With the increased importance of the financial markets, managing inflation expectations has become a key element of monetary policy making [1], because it determines the success of the monetary policy transmission. There are several benefits from successfully steering market expectations, like reduced uncertainty, improved planning of market participants, lower interest rate volatility and more effective monetary policy [2].

There is a broad consensus that, beyond it’s for making a central bank accountable, transparency may help enhance the effectiveness of policy [3], [4]. However, the central bank faces a potential conflict; a maximum level of transparency needs not to be optimal for the efficiency with which it is able to pursue its mandate. Such a conflict may occur when giving more information but less clarity and common understanding among market participants, as there are limits to how much information can be digested effectively [5]. Moreover, too much information may crowd out the formation of private beliefs which are a crucial source of information for a central bank, and thus for the effectiveness of policy making [6]. As such, transparency is not an end itself but merely a means to help the authority achieve its mandate [7], [8].

Transparency has become a prominent feature of the monetary policy during the last twenty years, but the systematic evidence on central bank transparency has been elusive due to the lack of data. Nowadays specialists have been able to exploit the transparency of the data collected by economists, in order to document and analyze different trends and
hypothesis during the last decade [9], [10]. There are many studies investigating both the global trends and the differences across monetary policy frameworks, but we need to supplement them with studies of the institutional and macroeconomic setting of the transparency trends.

Thus they provide a wide perspective on monetary policy transparency in order to enhance the understanding of this global trend. These studies establish several stylized facts; they show that there has been a significant increase in the disclosure of information relevant to monetary policy making during the last decade. The most pronounced improvement has taken place in the communication of policy decisions and the macroeconomic analyses on which they are based. However, there are significant differences across monetary policy frameworks in this respect. Central banks with inflation targeting have experienced the largest expansion of transparency, while central banks with monetary and exchange rate targeting exhibited the smallest increases of information disclosure, although the rise in transparency during the last decade has been significant for all monetary policy strategies. These studies conclude that countries with high inflation in the late 1990s and high levels of economic development have undergone the strongest increase in monetary policy transparency. Furthermore, countries with higher monetary policy transparency tend to experience lower subsequent inflation.

2 The need for transparency

Transparency refers to the physical property of an object to transmit light, which means one can see through it. When applied to concepts, transparent means clear; so colloquially it conveys a positive attitude. In an economic context, a useful economic definition of transparency can be formulated as the presence of information; lack of transparency, or opacity, and finally to asymmetrical information. However, transparency is not equivalent to complete certainty of perfect information. For instance, in the case of monetary policy, the central bank and private sector could both face uncertainty about the structure/evolution of the economy; but as long as both parts have the same information and are aware of it, transparency prevails [11], [12].

The increased importance attached to the notion of transparency in the monetary policy process is reflected by the fact that, nowadays, most of the central banks have an external website and a commitment to external disclosure of the information. The advent of the Internet has allowed the release of huge amounts of information at near zero marginal cost to a global audience. In addition, we can observe that the IMF’s Code of Good Transparency Practices in Monetary and Financial Policies has played a key role in promoting transparency in all areas of financial supervision and regulation, including central bank activities.

2.1 The rationale of central bank transparency

Transparency in monetary policy includes a set of communication channels through which the central bank provides information about its responsibilities and the ways they are carried out. Communications can include information about the present and future monetary policies, the way monetary policy is implemented, the publication of forecasts, the economic models employed in the decision – making phase, of the minutes of board meetings. However, it would be misleading to evaluate transparency on the basis of the amount of released information alone. The concept of central bank transparency encompasses also features like; accuracy, quality, truthfulness and the information relevance.

The eight reasons that stand as arguments in favor of a more transparent central bank are the following:

- **enhancing and maintaining a high level of central bank independence** – if a central bank is both transparent and independent, then the economic agents will be more capable of evaluating and following the central bank’s decision and actions. Moreover, a high level of transparency integrated in an independent central bank could have a positive impact upon the decision – making process and voting mechanism, minimizing the pressures of government influences and other pressure groups;

- **improving the public capacity of understanding the monetary policy actions and decisions** – a high level of central bank transparency will lead to a better understanding of the monetary policy process. The monetary policy transmission mechanism will be accelerating through the public understanding of how the central bank interprets the signals from the economy, and what measure needs to be undertaken;

- **strengthening central bank credibility** - in order to eliminate the time – inconsistency problem of monetary policy, the credibility is an essential element for reducing the inflationary bias.
Central bank credibility can be enhanced to the public trust constructed through central bank transparency: the private sector will know that once announced, the central bank will not have an incentive to deviate from the target; co

2.2 The main important types of central bank transparency
Owing to the multi-dimensional and qualitative measure, transparency is not a concept that can be captured by a single number in a non-controversial way. Nevertheless, some authors designed measures that were used to compare transparency across frameworks and countries [14], [15], [16], [17]. Most transparency measures are based on five main components as following:

- **political transparency** – which refers to the openness about policy objective; formal statement of the objectives with an explicit prioritization if there is no more than one objective, quantification of the primary objective, and explicit institutional arrangements between the central bank and the government;

- **economic transparency** – which concerns the way monetary policy decisions are taken; provision of explicit policy rule describing the monetary policy framework, comprehensive account of policy deliberations or explanations in the case of a single decision maker, disclosure of how each decision regarding the main operating instrument or target is reached;

- **operational transparency** – which concerns the implementation of the central bank’s policy actions; regular evaluation of the extent of information on macroeconomic disturbances affecting the transmission process, regular provision on an evaluation of the policy outcome in the light of macroeconomic objectives.

**2.3 Evidence upon the effectiveness of central bank transparency**
One of the main problems related to the central bank transparency debate has been the lack of the empirical data. This is not surprising since it is challenging to measure to what extent the private sector has the same information as monetary policymakers and fully understands the policy making process. In order to analyze the empirical evidence regarding central bank transparency we use the Eijffinger & Gerrats index, ranged from 0 – 15, and based on the information from some relevant sources [9]; the sample contains 100 countries, and stands for the period: 2001 – 2006.
Figure 1 reveals that in recent years there has been a remarkable increase in central bank transparency. This figure also shows a moving trend towards a higher degree of openness in the information disclosure regarding monetary policy.

The central bank transparency phenomenon is often associated with the inflation targeting strategy. We consider that the rise in central bank transparency also extends to the monetary policy frameworks. Our approach is based on IMF classification of central banks into: exchange rate targeting, monetary targeting and inflation targeting.

The figures 2, 3 and 4 show that countries that adopted inflation targeting as the monetary policy strategy have been the most transparent ones. Part of this is driven by the adoption of inflation targeting in a number of countries at the beginning of the sample period: Poland, Thailand, Hungary, the Philippines, while at the end of the sample, some developed countries as: New Zealand and the United Kingdom further increased their transparency.

The analysis based on the Eiffinger & Gerrats index focuses on information that is pertinent to understanding monetary policymaking; it is natural to expect differences in the degree of information disclosure across monetary policy frameworks. In particular, central banks with exchange rate targeting have limited scope for independent monetary policy in the presence of international capital mobility so they have no need to explain their monetary policy actions. Central banks with monetary targeting generally enjoy greater...
flexibility and face the problem that monetary aggregates can be controlled imperfectly, which makes them more inclined to focus on operational transparency. Inflation targeting strategy possesses a further challenge since the target can only be controlled imperfectly after a long and variable lag of typically two years. This makes the communication of anticipated macroeconomic developments critical in order to understand monetary policy actions, so that economic transparency becomes more relevant.

3 Assessing the central banks communication strategies

Over the last five years it can be noticed that many central banks around the world reported major advanced reforms in the field of communication: the publication of endogenous interest rate forecasts, votes of minutes, a reduction in the release time of minutes, a higher frequency of communications, more frequent appearances to legislative bodies. Moreover, we can observe that, in some instances, there has been made a reduction in the number of policy meetings in order to make them coincide more closely with the release of key economic data, and the phasing – out of forward guidance in favor of more direct means of communication.

Central bank communication can be identified as the provision of information by the central bank to the public regarding such matters as the objective of the monetary policy, the monetary policy strategy, the economic outlook, the outlook for future policy decisions.

Many central banks with similar monetary policy objectives follow, nonetheless, fundamentally different communication policies; these policies have evolved over time. In our study we focus upon the current practices by examining the different types of central bank signals first by content and last by sender.

By content central banks communicate about several aspects of monetary policy:

- *monetary policy objective and strategy* – independent central banks must have clear objectives – mandates by its government. Moreover, an inflation targeting strategy can focus more upon transparency and accountability through a continuous communication process of the central bank with the public and the financial markets;
- *monetary policy decisions* – this focused on the announcing and informing promptly (on the day they are taken) the public regarding the actual paths of the monetary policy;
- *economic outlook* – this means that the central bank must provide information about forecasts and assessments of future inflation and economic activity and it’s own inclination regarding future monetary policy decisions. Nonetheless, very important are the manner and the adequate distribution of such information;
- *forecasting and communicating future policy rates* - only a few central banks provide a quantitative guidance for publishing the numerical path of future policy rates that underlies their macroeconomic forecast.

By *sender*, central banks communicate about several aspects of monetary policy:

- *communication by committees* – the communication through an Monetary Policy Committee arises on the meeting days, when are announced the monetary policy decisions. The timing of this communication and the amount of information provided differ substantially across central banks. Among the important reporting vehicles are regular publications as: monthly bulletins, quarterly bulletins, inflation reports, monetary policy report for the congress;
- *communication by individual committee members* – committees come in different shapes and sizes: individualistic (example Bank of England), genuinely collegial (example the ECB Governing Council), autocratically collegial (FED’s Federal Open Market Committee). Communication by committees are generally pre-scheduled, and thus inflexible in time; but changes in to circumstances relevant to monetary policy do not always coincide with meeting dates and testimonies.

4 Conclusion

Regarding the importance and the assessment of central bank transparency in the communication strategies of the central banks we came to the following remarks:

- nowadays, central banks are more capable of communicating with the public and financial markets, raising also the quality of information on the timelier basis;
- strengthening central bank communication strategies for;
accountability, enhance public understanding of the objective of policy and
the decision – making process, guide market – expectations;
while all central banks now provide short statements explaining the reasons for policy
actions, this is by no means the sum total of their communication efforts; in several
cases, those statements are coupled with more comprehensive background
documents containing a forecast;
a high level of central bank transparency leads to a great deal of diversity in the
quantity and quality of the information disclosed. In our opinion, central banks
operating under inflation targeting frameworks tend to provide more
information than entities operating under other frameworks, although there is a wide
variation within the central banks belonging to each broad framework;
many central banks continue to set limits on the amount of information they reveal about internal policy deliberation and especially internal differences of opinion; these limits demonstrate a preference for limiting noisy signals by broadcasting a consensus view;
although a significant progress was registered in communicating with the markets, greater attention for education of the general public about monetary matters should be considered.

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