

SHOULD MONETARY POLICY BE TRANSPARENT?

There is an overwhelming consensus that monetary policymaking should be transparent. **Jan Libich** evaluates the arguments.

‘Institutions form the incentive structure of a society, and the political and economic institutions, in consequence, are the underlying determinants of economic performance’.

From the Nobel Prize lecture of Douglass C North, Stockholm, 9 December 1993.

Central banking offers a unique environment to examine the widespread belief that ‘institutions matter’. Over the past three decades, the general trend in institutional design of monetary policy has been towards

independent (i.e. apolitical) policymaking performed by increasingly accountable and transparent central bankers. This has come as a surprise given the past record of secrecy in central banking.¹ What were the driving forces behind these developments? What were the effects on policy outcomes?

This article will focus on the pros and cons of one pivotal institutional characteristic—transparency—in the light of these developments and relate the findings to the case of the Reserve Bank of Australia (RBA) to evaluate whether its transparency arrangements approach today’s best international practices.

Types of transparency

In Webster’s English dictionary the word transparent is defined as ‘easily understood or seen through’.² In the context of economic policymaking, transparency commonly refers to the existence of symmetric information (whereby the public has the same information as the policymaker) and conversely opacity refers to asymmetric information (whereby

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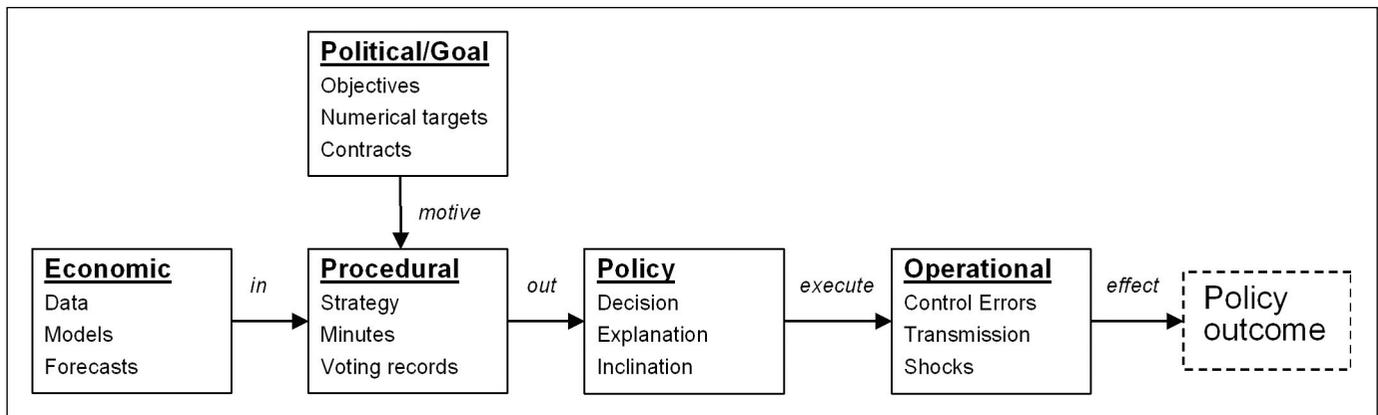
the policymaker has some private information). What are then the various areas in which the central bank can be transparent and reduce informational asymmetries?

The exposition and discussion will be based on a comprehensive model of transparency developed by Petra Geraats and presented in Figure 1.

Five broad types of transparency are identified that focus on the informational content rather

differences across countries in these developments; monetary policy is currently most transparent in the UK, New Zealand, and Sweden. Together with countries such as the US and Japan, Australia is in the middle tier in terms of transparency among industrial countries. The arrangements in Germany, France, Austria, and Singapore are considered yet less transparent.³

Figure 1: Types of transparency



Source: Petra Geraats, 'Central Bank Transparency', *Economic Journal*, 112, 2002, 532-65.

than the form of information disclosure. Roughly speaking, (i) political/goal transparency relates to what the central bank wants, (ii) economic transparency refers to what the central bank knows about the economy, (iii) procedural and (iv) policy transparency summarise the openness about what the central bank does internally and how it explains its decisions externally and (v) operational transparency relates to how the central bank evaluates its actions, both in prospect and retrospect.

The trend towards all types of transparency has come under the heading of inflation targeting. Goal transparency was the first one on the list; following the revolutionary Reserve Bank of New Zealand (RBNZ) Act 1989 the majority of industrial countries have clarified the goals of monetary policy in the central banking legislation. In most cases, price stability was promoted to be the sole or primary goal and this took the form of an explicit commitment to a numerical inflation target. Progress in other types of transparency has followed. Nevertheless, there have been striking

Political/goal transparency

Why should monetary policy goal(s) be transparent? The main reason is, in the spirit of the above Douglass North's quotation, incentives. If (and only if) policy goals are transparent and clearly specified, an accountability arrangement can be implemented—an optimal incentive contract can be written between the principal (government on behalf of the society) and the agent (central bank) that imposes punishment for deviating from the given goals. The fact that the goals/targets are legislated then guarantees that they cannot be easily 'reconsidered' by either party. The prime example is the New Zealand's Policy Target Agreement between the Minister of Finance and the Governor.⁴

What then are the goals of monetary policy to be made transparent? The answer to this question is much less controversial than three or four decades ago. It has long been accepted that prosperity is best achieved if both inflation and unemployment are low and stable. Unlike in the 1960s and 1970s, when it was believed that a trade-off existed between

the long-run levels of inflation and unemployment, there is currently an overwhelming consensus on there only being a short-run trade-off. The fact that monetary policy cannot affect the long-run level of unemployment then implies that (i) low inflation should be its only long-run goal and (ii) stability of both inflation and unemployment (around their long-run levels) should be attempted 'along the way'.

The formalisation of this structure of goals has however differed across countries with three main types prevailing. Some countries, for example, New Zealand and Sweden, have stressed the long-term objective and promoted price stability to be the sole objective of monetary policy ('unitary' mandate). Others have stressed the short-term considerations and have multiple objectives. Among these, in some cases the given objectives are not prioritised, for example, the United States or Japan ('dual' mandate), and in others price stability is stated as the primary goal, for example, the United Kingdom and the European Central Bank ('hierarchical' mandate). This is also the case of Australia (to some extent); the Reserve Bank Act 1959 (further the Act) postulates multiple objectives and the prioritisation is mentioned in the 1996 Statement on the Conduct of Monetary Policy.⁵

There is a debate on which of these arrangements is superior. There seems to be agreement about the inferiority of the most discretionary dual mandate setting without prioritisation and an explicit inflation target.⁶ In terms of the other two settings (in which a long-run inflation target is transparently implemented) the views are contradictory. It has been argued that the Australian hierarchical setting constituted a part of RBA's success over the past decade.⁷ This is apparently because this has given the Bank more flexibility to react to shocks, with the post-1998 Asian crisis offered as an example (comparing the outcomes to those of New Zealand). On the other hand it has been argued that the RBA's setting should be improved and formal priority to price stability should be stated in the Act itself to reduce uncertainty in the markets and better anchor inflation expectations to the target.

The empirical evidence that could resolve this disagreement is inconclusive, partly because both specifications leave flexibility to stabilise unemployment in the short run. Since the inflation

target is postulated as a medium/long-term objective, it must be achieved on average (over the course of the business cycle), that is, it is not required that inflation be on target at every point in time. Specifically, after a shock the policymaker still has some flexibility gradually (rather than harshly) to bring inflation on target and hence minimise the associated employment loss. Put differently, a transparent inflation target provides a long-run rule, but still allows for short-run discretion.

Furthermore, to add extra flexibility, inflation targets have commonly been specified as a narrow range rather than a point target. The RBA's target of 2-3% is very much in line with international practice. The RBNZ's and Bank of Canada's targets are 1-3%, the Bank of England's and Swedish Riksbank's targets are specified as 2% with a $\pm 1\%$ 'tolerance interval'.

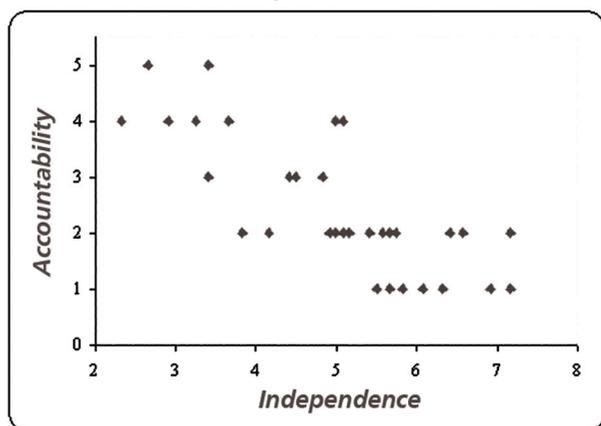
Effect on accountability

As argued above one of the prime benefits of goal-transparency is the ability to enhance the accountability of the policymaker. How does the RBA compare in this respect? While the Bank scores relatively high in accountability indices there exists no clear accountability arrangement such as the RBNZ's in which the Governor himself is responsible for achieving the target and his job is at stake if he fails to do so. One obvious reason for this is the fact that the decisions at the RBA are made collectively by the Board so a clear accountability arrangement may not be feasible. There is an ongoing debate on whether interest rate decisions should be made collectively or ultimately rest with the Governor (as in New Zealand). There exists some evidence that while collective decision making results in superior decisions on average, the latter setting is more readable to the private sector and enables a personal punishment clause.⁸

It is perhaps true that a conservative central banker with a good track record of low inflation (like Chairman Greenspan) may not need explicit institutional arrangements in order to enjoy high credibility; however it has been argued that good monetary policy should be 'institutionalised'. This need has recently been highlighted by the finding of a 'democratic deficit'; a situation in which an independent institution without a political mandate or a high degree of democratic accountability is in

charge of monetary policy in a number of countries. Figure 2 presents an example of the negative correlation between central bank independence and accountability which has been reported by various studies (using differently constructed indices of these institutional features).

Figure 2: Central bank accountability vs. independence



Source: Pedro Sousa, 'Central bank independence and democratic accountability,' mimeo, Portucalense University. See his paper or Libich and Hughes Hallett (2006) for details on the criteria, countries, and scores. The correlation coefficient equals -0.78 ($t=-6.94$).

It is interesting to notice the two distinct groups of countries, namely the inflation targeting countries of the top left corner and the 'democratic deficit' counties of the bottom right corner. A recent research paper offers an explanation for these findings.⁹ It first shows that central bank independence and (transparent/accounted for) inflation targets can serve as substitutes in keeping inflation under control and delivering policy credibility. It then demonstrates that although transparent targets are socially superior, an independent central bank is likely to remain secretive about them (as well as about other aspects of its policymaking) to avoid democratic accountability.¹⁰

This has implications for optimal timing of institutional reform, namely that a transparent inflation target accompanied by an accountability arrangement should first be legislated and only then independence may be granted to the central bank. This is the Bank of England scenario; unfortunately, the majority of transition economies have taken the opposite route—the Fed scenario—and their governments have appointed independent central bankers before transparency and accountability have been established.

Economic transparency

Why have central banks become more transparent about available economic data, models used, and forecasts made—something they resisted for decades? This trend seems to be, to a large extent, a by-product of transparent inflation targets. Due to the presence of shocks and uncertainty about the transmission mechanism (that is, the channels through which the policy affects the targeted variables and the magnitude of their impact), the policymaker's control over inflation is imperfect and the inflation target may be accidentally missed. In order for the government/society to recognise whether missing was a result of unpredictable events, idiosyncratic intentions, or merely a bad job, the central bank continually needs to explain what information comes into its decision making, how it is processed, and what procedures are used to derive a decision. All these transparency arrangement further strengthen accountability in the spirit of the familiar phrase: 'Everything you say may be used against you'.

Furthermore, some countries have implemented a formal procedure in the event of missing a target. For example in the UK the Governor is required, in an 'Open Letter' to the Chancellor of Exchequer, carefully to explain the reasons for missing the target and state what measures will be taken to correct for the situation. Such a procedure seems desirable—especially in countries in which collective decision making prevents a personal accountability arrangement of the RBNZ type—and would arguably be a step toward strengthening the RBA's institutional framework.

Other benefits of economic transparency have been identified. It has been argued that publication of forecasts may guide inflation expectations more accurately and this may help the central bank fine tune the economy. Further, it is widely agreed that economic transparency reduces the public's cost of accessing information and 'monitoring' the central bank. Finally, economic openness commonly (but not always) increases the credibility of the central bank's policy.

Some studies have, however, shown that this credibility benefit may, under some circumstances, be outweighed by a reduction in policy flexibility (the so-called credibility/flexibility trade-off) and lead to higher output volatility. It was also argued that more (too much) information can in fact obscure rather than clarify the policy's intentions—

that is, a distinction has been made between the 'need to know' and the 'need to understand'. Furthermore, it was believed that certain pieces of information could destabilise the markets and increase the volatility of interest rates. Finally, secrecy may be beneficial in some cases as it may shield a 'dependent' central bank from political influence and help gain more autonomy from the government.

In terms of publishing available economic data the RBA does quite well and a great number of statistical time series can be downloaded from its website. The RBA is one of the few central banks that has also disclosed a macroeconomic model used for policy analysis.¹¹ However, in regards to the publication of forecasts the RBA lags behind the Bank of England, Swedish Riksbank, the RBNZ or Banco Central do Brasil. Unlike these central banks that publish detailed forecasts for inflation and output two or more years ahead on a quarterly basis in their inflation reports (for example, using fan charts with probabilities of various scenarios), the RBA only publishes a rough short-term inflation projection in its Statement on Monetary Policy and the Governor's semi-annual testimony to the House of Representatives includes a rough output projection. Importantly, RBA projections are based on the assumption of the policy (official interest rate) being unchanged whereas for example, RBNZ forecasts are conditional on the Bank's future policy, that is, endogenously incorporate intended interest rate changes. The latter approach has been argued superior in terms of the Bank's credibility as it signals that inflation is under the Bank's control rather than an exogenous variable.

Procedural transparency

There exists a lively debate on the desirability of making the voting records and minutes publicly available. It has been argued that the government and the public can then better learn about the competence of each individual board member and only re-elect the high quality ones. Further, such exposure has been believed to lead to more effort being put into decisions which is likely to result in fewer policy mistakes and superior decisions.

The counter-arguments are based on the fact that such disclosure may compromise the independence of the central bank and alter the

incentives of the bankers in a socially undesirable way. This may be why even in countries that are, unlike Australia, transparent about these procedural issues, for example, Japan, the United States, the UK, and Sweden, the minutes are non-attributed. Nevertheless, they are very informative about the arguments used in the decision-making process. As this enhances private agents' understanding and makes their reactions more accurate and predictable, there have been voices in the media and academia that the RBA should join these countries and make its procedures more transparent.

Policy transparency

There is probably little need to convince the reader that prompt announcements of policy decisions and their careful explanations are desirable as they reduce uncertainty and hence have a positive effect on the volume and efficiency of investment.

The RBA follows the current international practice and is prompt in the announcement of its policy decisions. This relatively recent worldwide trend is quite surprising; central banks used to keep interest rates decisions secret until at least the next policy meeting. However, RBA's decisions are only accompanied by an explanation if a change in the cash rate has been made—not if the rate is unchanged. Further, the RBA provides no explicit policy inclination. This is in contrast to the Federal Reserve whose policy statements incorporate a fixed phrase indicating the policy bias or the RBNZ that goes even further and includes a medium-term projection for short-term interest rates in its quarterly report.

Operational transparency

This aspect is analogical to economic transparency in that both attempt better to communicate the central bank's intentions; but it differs in that the signal to the market relates to policy outcomes rather than policy actions.

There exists a large body of literature showing that opacity or 'constructive ambiguity' may be socially beneficial. This happens because the public's asymmetric information about control errors allows the policymaker to exploit the short-run inflation/unemployment trade-off and better stabilise output through little inflation surprises. Alternatively, it has been argued that being truthful

about the high degree of uncertainty that surrounds real-world monetary policy may undermine its credibility. Similarly, some commentators have claimed that the main reason behind operational opacity is simply the reluctance of central banks to admit their errors.

The RBA graphically evaluates to what extent its cash rate target has been met. The Bank, nevertheless, does not provide detailed information on unanticipated disturbances that affect the policy transmission process (except a rough inflation forecast in the Statement). Furthermore, the RBA does not discuss past policy errors and only graphically evaluates how the inflation target has been achieved. This falls short of the Bank of England and Swedish Riksbank that provide a detailed discussion of past policy mistakes.

Conclusion

This article discussed five types of transparency in monetary policymaking and showed that while the views on their desirability have differed greatly (with secrecy often found beneficial), transparency has become the norm.

The trend towards transparency coincided with a general improvement in economic outcomes among industrial countries over the past 15 years, namely an increase in the rate of economic growth and a reduction in the volatility of prices, unemployment, and interest rates. To what extent these improved outcomes have been driven by enhancements in the institutional design of monetary policy and transparency in particular has been a matter of professional debate. Nevertheless, there exists an overwhelming consensus that 'transparency matters'. While the RBA is rather open in most respects, several suggested changes could further enhance the transparency and accountability of its policymaking.

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Endnotes

- ¹ See for example Marvin Goodfriend, 'Monetary Mystique: Secrecy and Central Banking,' *Journal of Monetary Economics*, 1986, 17, 63–92, or William Greider, *Secrets of the Temple: How the Federal Reserve Runs the Country*, 1987, New York: Touchstone.
- ² For all definitions see <http://www.websters-online-dictionary.org/definition/transparent>.
- ³ See for example the quantification in Sylvester C. W. Eijffinger and Petra Geraats, 'How Transparent Are Central Banks?,' *European Journal of Political Economy*, (forthcoming) or Lavan Mahadeva and Gabriel Sterne, *Monetary Frameworks in a Global Context*, 2000, London: Routledge.
- ⁴ The importance of legislating various aspects of policy rather than just announcing them is apparent in for example, 'The Code of Good Practices on Transparency in Monetary and Financial Policies' by the International Monetary Fund, 1999, available at www.imf.org.
- ⁵ The objectives are as follows: (a) the stability of the currency of Australia; (b) the maintenance of full employment in Australia; and (c) the economic prosperity and welfare of the people of Australia (*Reserve Bank Act 1959*, Part II 10(2), Functions of Reserve Bank Board). The prioritisation: 'These objectives allow the Reserve Bank to focus on price (currency) stability while taking account of the implications of monetary policy for activity and, therefore, employment in the short term.' (the *Statement on the Conduct of Monetary Policy*, by the Treasurer and the Reserve Bank Governor (designate), 14 August 1996).
- ⁶ This debate has been very lively even in relation to the central bank of the United States, the Federal Reserve (the Fed), the prime example of a non-inflation targeter. The following plea of former Executive Vice President of the New York Fed Cecchetti expresses the sentiment: '... critics have asked that Mr Greenspan and his colleagues to give us a clearer sense of what their objectives really are. We are happy to leave them alone to do their jobs; we just want to understand some of the details of what that job is. Would it really do that much harm to the policymaking process if the Fed were to announce a medium-term numerical inflation objective?' (Stephen Cecchetti, 'The Pitfalls in the Practice of Inflation Targeting,' *Occasional Essays on Current Policy Issues*, 29, 2003).
- ⁷ For example in Stephen Bell, *Australia's Money Mandarins: The Reserve Bank and the Politics of Money*. New York and Melbourne: Cambridge University Press, 2004. For a discussion and counterarguments see Stephen Kirchner, 'The Mandarins of Martin Place', *Policy*, 20:3, (Spring 2004), 53–56.
- ⁸ The latter possibility drove the arrangements in the 1989 RBNZ Act (for an illuminating account of the developments leading to this Act see the forthcoming book by John Singleton, Arthur Grimes, Gary Hawke and Frank Holmes, *Innovation and Independence: The Reserve Bank of New Zealand 1973–2004*, Auckland: Auckland University Press). To illustrate this point, Don Brash recalls the time he first found out he as the Governor, not the Bank as such, would be accountable for achieving the inflation target and quotes the reasoning of the involved Minister of the time: 'We can't fire the whole Bank. Realistically, we can't even fire the whole Board. But we sure as hell can fire you!' (Don Brash, 'Inflation Targeting 14 Years On,' a speech delivered at the American Economic Association conference, Atlanta, 5 January 2002).
- ⁹ Jan Libich and Andrew Hughes Hallett, 'Central Bank Independence, Accountability, and Transparency: Democratic Complements or Strategic Substitutes?,' Centre for Economic Policy Research, London, CEPR DP 5470.
- ¹⁰ This is in the spirit of Milton Friedman who argued that: 'By far and away the two most important variables in the central banker's loss function are avoiding accountability on the one hand and achieving public prestige on the other' (quoted in Stanley Fischer, 'Rules Versus Discretion in Monetary Policy,' in *Handbook of Monetary Economics. Volume 2*, ed. By B. M. Friedman, and F. H. Hahn. North-Holland and Elsevier Science New York, 1990, 1155–84).
- ¹¹ It was only revealed in the speech of Assistant Governor Glenn Stevens ('The Monetary Policy Process at the RBA', Melbourne, 10 October 2001) that the model published in an RBA discussion paper by Meredith Beechey, Nargis Bharucha, Adam Cagliarini, David Gruen, and Christopher Thompson, 'A Small Model of the Australian Macroeconomy,' *Reserve Bank of Australia Discussion Paper*, 2000–05, is indeed used in the policymaking process.