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The impact of central bank transparency on inflation expectations

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Abstract

We investigate how the link between inflation and inflation expectations alters with increasing transparency. Our motivation stems from the belief that changes in the institutional features or operations of the central bank affect, first and foremost, the way that private agents form their expectations about the future behavior of the central bank and only through them, inflation. To examine the link between inflation and inflation expectations, we apply the framework used by Levin et al. [Levin, A.T., Natalucci, F.M., Piger, J.M., 2004. The macroeconomic effects of inflation targeting. Federal Reserve Bank of St. Louis Review 86, 51–80.] and make use of the recent development of quantitative measures for transparency. We find evidence that transparency helps fixing private sector inflation expectations.

JEL classification: E31; E52; E58
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1. Introduction

In a study undertaken by Blinder (2000) in which a group of central banks and academic economists were asked to rank those features that help, in their view, build credibility in monetary policy, transparency ranked fourth. Although admittedly not very different in terms of scores, central bank transparency was preceded by, “history of honesty”, “central bank independence” and “history of fighting inflation”. Still, transparency has attracted a significant amount of attention in the past two decades, for the following reasons. First, the literature has been very

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concrete about the benefits of making central banks independent from the government. When central banks began to acquire greater autonomy in setting and pursuing their objectives, there was automatically a greater need for accountability. Reasons of democratic legitimacy thus provided a political economy justification for greater transparency. Second, and this time from the point of view of the central bank, the three features deemed more important than transparency in Blinder's survey do not constitute choice variables for the central bank to act upon; they are either the result of its actions or imposed. In that respect, therefore, to the extent that the central bank wishes to help improve its credibility, the level of transparency is the first of these features it can act upon directly. Finally, the establishment of the European System of Central Banks and the creation of the European Central Bank forced policymakers to reconsider the architecture that would help establish credibility.

Despite extensive discussions on the desirability of central bank transparency[1], economic literature does not always arrive at a unique conclusion on this issue. By means of an example, regarding the publication of forecasts produced by central banks, Buiter (1999) and Issing (1999) argue at opposite ends of the spectrum. Buiter argues in favour of their publication, on grounds of accountability, such that the public can evaluate the quality of monetary policy. Issing on the other hand, argues that to the extent that actual policy decisions are not entirely based on these predictions, their publication may be misleading. Similar 'disputes' arise with reference to the publication of the minutes of meetings (and indeed their timing), or on whether decisions should be accompanied by press conferences.

Although transparency is certainly desirable for reasons of accountability, it is not the sole means to enhancing central bank credibility. Inevitably the merits of transparency can only be justified through empirical validation, enabled by the recent development of explicit indices for central bank transparency. Eijffinger and Geraats (2006) (EG) construct an index for nine major central banks based on the five aspects of central bank transparency identified by Geraats (2000) and allow for changes in the index for the period 1998–2002. Other attempts to capture various aspects of central bank transparency include those by Bini-Smaghi and Gros (2001), Siklos (2002), Chortareas et al. (2002) and De Haan et al. (2004). The limited availability of data however, makes the empirical investigation still problematic. Demertzis and Hughes Hallett (in press) calculate correlations between the EG index and the mean and standard deviation of inflation and the output gap and discover that while greater transparency does not affect the averages, it does affect the variability of these magnitudes. While greater transparency is beneficial to inflation, it appears to be detrimental to the output gap (although weak).[2] Using the same index, Geraats et al. (2006) use a Taylor rule type of set-up and show that greater transparency reduces both the level of the short term interest rate (thus increasing flexibility in monetary policy), as well as the long term interest rate, thus enhancing the authorities' reputation.[3]

We will argue in this paper that any change in the institutional features or operations of the central bank affects the way private agents form their expectations about future inflation. We thus attempt to check the effect of greater transparency on the way that expectations are formed, directly. We base our analysis on the work by Levin et al. (2004) who examine the impact of inflation targeting on the way that expectations are formed. They argue that if expectations are

[1] Inter alia Jensen (2002), Faust and Svensson (2002), Geraats (2002), Demertzis and Hughes Hallett (in press). See also van der Cruijsen (2004) for a comprehensive survey.

[2] It is worth noting that the authors of the index appreciate themselves how sensitive these corrections are to changes in the measure of transparency (Eijffinger and Geraats, 2004). It is therefore, difficult to draw conclusions about the empirical relevance of transparency based on such indices.

[3] See also earlier attempts by Chortareas et al. (2003).