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Central Bank forecasts and disclosure policy: Why it pays to be optimistic

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Abstract

In a model with forward-looking behavior, we study disclosure policy when a central bank has private information on the future state of the economy. We find that the effects of advance disclosure depend on the presence of uncertainty about policy targets when the shock occurs. With uncertainty about policy targets, disclosure is harmless to current outcomes, owing to the strong dependence of inflation expectations on policy actions, which induces the central bank to focus exclusively on price stability. If the central bank's targets are common knowledge, disclosure of future shocks impairs stabilization of *current* inflation and output.

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1. Introduction

Over the past several years, many central banks (especially those engaging in inflation targeting) have become more open about releasing their internal forecasts of the state of the economy. In this case, almost all inflation targeting central banks publish their inflation forecasts although some do not publish their output forecasts and nearly all central banks do not announce projections of their interest rate policy path (see Mishkin, 2004 for a detailed discussion). Mishkin

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asks whether being more transparent helps a central bank "to do its job — that is, enable it to conduct monetary policy optimally with an appropriate focus on long-run objectives?", and says that "the answer might well be no."

From the private sector's point of view, publication of central bank forecasts is welcome because for some reasons, central bank forecasts outperform those of the private sector, an indication perhaps of central bank's superior information about the future state of the economy, including the state of shocks affecting economic activity. For instance, in their empirical analysis on differences between commercial and Federal Reserve (Fed for short) forecasts, Romer and Romer (2000) conclude that "the most important finding … is that the Federal Reserve appears to possess information about the *future* state of the economy that is not known to market participants." (p.455), (emphasis ours).[1]

The theoretical literature has explored disclosure of forecasts in the context of a discretionary monetary policy with private information about shocks to *current* inflation and output.[2] The results are usually mixed and depend on whether there is also additional asymmetry regarding the central bank's preferences. Under a perfectly credible monetary policy, it turns out that rationalizing disclosure of forecasts is usually difficult, at least theoretically (Gersbach, 2003; Cukierman, 2001; Jensen, 2000). For instance, in a static setup that features a Lucas-type aggregate supply function, Gersbach (2003) and Cukierman (2001) show that a central bank can improve stabilization policy by withholding its private forecasts of *current* real shocks. Cukierman (2001) finds a similar result using a simplified version of the backward-looking model of Svensson (1997) that features time lags from the policy instrument to policy goals, and when interest rate variability enters the loss function. Crucial here is that, in both transmission mechanisms, what matters is past expectations of current inflation and the public forms expectations before policy decisions are taken.

When there are concerns about the central bank's credibility and private sector expectations respond to central bank actions, the formation of private sector expectations plays a crucial role in determining equilibrium outcomes. Geraats (2001) argues that uncertainty about the inflation target can give rise to credibility concerns. In a two-period framework, Geraats shows that, if the public uses monetary policy actions to infer the unobserved inflation target, there is an incentive for the central bank to invest in reputation in the first period in order to have more flexibility to react to shocks in the second period. This incentive is stronger the more the public knows about current period shocks that the central bank is responding to.[3]

However, in a two-period New-Keynesian framework that features forward-looking expectations, Jensen (2000) shows how releasing forecasts of *current* period shocks distorts stabilization policy, even though it solves the credibility problem arising from overambitious (unobserved) output target. Like Geraats, Jensen assumes that the public observes central bank

[1] In the case of the Federal Reserve, Romer and Romer (2000) discuss some of the reasons for higher quality forecasts, including inside information about future monetary policy, access to official and unofficial data, and enormous devotion of resources.

[2] In the terminology of Geraats (2001), the release of internal forecasts is part of what she calls *economic* transparency. She discusses several aspects of transparency including political (formal goals, numerical targets), economic (data, models, forecasts), operational (control errors, transmission shocks), procedural (minutes of meeting, voting), and policy (statements, inclination).

[3] In a cross-section study using 87 countries Chortareas et al. (2002) find that publication of forecasts reduces average inflation. Geraats and Eijffinger (2004) use time-series data on several aspects of transparency for nine major central banks, based on an index of transparency constructed by Eijffinger and Geraats (2006), and conclude that higher transparency is associated with lower short-term as well as long-term interest rates, thus lending support to the positive reputation effects of releasing forecasts, as was argued in Geraats (2001).

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