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Central Bank transparency in theory and practice ☆

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Abstract

We study the effects of Central Bank transparency on inflation and the output gap. Our intention is to illustrate, with the help of a small analytical model, how an imperfectly transparent Central Bank affects the two main macroeconomic variables, inflation and the output gap. The model tells us that transparency affects the variability of inflation and output but not their average levels. Then we examine the extent to which this conjecture is justified by the index of transparency constructed by Eijffinger and Geraats. Given the limitations of such indices, we only examine the correlations between the index of transparency and the macro variables in question. This analysis shows that the average magnitudes are not affected by transparency but their variability is. In the case of inflation, its variability benefits from the reduction of transparency and about 50% is explained by the variability in the transparency index. The effect on output volatility on the other hand is less clear, and in any case transparency seems to increase it rather than decrease it.

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1. Introduction

Most economists agree that greater transparency in monetary policy is desirable because it allows the private sector to make better – that is, welfare improving – decisions, as well as better informed decisions (Blinder, 1998). But not all agree. Some argue that incomplete transparency is optimal, as the effect on the Central Bank's reputation and its consequent ability to control inflation has to be balanced against the private sector's wish to see output, employment and prices stabilised (see for example Faust and Svensson, 2001 or Jensen, 2002). Others argue that certain restrictions on transparency are important for operational reasons. Once again the idea is to reinforce the Bank's credibility (see Eijffinger and Hoeberichts, 2002) and to separate 'the need to know' from 'the need to understand' (Issing, 1999).

In practice, many Central Banks have actually increased their transparency in recent years – using inflation forecasts, extensive explanations of the reasoning behind their decisions, and sometimes voting records on policy decisions or a discussion of the 'bias' in those decisions, to do so. Prominent examples are found in the Federal Reserve System in the US; but also in the Bank of England and the Central Banks of Canada, New Zealand and Sweden. Yet, on the basis of casual empiricism or circumstantial evidence, one cannot tell whether greater transparency has actually made any material difference to the policies chosen – or more exactly, to the impact and effectiveness of those policies. Nor is it possible to determine exactly what kinds of effects one should expect, in terms of average inflation, output performance and the stability of these indicators. Our purpose in this paper is therefore to determine what effects a lack of Central Bank transparency should be expected to have on monetary policies and what impact that would have on the economy.

The main problem is that transparency has many different dimensions, and may mean different things to different people (Eijffinger and Geraats, 2002). Kuttner and Posen (2000) list a number of characteristics thought necessary for institutional transparency. These are: (1) a numerical goal for monetary policy, (2) an inflation report, explaining the expected effects of changes in monetary policy, (3) an inflation forecast (plus assumptions) explaining why those changes were necessary and, (4) a post-mortem evaluation of past policies and their achievements.

These attributes cover both the information content as well as the way in which that information has been used. That distinction is important, but is seldom made.[2] This distinction itself relates directly to the potential for conflict between the ability to control and the need for transparency. As a result, many commentators reach opposite conclusions about the need for transparency. Kuttner and Posen (1999) argue that it enhances the Central Bank's ability to use discretionary policies, while Faust and Svensson (2002) argue the opposite (although for particular circumstances). In fact, both sets of authors agree that transparency will reduce the noise and the imprecision in the private sector's decision mak-

[2] See the discussions in Friedman (1997) or Bomfin and Reinhart (2000).