European Journal of Political Economy 26 (2010) 506–516

Contents lists available at ScienceDirect

European Journal of Political Economy

journal homepage: www.elsevier.com/locate/ejpe

Macroeconomic shocks, unionized labour markets and central bank disclosure policy: How beneficial is increased transparency?

Jonathan G. James, Phillip Lawler *

School of Business and Economics, Swansea University, Singleton Park, Swansea, SA2 8PP, UK.

ARTICLE INFO

Article history:
Received 24 July 2008
Received in revised form 24 March 2010
Accepted 17 April 2010
Available online 22 April 2010

JEL Classification:
E58
J51

Keywords:
Central bank
Information quality
Union wage setting

ABSTRACT

The paper investigates the implications of disclosure by the central bank to the private sector of information relating to the current realizations of macroeconomic disturbances. In the context of an economy in which the goods market is monopolistically competitive and where wages are set by atomistic unions, we find that greater precision of information provided to wage setters in respect of supply shocks has ambiguous welfare effects, both from the perspective of the social loss function and from the viewpoint of unions who act on the information. An important feature of the model is an externality in union wage setting which implies the outcome of the wage determination process is collectively inefficient.

1. Introduction

One of the most significant trends in the conduct of monetary policy over recent years has been the move towards greater transparency by the world's central banks. It is now the norm to find information relating to central bank objectives, operating procedures and decision-making processes all placed within the public domain. In part, this drive towards increased transparency can be explained in terms of the parallel shift to greater central bank independence and the need, in this context, to ensure continued accountability of monetary policy institutions to government and the wider public. Additionally, though, fuller disclosure of central bank goals and the factors underlying its policy decisions, in particular its assessment of the current and likely future state of the economy, is argued by many to enhance the efficacy of monetary policy and, hence, to aid the central bank in pursuit of its objectives: see Blinder et al. (2001) for a clear statement of this view.

Although this latter motivation for openness in policymaking may hold an immediate appeal, existing theoretical models appear to provide a less than unequivocal endorsement of its general validity. The ambiguous welfare effects of increased transparency are a key finding of Cukierman and Meltzer's (1986) influential study[1], and this theme is present in a range of papers which examine different dimensions of the issue: see, for example: Eijffinger et al. (2000); Grüner (2002); and Jensen (2002). A review of the relevant literature and a clear analysis of the conflicting forces which may arise as a consequence of greater transparency in monetary policy are presented in Geraats' (2002) comprehensive overview.[2] More recent contributions to the transparency literature are considered in the surveys of Cruijsen and Eijffinger (2007) and Blinder et al. (2008).

* Corresponding author. Tel.: +44 1792 602 104; fax: +44 1792 295 872.
E-mail address: p.lawler@swansea.ac.uk (P. Lawler).

[1] Though we note that Faust and Svensson's (2001, 2002) refinement of their approach gives somewhat more definite support to the notion that greater transparency is beneficial.

[2] See also de Haan et al. (2007) for a concise assessment of the key issues.

0176-2680/$ – see front matter
doi:10.1016/j.ejpoleco.2010.04.002

While the literature on central bank transparency has considered the issue from a variety of perspectives, a feature which is common to much of it is the central role played by the stabilization function of monetary policy, with the realized values of exogenous shocks, or alternatively their forecast values, assumed to be private information of the central bank. The latter assumption, a standard feature of much monetary policy analysis, raises the question of the extent to which it is desirable for the central bank to disclose its information regarding shocks to the private sector. This issue relates to the desirability of *economic*[3] transparency, as defined by Geraats (2002), and lies at the centre of a number of contributions. Several of these explore the relationship between transparency concerning shocks and central bank credibility using models which assume some uncertainty on the part of the private sector regarding central bank objectives. Jensen (2000) and Eijffinger and Tesfaselassie (2007), for example, investigate the welfare consequences of disclosure by the central bank of its information regarding cost-push shocks, when firms' pricing decisions depend upon their expectations of future (rather than current-period) inflation, and the economy is consequently characterized by a New Keynesian Phillips curve.[4] Jensen finds disclosure of *current*-period shocks induces an adjustment in expectations of future inflation which compromises the central bank's ability to stabilize the shocks' current impact, and therefore lowers welfare if the central bank's credibility is sufficiently high (and the mean inflation bias correspondingly low). Eijffinger and Tesfaselassie, focusing instead on disclosures of *future* shocks, confirm that in general Jensen's anti-transparency conclusions also apply to scenarios in which the central bank is known not to have an output-related temptation to create inflation (i.e. enjoys high credibility).[5] Reflecting the different economic structure assumed, Geraats' (2005) study, in contrast, finds a result which is more favourable to economic transparency: in her model disclosures of central bank forecasts of shocks may enhance welfare by allowing the interest rate to signal more clearly a resolve on the part of the central bank to fight inflation.

Unlike the three aforementioned works, the papers by Cukierman (2001) and Gersbach (2003) abstract from reputational considerations by assuming the private sector to have complete knowledge of central bank objectives, and focus on the direct consequences of disclosure for private sector expectations and the resulting output and employment outcomes. The common approach adopted in these two contributions leads to an identical and unequivocal result. Specifically, they find that increased transparency in respect of supply shocks is associated with greater instability in output and employment and consequently, given the standard specification of the social loss function employed, has an unambiguously detrimental effect on welfare.

Because the present paper shares a common focus with the contributions of Cukierman and Gersbach, it is useful to identify the economic logic which underlies their finding. Both studies assume aggregate employment, l, to be determined by a relationship of the form: $l=a(\pi-\pi^e)+\theta$, where π and π^e are, respectively, actual and expected inflation, while θ represents a random supply shock. In this context, so long as θ remains the private information of the central bank, the latter can adjust actual inflation relative to expected inflation in such a fashion as to offset the impact of the shock on employment. However, if the value of θ is disclosed to the public, knowledge of central bank objectives allows the policy response of the central bank to be fully anticipated. Consequently actual inflation will not diverge from its expected value, and non-zero realizations of θ are reflected fully in movements in employment.

A potential limitation of the foregoing argument derives from the augmented Phillips curve relationship which underlies it. In particular, the latter's specification precludes any private sector response to anticipated supply shocks other than that working indirectly through inflation expectations. This implication of the employment-determination equation appears unduly restrictive, and it is certainly possible to conceive of structural underpinnings for the relationship which imply a direct private sector reaction (i.e. additional to that associated with expected inflation) to anticipated shocks.

The present paper develops this argument using a model of an economy in which wages are set by atomistic unions and where the product market is modelled as monopolistically competitive, though capturing perfect competition as a limiting case. Whilst a substantial body of work examining the interaction between monetary policy and union wage setting has evolved over recent years,[6] as Geraats (2002) indicates this literature has to date paid little attention to the particular issue of central bank transparency. Within the framework, the realized values of the supply shocks to which the economy is subject are the private information of the central bank, to which it can respond in terms of its setting of monetary policy. However, prior to the setting of wages, the central bank can supply a potentially noisy signal of the shock's value to unions. In this context, we associate transparency with the degree of accuracy of the signal: our interest then lies in the relationship between signal precision and welfare outcomes, as reflected in the expected values of the union and social losses.

A key aspect of the analysis is the specification of union objectives, which relate to both employment and the real wage. Given its expectation of the supply shock, conditional on the signal provided by the central bank, each union will set its nominal wage with the aim of attaining the optimal trade-off between employment and real wage stability. Thus, the aggregate nominal wage

[3] 'Economic' transparency in Geraats' taxonomy refers to central bank disclosure of the macrodata at its own disposal: an alternative focus for much of the literature is 'political' transparency, relating to openness about central bank objectives and the consequent nature of the central bank reaction function. (For a recent discussion using Geraats' classification, see Crowe and Meade, 2008.)

[4] Hoeberichts et al. (2009) employ a similar framework to analyze the implications of noisy central bank disclosures of its assessment of private sector expectations of the output gap. Tarkka and Mayes (1999) and Evans and Honkapohja (2003) consider related issues.

[5] Eijffinger and Tesfaselassie also confirm that Jensen's result holds when the central bank does have a temptation to inflate, but its future-period preferences are known with certainty. The only situation for which they find economic transparency does not have adverse consequences is that in which the private sector is ignorant of the central bank's future preferences. When considered in relation to the general tenor of their findings, this particular result appears to provide only limited support for economic transparency.

[6] A significant portion of this work is concerned with the interaction between monetary policy and strategic wage setting by non-atomistic unions: see, for example: Skott (1997), Lawler (2000), Acocella and Di Bartolomeo (2004), Coricelli *et al.* (2006), and Bratsiotis (2008). In the Appendix to this paper, available from the authors on request, we briefly note the implications of allowing for strategic behaviour by a finite number of unions.