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Central bank communication and its role in ensuring financial stability

Ioana-Iuliana Tomuleasa*

Alexandru Ioan Cuza University of Iasi, Carol I Bvd., Iasi, 700505, Romania

Abstract

An ongoing challenge for central banks is represented by communication policy paradox, which involves the effectiveness of monetary policy strategies in pursuing financial stability. The communication paradox captures the idea that an increasing level of communication and transparency of central banks, along with more efficient economic policies will lead to a higher level of financial stability. The paper aims to outline the communication policy significant implication on the effectiveness of monetary policy, starting with a qualitative approach and continuing with an empirical analysis based on the example of four central banks, namely BOJ, ECB, FED and NBR.

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Keywords: monetary policy, communication, transparency, financial stability, global financial crisis

1. Introduction

Amid deepening economic and financial turmoil, which started in the summer of 2007 in the U.S. real estate market, through major disruptions in the financial markets and real economy, central banks have acted to restore the "health" of the financial system, giving priority to financial stability objective.

* Ioana-Iuliana Tomuleasa. Tel.: +40-742-117-460.
*E-mail address:*iulianatomuleasa@yahoo.com

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A key aspect in the adoption and implementation of monetary policy decisions was and still is communication policy. A notable change in central banks strategy in the recent years has been the movement towards a progressive communication of monetary policy decisions, of the main objectives that central banks pursue and also their projection regarding future developments in the economy, by these enhancing central banks actions.

Central banks, although they used to be really reserved, they communicate much more about monetary policy issues, especially because of the pressures from the recent financial crisis.

The paper is structured in five parts and it begins with a short incursion in the theme and its importance. The second part reviews some concepts regarding communication policy and the binomial monetary policy-financial stability. In the third part it was highlighted the role of central banks in ensuring financial stability in the current global crisis, including and comparative analysis and also an empirical one. The fourth part surprises some lessons draw from the current crisis and the challenges that revolve around the financial system.

The study ends with a summary conclusion.

2. Literature review

In the previous period, central banks used to be very reserved in the information disclosure, being accused of a lack of clarity and transparency, the communication policy being linked to phrases such as “esoteric art”, “secret of the temple”, “monetary mystic” or “constructive ambiguity”, being elevated as a desire the following reasoning: the effectiveness of monetary policy is directly proportional to the monetary policy shocks (the information is provided by surprising market actors) (Brunner, 1981).

Over time, it has been noticed a process of transformation, which can be based on the fact that if the monetary authorities are more open to general public, there could be registered an increasing level of monetary policy effectiveness, so the actions provide a link between long-term and short-term interest rates. In this regard, an increase of the predictability of central banks actions can lead to a more effective management of monetary policy, or the economy as a whole. For example, in the vision of the economist Woodford, the success of monetary policy is not guaranteed just by controlling short-term interest rates, but also by influencing market expectations in the desired direction (Woodford, 2005).

Also, after acquiring central bank independence by removing political interference factor, it was induced also the increasing level of accountability of monetary authorities, which involved a shift towards a greater transparency of monetary policy.

Currently, central banks' ability to influence the real economy depends to a significant extent on their competence with respect to the market expectations on the future evolution of the interest rates. A comprehensive set of current policies and also future ones for the general public is crucial for the effectiveness of monetary policy. In this respect, it is considered that monetary policy becomes gradually the art of managing expectations (Haan et al., 2009).

Arguments in favour of a strong communication are:

- Increasing monetary policy efficiency;
- Increasing the predictability of central banks actions;
- Increasing the central banks’ independence.

Through a wide communication policy, it’s imposed an increased transparency, so the central bank will provide to market actors its own vision regarding the fundamental factors that guides monetary policy, leading to the creation of a virtuous cycle (Blinder, 2006). More precisely, transparency allows the increase of monetary policy effectiveness by amplifying its credibility, by means of a growing responsibility and self-discipline and also improves the monetary policy anticipations on a medium term.

Central banks’ transparency is seen as an ingredient of good practice in term of monetary policy, so it is considered necessary not only because enhances democratic responsibility but also because it promotes an efficient control of public's expectations regarding the bank (Cukierman, 2007). If we consider the arguments regarding the monetary authorities secret actions, in the paper Monetary Mystique: Secrecy and Central Banking, we can find the following reasons: the braking of speculative gains, the avoidance of assuming by FOMC an unwanted previous engagement, the conservation of central banks’ capacity to intervene on interest rate according to the principle of gradualism and others (Goodfriend, 1985). Currently, a possible justification of the secrecy maintenance concerning