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Optimal central bank transparency☆

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A B S T R A C T

Should central banks increase their degree of transparency any further? We show that there is likely to be an optimal intermediate degree of central bank transparency. Up to this optimum more transparency is desirable: it improves the quality of private sector inflation forecasts. But beyond the optimum people might: (1) start to attach too much weight to the conditionality of their forecasts, and/or (2) get confused by the large and increasing amount of information they receive. This deteriorates the (perceived) quality of private sector inflation forecasts. As a result, inflation is set in a more backward looking manner resulting in higher inflation persistence. By using a large scale panel data set on the transparency of central banks we find empirical support for an optimal intermediate degree of transparency at which inflation persistence is minimized. Our results indicate that while several central banks would benefit from further transparency increases, some already have reached the optimal level.

1. Introduction

Only a few decades ago monetary policy making was veiled in secrecy. In 1986 Goodfriend, summarized the arguments for secrecy that were used by the US Federal Reserve (Fed) in the Merrill

☆ Views expressed are our own and do not necessarily reflect those of the institutions we are affiliated with.

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versus FOMC court case. It encouraged further research on the desirability of secrecy because the theoretical arguments were inconclusive. Nowadays, central banks have made several steps towards transparent monetary policy regimes and they pay a lot of attention to day-to-day communication with the financial markets and the public at large.

Central banks are likely to continue their transparency enhancing practices. Last year, the executive board of the Swedish Riksbank decided that voting records will be published at the same time as the monetary policy decision and not with a delay of a few weeks. A quite recent step of the Fed has been to increase and expand the content of the disclosed economic forecasts of the Federal Reserve Board members and the Reserve Bank presidents. Bernanke's comments on this move point out that these transparency changes:

> "…*represent just one more step on the road toward greater transparency at the Federal Reserve*." (Bernanke, November 14th 2007).

Not only is transparency used as a tool for independent central banks to be held accountable, it is often argued that transparency is also desirable from an economic point of view. Policymakers and researchers have discussed the possible economic effects of central bank transparency. Theoretically, the debate on the desirability of transparency is a continuing story, although the more recent literature yields outcomes in favor of more transparency. Most empirical studies conclude that previous transparency enhancements have been desirable from an economic standpoint. For example, they have resulted in improved anticipation of monetary policy and better anchored inflation expectations (van der Cruijsen and Demertzis, 2007). For a recent overview of the transparency literature we refer to van der Cruijsen and Eijffinger (2010b).

We investigate whether it is desirable for central banks to increase their degree of transparency any further. We use two theoretical arguments in the transparency debate (uncertainty and confusion/information overload) to substantiate our case for the presence of an optimal intermediate degree of transparency. To our knowledge the empirical research on an optimal degree of central bank transparency has just started and focusses on analyzing the effects of particular aspects of transparency instead of the overall level. It shows us that most forms of transparency lead to better economic outcomes while some forms do not. Therefore it seems to be optimal to have an intermediate degree of transparency by limiting some forms of transparency. For example, Ehrmann and Fratzscher (2009b) demonstrate that limiting the communication in the week before Federal Open Market Committee meetings is a useful way to prevent market volatility and speculation. While the previous theoretical literature makes a case for or against *one particular* form of transparency, e.g. the publication of the goals of the central bank or the central bank's forecasts of inflation, our analysis is about the optimal degree of *overall* monetary policy transparency.

We relate central bank transparency to the quality of private sector forecasts. At low degrees of transparency, more information provision (e.g. about the complexity of monetary policy making and the conditionality of policy and economic forecasts) might be desirable because it could improve the private sector's forecasts of inflation. However, at some degree of transparency more transparency might be detrimental because it could worsen these forecasts. We argue that for two reasons this is likely to hold.

The first reason is that a lot of transparency could lead to *uncertainty*. By providing too much information, people start to focus too much on the complexity of monetary policy making and the uncertainty surrounding forecasts. While the actual quality of their forecasts might not be affected, agents perceive the quality of their forecasts to be worse.

The second reason is that a high degree of transparency could lead to an *information overload* and *confusion*. The assumption that individuals are capable to absorb, understand, and weigh all the information that the central bank provides is probably too strong. Although some degree of transparency might help clarify matters, it is likely that a large amount of information disclosure would result in an information overload and confusion. At some level of transparency agents can not see the forest for the trees, which is detrimental for the quality of their inflation forecasts.

Since the (perceived) quality of inflation forecasts is difficult to measure we use inflation persistence instead. Price setters are more inclined to determine price increases based on past inflation when they can not rely on their forecasts of future inflation. We use a New Keynesian model to illustrate that the