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The design and communication of systematic monetary policy strategies☆

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ABSTRACT

The efficacy of central bank communications is inextricably linked to the characteristics of the monetary policy framework. Therefore, this paper presents a set of fundamental principles regarding the joint design of monetary policy strategy and communications. The practical implications of these principles are illustrated by considering a number of significant policy challenges faced by central banks in the advanced economies.

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1. Introduction

Over the past two decades, central banks around the world have made tremendous strides in clarifying their monetary policy communications. Indeed, while many other aspects of monetary policymaking remain controversial, economists have reached a broad consensus regarding the strong rationale for clarity about the central bank's policy framework, that is, its longer-run goals and strategy, its assessments of the economic outlook, and its judgments about the appropriate path of policy.[1] In large part, the breadth of this consensus is a reflection of two distinct benefits:

- Clarity about the monetary policy framework bolsters the effectiveness of the *monetary transmission mechanism* by enhancing the private sector's understanding of how the stance of policy is likely to evolve in response to changes in economic and financial conditions.

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[1] See Blinder et al. (2009) and Yellen (2013).

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- Transparency about monetary policy is essential for maintaining the central bank's *operational independence* in a context of public accountability, thereby enabling its policy decisions to remain insulated from short-term political pressures.

Economic and financial developments in recent years have broadly confirmed the importance of clear central bank communications and in many instances have also underscored the scope for significant further improvements.

In contemplating these issues, it is essential to recognize that the efficacy of central bank communications is inextricably linked to the characteristics of the monetary policy framework. Therefore, this paper presents a set of fundamental principles regarding the *joint design of monetary policy strategy and communications*. These principles are framed in terms that are likely to be relevant for a wide array of central banks, including those of emerging markets and low-income countries. For the sake of brevity, however, the practical implications of these principles are generally illustrated using current policy challenges facing central banks in advanced economies. It should also be emphasized that such examples are solely for illustrative purposes and *not* intended to provide any definitive policy recommendations.

In particular, simple monetary policy rules can serve as valuable benchmarks for central banks in the decision-making process and in explaining those policy decisions to the public.[2] Of course, it would be inadvisable for policymakers to mechanically follow the prescriptions of a rule whose specification has been permanently fixed. However, in circumstances where policymakers judge that the stance of policy should deviate temporarily from the path prescribed by the policy rule, the rationale for doing so should be clearly explained to the public. Moreover, the central bank should maintain a systematic procedure for considering potential adjustments to the specification of its policy rule, recognizing that minor technical adjustments might occasionally be warranted whereas the fundamental characteristics would not be modified unless there were compelling reasons for doing so.

The remainder of the paper is organized as follows: Section 2 lays out several broad principles regarding monetary policy strategy and communications. Section 3 considers the framing of the central bank's inflation objective. Section 4 discusses the central bank's assessments of resource slack. Section 5 analyzes the use of simple policy rules as benchmarks. Section 6 considers the merits and limitations of specific communication tools. Section 7 concludes.

2. Some general principles

Central bank communications contribute to economic prosperity by facilitating well-informed decisions of households and businesses and by reducing economic and financial uncertainties. Clear communications also enhance the effectiveness of the monetary transmission mechanism by helping financial market participants and the general public understands how the stance of policy is likely to evolve in response to changes in economic and financial conditions. In recent decades, economists have also arrived at a broad consensus regarding the importance of insulating monetary policy decisions from short-term political pressures. However, the central bank's operational independence is only sustainable if the government provides a clear legal mandate regarding its policy objectives and instruments and then holds the central bank accountable over time for fulfilling that mandate. Consequently, enhancing the transparency of the central bank's policy framework and communicating clearly about the rationale for its specific policy decisions facilitate accountability to the general public and thereby reinforce the central bank's operational independence.[3]

> ⇒ *Provide regular communications regarding the central bank's assessments of the balance of risks to the economic outlook and contingency plans for mitigating and addressing such risks.*

Forecasters at many central banks and in the private sector have tended to focus on providing precise assessments of the modal outlook rather than on gauging the evolution of the balance of risks. Scenario analysis is a valuable tool for examining key risks and formulating contingency plans aimed at mitigating such risks. In effect, it may be beneficial for central banks to conduct and publish stress tests for monetary policy, analogous to the stress testing that is becoming standard practice for private financial institutions.

> ⇒ *Communicate clearly about the central bank's plans for adjusting the specific instruments that will be used in implementing its policy strategy over time.*

The central bank may be able to deploy a number of distinct monetary policy instruments, depending on its legal mandate and on the characteristics of the domestic financial system. For example, such tools may include direct lending to financial institutions, payment of interest on reserves, and transactions in publicly traded securities or foreign exchange. Thus, clarity about the central bank's monetary policy framework necessarily involves transparency about its choice of instruments, including its assessments of their efficacy, costs, and risks. There are also substantial benefits of clarifying the central bank's judgments regarding the appropriate path of policy as well as the conditions that could warrant significant adjustments to that path.[4]

[2] See Taylor and Williams (2010) for further analysis and discussion.

[3] Indeed, in his remarks at last December's official commemoration of the Federal Reserve's centennial, then-Chairman Bernanke (2013) stated: “Ultimately, however, the most important reason for transparency and clear communication is to help ensure the accountability of our independent institution to the American people and their elected representatives.” See also Bernanke (2007) and Kohn (2014).

[4] See Gurkaynak et al. (2005), Swanson and Williams (2014), Stein (2014), and Yellen (2011, 2014).