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CENTRAL BANK COMMUNICATIONS[‡]

Through a Crystal Ball Darkly: The Future of Monetary Policy Communication[†]

By Alan S. Blinder*

"It's tough to make predictions, especially about the future" is one of my favorite pieces of Yogi Berra wisdom. Yes, it is tough, but I am going to try nonetheless, hedging my bets as appropriate because crystal balls are notoriously cloudy. And these predictions, mind you, cover the next few years, not the next few decades. No one can see that far ahead. I begin with:

I. Prediction #1

Transparency about Monetary Policy will Increase Over Time

I feel confident in predicting this as a generic statement, although the pace and details will vary from one central bank to the next. After all, some are extremely transparent already, while others are less so. But virtually all central banks have been moving in one direction in recent decades—toward greater openness—and I do not believe that process is over. This prediction derives in part from pretty strong historical evidence that transparency is a one-way street: Once a central bank moves toward greater transparency in some dimension, it never reverts back to its old, less-transparent ways.

Here is one new piece of evidence. Three coauthors and I recently conducted a survey of central bankers (Blinder et al. 2017), asking them a variety of questions about how monetary policy did or did not change during and after the financial crisis. Among the questions was:

> *Once conditions return to normal, do you think forward guidance about future monetary policy should remain a potential instrument of monetary policy, remain an instrument but in modified form, be discontinued, or that it is too early to judge?*

Remember, the very idea of forward guidance was rejected by most central banks outside of New Zealand for years and became common only as an emergency measure during the crisis. So you might imagine that the attractiveness of forward guidance would wane as the crisis retreats into history. But no. The central bankers' answers were:

Remain a potential instrument:	59%
Remain, but in modified form:	13%
Be discontinued:	0%
Too early to judge:	28%

While 28 percent reserved judgment, it is remarkable that not a single central banker thought forward guidance should be discontinued.[1]

My second prediction is made with far less confidence because it is about future interest rates. (Yogi, please forgive me.)

[‡]*Discussants:* Ricardo Reis, London School of Economics; Michael Ehrmann, European Central Bank; Refet Gurkaynak, Bilkent University.

*Department of Economics, Princeton University, 284 Julis Romo Rabinowitz Building, Princeton, NJ 08544 (email: blinder@princeton.edu). I thank Princeton's Griswold Center for Economic Policy Studies for its support of my research over the years.

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[1] A parallel survey asked economists, most of whom were academics, the same question. Among the academics, only 4 percent thought it was too early to judge and 9 percent thought forward guidance should be discontinued.

II. Prediction #2

Over the next n years, central banks will encounter the effective lower bound (ELB) *on short-term nominal interest rates more frequently than they did in the n years prior to the financial crisis*. (*You can choose your own n*.)

This forecast is relevant to monetary policy communication because forward guidance is one of the main unconventional tools a number of central banks adopted *after* encountering the ELB. (The other is quantitative easing.) Before that, the canonical belief was that (i) refusing to give forward-looking information was part of proper central banking practice and (ii) they did not need forward guidance for monetary control anyway. But with *average* nominal interest rates during, say, the next quarter century very likely to be below the average over, say, 1983–2008, and with recessions not banished, central banks seem highly likely to encounter the ELB more in the future than they did in the past (Kiley and Roberts 2017). They will therefore need to deploy unconventional monetary policies more often; and one of those unconventional policies will be forward guidance. This observation leads naturally to my third prediction.

III. Prediction #3

Forward guidance is now an instrument of monetary policy.

Forward guidance, as practiced during and after the crisis, changed the nature and purpose of central bank communication. Traditionally, greater communication was seen as a way to tighten the link between the overnight nominal interest rate (which the central bank controls) and the medium- and long-term interest rates that matter for saving and investment decisions (Blinder 1998; Bernanke 2004). The idea was to use central bank talk to move the whole yield curve up or down. But doing that became impossible once short rates hit their ELBs. Hence a new idea was born: use forward guidance to flatten the yield curve, that is, to pull medium- and long-term interest rates down even though the short rate is stuck at the ELB. Communication thus morphed from a facilitator of conventional monetary policy into a new policy instrument in its own right. As Ben Bernanke (2015) colorfully put it, "monetary policy is 98 percent talk and only two percent action." Paul Volcker would never have said that.

I believe central bank talk will continue as a policy instrument in the future, despite what I like to call *The Great Embarrassment*. The what?

Conceptually, forward guidance relies on the expectations theory of the term structure. A central bank moves medium and long rates by moving *expectations* of future short rates. But as we all know, the expectations theory with rational expectations is an abysmal empirical failure. The theory has been tested many times, on different combinations of interest rates, in different countries and different time periods, and almost always gets rejected by the data.[2] Yet academics, market participants, and central bankers alike treat the naked emperor as if he were smartly clothed–and keep on using the expectations theory. That is the Great Embarrassment.

I leave it as an open question whether the theory's abject failure stems from the expectations mechanism itself or from the assumption of rational expectations—though I cannot resist observing that rational expectations typically fails when tested directly on expectational data.[3] The important point for present purposes is simpler: Since the expectations theory with rational expectations fails miserably as an empirical matter, we have no valid empirical reason to believe that forward guidance should work in practice. Yet we believe it does.

The eighteenth century philosopher George Berkeley allegedly asked whether a tree falling in a forest actually makes a sound, if there is no one around to hear it. Let us leave that one to the philosophers. A simpler statement that requires no philosophical debate is that communication requires both a *sender* and a *receiver.* If a central bank sends a message, but no one pays attention, there is no communication. So who is the intended audience for central bank communications about monetary policy? I venture to add this fourth prediction.

[2] See, for example, several of the references cited in Sarno, Thornton, and Valente (2007)

[3] Gennaioli, Ma, and Shleifer (2016) contains many references.

IV. Prediction #4

Central banks will keep trying to communicate with the general public, as they should. But for the most part, they will fail.

Many economic models presume that central bank communication is aimed at wage-setters, price-setters, consumers, or investors—maybe all of them. But are they listening? A recent paper by Kumar et al. (2015) suggests they are not. The authors studied survey results on inflation expectations and knowledge of monetary policy among (mostly small) business managers in New Zealand, the country where inflation targeting has been practiced longer than anywhere else. They found not only huge cross-sectional variance in expected inflation rates, but also that inflation expectations were not at all anchored around the Reserve Bank of New Zealand's (RBNZ) widely-publicized target. In short, business managers apparently had not *received* the messages that the RBNZ had sent over and over again. Or maybe they just did not *believe* the messages, which is almost the same thing.

Who *did* receive the central bank's messages? Well, monetary policy experts and RBNZ watchers, of course. Thus, much as we may believe that an independent central bank in a democracy *should* communicate with the citizenry, only a tiny fraction of the citizenry will tune in. As I said in discussing the Kumar et al. (2015) paper, "it reminds us that most people are not obsessed about the central bank; as the authors note, they would rather watch puppies on YouTube."[4]

This point may seem obvious, and perhaps it is. But it does color the details of how a central bank talks about monetary policy. You speak one way if you are addressing experts who understand the jargon and dote on every word, quite another if you are talking to members of the broad public who lack both expertise and interest and who are half-listening at best. I am a big believer in democratic accountability, which requires communicating with the broad public. But in truth, the part of central bank communication that matters most is the way policymakers communicate with markets—and for a simple reason: market participants listen.

[4] Blinder (2015, p. 209)

V. Prediction #5

Forward guidance is and will remain about prediction, not commitment.

Academic models of central bank communication often portray forward guidance as a commitment device to help policymakers overcome the time inconsistency conundrum.[5] In the terminology of Campbell et al. (2012), central bank communication is modeled as Odyssean (like tying yourself to the mast) rather than Delphic (making oracular proclamations).

Though attractive to game theorists, I believe the commitment view is wrong as a matter of history. Furthermore, it will continue to be wrong going forward because central bankers do not like to tie themselves to masts or to anything else. Instead, the main purpose of communication about monetary policy is to influence market expectations by *forecasting its own behavior*, not to *pre-commit* policymakers to any future course of action. It is about prediction—and highly *conditional* prediction at that.

The adjective, "conditional," is crucial—and problematic—here. Ever since the RBNZ started publishing "forward tracks" in 1997, central banks have emphasized the conditional nature of their interest-rate projections: "We will do this only if x, y, and z happen (or don't happen)." But it is impossible for a central bank to spell out at time t *all* the conditions that might be relevant to its monetary policy decision at time $t + j$. Even attempting to do so would produce a long list that might well confuse market participants more than enlighten them. KISS is an essential principle when dealing with traders, who seem incapable of entertaining more than one thought at a time.

A telling Federal Reserve example arose in December 2012, when the Federal Open Market Committee (FOMC) adopted the "Evans approach" to forward guidance with these words:

> *the Committee … currently anticipates that [the near-zero interest rate] will be appropriate at least as long as the unemployment rate remains above 6–1/2 percent, inflation between one and two years ahead is projected to be no more than a half*

[5] For one well-known example, see Eggertsson and Woodford (2003).

percentage point above the Committee's 2 percent longer-run goal, and longer-term inflation expectations continue to be well anchored. … the Committee will also consider other information, including additional measures of labor market conditions, indicators of inflation pressures and inflation expectations, and readings on financial developments.[6]

Notice a few things about this carefully-crafted statement. First, the Committee enunciated three criteria for staying at "zero," two of them with numerical precision: Unemployment must stay above 6.5 percent, inflation cannot go higher than 2.5 percent, and inflation expectations must remain "well anchored" (presumably near 2 percent). Second, in addition to these three variables, "other information" from labor markets, financial markets, and elsewhere would be relevant to the Fed's "lift-off" decision. Finally, the important words "at least as long" indicated that unemployment dropping below 6.5 percent would not necessarily trigger a rate hike. It was a necessary, but not a sufficient condition. All that added up to pretty complicated conditionality.

Too complicated, it turned out. Before long, traders had translated this careful, complex message into an overly-simple, and hence inaccurate, one: The Fed would begin to raise rates as soon as the unemployment rate dipped below 6.5 percent. Period. The FOMC was unhappy about this (mis)translation of its intent and abandoned the Evans approach at its March 2014 meeting. (The unemployment rate was then 6.7 percent and falling.) Since then, the FOMC has kept its conditionality vague. For example, the most recent statement "looks forward" in this way:

The Committee expects that economic conditions will evolve in a manner that will warrant gradual increases in the federal funds rate; the federal funds rate is likely to remain, for some time, below levels that are expected to prevail in the longer run. However, the actual path of the federal funds rate will depend on the economic outlook as informed by incoming data.[7]

[6] https://www.federalreserve.gov/newsevents/pressreleases/monetary20121212a.htm.

[7] https://www.federalreserve.gov/monetarypolicy/files/monetary20171213a1.pdf.

Try translating that into a number, or even into a simple set of inequalities.

VI. Prediction #6

The cacophony problem on monetary policy committees will not go away soon.

Finally, let me address the cacophony problem that bedevils some monetary policy committees (MPC). Central banks (or any organizations) with multiple decision-makers are bound to encounter disagreements now and then. And when the macroeconomic or financial backdrop to monetary policy is complex or ambiguous, such disagreements are apt to be common. Under such circumstances, how does a central bank talk if it wishes to communicate effectively and honestly? As I have observed before (Blinder 2004), a central bank that speaks with too many voices may, in effect, have no voice at all.

Cacophony is one of those problems central bankers must strive to *manage* rather than to *solve.* If there are serious disagreements on an MPC, hiding them is an obvious violation of transparency. Doing so may also conceal market-relevant information, since today's minority opinion may signal tomorrow's policy direction. The name of the game, conceptually, is to maximize the ratio of signal to noise. The question is how, in practice, to do that.

It is a relatively easy task in an *autocratically collegial* committee, that is, a committee so dominated by its leader that, in effect, only one voice matters. The FOMC under Alan Greenspan came close to that model. But the FOMC under Ben Bernanke and Janet Yellen—and, I will venture to guess, Jay Powell—was and will continue to be a *genuinely collegial* committee, where members strive for consensus, but some do not hesitate to voice their own opinions. That is where communication can devolve into cacophony.

Prediction #6 is that the Powell Fed will not beat this problem any more than the Bernanke Fed or the Yellen Fed did. But I have long thought the FOMC could *mitigate* the cacophony problem by changing the nature of the statements that follow each meeting. The basic idea is to give voice to the losing arguments and perhaps even to explain why they lost out to the winning arguments. Here is an example of what I mean.

When the FOMC raised the federal funds rate range by 25 basis points in December 2017, the third paragraph of the statement read:

> *In view of realized and expected labor market conditions and inflation, the Committee decided to raise the target range for the federal funds rate to 1–1/4 to 1–1/2 percent. The stance of monetary policy remains accommodative, thereby supporting strong labor market conditions and a sustained return to 2 percent inflation.*[8]

Two Reserve Bank presidents, Charles Evans and Neel Kashkari, dissented in favor of keeping the funds rate where it was. It is a reasonable supposition that other participants agreed with Evans and Kashkari but did not dissent (or had no vote).

Here is my suggested rewrite of that paragraph, which takes 48 more words:

> *In view of realized and expected labor market conditions and inflation, the Committee decided to raise the target range for the federal funds rate to 1–1/4 to 1–1/2 percent. Some members thought a tightening at this meeting was premature, given that inflation remains below 2 percent and shows no signs of rising. The majority, however, viewed the stance of monetary policy as still quite accommodative, and therefore supportive of strong labor market conditions, even with the higher funds rate range. Most also saw a sustained return to 2 percent inflation as likely, given the tightness of labor markets.*

The message here is pretty clear: The FOMC was not unanimous in December 2017, but the majority believed that, with labor markets so tight, it was prudent to nudge interest rates up another 25 basis points. A minority, however, thought that was premature.

The central bank can thus give voice to both majority and minority views without producing a cacophony. But it may need a few more words to do so. It is high time that central banks, which have traveled a long way down the communications road already, cease viewing words as scarce commodities to be given only grudgingly. Montagu Norman was wrong; they should explain.

[8] https://www.federalreserve.gov/monetarypolicy/files/monetary20171213a1.pdf.

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