

Communication Policy in Inflation Targeting: The Czech Experience

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Inflation Targeting: Performance and Challenges

January 19–20, 2006, Istanbul

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Why communicate?

- Montagu Norman (BoE Governor between 1920s and 1940s): “Never explain, never excuse”
- Mervin King (2005): “Inflation targeting is a framework for making and communicating decisions”
- Central bank transparency a new phenomena (since 1990s), because of:
 - progress in theoretical research: Muth, 1961 – rational expectations, Kydland and Prescott, 1977 – dynamic inconsistency
 - progress in financial markets and information technology
 - central banks have gained independence...
 - ... and moved towards rule-based policy
=> More emphasis on communication than ever before

Why communicate? (continued)

Transparency makes monetary policy more

1. Accountable:

independence => accountability to the public => need for transparency towards the public

2. Predictable:

higher transparency => more predictable central bank actions => smaller forecast errors => lower risk premium => potential improvement in output/inflation trade-off

3. Credible:

higher transparency => higher credibility of central bank actions => higher impact on real economy + improved output/inflation variability trade-off
=> EFFICIENT



The CNB's approach

Transparency about:

- institutional arrangement (legal position of the CNB, main objectives, voting procedure,...)
- policy implementation (instruments, targets, caveats)
- forecasting and policy analysis system (process of forecast production, major aspects of the forecast, how are decisions based on the forecast)
- policy decisions (main arguments, voting pattern)
- performance in the past (what should be done better)



The CNB's approach (continued)

Institutional arrangement:

- Act on the Czech National Bank: “The primary objective of the Czech National Bank shall be to maintain price stability. Without prejudice to its primary objective, the Czech National Bank shall support the general economic policies of the Government leading to sustainable economic growth.”
- “The Bank Board shall act by a simple majority of the votes cast. The Bank Board shall have a quorum if the Governor, or his nominee, and at least three other members of the Bank Board are present. In the event of a tie, the chairperson shall have the casting vote.”



The CNB's approach (continued)

Policy implementation:

- instruments – main instrument short interest rates (2W repo tenders), described on website, in Annual Report and factsheet, in detail in specialised economic journals
- inflation target – decreasing band from 3–5% in Jan 2002 to 2–4% in Dec 2005; 3% ± 1 p.p. from Jan 2006. Targets described on website, shown or mentioned on almost every occasion (Inflation Reports, press conferences, comments in newspapers, factsheet...)
- caveats – exogenous shocks (e.g. food prices, administrative changes, fluctuations in prices of raw materials, fluctuations in exchange rate, natural disasters, described on website and mentioned whenever applied)



The CNB's approach (continued)

Forecasting and policy analysis system:

- forecast and forecasting tool, its basic characteristics (gap model, calibration, reaction function of CB, forward-looking inflation/ER/IR expectations,...), its evolution (quarterly basis, alternative scenarios, responsibility and ownership of the forecast,...)
- seminars with journalists and analysts after each forecast
- special publication “The Czech National Bank’s Forecasting and Policy Analysis System” (printed and on website) – including equations and coefficient values
- articles in domestic and foreign economic journals



The CNB's approach (continued)

Policy decisions:

- regular meeting of Bank Board every month based on Situation Report, available to the public after 6 years
- individual responsibility of Board members – individual opinions expressed in comments, interviews or newspaper articles, embargo on any comment 7 days before Board meeting
- briefing held immediately after meeting, new forecast (Jan, Apr, Jul, Oct) or new risk assessment of forecast (other months) made public
- arguments in detail and voting patterns published in minutes with 8-day delay (website, Inflation Report)



The CNB's approach (continued)

Performance in the past:

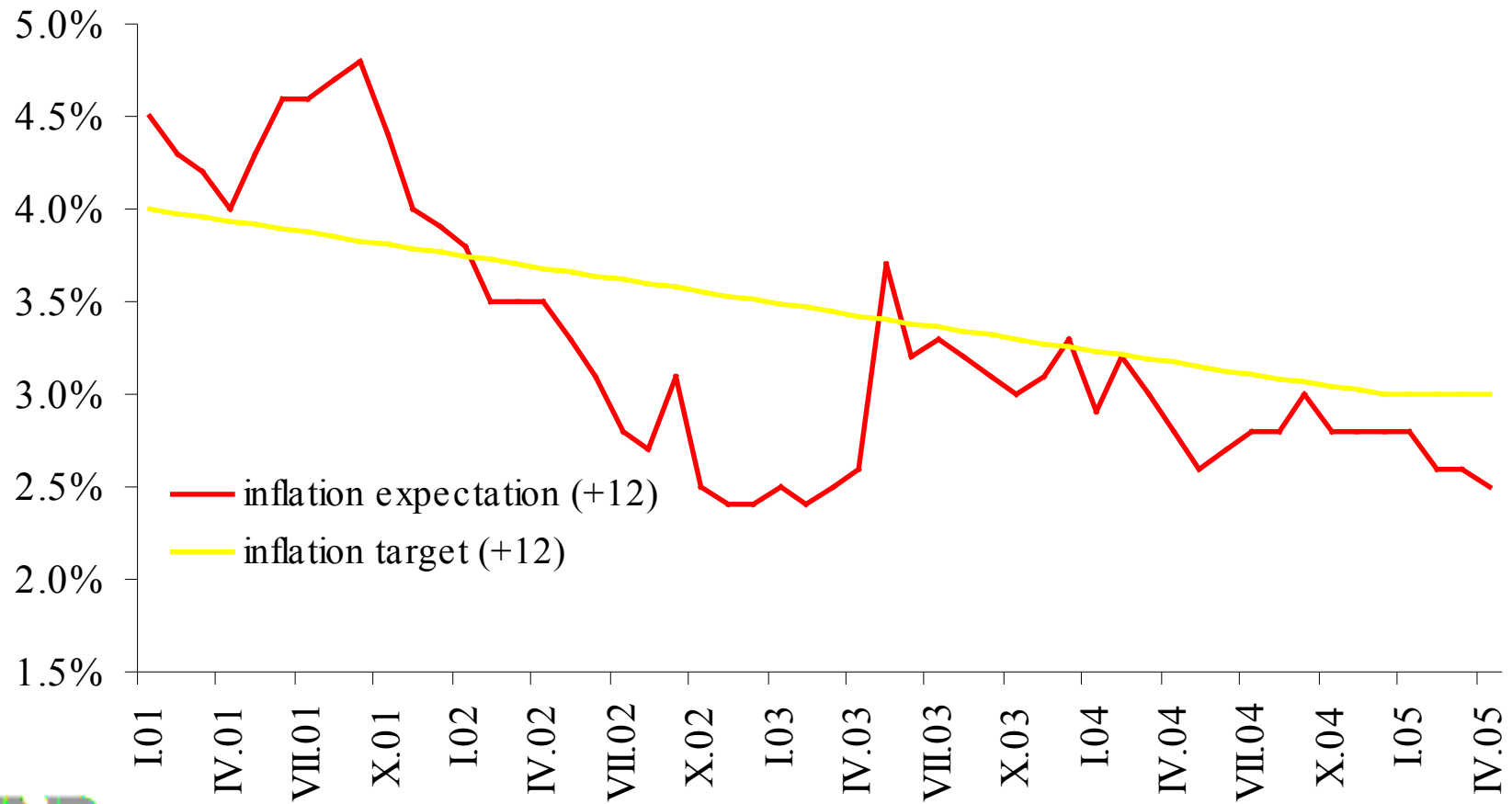
- evaluation of past performance can improve future performance
- deviation of inflation from inflation target in last three months explained in Inflation Report, deviation in last year explained in Annual Report
- detailed analysis for internal purposes only – including assessment of forecast accuracy and adequacy of forecast risk evaluation



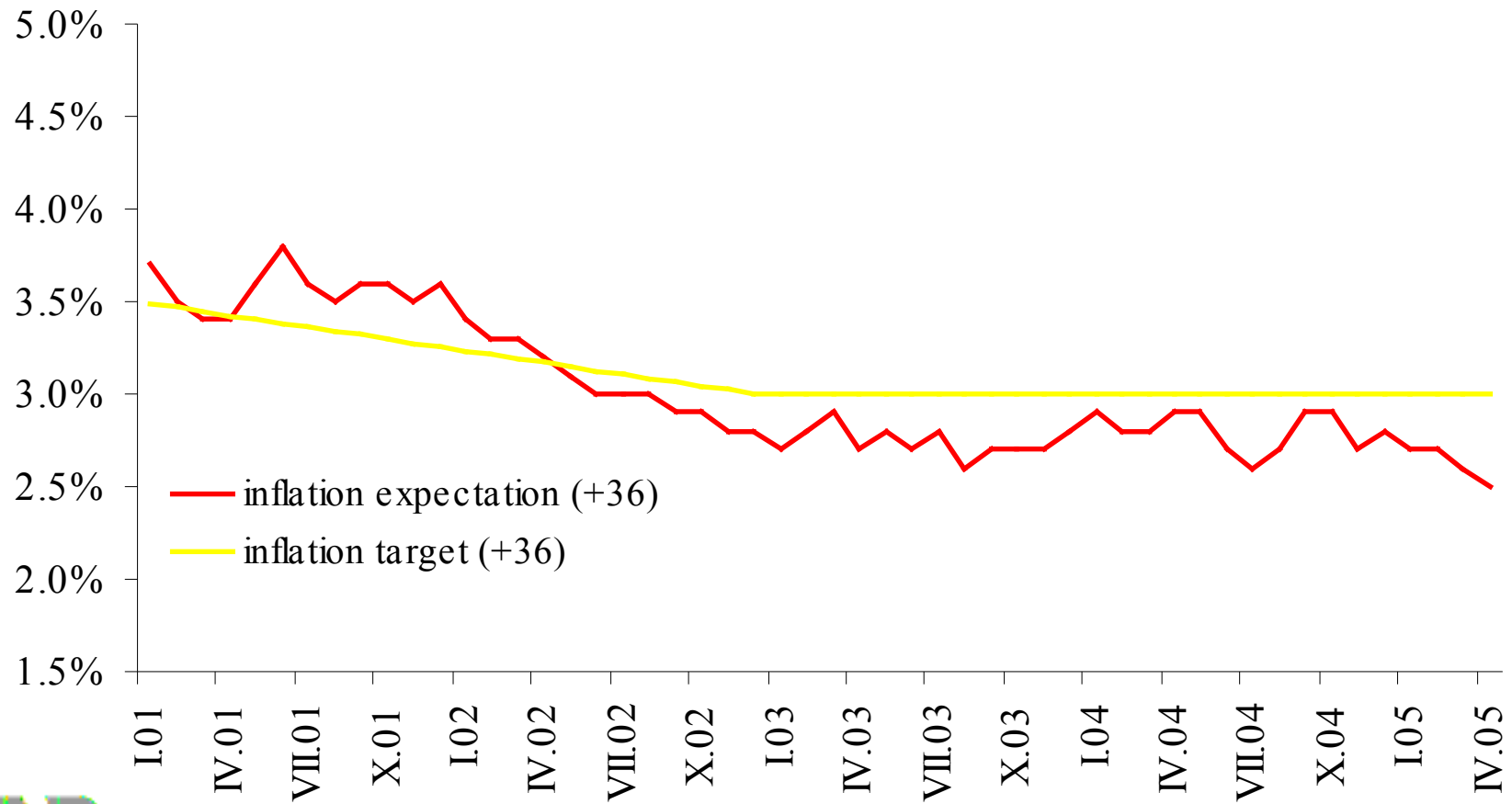
Empirical evidence on market expectations

- The aim of communication is to affect inflation (and other variables') expectations, as it is believed that expectations near the inflation target contribute to self-fulfilment of the target
- Given the lag in MP transmission, attention should be paid to medium-term inflation expectations (>2 years) rather than short-term expectations (<1 year)

Inflation expectations



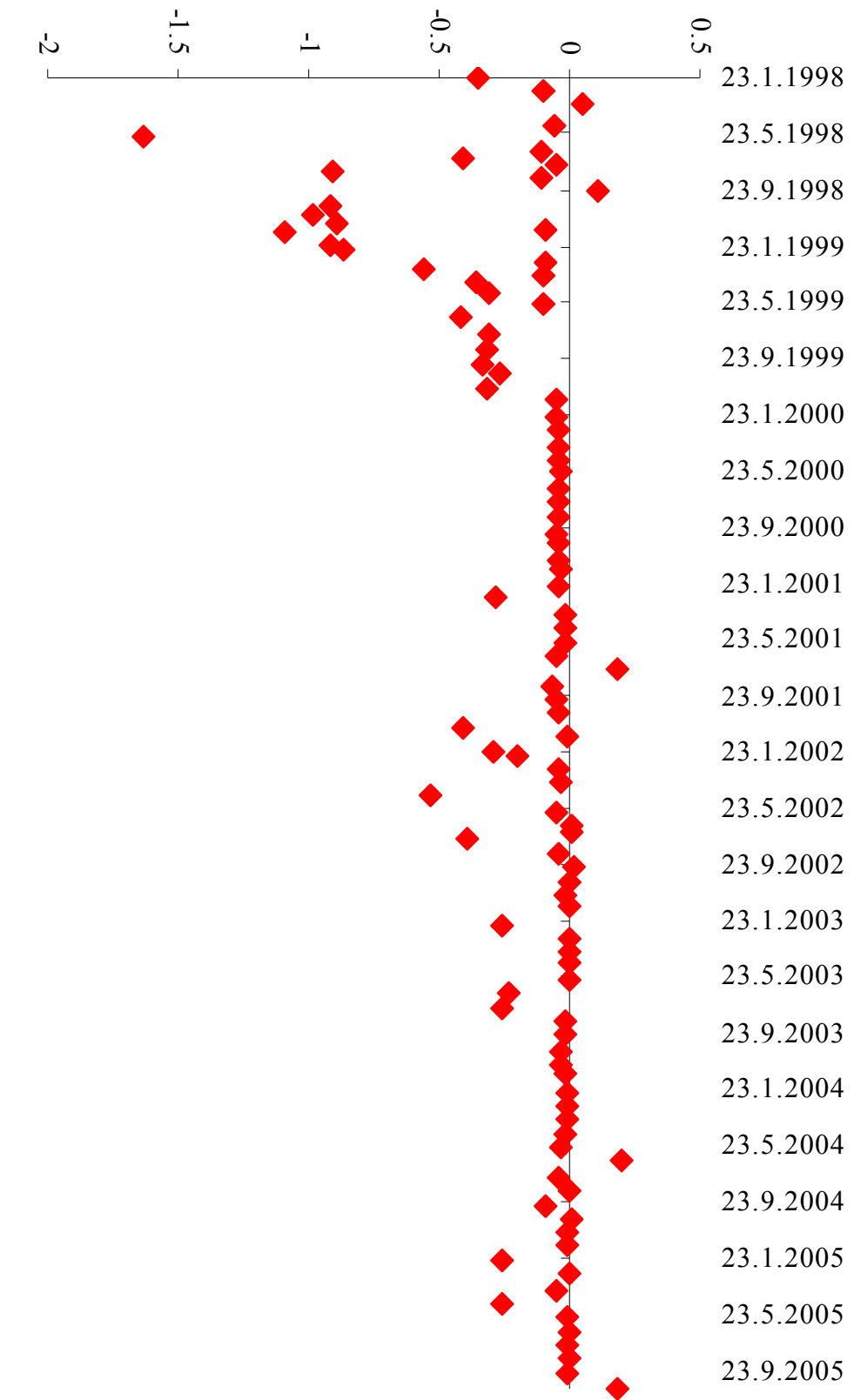
Inflation expectations (continued)



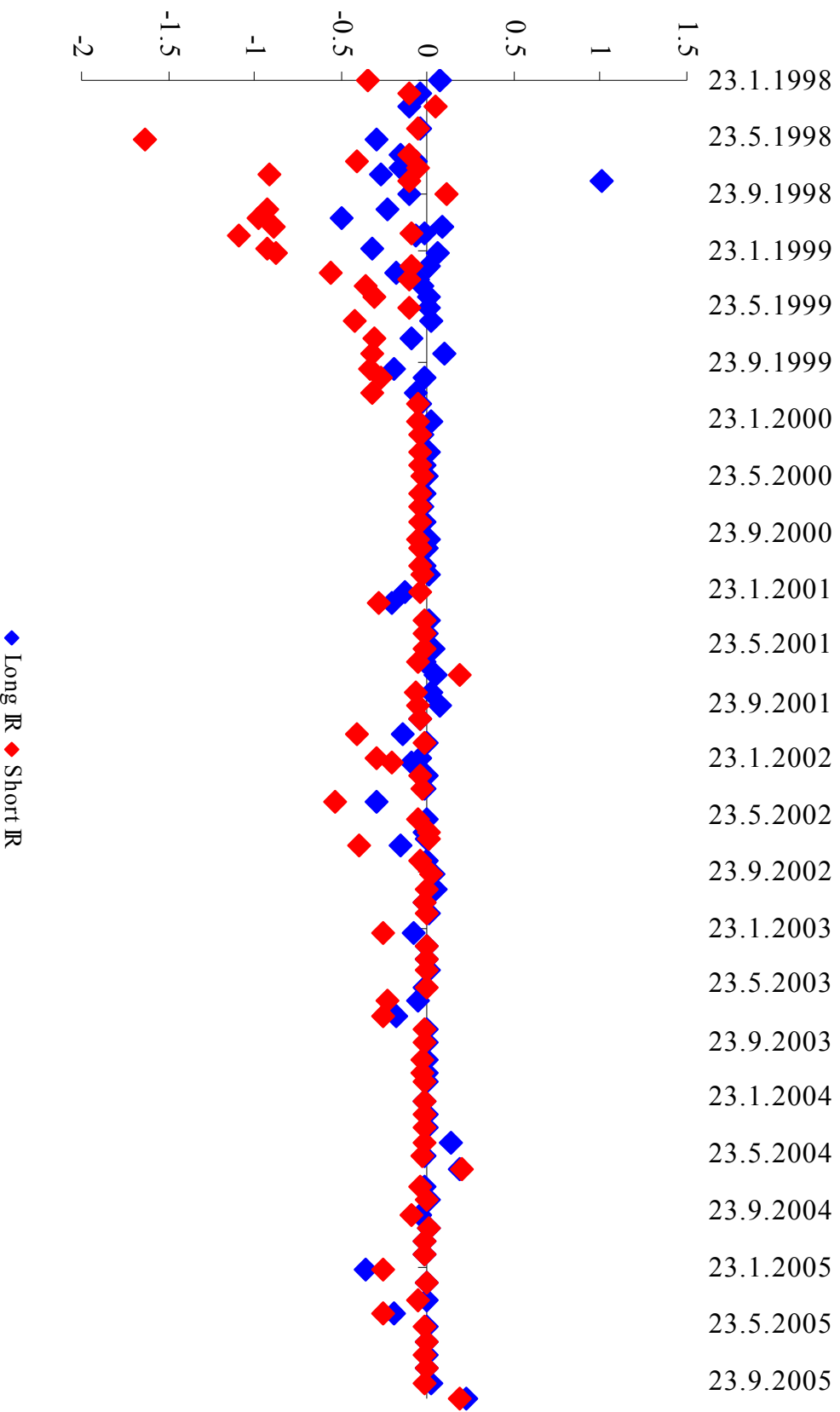
Policy expectations

- CB controls only short-term interest rates, but economy is affected by long-term interest rates, which can be influenced mainly by communication (outlook, bias, future path of interest rates)
- Proper communication smooths interest rate movements and reduces surprise component ($ir-ir^e$)

Policy expectations (continued)



Policy expectations (continued)



"Hot" communication issues

- Publishing names by voting
- Ownership of the forecast – Board or Staff?
- Publishing interest rate trajectory
- KISS (Keep It Short and Simple)
- Public admission of past mistakes and CB credibility?
- Is ERM II consistent with inflation targeting?

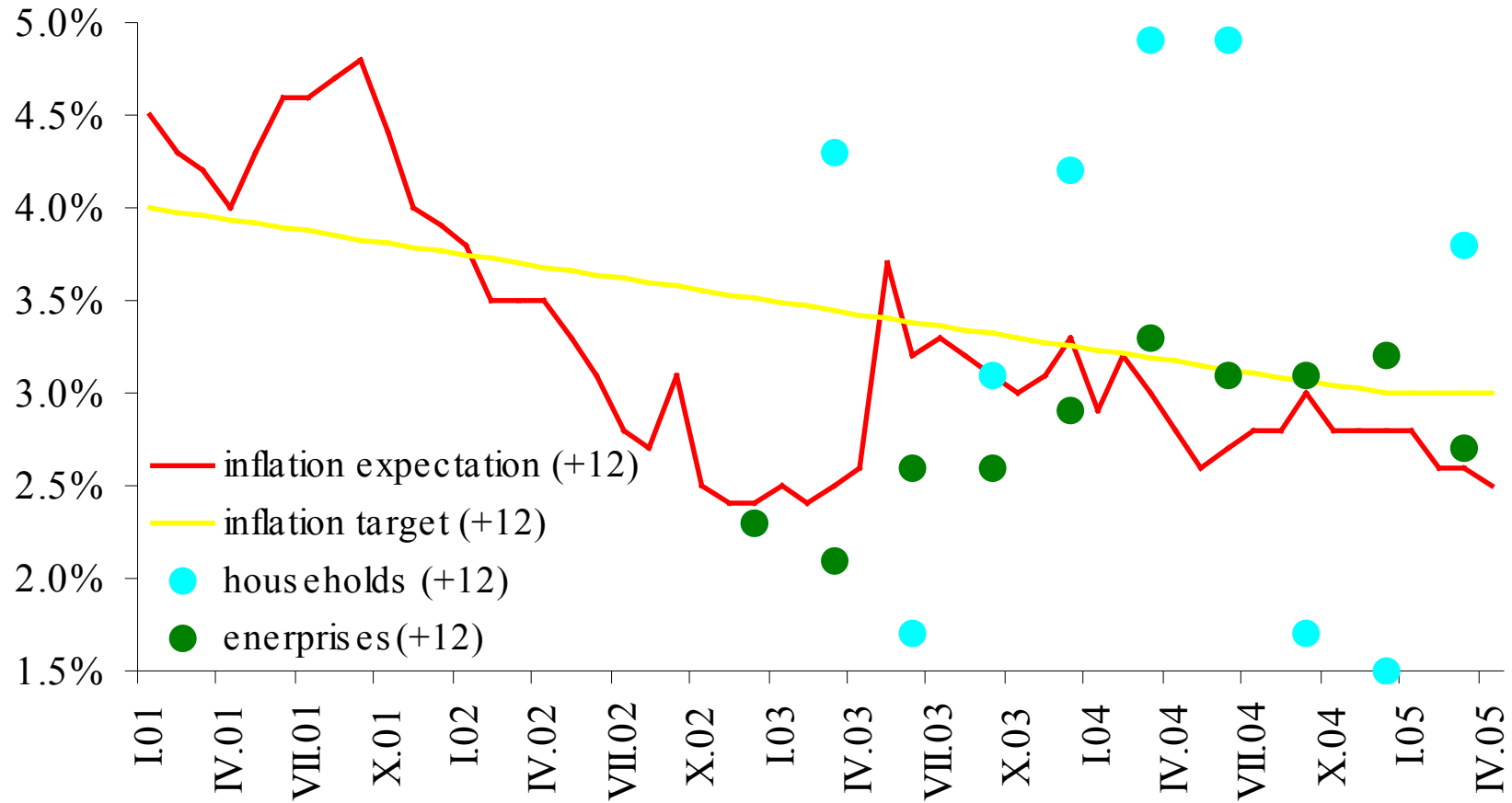
Thank you for your attention



Reserve Slides



Inflation expectations



Inflation expectations

