Discussion

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Introduction

Central bank talk has been a topic of debate and empirical analysis within the central bank community and the economics profession for at least the thirty years that span Chuck's career as a central banker. And what many regard as the seminal work in this area has a particularly Canadian connection. The work on bureaucratic theory and the choice of central bank goals by Acheson and Chant (1973) challenged the prevailing view in central banks that it was best to say nothing and let actions speak for themselves.

The literature expanded through the eighties as recognition of the time-inconsistency problem (Kydland and Prescott 1977) spawned work on how to ensure a credible pre-commitment to sound objectives. As well, there was growing recognition of the importance of transparency and of working with, rather than against, the market. It was in this context that the Reserve Bank of New Zealand in 1990 became the first central bank to adopt inflation targeting with a strong emphasis on transparency. As more central banks followed the lead of the RBZN, the focus on central bank talk gathered force.

1 The Freedman Perspective

Before discussing the paper by Don Kohn and Brian Sack, let me start by offering my perspective on Chuck's contribution to the debate on central bank talk, or more generally the importance of central bank communications.

We all know (and love) Chuck's ability to communicate effectively, including his ability to get through the material he wants when he is making a presentation, *regardless* of the time available. There are no speed bumps for Chuck! It is always full speed ahead.

Chuck and I have discussed on many occasions the importance of communications in the conduct of monetary policy. I would summarize his views, as expressed in those discussions and in his writings, as follows.

First, effective communications, or talk, is a means to an end. The end is increased transparency on the part of central banks. Increased transparency, in turn, is important for two reasons: it improves the effectiveness of monetary policy; and it makes central banks more accountable.

The effectiveness of policy is improved through several channels. Like all public policies, monetary policy benefits from increased public support and understanding. The key point is to make clear what monetary policy can deliver. This can contribute to behaviour, such as wage and price setting, in a way that will facilitate achievement of policy objectives.

Another channel involves the behaviour of participants in financial markets. If markets understand the objective of monetary policy and the tools used by the central bank to achieve the objective, and have a clear read on the central bank's view of the economy, the transmission mechanism should work more smoothly.

The important element in all this, as Chuck has emphasized, is to shape expectations of agents, whether it be about the direction of the stance of policy or the ultimate outcome of policy. The fact that there are many different audiences makes the task complicated.

I can be brief on the second reason why transparency is important. Greater accountability through increased transparency is an important element supporting the independence of central banks.

2 Comments on Kohn and Sack

At the outset of their paper, the authors state that "it is not obvious, a priori, in what ways statements by the central bank have a role in shaping the expectations of investors and other private agents." They approach this empirically by attempting to measure the effects of statements on selected financial variables in two ways: by looking at different types of statements; and by making a distinction between statements that reveal a "policy inclination" and statements that convey information about "the economic outlook."

Their findings reveal that central bank talk does have effects, especially when the statements concern future directions of the economy. The effects are seen primarily in terms of interest rate movements, with equity prices and the exchange rate little affected. And the Chairman's testimonies before Congress have more of an effect than his other public statements.

I have organized my detailed comments around two themes. First, a few brief comments on the empirical work itself; second, comments on the interpretation and on the implications of their results. I will conclude with a few thoughts on future research.

2.1 Comments on empirical work[1]

Let me start by commending the authors for the care they have taken in assembling their data set, and in estimating the various influences on the financial variables chosen. Because of their thoroughness, I have only a few comments on their empirical work.

First, in Table 2, it is not clear whether the authors used first-release data (for example, for retail trade and durable goods orders) or revised data. If it is the former, they should make that clear. If it is the latter, it would raise questions about the empirical results.

In several tables (e.g., Tables 3 and 5), it would be useful, for purely presentational purposes, to present the number of observations in the various columns of results.

In Table 5, the effect of Greenspan testimonies on medium- and longer-term interest rates is large. An interesting extension of this part of their empirical work might be to include a 10-year inflation-indexed bond rate (although the time series available is limited) to determine whether the effects are especially important for inflation expectations.

The results in Table 6, the decomposition of the effects of policy actions and statements, depend critically on the calibration of β, which is set to 1.70. It would be useful for the authors to do some sensitivity analysis to see how the results vary when β is set to other values.

Finally, the authors suggest that "at least a part of the identified effects of the economic-outlook component" of their results reflects revisions to private sector forecasts following Federal Reserve statements. They cite Romer and Romer (2000) as evidence of more accurate Federal Reserve forecasts compared with private sector forecasts. However, other researchers have found less of a difference. Gavin and Mandal (2003) find that FOMC

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1. I would like to thank Greg Tkacz and Nicolas Perrier for helpful input.

forecasts are as good as private sector forecasts of output, whereas Federal Reserve staff forecasts of inflation are better than those of the FOMC. And Joutz and Stekler (2000) find that Federal Reserve staff forecasts are of the same quality as those of the private sector.

2.2 Interpretation and implications of results

I would now like to discuss their results more generally, starting with a few comments on the evolving nature of the FOMC statements as described in the paper. The authors lay out very concisely the changes that have occurred in the FOMC "disclosure policy" since 1989.

What strikes me in working through this evolution is how the changes progressively moved FOMC statements in the direction of greater recognition of the framework being used by the Federal Reserve (and other central banks, for that matter) in the conduct of monetary policy.

Let me explain.

From 1989 to 1993, there were few statements. From 1994 to 1998, the statements focused on the near term, with a brief description of the rationale for policy. In 1999, the FOMC began to introduce the notion of balance of risks, thereby placing more emphasis on the future direction of policy. Then in 2000, it formalized its use of the balance of risks in its statements by linking the risks to the Federal Reserve's long-run goals of both price stability and sustainable economic growth.

More recently, the Committee changed course again. In March 2003, it refrained from making any assessment of the balance of risks, and in May, it allowed for the specification of two-sided risks to both inflation and growth.

With these latest changes, the FOMC statements now recognize, consistent with the framework being used in its conduct of monetary policy, that the risks to sustainable (i.e., potential) economic growth may be balanced while the risks to inflation may be down because of an output gap. In other words, growth rates as well as levels of activity matter, and central banks need to be able to communicate this difference in how they talk. A complicating factor for the FOMC is that it has a dual mandate without a numerical inflation target. For a central bank with an explicit inflation target, the relationship between the growth of output, levels of activity and inflation relative to target seem to provide a framework that makes it easier to communicate.

Let me try to link these thoughts back to the Kohn and Sack empirical results.

Their results support two basic conclusions: central bank talk matters; and what matters most are statements about the economic outlook, especially those that contain more detailed discussions.

Simple balance-of-risk statements alone don't work, because in some circumstances, such as those currently facing the Federal Reserve, they can't convey the full story.

Let me quote the authors (p. 201): "We would argue that providing more detailed language has considerable advantages over a simple, discrete categorization of risks. A detailed statement, speech, or testimony can provide a more accurate description of the outlook for the economy, one that can better describe the various risks, describe how potential outcomes may be conditional on particular events, and provide the appropriate amount of nuance and caution regarding the central bank's views."

Put differently, what the authors seem to be saying is that central banks must be able to tell a story. But is has to be a story set in the context of a clear statement of the objective of policy, a view of the key macroeconomic relationships, especially the inflation process, and an understanding of the tools (and thus actions) used to achieve the policy objective.

It also has to be a story told in recognition of the forward-looking nature of monetary policy (i.e., the policy lags) and of the conditionality of the central bank outlook (i.e., that the future path of interest rates is dependent on conditions in the economy).

This, to be sure, is not a simple story. But for it to be clear, the elements have to add up in a way that reflects the monetary policy framework being used to conduct policy. Only then can the relationships, nuances, and conditional nature of policy be conveyed.

The Kohn and Sack results raise another important issue. Movements in interest rates at the one- to two-year horizon appear to be strongly influenced by policy statements reflecting changing perceptions of the FOMC's economic outlook. If the Federal Reserve has little, if any, information that is not available to the market, why do we see such a response? One explanation they offer is that these statements lead to the private sector updating their outlooks because of the Federal Reserve's forecasting record. Another possibility is that the statements provide useful information about the Fed's long-run inflation target.

This set of results and their suggested explanations underscore for me the important challenge of communicating the medium-term time horizon over which monetary policy operates. When a central bank raises or lowers interest rates, we usually think in terms of the impact on inflation from these policy actions being spread over six to eight quarters. Thus, given that monetary policy should be viewed from a medium-term perspective, perhaps what we are seeing in these results is the value-added that comes from statements conveying how the central bank perceives the key trends in the economy and inflation, and how the conduct of monetary policy relates to these trends. Moreover, it is usually the accumulation of information that gives understanding to these trends. And by transmitting a view of the larger trends in the economy, central bank talk can promote better anticipation of the direction of policy.

Conclusion

I would like to conclude by going back to my Freedman perspective. If expectations play a central role in determining economic performance, then it is important to find ways to shape those expectations. The Kohn and Sack paper strongly suggests that central bank statements help in that regard and should therefore be "viewed as a vital component of the monetary policy process." I agree. My emphasis, not inconsistent with their own, would be on statements (i.e., press releases, reports, speeches, testimonies) that focus on telling a story framed in a way that captures the key elements of what makes up an overall, coherent monetary policy framework.

If central bank talk is to help shape expectations, then the talk must reflect the monetary policy process itself. This approach, I believe, also gives central banks a degree of flexibility to adapt what is said and how much is said to changing circumstances. Sometimes a short press release suffices, sometimes a longer one is needed. But at all times, what is communicated must be couched in a way that captures the policy framework. Thus, "more" isn't necessarily "better" when it comes to central bank talk. It is "quality," not "quantity," that is of importance (see Jenkins 2001).

As well, central bank talk is a repeat game. This means thinking about communicating monetary policy from a strategic perspective. Who are our audiences, what vehicles are used to reach those audiences, and are communications events integrated in a way that helps tell what is inherently a complex, uncertain, and unfolding story?

The authors offer several thoughts about avenues for future research. One topic they raise is whether central banks are achieving the desired effect of their statements. Recent research conducted here at the Bank of Canada (Gravelle and Moessner 2002 and Parent 2002–2003) strongly supports the view that, since our move to fixed announcement dates for setting and explaining policy, financial markets now have a much greater understanding of the elements that contribute to the conduct of monetary policy and that the Bank's efforts to explain its actions and views have yielded the desired results.

A useful extension of the Kohn and Sack paper would be to ask whether the FOMC has managed to move rates, or market expectations, in the right direction. What were the FOMC's objectives and did it manage to achieve them? More generally, are there limits to central bank transparency?

Clearly, the authors are correct in emphasizing that central bank talk is an important topic that warrants extensive research. Their paper represents an important addition to that research.

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