MONETARY POLICY IN A TIME OF UNCERTAINTY *

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Revised speaking notes for Regional Seminar on central Bank Communications, Munbai, 23-24 January 2006; with apologies to the 1982 Nobel Prize Winner for Literature Gabriel Garcia Marquez.

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I. Why Transparency and Communication are Important for Monetary Policy

Over the past decade or so, there has been a trend toward increased transparency and greater communication in the conduct of monetary policy among central banks. Indeed, transparency and communication have increasingly taken on both a central role in modern monetary policymaking and being part of best practice in monetary policy. Whether too little or too much will depend on each country's circumstances and actual needs.

This trend is partly born out of necessity. Financial markets worldwide have dramatically developed, expanded and interconnected with one another. Both good and bad monetary policy can be rapidly transmitted to an increasingly seamless global market. It is therefore possible to think of central bank communication strategies as having two main goals: (1) to allow financial markets to anticipate the policy decisions as well as the future path of monetary policy; and (2) to reduce the uncertainty surrounding these expectations. Amato, Morris and Shin (2003) observe that "*central bank communication is a key determinant of the market's ability to anticipate monetary policy decisions and the future path of interest rates*." This observation has some empirical support. Ehrmann and Fratzscher (2005), for example, analyzing the impact of communication on the predictability of monetary policy in the US, EU and Japan, conclude that a higher frequency of communication tends to help markets predict future monetary policy decisions.

Exactly why expectations of financial market players matter is perhaps best articulated by Blinder (1998): "*Central banks generally control only the overnight interest rate, an interest rate that is relevant to virtually no economically interesting transactions. Monetary policy has important macroeconomic effects only to the extent that it moves financial market prices that really matter—like long-term interest rates, stock market values and exchange rates. The links from the direct lever of monetary policy (the overnight rate) to the prices that matter depend almost entirely upon market expectations*." Blinder goes on to argue that this expectational mechanism works best in an environment of central bank transparency.

The trend toward greater transparency and better communication, therefore, was driven by the increasing recognition that they make monetary policy work more effectively. As Ehrmann and Fratzscher (2005) observe, "*Central banks have direct control only over a single interest rate, usually the overnight rate, while their success in achieving their mandate requires that they are able to influence asset prices and*

[*] Revised speaking notes for Regional Seminar on Central Bank Communications, Mumbai, 23-24 January 2006; with apologies to the 1982 Nobel Prize Winner for Literature Gabriel Garcia Marquez.

interest rates at all maturities." Effective communication as much as credible policy actions is of fundamental importance for achieving central bank objectives.

The emphasis on transparency and communication was also spurred by the growing interest in the greater accountability of central banks, as an increasing number of them were accorded greater independence from political authorities. As Kohn & Sack (2003) point out, the value of transparency consists in not only improving the public's understanding and support of monetary policy and its goals but also in improving the accountability of the central bank to the public. The responsibility over money and banks by an unelected central bank can be established if it were to make its targets and policies known to the general public.

At the same time, the increasing popularity of inflation targeting, with its emphasis on transparency and accountability of the central bank, has also helped in improving the disclosure and openness of central banks. Inflation targeting as a framework attempts to establish an explicit link between monetary decisions and the central bank's assessment of future inflation, and thus places an emphasis on the release of timely information about the views of the central bank on the inflation outlook.[1] Recent converts to inflation targeting, including the Philippines, have also had to develop disclosure and transparency mechanisms along these lines.

II. Central Bank Communication in an Emerging Market Context: The Philippine Case

A. The Communications Strategy of the BSP

The BSP's shift to inflation targeting in 2002 prompted an increased emphasis on transparency in the conduct of monetary policy. As Guinigundo (2005) explains, "*by coordinating with the National Government on the desirable inflation targets for the medium term, announcing these targets to the public and committing itself to achieving these known parameters by reviewing its policy stance every four weeks, the BSP entered into a virtual contract with the citizenry. Thus was established the BSP's accountability to the larger community*."

The accountability of the BSP derives from the fact that, in making a public commitment to achieve the announced inflation targets, the BSP is formally submitting itself to the judgment of financial markets and the general public, and faces reputational risks (along with adverse changes in market sentiment and inflation expectations) should it fail to achieve the targets. This is in contrast to the more direct form of accountability exemplified in the Reserve Bank of New Zealand model which explicitly binds the tenure of the RBNZ governor to the inflation target.

[1] As Fracasso, Genberg and Wyplosz (2003) argue, "merely announcing IT and publishing inflation forecasts is not enough: the benefits from IT only accrue to central banks that convince the public that their decisions are rooted in the relatively tight constraints imposed by a process that starts with forecasts, considers the optimal responses and ends with decisions which, year after year, appear as derived from the same logic."

Conduct of Public Information Campaign. The new emphasis on transparency required the familiarization of the public with the concept of inflation targeting. Thus, the most important component of the preparatory blueprint for the new policy framework was the series of public hearings and discussions in 2000 and 2001 held by the BSP in key cities around the country. The objective was to introduce the concept of inflation targeting to the public and increase public understanding of the monetary policy process in general.[2] The public information campaign has continued well after the formal start of inflation targeting and the BSP presently holds public briefings on a regular basis in various locations around the country.

The BSP's various disclosure and reporting mechanisms are intended to help the public understand what the BSP is doing and the reasons for its monetary policy actions. The seven-member Monetary Board, which is the policymaking body of the BSP, meets every four weeks to discuss the monetary policy stance. The results of each meeting is accompanied by a press statement, which is released immediately afterwards, and an account of the highlights of the discussion, which is published after a predetermined lag of six weeks.

Publication of the Quarterly Inflation Report. The BSP also publishes a Quarterly Inflation Report, which provides a longer discussion of the assessment of monetary conditions. The release of the Inflation Report for each quarter is accompanied by a briefing for the media. The Inflation Report is considered a key document in the monetary policy process. The report conveys to the public the overall thinking and analysis behind the BSP's decisions on monetary policy, so that monetary policy will be easier to follow and understand. It is also aimed at enabling the public to better monitor the BSP's commitment to the inflation target, thereby helping anchor inflation expectations. The report is thus essentially a survey of the various factors affecting inflation—recent price and cost developments, prospects for aggregate demand and output, monetary and financial market conditions, labor market conditions, fiscal developments, and the international environment. A section is devoted to the BSP's view of the inflation outlook over the two-year policy horizon. This is followed by a discussion of the implications of the analysis on future monetary policy stance of the BSP. Box articles on selected topics offer more detailed analysis and information concerning issues relevant to monetary policy.

The quarterly BSP Inflation Report was first published in January 2002 and has been favorably received by various institutions, including the International Monetary Fund (IMF). The IMF, in particular, has noted that the report "*provides a comprehensive description of recent developments, an incisive analysis of monetary policy, and a forthright assessment of inflation prospects. Moreover, it is clearly written, so that it can be readily understood by the informed public*."[3] Meanwhile, Fracasso, Genberg, Wyplosz (2003) evaluated the inflation reports of 20 inflation targeting central banks ranked the three-quarter old BSP Inflation Report in the middle (11th place) in terms

[2] The public hearings also enabled the BSP to gather views on a number of operational issues, such as the choice of inflation target (headline or core inflation; range or point target), the target-setting body (government or the BSP) and other key issues. Headline inflation, for example, emerged as a clear choice for the basis of the inflation target, mainly on account of its familiarity to the public.
[3] BSP Press Release dated 08 January 2003. Available on the BSP website at http://www.bsp.gov.ph/archive/news_2003/2003-01/news-01082003a. htm

of the following set of criteria: (1) how convincing their Inflation Report is judged to be; (2) how well the central bank's level of expertise comes through in the report; (3) the completeness of the Inflation Report; (4) the clarity of the writing style; (5) the quality and comprehensiveness of the information provided; and (6) whether or not the report is intimidating to economists or non-economists.[4] The BSP Inflation Report scored well in terms of the clarity and readability of the text as well as the comprehensiveness of the information presented. However, there were also areas for improvement. For example, greater effort is needed in making the Report more convincing to readers and conveying the Bank's expertise in monetary policy. Other areas for improvement include the quantity of information presented in the report**,** particularly with regard to data on prices and growth; underlying assumptions of inflation forecasts and the risks involved; details of the inflation forecasting models used; and coverage of financial stability issues. The quality of the information presented also needs to be improved, by (1) providing greater detail on past monetary policy decisions and their rationale; (2) discussing what information was most relevant for recent policy decisions and how such information was processed; and (3) strengthening the presentation of current challenges to monetary policy, the present policy strategy, and the arguments for future decisions.

Issuance of Open Letter. In addition to the periodic reports and policy pronouncements, the BSP issues an open letter addressed to the President whenever the BSP fails to achieve the inflation target. The Open Letter explains the reasons why actual inflation did not meet the target, and discusses possible measures to be adopted to bring actual inflation back in line with the inflation target. The Open Letter is typically issued in January following the release of the full-year inflation data for the preceding year and is published on the BSP website. So far, the BSP has had to issue four Open Letters since the start of the inflation targeting regime: two for achieving inflation below the target and two for inflation above the target.

Collegial Approach to Communication. The BSP's overall approach to communication may be described as "collegial", to use the term employed by Ehrmann and Fratzscher (2005). That is, communications with the public emphasize portraying the consensus or majority view within the Bank, so that officials speak in one voice, rather than conveying the diversity of views within the Monetary Board. This is similar to the approach of the Bank of England and the European Central Bank and is in contrast with the individualistic or dispersed approach of the US Federal Reserve. The collegial approach is intended to prevent confusion on the part of market players arising from multiple signals concerning the direction of monetary policy. In practice, views on the monetary policy stance are typically articulated in the media by the BSP Governor. Monetary Board members seldom make public comments on the likely path of monetary policy. Empirical evidence

[4] The top 10 among all 20 countries in the sample, based on the unweighted average of ratings across categories, were as follows: (1) United Kingdom; (2) New Zealand; (3) Brazil; (4) Thailand; (5) Chile; (6) Czech Republic; (7) Iceland; (8) Norway; (9) Sweden; and (10) South Korea. The BSP Inflation Report for the Third Quarter 2002 was used as the basis for the evaluation. The authors asked five different readers to read a recent inflation report from each central bank and give each of these reports a rating of between 1 and 10 (1=bad, 10=good) on a number of characteristics. The readers were graduate students in economics who are familiar with the broad principles of IT but not necessarily all "central bank watchers". The ratings per criterion were averaged for each country.

from developed countries offers some support for the collegial approach to communication. Ehrmann and Fratzscher (2005) find that a higher degree of communication dispersion among monetary policy committee members about monetary policy worsens the ability of financial markets to anticipate future monetary policy decisions.

The BSP's communications with the public have also been aimed at the very broadest audience possible, with the policy stance articulated in general terms and difficult technical details omitted as much as possible in order to bring the policy message across more clearly to the wider base of informed laymen.[5] This general-audience approach to central bank communication has thus far served the BSP in good stead, and has generated positive feedback from various quarters. Public opinion on the IT framework may have also been helped by the fact that the introduction of the new framework coincided with a period of low (even below-target) inflation, during which the public is more able to see clearly the benefits of low and stable inflation, particularly in terms of improved purchasing power.

B. The Challenges in Communicating Monetary Policy

In the initial phase of the shift to inflation targeting, the task of improving transparency and communication at the Bank posed a number of challenges to monetary authorities. One such problem was the general state of economic literacy. Outside of financial market professionals, academics and economists, the public had relatively little familiarity with central bank functions. The BSP's initial attempts at greater transparency through public briefings and awareness campaigns were generally well received by the public, who were appreciative of the authorities' efforts to expand general public awareness and understanding of the monetary policy process and explaining what inflation targeting is. Three years on, the awareness campaign has helped partly overcome the public's unfamiliarity with inflation targeting and monetary policy in general.

Increased public awareness has paid dividends from the BSP in its conduct of monetary policy, particularly in terms of managing public expectations about future inflation in the face of the recent oil price shock. For example, the BSP exerted efforts to make the public aware of the lags of monetary transmission and the fact that the assessment process for the monetary policy stance gave less weight to current and past inflation than to future or forecasted inflation.[6] This has helped the public understand better the reasons for monetary action even in the face of favorable data on current inflation. In addition, the Bank's efforts to explain the difference between cost-push and demand-side sources of inflation have made it considerably easier to explain the policy responses to the recent runup in inflation due to oil prices.

In an inflation targeting regime, the central bank may be able to accommodate some of the direct impact of higher oil costs on final goods prices as long as inflationary expectations remain well-anchored. But if higher oil prices threaten to percolate

[5] Guinigundo (2005)
[6] Ibid.

through to rising wages or inflationary expectations become heightened, monetary authorities will need to consider tightening to protect the inflation target and guard against the risk of a cost-push spiral.

Consequently, the management of public inflation expectations became a top priority for the BSP as oil prices continued to trend upwards. Initially when oil prices started going up, the BSP's response was to accommodate the shock, on the basis that it largely originated from the supply side and that the shock was temporary. The management of public inflation expectations became a top priority for the BSP as oil prices continued to trend upwards. The BSP was careful to make clear to the public that the inflationary impact of higher oil prices was not something that could be directly addressed by monetary policy, since it was primarily a cost-push effect.

Authorities also made clear, however, that monetary action would be considered if the economic evidence would suggest the following: (a) an adverse shift in the public's inflation expectations; (b) the emergence of second-round effects of the oil shock, particularly in the form of wage increases in excess of cost of living requirements; and (c) demand-based pressures on prices, as denoted by a rise in core inflation, for example.

As it became clearer that the regime of high oil prices was bound to persist for some time, the authorities were compelled to exercise their judgment. In principle, an environment of mounting cost-push pressures, driven by continued high oil prices and the resulting effects on energy and transport costs, creates the risk of a generalized increase in consumer prices. Policy concern therefore shifted to the impact of oil prices on inflation expectations and on wage-setting (i.e. the second-round effects of the oil shock).

Monetary authorities thus worked to strengthen transparency and communication of policies and prospects of inflation in order to manage inflation expectations. Efforts were focused on the need to communicate publicly the BSP's outlook for future inflation, its assessment of what needs to be done on the monetary policy front, and the various considerations behind monetary policy decisions.

In addition, calibrated policy rate increases were carried out in April, September and October partly to help guide down inflation expectations. These were accompanied by increases in reserve requirements in July to keep excess liquidity in check and prevent it from feeding into exchange rate depreciation and creating additional inflationary pressure.

Challenges in the operating environment for monetary policy also pose problems for the content of central bank communications, which after all consist mainly of the assessment of and responses of the central bank to its environment. Some economists have argued that the operating environment and practice of inflation targeting is quite different in an emerging market economies compared to developed economies. A central bank in an emerging economy, for example, is likely to face larger hurdles in terms of credibility, typically because of a history of double-digit inflation and exchange rate crises. In the same way that fiscal consolidation efforts may be hampered by a history of fiscal slippages, a poor inflation record leads to skepticism about the probability of a secular disinflation, and about the central bank's ability to engineer such a process. Perhaps the only means by which this can be truly addressed is to make sure that pronouncements are backed by action and that actions are based at all times on the tight logic and discipline prescribed by inflation targeting.

The realization that emerging market economies have to approach inflation targeting somewhat differently from their industrial economy counterparts has only recently gained currency in the economic literature. Fraga, Goldfajn and Minella (2003), for example, argue that emerging market economies under inflation targeting are faced with the challenge of "breaking the vicious circle between, on one side, low credibility and more fragile institutions, and, on the other side, higher macroeconomic instability and vulnerability to external shocks". They add that emerging market economies face more acute tradeoffs in terms of output and inflation variability because of the presence of more pronounced external shocks, lower policy credibility, and a lower level of development of institutions. Achieving price stability under inflation targeting is therefore a long process of, among other things, enabling the central bank to acquire credibility as a monetary policy institution committed to price stability in the context of greater uncertainty.

III. Concluding Remarks

The brief Philippine experience with inflation targeting has highlighted the importance of communication and transparency to the operational success of the new policy framework. Judging merely from the numerous transparency mechanisms currently in place, the monetary policy of the BSP is certainly more transparent now under IT than previously. More importantly, there is a greater conscious effort within the policymaking circle of the need to properly communicate the policy impulses to financial markets, the media and the public at large. Greater transparency and communication, in turn, have not only enabled financial markets and the public to better anticipate the direction of monetary policy, but also have made the task of explaining the stance of monetary policy, and the rationale behind it, easier for authorities.

Nevertheless, there continues to be plenty of room for improvement in the communication strategy of the BSP. The Bank, for one thing, remains very much still in the process of educating the public and the local press, whom it would like to familiarize with important concepts such as core inflation, changes in the CPI base year, and so on through the continued conduct of regional briefings and other means. Future efforts to increase economic literacy will center on these and other issues, including the importance of looking at the forecasted path of inflation over the policy horizon, not just the forecasted figure for the month ahead. In time, increased public understanding of the basic concepts will allow the BSP to employ greater nuance in communicating its monetary policy stance with greater assurance of better public appreciation and support.

Efforts to familiarize and educate the public about the nature of inflation, monetary policy and other economic issues should also be complemented with measures to improve transparency in monetary policy. Such measures may include, among other things, documenting and publishing the range of views aired during the Monetary

Board discussions on monetary policy, in order to emphasize that BSP monetary decisions are the product of intensive debate and discussion, and more generally to help stimulate public debate on monetary policy. Transparency efforts may also include providing more details on the Bank's inflation forecasts, in order to allow the public to better gauge their reliability. However, the disclosure of such information will be conditional on the progress the Bank makes with improving its forecasting process.

Improving transparency and communication is part of the larger challenge of making inflation targeting work successfully in the Philippines. Many of the future tasks have to do with the operational and institutional arrangements for policymaking. They also include capacity building and improved resource deployment within the BSP, particularly with respect to monetary analysis and assessment.

Making monetary policy work better also means improving the channels of monetary policy. It is therefore imperative to sustain the efforts to restore the health of the financial system through asset cleanup, better risk management, and ensuring that prudential regulatory standards are not only elevated to international benchmarks but also effectively enforced.

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