

The Benefits of Enhanced Transparency for the Effectiveness of Monetary and Financial Policies

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The topic of this first panel is *The benefits of enhanced transparency for the effectiveness of monetary and financial policies*. This is an appropriate topic for our first panel of the day, as the contribution of transparency to the effectiveness of policies is listed by The IMF Code of Good Practices as the first premise on which the case for transparency is based. To quote from the Code, (para. 4):

“...the effectiveness of monetary and financial policies can be strengthened if the goals and instruments of policy are known to the public and if the authorities can make a credible commitment to meeting them. In making available more information about monetary and financial policies, good transparency practices promote the potential efficiency of markets.”

This statement highlights two aspects of the case for transparency. First, it refers to the role of transparency as part of a strategy for promoting a credible commitment to the policymakers' monetary and financial policies. Second, it suggests that greater transparency has a beneficial effect on private markets in promoting economic efficiency.

In my remarks, I would like to discuss the changing views of the role transparency can play, discuss why the way one implements transparency may differ in the areas of monetary and financial policies, as well as in different institutional settings,

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and highlight some questions that are relevant in considering how to implement transparent policies.

In many ways, a focus on transparency as a contributor to policy effectiveness reflects a changing perspective that has occurred over the past decade. The early emphasis on transparency was not on how it might aid in improving policy effectiveness, but was instead concerned with how it might ensure improved accountability. This focus grew out of concerns about discretionary decision making and the possibility of policy biases.

Of course, this concern for accountability was directly motivated by the poor monetary policy experiences of many countries during the decades of the 70's, 80's and, for many, into the 90's. Accountability was seen as a means of holding central banks responsible for policy outcomes in ways that would improve the overall conduct of policy.

What was often less clear was the issue of accountability to whom? Monetary and financial policies are delegated by governments to institutions that are increasingly independent to pursue policies that, we hope, ultimately benefit the public. So these institutions may need to be accountable both to the governments that appoint them and to the public they ultimately serve.

Often, conflicting conclusions about the benefits of transparency in the academic literature can be traced to the question, accountable to whom? In one branch of the literature, transparency was interpreted to mean that it would be more difficult for a central bank to engage in inflationary policies, perhaps because the public would be better informed about policy actions and the rationale for the actions. In practice, this

type of transparency is now fairly common and is achieved through the type of regular monetary or inflation reports issued by many central banks. The frequency of these reports varies considerably, however. (e.g., Canada has a total of 6 reports and updates each year, UK and Brazil issue inflation reports quarterly, Korea three times a year, and Poland annually). These reports allow the public to monitor more than just the realized outcomes such as inflation, but to also discern when, for example, inflation has exceeded targeted levels, whether the bank has provided a clear and credible explanation consistent with its promised policies.

In another branch of the literature, transparency allowed the government to better monitor the central bank and thereby potentially bring more pressure on it to engage in inflationary short-run policies, or the government could more easily identify (and presumably eventually replace) board members whose votes displeased the government. Such an environment does not necessarily call for less transparency – instead it requires governments to be transparent about their instructions to the central bank. Where the primary responsibility for transparency lies, therefore, may differ, depending on the institutional degree of independence enjoyed by policy makers.

To the extent that periods of high inflation could be traced to political influences on policy makers, the early calls for transparency emphasized accountability to the public and the contribution a transparent system can make in insulating a central bank from direct political influence.

The answer to the question, accountable to whom, also bears on the issue of whether detailed minutes and voting records of board members should be made public, a practice that varies widely among countries. In ensuing accountability to the public, it is

not obvious that there needs to be greater transparency about internal policy debates and board voting records. The public can judge the institution by observing outcomes and the information on which policy decisions are based. More important than voting records is clarity about the goals of policy and the conceptual framework the central bank employs in interpreting the information it has about the economy and in deciding on policy actions. If special interest groups are represented on the board, as in the case of the Bank of Korea for example, then the public's right to know may legitimately extend to voting records.

Of course, it is critical that the public be able to effectively evaluate monetary policy, so many central banks (e.g., the Federal Reserve, the Bank of England, the Bank of Korea, and Central Bank of Sri Lanka) have public education programs that are an important aspect of the implementation of transparency.

In some of my own work (Walsh 2003), I relate the role of inflation targeting in promoting an environment of accountability to the ability of the public to monitor the central bank – transparency, by improving the ability to monitor, also strengthens the role inflation targeting can play in ensuring accountability while still preserving the flexibility that is needed to respond to new economic developments.

In contrast to this earlier focus on accountability, the terms of debate for our present panel emphasize *effectiveness*, and the contribution that transparency can make to the effectiveness of both policy making and private markets.

To frame a discussion on this topic, I think it is useful to distinguish between two different interpretations of what we mean when we say something enhances policy

effectiveness. Most policy problems can be conceptualized in terms of an efficiency frontier – for example, in a standard framework for discussing monetary policy, the efficiency frontier represents the minimum achievable inflation variability associated with a given level of output gap variability.

One sense of effectiveness, then, is the extent to which transparency moves actual outcomes closer to the efficiency frontier. As a simple monetary policy example, one that does not involve transparency, consider the movement from a simple Taylor rule to an optimized Taylor rule – this policy change would not affect the efficiency frontier but it would make policy more effective by moving outcomes closer to the frontier.

The second sense of effectiveness refers to actions that shift the policy frontier, thereby improving the feasible set of outcomes. A structural change in the economy that increased price flexibility, for example, would result in a shift in the efficiency frontier that would allow for both greater inflation and greater output gap stability to be achieved.

Now how do these two notions of effectiveness relate to our discussions of transparency?

The first sense – moving outcomes closer to a given efficiency frontier – played the dominant role in the debates over transparency as a means of reducing any inflationary bias of discretionary monetary policies. These early debates, as I mentioned previously, emphasized the importance of accountability.

More recently, the recognition of the forward-looking nature of economic decision making has led to a realization that providing clear and transparent information about the future path of policy can actually serve to enhance effectiveness in the second sense – that is, it can shift the efficiency frontier in a favorable direction. The statements

over the last couple of years by the FOMC, for example, in first providing signals that interest rates would remain low and, more recently, in indicating that rates will continue to rise, act as a commitment device that operates by influencing private sector forecasts. By affecting expectations of future inflation, such policies can improve the trade-offs available to the central bank.

Markets may also function more efficiently – shifting the efficiency frontier – if participants face less uncertainty about future monetary policy. Providing clear explanations of current policy actions, combined with information that assists the market in understanding likely future policy, important components of policy transparency, can promote financial market stability.

Now, while much of the academic literature on transparency has focused on the problems that arise in the design of monetary policy, this panel has been asked to focus on both monetary *and* financial policies. One similarity between the two types of policies that I would draw is that both involve a moral hazard problem. In the case of monetary policy, the problem is one of moral hazard on the part of the policy maker – once expectations are set, the central bank has an incentive to renege from its prior commitment to low inflation. Transparency that ensures accountability and signals commitments to future policy are designed to address this problem.

The situation with respect to financial policies is, however, quite different. The moral hazard problem is located in the private sector, not with the policy authority. Specifically, financial policies may require policy makers to deny that they are willing “to provide a financial safety net *ex ante*, but to intervene to bail out financial institutions *ex post*.” (Gai and Shin p. 92) While the desire *ex ante* is to limit the moral hazard

problem that arises when financial institutions believe their creditors are protected against loss, the optimal policy *ex post* is to intervene to prevent systemic bank runs. This contrasts with the case of monetary policy where the objective is to ensure the central bank does *not* implement the *ex post* optimal policy.

Perhaps reflecting these differences, the summary of the case studies indicates that there does seem to be greater variation in how transparency is interpreted with respect to financial policy than there is with respect to monetary policy.

Another difference between monetary and financial policies is in the contribution of better information to market stability. Predictable monetary policy reduces private sector forecast uncertainty and therefore is likely to promote stability, improving the efficiency frontier. But too much transparency too soon about emergency liquidity assistance may contribute to financial instability, worsening the efficiency frontier. It can potentially lead to a “bad” equilibrium being selected (i.e., revealing a bank bailout may lead to a run on other healthy banks). So transparency may need to play a somewhat different role in enhancing the effectiveness of financial policies.

What does all this imply about making the Code of Good Practices operational in diverse circumstances? The answer depends on achieving clarity on some of the following issues:

Who is ultimately responsible for monetary and financial policies? If it is the elected government, as in the U.K. or New Zealand, then transparency needs to include the timely release of minutes and voting records so that the policy institution can be held

accountable to elected officials. This type of system also requires that the instructions to the policy makers from the government be public so that the government can also be held accountable.

If, as with the Federal Reserve and the ECB, the policy making institution has greater goal independence, then transparency requires the institution itself to provide the public with clear statements of its objections and the rationale for its policy actions, but there would seem to be less reason to release voting records.

How does transparency improve the efficiency of private markets? The efficiency of private financial markets is likely to be increased if private agents have a clearer sense of the framework guiding policy decisions. By reduce private sector forecast errors, financial stability is enhanced.

But this is not the only effect. Announced policy intentions that are credible can, by steering private sector expectations, improve the trade-offs policy makers face – that is, shift the efficiency frontier to use my earlier characterization, while too much transparency about emergency liquidity operations may contribute to market instability and reduce the efficiency of private markets.

What moral hazard problem is transparency meant to fix? Clear communications about monetary policy help to support commitment policies. This helps to solve the potential biases of discretionary policies. As a consequence, *ex ante* optimal policies and *ex post* optimal policies are more closely aligned. But *ex ante* transparency with respect to some aspects of financial policy may worsen moral hazard problems among financial

institutions. However, *ex post* transparency about such financial operations is surely a requirement for any public institution.

I look forward to hearing of the experiences of our four panel members as I am sure they will cast some interesting light on these, and other, questions.

References

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