Discussion of “The Limits of Transparency” by Alex Cukierman

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Issues

• Feasibility of transparency
  – Potential output and output gap
  – Central bank preferences

• Desirability of transparency
  – Financial crisis and systemic risk
  – Central bank preferences (credibility and stabilization)
  – Forecast of economic shocks
Issues

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Are Markets “Irrational”? 

- Global game models with public information

- Thailand 1997 vs. LTCM 1998
  - crisis as coordination
  - common knowledge of distress as lightening rod

- Marking to market amplifies distress cycle
  - price as a coordinating mechanism
  - externalities of distress
Asset and Liability Growth

Merrill Lynch Asset and Liability Growth (Quarterly)
Equity Cushion

Merrill Lynch: Net Worth to Liabilities Ratio (Quarterly)
Merrill Lynch: Scatter plot of asset growth and change in equity cushion
Are Markets “Irrational”?  

• In what sense is the market a single coherent agent, meeting the standards of consistency of beliefs?  
  
  – We often speak informally of the “market’s expectations”  
  – Formal models with a representative individual impose this as a matter of course  
  – But is there a danger that we are misled by using oversimplified models?  

• In Allen, Morris and Shin (RFS 2006), market prices with fully rational, forward-looking traders take the form:  

\[ p_t = \bar{E}_t \bar{E}_{t+1} \cdots \bar{E}_{t+h} \theta_{t+h} \]

\[ \neq \bar{E}_t \theta_{t+h} \]
and price overweights public information relative to the average expectation of the fundamental value.

• “Market’s expectations” is just a metaphor
  – There is no single individual called “the market”
  – Market prices are determined as the result of a complex interaction
  – Being able to handle conditional forecasts is not a matter of taking a stand on whether markets are rational or irrational.

• Better to ask how market prices incorporate information from:
  – public pronouncements,
  – disclosures of financial distress,
  – conditional forecasts of CB,
  – etc.
Managing Expectations through Central Bank Forecasts

Argument from the effectiveness of monetary policy.

- Central banks directly control only overnight rate, not prices that matter (long-term interest rates, other asset prices).
- Expectations determine prices that matter
- Long-term interest rates are determined by the market’s expectations of the future course of short term rates.
- Central banks can shape expectations by disclosing path of future policy rates.
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Expectations Theory of the Yield Curve

Campbell, Shiller and Schoenholtz (Brookings Papers, 1983)

“The simple expectations theory, in combination with the hypothesis of rational expectations, has been rejected many times in careful econometric studies. But the theory seems to reappear perennially in policy discussions as if nothing had happened to it. It is uncanny how resistant superficially appealing theories in economics are to contrary evidence. ⋅⋅⋅ ”
“… We are reminded of Tom and Jerry cartoons that precede feature films at movie theatres. The villain, Tom the cat, may be buried under a ton of boulders, blasted through a brick wall (leaving a cat-shaped hole), or flattened by a steamroller. Yet seconds later he is up again plotting his evil deeds.”
• This paper was published almost 25 years ago, but the force of the argument seems (if anything) stronger.

• Yet, the expectations theory of the yield curve pervades the policy discussions and market commentary in the press.
Can Central Banks Control Long Rates?

Central bank guidance seems important in pricing one or two years out in the yield curve (Piazzesi (2005)), but there is little evidence that long-term rates can be managed.

When Merrill Lynch fixed income traders trade 10 year swaps, are they influenced primarily by their beliefs of central bank policy 7, 8 or 9 years from today?

There is some evidence that expectations theory of the yield curve works for small countries (Gerlach and Smets (1995)).

But precious little evidence from countries that host major financial markets.
Norges Bank Experience

Norges Bank interest rate projection of autumn 2006 did not affect long rates.

“It is now almost three months since the previous Inflation Report was published. ... Forward rates somewhat further out are still lower than our forecast. ... [T]he market may have the same short-term interest rate expectations as Norges Bank, but because of extraordinary conditions long-term bond prices are being pushed up and, consequently, long-term bond yields are being pushed down.”

Deputy Governor Berlo, January 26, 2007
Monetary Policy and Financial Markets

- Monetary policy works via the financial markets.

- Central banks have a large impact on financial markets (maybe too large an impact) via the coordinating role of prices and marking balance sheets to market.

- But this impact is not something that can be easily wielded to fine-tune prices.

- If Norway, with its small financial sector has problems in fine-tuning, can central banks in the major financial centers hope to do better?
Informational Efficiency

• Market prices guide real economic decisions, and the informational value of market prices ought to be of interest to central banks.

• IS curve based monetary models focus on flows (e.g. consumption).

• Many decisions are about stocks (e.g. debt), and are difficult to reverse.
  – Subprime mortgage debt
  – Carry trades

• LM curve fell out of favor, because IS/LM tried to mix stocks with flows.

• Time for a revival of balance sheets and liquidity in monetary policy?