

Economics focus

It's not always good to talk

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Do communicative central banks make financial markets lazy?

LOCATED just a mile or two from Capitol Hill, the Federal Reserve stands far beyond legislators' political reaches. In 1978, a law sponsored by two such legislators, Hubert Humphrey and Augustus Hawkins, required the chairman of the Fed to travel the short distance from his office to the Hill twice a year to testify before Congress. The act expired four years ago. But these days, the chairman needs little persuasion to talk. Alan Greenspan's Humphrey-Hawkins testimony, as it is still called, delivered on July 20th and 21st, was his 24th speech of the year.



Mr Greenspan has spent much of this year preparing markets for higher interest rates. This week, he had little to add. Rates are on their way back to "neutral", he confirmed, though he could not tell senators what that neutral rate might be. (We'll know it when we get there, he said.) He would move at a pace "likely to be measured." But if that were not fast enough to safeguard price stability, he would move faster.

Central bankers were not always so happy to talk. Until February 1994, the Fed's rate decisions were not announced—let alone discussed publicly in advance—but had to be inferred from its operations in the markets. When, in 1975, this reticence was challenged under the Freedom of Information Act, the Fed spent six years defending its right to secrecy in court. As Marvin Goodfriend, an American economist, has put it, central bankers were anxious to cultivate their "monetary mystique".

That mystique still appeals to some. In an interview with the *Wall Street Journal* published on July 15th, Tommaso Padoa-Schioppa, one of six members of the executive board of the European Central Bank, argued that central banks now talk too much. He gently mocked the Fed's pet phrases. Surely, it goes without saying that the Fed will be "measured". (It could hardly act without measure.) And if it goes without saying, why say it?

Fedspeak is easy to mock. But it is now a truism that a central bank's words are as important as its actions. After all, a tweak in the federal funds rate counts for little by itself. It is only if the markets expect a succession of rate changes that mortgage rates, bond yields and equity prices will move in sympathy. Credible central banks steer such expectations by what they say.

Mr Padoa-Schioppa, however, thinks central banks are guilty of oversteering the markets. "The danger that I see is that the market becomes lazy," he told the *Journal*. "If it is spoiled to the point that it is told everything in advance, it relies not on its own analysis, but on the analysis of the central bank." He is not alone in this worry. The same argument is set forth, in equations, by Jeffrey Amato, of the Bank of International Settlements, Stephen Morris, of Yale University, and Hyun Song Shin, of the London School of Economics, in a number of recent papers^{*}.

Beauty is truth, or conventional wisdom

Messrs Amato, Morris and Shin explain their argument by reviving Keynes's famous "beauty contest" analogy. In Keynes's day, newspapers invited readers to pick the six prettiest faces from 100 photographs. Readers won by picking the faces that "most nearly corresponded to the average preferences of the competitors as a whole". Financial markets, Keynes argued, work in much the same way. An investor wins by anticipating which asset will become the popular choice. Like the readers of 1930s newspapers, speculators "devote [their] intelligences to anticipating what average opinion expects average opinion to be."

How much easier the contest would be if some widely watched, widely respected authority figure offered his public judgment on the faces in the photographs, telling readers whom he deemed the prettiest. His judgment may or may not be sound. What counts is that everyone pays attention to what he has to say—and everyone knows everyone else is paying attention. For this reason if no other, his public judgment would lay down a marker around which average opinion could coalesce. Once the authority had spoken, it would take a brave reader to bet against his judgment—and a foolish one to expend much energy scouring the faces in the photographs himself, to form his own independent opinion of their fundamental attributes.

Messrs Amato, Morris and Shin worry that today's loquacious central banks play this role in the financial markets. Their public pronouncements on the state of the economy provide a rallying point for conventional wisdom. Central bankers no doubt offer genuine insight. But however sound as a guide to the underlying fundamentals, their pronouncements are even better as guides to what average opinion will be. As a result, traders give the opinions of central bankers undue weight, and skimp on their own independent assessments of the economy.

Errors, which creep into even the best central-bank analysis, are thus amplified, because they are not gainsaid. And if the analysis is not the best, it can steer expectations about the economy widely off the mark (as, for instance, if it legitimises "irrational exuberance" by heralding the dawn of a new economic age). Public pronouncements crowd out private opinions, and the market ceases to function as a way of aggregating and revealing diverse, private judgments of the world. The monetary authorities look to the markets to hold a mirror up to the economy, but what is reflected back is simply the bank's own prior beliefs.

Even if true, this is not a clinching argument for central banks' silence. As Messrs Humphrey and Hawkins believed, openness is the price of their political independence. Since they do not have to answer to voters, they must at least explain themselves to the public and their elected representatives. Central banks should keep talking. But the

markets should not hang on their every word. Messrs Amato, Morris and Shin are right about that.

* The most apposite, "

Communication and Monetary Policy", and others are available at www.nuff.ox.ac.uk/users/Shin/policy.htm

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