When facts change, so should central banks

By Francesco Giavazzi and Charles Wyplosz

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In his Mansion House speech last week, Mervyn King, governor of the Bank of England, expressed his view of how central banks should communicate their intentions. Acknowledging that “markets need to form a view on the probabilities of different paths of future interest rates in order to price a wide range of financial instruments”, he said: “We don’t say where interest rates will go next for the simple reason that we don’t know . . . Knowledge of our objective and our analysis is all that markets need from us to form judgments about the future path of interest rates.”

Other central banks – the Bank of Norway and the Reserve Bank of New Zealand – have started publishing interest rate forecasts two years ahead. The governor of Sweden’s Riksbank has said he will move in the same direction. How sad to see the Old Lady, which once pioneered transparency and innovative communication, trailing behind.

Of course, no central banker knows what he will decide in two years’ time. Future interest rate decisions depend on information not yet available. Mr King argues that revealing such views would be pointless and could be misleading, as it might induce markets to believe the central bank has information it is not making public. But when central bankers set today’s interest rate, do they really *not* have the faintest idea where they are heading? Fortunately, they do. Uncertainty about the state of the economy suggests caution: moving in small steps on interest rates makes it easier to correct the course if new information changes the picture. This is why nowadays, central banks tend to move rates in 25-basis point instalments. It takes one to two years to bring them from a low to a high point when the economy is heating up, and about as much to bring them down when the economy is slowing.

Everyone interested in financial matters well knows what is going on. What the markets do *not* know precisely is how quickly the central bank will move, or how far. The central bank does not know either. This is where transparency and communication enter the picture. The markets have no choice, they must form a view because they have to set a price for financial assets whose returns depend on future rates. The central bank can pretend not to know, leaving the markets in the dark. But it cannot pretend it has no view about where interest rates are going and how fast, or that it does not observe market expectations. It is certainly convenient to stay out of the muddle, but is it justified?

There is a good reason why central banks are reluctant to publish interest rate forecasts. As the central bank sets the interest rate, its forecasts really are intentions. Because so much can and will happen over the next two years, inevitably the forecast will be proven wrong. Would not the central bank lose some credibility as it strays away from its earlier intentions? There is no reason for this. Intentions as of today, based on today’s information, have no reason to stay unchanged as new information pours in. Twice so far, the Bank of Norway has acted differently from what it announced earlier. The bank plainly explained what piece of news had changed its view, the markets understood and the bank’s credibility was enhanced.

But there is a more subtle issue. The way many central banks, including the Bank of England, build their inflation forecasts risks being inconsistent. That is because in order to build such forecasts, central banks must make an assumption about the future path of policy rates. For a long while, they assumed unchanged interest rates, a rather foolish assumption. Most – including from this month the European Central Bank – are now using the rates implied by the market yield curve. This is not right either. The yield curve is based on market expectations of future central bank actions. But such expectations may differ from the central bank’s intentions. If they do, inflation forecasts based on market expectations will be wrong and the central bank will have purposely misled the markets. This is not a great way to be transparent or earn one's reputation. The only logical and practical way out of this issue is to follow the lead of Norway and New Zealand.

Maybe Mr King wants to wait and see how the latest innovation fares in practice; prudence is indeed a central banker's virtue. But he needs better arguments to justify his position.

Francesco Giavazzi (Bocconi University, Milan) and Charles Wyplosz (Graduate Institute of International Studies, University of Geneva) are research fellows at the Centre for Economic Policy Research in London