Building transparency and credibility of the central bank. The case of Polish inflation targeting†

[Some introductory remarks]

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In the inflation targeting framework central banks attempt to establish credibility by conducting a transparent policy, therefore the adoption of this framework is typically followed by major improvements in central bank communication with the public and with the market (Mishkin and Schmidt-Hebbel, 2001). Due to delays in the monetary transmission mechanism – which in the case of Poland are approximately 4-6 quarters – central banks with quantitative inflation targets must have adequate tools to form views on future macroeconomic performance, especially on inflation prospects. Moreover, they should have good understanding of the monetary transmission mechanism. For these reasons inflation forecasts, capturing not only macroeconomic developments in general, but highlighting the effects of monetary policy, are crucial in the process of building central bank transparency and credibility.[1]

Empirical studies show that through communication central banks are able to reduce uncertainty about future interest rates, anchor inflation expectations and lower sacrifice ratios. These benefits from inflation targeting seem to be greater in developing economies than in the developed ones (Mishkin and Schmidt-Hebbel, 2007).

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† By Tomasz Łyziak, Economic Institute, National Bank of Poland, e-mail: Tomasz.Lyziak@nbp.pl. Opinions expressed in this address represent the author's views and do not necessarily correspond to those of the National Bank of Poland.

[1] Inflation forecasts play a very important role in the inflation-targeting framework. Svensson (2003) defines this regime as inflation-forecast targeting, underlining that the inflation forecast may be treated as intermediate goal in this type of strategy. In his view the monetary policy making process should be as follows: The central bank selects the feasible combination of inflation and output gap projections to minimize the loss function. Then it chooses the corresponding instrument-rate plan and sets the interest rate accordingly. Announcing and motivating these forecasts maximize the impact on private sector expectations and the economy and make the implementation of policy most effective.

Before 1998 the strategy of the National Bank of Poland combined elements of the exchange rate targeting, inflation targeting and monetary targeting. The integration with the global economy created problems for such strategy, making it impossible to control both the money aggregates and the exchange rate. Therefore in 1998 the Monetary Policy Council decided to introduce inflation targeting. Another important reason for adopting inflation targeting was the need to anchor inflation expectations, perceived as one of the main obstacles for the continuation of the disinflation process.

Over the almost 15 years of inflation targeting, monetary policy of the National Bank of Poland has been quite successful:

- In spite of a relatively poor target performance – especially in the initial stage of inflation targeting (1998-2003) – inflation went down: while at the beginning of 1998 it was about 13%, by the end of 2003 it had fallen to 1.5%.
- Since 2004 the central bank has targeted inflation at 2.5% (with a tolerance band of ±1 pp.) and in fact inflation and inflation expectations of private sector agents stabilized at a relatively low level.
- The framework performed quite well when Poland faced an inflation shock caused by its entry to the European Union in May 2004. Then, the MPC made inflation gradually go down.

Polish inflation targeting had a difficult time in 2007-2008, when oil and food prices rocketed, and even more so during the financial crisis of 2008-2009. The financial crisis prompted a change in the central bank's monetary policy rule – MPC put more weight on output stabilization than before even though inflation exceeded the target (Demchuk et al. 2012).

Over these 15 years NBP has not avoided policy errors. For instance, there are analyses showing that in some periods monetary policy was too restrictive and could have been performed with a smaller output loss; there were also periods in which monetary policy turned out to be too lax (Kokoszczyński et al. 2006). However, determination of the National Bank of Poland to achieve its policy goals combined with developed communication patterns enhanced the credibility of the central bank despite these policy errors.

These considerations lead us to the problem of building central bank transparency and credibility by different means of communication, especially by publishing inflation projections.

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Central bank transparency is a multidimensional phenomenon. First of all, monetary policy is transparent when those outside the central bank are provided with full access to information necessary to understand goals and decisions of monetary policymakers. There are well known transparency indices measuring central bank disclosure practices such as those of Eijffinger and Geraats (2002) or Mahadeva and Sterne (2000).

Explanation of policy is a crucial, but insufficient condition for central bank transparency. Effectiveness of communication is another important aspect to be considered (Winkler, 2000). Monetary policy is transparent if the information released by the central bank helps the private sector understand policy objectives and predict central bank decisions.[2]

Over the last 15 years, the National Bank of Poland has been putting more and more stress on a development of effective communication with the public. Transparency indices by Eijffinger and Geraats (2002) as well as Mahadeva and Sterne (2000) show that the degree of information openness of the NBP has become relatively high after the central bank started publishing its staff inflation projections with a formal risk assessment. It took place in August 2004, after more than 3 years of preparing unpublished internal inflation projections at the central bank, and coincided with significant changes in the structure of Polish *Inflation Reports*. Previously the public did not have access to inflation forecasts prepared at the bank and the forward-looking orientation of monetary policy was significantly less pronounced than in other central banks pursuing inflation targeting. Also the quality of information released was insufficient (e.g. Fracasso, Genberg and Wyplosz, 2003).[3]

Central bank transparency, as measured with both transparency indices, increased again in 2007, when the NBP started releasing minutes that present the main issues discussed, arguments put forward and the decisions taken at the MPC meetings.

The increase in the transparency of the Polish monetary policy, as measured with the information disclosure practices, was accompanied by an increase in the predictability of interest rate decisions. Even if the initial stage of inflation targeting in Poland did not bring improvements in this respect (see Łyziak, Mackiewicz and Stanisławska, 2007), publishing central bank inflation projections since 2004 has made a substantial difference. As a result of changes in communication patterns the mean absolute error of interest rate expectations measured on the basis of financial market data declined by 60%, while the mean absolute percentage error declined by more than 25%.

Interestingly, the introduction of the minutes in 2007 was not accompanied by a further improvement in the predictability of interest rate decisions and the relative forecast errors even increased slightly. It seems that this result is due to a substantial uncertainty concerning monetary policy decisions at the beginning of the financial crisis in September 2008.

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[2] Empirical evidence supports this view. E.g. Fracasso, Genberg and Wyplosz (2003) show that the quality of *Inflation Reports* reduces interest rate surprises.

[3] The main weaknesses mentioned included: incompleteness, insufficient information concerning committee discussions about policy and objections that could be raised to decisions, too few arguments for future decisions presented.

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Better understanding of central bank actions achieved via appropriate communication policy influences ability of the central bank to manage inflation expectations of the private sector. Such a central bank is deemed credible. Blinder (2000) provides a very short and intuitive definition of credibility: *"a central bank is credible if people believe it will do what it says"*. Therefore existing measures of central bank credibility refer to a gap between inflation expectations of economic agents and the central bank inflation target or forecast (e.g. Faust and Svensson, 1998; Hutchison and Walsh, 1998; Cecchetti and Krause, 2002) or to the weight attached to the inflation target in the formation of the long-term inflation expectations by economic agents (Bomfim and Rudebusch, 2000).

Both types of empirical measures of the central bank credibility show that the inflation target of the National Bank of Poland has a strong impact on inflation expectations of financial sector analysts and enterprises, while a relatively small impact on consumer inflation expectations. It seems that advances in the NBP communication with the public, reflected in better predictability of interest rate decisions, contributed also to the increase in the credibility of the central bank.

Since the first publication of the NBP staff inflation projection in 2004, expectations of all economic agents under consideration have become closer to the NBP inflation target and in each group the share of agents whose inflation expectations are based on the target has increased. This effect was particularly strong in the case of financial sector analysts and enterprises, while statistically insignificant in the case of consumers.

Remarkably, inflation forecasts formed by financial sector analysts are usually closer to the NBP inflation target of 2.5% than to the NBP inflation projections. Given that the NBP staff inflation projections assume constant interest rates it suggests that financial sector analysts observing deviations of the NBP staff forecasts from the target believe that NBP actions will bring future inflation closer to the target than it results from the projection currently available. It confirms a high degree of central bank credibility in Poland.

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Polish experience suggests that inflation projections published by the central banks can lead to improvements in the predictability of interest rate decisions and in the degree of central bank credibility. However, there are some pre-conditions that should be met to make such improvements possible:

- Firstly, some institutional characteristics of the central bank are crucial, i.e.: the central bank must be perceived as independent (*de iure* and *de facto*), the goals of monetary policy must be precisely understood and the policy makers should be perceived as able and determined to achieve the declared goals of monetary policy.
- Secondly, publishing inflation forecast the central bank should communicate not only numbers, but mainly the story behind them and an analysis of risks. Only in this way could inflation forecasts contribute to better understanding of the conduct of monetary policy and enhance central bank credibility despite forecast errors committed.
- Thirdly, inflation projections published by the central bank should influence the whole communication process of the central bank and should be perceived as at least one of the important factors determining monetary policy decisions.

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[Some closing remarks]