

Commentary: Monetary Policy in the Information Economy

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Introduction **1**

I think of Michael Woodford as the Charles Dickens of American economics. When you pick up a Woodford paper, it looks rather long and involved; indeed, it usually is rather long. Yet, by the end, you wish it could go on a little longer. This paper is an excellent combination of intellectual rigor and great clarity of exposition. I have no significant disagreements with any part of it.

I will comment on two issues: the first is the case for transparency and the importance of central bank communication, and the second is the determination of the monetary unit of account when the central bank no longer has a monopoly of final settlement.

The case for transparency **2**

As Woodford points out, during the past decade central banks have moved from mystery and mystique to transparency and openness. That movement has been led by those central banks for which the need for a new approach was most urgent. In the case of the Bank of England, a track record of monetary mismanagement for more than two decades, culminating in our departure from the exchange rate mechanism, meant that a degree of openness was not only desirable but also necessary for any degree of credibility. The view that one should explain clearly what we think we know, and equally clearly what we know we do not know, has served us very well.

All central banks have put a good deal of effort into communication with the public in recent years. Indeed, the case for transparency is so overwhelming that Woodford has a hard time in putting up counterarguments to knock down. For example, he asks whether the faster transmission of information in financial markets, resulting from the information economy, makes it more difficult for central banks to surprise the markets. And he concludes that even if it does, central banks should not try to surprise the markets. It is difficult to argue that they should.

For some time now, I have been arguing that central banks should judge their success by how boring they are. The news should be in the economic data, not in the response of central banks to those economic developments. That response should be reasonably predictable. In that sense, surprising the markets is something that should happen rarely. I am glad to report that most of us in central banking circles have done a pretty good job in boring the public. I often find that when asked to speak to, for example, the annual dinner of some local business organization, the organizers have invited a professional comedian to entertain the audience following my speech. The somewhat hysterical nature of the laughter that the often rather poor jokes induce in the audience is, I believe, convincing evidence of how boring my talk really had been.

The case for transparency is that a clearer understanding by the private sector of how the central bank will set monetary policy will lead to an improvement in the efficiency policy. This is because policy works, in part, through expectations of future policy. It is not just the overnight interest rate that matters, but interest rates further along the yield curve. More predictable expectations of the future level of interest rates, and, hence, asset prices, will lead to less noise in the impact of monetary policy on private behavior. In essence, the bond market does some of the work for us. To bring this about, the central bank needs to create a clearer understanding of how policy will be set in the future.

It is not easy to disagree with this case for transparency. Woodford argues that because new Keynesian Phillips curve models give more weight to expectations of future inflation, and that these models are

more realistic than classical models, transparency is in line with new thinking about macroeconomics. There is an element of a straw man here since the proponents of new classical models did not advocate surprise changes in policy, even though it was only unanticipated changes in monetary policy that mattered in their models, precisely because any systematic attempt to exploit such surprises would quickly be learned and become ineffective.

Nevertheless, it is certainly the case that the more private sector behavior reflects expectations of future interest rates or asset prices, the more a central bank has an interest in trying to affect those longer rates. If official rates move as a white noise process, the smaller the leverage a central bank has on longer maturities. Hence, some central banks make a virtue of moving interest rates slowly so that a change in rates would be seen as a signal of further changes in the same direction—interest rate smoothing. But this introduces unnecessary sluggishness in the response of interest rates to changes in the economy. It is more efficient to be open about what the central bank is trying to achieve, thus allowing expectations of future rate changes to follow the economic data, and also allowing short rates to move quickly when necessary.

I conclude, with Woodford, that the case for transparency is overwhelming. But central banks have not necessarily been easy to persuade to move in this direction.

The most important question concerns what it is that the central bank should be trying to communicate. The key principle is that the central bank should try to communicate a timeless aspect of its decision-making, not an ad hoc justification for a particular decision. What is timeless is not the individual decision at a particular policy meeting, but the “policy reaction function,” which explains how the central bank reacts to the data available to it. In his opening remarks, Alan Greenspan identified a problem with this approach. It is that there is no timeless model of the economy that generates a policy reaction function, which itself remains constant over time.

Both central banks and economic agents are continuously learning about the nature of the economy. And that nature too is changing over time. The result is that there will be no timeless policy reaction function. In the presence of learning, there is no mechanical policy reaction function that can be applied to the data to reach an optimal decision. In large part, that is why central banks have monetary policy committees, not automatic responses generated by an econometric model. Our understanding of optimal monetary policy in a world of learning is in its infancy. Tom Sargent and others have expanded our understanding in this area, but it is far from complete. Hence, in my view, the most important aspect of central bank communication is to explain to the public how the central bank is learning about the economy and what lessons it has drawn from recent experience. It is almost a common intellectual journey in which the central bank guides the public—even has a conversation with the public—and is open about both what it does and does not understand. It is not about hinting what may or may not happen at the next meeting. The issues surrounding the rise in the stock market and the development of the “information economy” are good examples of where the Federal Reserve has been very successful in explaining to people what are the issues raised by these phenomena, what the Fed does and does not understand about it, and how much uncertainty there really is. It is the learning process that has been communicated.

Woodford is conscious of these arguments, as can be seen from his comments to the effect that, “I do not mean that a bank should commit itself to an explicit state-contingent plan for the entire foreseeable future, specifying what it would do under every circumstance that might possibly arise. That would obviously be impractical It suffices that a central bank commit itself to a systematic way of determining an appropriate response to future developments, without having to list all of the implications of the rule for possible future developments.”

Woodford goes on to say that the economic commentaries of the central bank—inflation reports for example—are crucial in communicating the learning process and the understanding of the central bank. He is surely right to say that, in many ways, they are more important

than the records of votes of individual members. It is the thinking behind decisions that provides the most effective guide as to how the central bank might respond in the future. In the case of the Bank of England, the publication of individual votes is more a matter of trying to improve the incentives for better decision-taking and to ensure accountability of members *ex post*. It plays a less important role in the communication of the thinking of the Bank of England, which is focused on the Inflation Report and the discussion in the minutes, which is not attributed to individuals.

The erosion of the demand for the monetary base

3

The second issue that Woodford raises concerns the consequences of the erosion of private-sector demand for base money. This may result from the development of alternative payment systems produced by the information economy. In considering some of these “futuristic” issues, it is important to distinguish between the cases where the central bank continues to provide final settlement and where it does not. In itself, whether the demand for the monetary base declines without limit is irrelevant to the outcome.

In the case in which the central bank continues to provide settlement balances, as Woodford points out, the size of the monetary base is irrelevant. What matters is that because central banks are the monopoly supplier of final settlement balances, they can control overnight interest rates. There are many ways of doing this, and Woodford considers the channel system used in a number of overseas central banks to maintain overnight interest rates within a desired band. For some time, the Bank of England has argued that within such a system reserve requirements are irrelevant. Woodford’s discussion of the channel system is elegant and informative, and I hope will be widely read in the context of designing central bank operating procedures.

The second, and in some ways more interesting, case is where there is no demand for settlement balances at the central bank because final settlement can be provided by the private sector. At some date in the future, this might be provided by companies specializing in software

rather than traditional central banks. It is the case discussed in my own contribution to the Jackson Hole symposium in 1999. I certainly agree with Woodford that, at present, such a development is only a possibility rather than a likelihood, and is many years away. But it would imply a discrete change in the way in which the value of “money” was determined.

The key implication of such a system is that the government would need to decide on how the unit of account was set. There are two possibilities. First, there might be competing units of account or currencies. In addition to the U.S. Treasury dollar, there might be a Microsoft or a Wal-Mart dollar. In this world, as Woodford describes, a national central bank would have no necessary advantages other than a brand name. But it is far from clear that competing units of account are desirable. We do not do this in the field of weights and measures, and, indeed, in the UK it has become illegal to use imperial weights and measures only without providing their metric counterpart.

More likely in practice is the development of a single unit account mandated by government. This could either be a commodity standard implemented in a mechanical way, or it could be a managed standard as described by both Michael Woodford and Robert Hall. In this latter case, the standard could be managed by a central bank. But, in general, it would be possible to adopt a standard for the unit of account that did not require the operation of a central bank. As I wrote in my symposium contribution two years ago:

“The choice of a unit of account would be a matter for public choice, perhaps along the lines of existing weights and measures inspectors. Only if the unit of account was managed would there be a role for a body such as a central bank as we know it. Whether the unit of account should be determined by a mechanical rule, as other weights and measures, or managed in a discretionary way depends on some deep issues about the nature of nominal rigidities in such an economy.”

This is certainly an area where our knowledge is imperfect. But it is not likely to be a pressing issue for the practice of central banking for some time, its intellectual fascination notwithstanding.

Conclusion

4

The key message from this paper is that the way central banks talk and communicate with the public is important. Clear communication increases the efficiency of monetary policy. Careless talk may not cost lives, but it will cost money. Nevertheless, central bankers must not compromise in their message—we are not aiming to be popular but to be understood. Rudyard Kipling described this in his poem “If” with a line aimed at central bankers. The more famous lines from the poem, which appear at the entrance to Centre Court, Wimbledon, are also apposite to central bankers:

“If you can meet with Triumph and Disaster,
and treat those two impostors just the same ... ”

But the advice for central bankers is (with apologies to Kipling for some minor alternations of the final line):

“If you can talk with crowds and keep your virtue,
then you’ll be a central banker my son.”

Michael Woodford is an honorary central banker.

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