

Lessons for Monetary Policy Communication

by Michael McMahon*

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Professor McMahon was charged with an ambitious task, which he has fulfilled admirably. Given the short length of this discussion, rather than critique his paper—which would serve little purpose being so vast in scope and be hard to do in any event as I largely agree with him—I offer some remarks about the Australian institutional context which I hope will amplify some of his many insights and provide further context for discussions over the coming days.

By design central banks are:

- i. Statutory authorities
- ii. Political entities
- iii. Charged with implementing monetary.¹

Each of these identities demands communication. As a matter of democratic accountability and transparency central banks must provide information about how they are to pursue and achieve mandated objectives. They communicate to build consensus for policy actions, often highlighting the limitations of available instruments and perhaps the need for others, and also to shape how they are evaluated by the public and their political masters. And given many economic decisions are forward looking, communication manages the transmission mechanism of monetary policy, ensuring changes in policy instruments are efficiently reflected in various market prices relevant to those decisions. Much has been written about the communication requirements of the first and third identities, with considerably less on central banks as political institutions.² But central to each is that communication is central to credibility.

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¹Of course, central banks have many responsibilities other than monetary policy.

²A notable exception is Sarah Binder’s and Mark Spindel’s “The Myth of Independence: How Congress Governs the Federal Reserve”.

Focusing on the third identity, credibility and its close relative reputation are assets of the central bank. Credible central banks have more precise control of long-term expectations permitting policy to deliver smaller fluctuations in economic activity and inflation in response to adverse developments. Importantly, credibility is a vacuous concept without communication. As emphasised by Michael Woodford, one of the world’s great monetary economists, inflation targeting regimes exchange strict adherence to a policy rule with “visibility” of the policy strategy to the public. Without visibility of the economic framework for setting interest rates, the public cannot evaluate the central bank’s performance because there is no way to distinguish policy errors from unanticipated developments. Without being able to form an assessment of whether a central bank does what it said it would do, there can be no credibility.

To render this idea concrete, we can think of inflation targeting as the following rule. At each point in time the central bank must ensure the target criterion

$$E_t\pi_{t+8} = 2.5\%$$

is satisfied. That is, current and future policy must be determined to ensure that expected inflation in eight-quarters time equals the target of 2.5 percent per annum.³ This is a fundamentally different prescription for policy than a nominal exchange rate peg, a Taylor rule, or Friedman’s celebrated money growth rule. Each of these proposals for policy have the property that adherence to the rule is directly observable. The central bank is either implementing the exchange rate peg or it isn’t. In contrast, because inflation targeting is stated in terms of an expectation, rather than say past observed inflation, we cannot directly evaluate the central bank’s performance from currently available data.⁴ However, after the passage of two years, we are in a position to evaluate policy over this period. In the presence of uncertainty, inflation is unlikely to be exactly 2.5%. But should we conclude this is due to bad policy or bad luck. Without information about the policy framework and how the central bank intends to achieve this objective, it is impossible to know. And without this knowledge, credibility unlikely to be secured.

Like many monetary authorities, the Reserve Bank of Australia uses a range of communication devices, depending on the intended audience. These include the Statement of the Conduct of Policy; the Statement of Monetary Policy; announcement and minutes of policy-meeting decisions; press conferences; and speeches, articles and explainers about a range of

³Of course, the Reserve Bank of Australia has a second mandate in the form of a full employment objective, but this does not change the logic of the argument I now make.

⁴Some aspects of the policy can be evaluated. For example, published projections should satisfied the target criterion.

topics. Pointing to the volume of communication, senior officials in the past have argued that they are necessarily transparent, accountable and effective communicators—but as I have written elsewhere, this confuses quantity with quality. Indeed, the recent Review of the Reserve Bank acknowledged deficiencies in the RBA’s communication strategy, and made a number of recommendations for improvement. This included clarification of key language in the Statement on the Conduct of Policy as well as the requirement to hold press conferences after each policy meeting. These are welcome developments.

But problems remain. The Statement on Monetary Policy should be a document of public record that definitively states the Reserve Bank’s evolving views about the economy, and what these views mean for monetary policy and the achievement of mandated objectives. Prior to the Review some steps were taken by the Bank to talk about current and future monetary policy in this document—as opposed to it being solely a sophisticated assessment of the current state of the economy. However at the time of this conference, the largest post-Review change appears, embarrassingly, to be putting the first sentence of each paragraph in bold font. Whatever one’s views about the ability of fonts to demystify the complexities of monetary policy, this document, and much of the Bank’s public discourse, is hampered by a reluctance to tell the public what it plans to do. Reporting projections of the economy based on market expectations fundamentally hampers communication. Why tell the public about the likely evolution of the economy given assumptions about future policy which the Bank has no intention of implementing? It is hardly surprising that Bank officials have to devote precious time and resources explaining why their actions are inconsistent with market expectations, not to mention the additional welfare-reducing economic fluctuations caused by such a communication policy. We can only hope that this and other documents are works in progress, with further refinement to come.

To that end, Professor McMahon’s overview of academic and central bank thinking about communication policy provides a useful resource to focus and challenge future developments in communication policy.