

Central Bank Communication and Expectations Stabilisation

(with S. Eusepi)

Abstract

This paper analyzes the value of communication in the implementation of monetary policy. The central bank is uncertain about the current state of the economy. Households and firms do not have a complete economic model of the determination of aggregate variables, including nominal interest rates, and must learn about their dynamics using historical data. Given these uncertainties, when the central bank implements optimal policy, the Taylor principle is not sufficient for macroeconomic stability: for all reasonable parameterizations self-fulfilling expectations are possible. To mitigate this instability, three communication strategies are contemplated: i) communicating the precise details of the monetary policy — that is, the variables and coefficients; ii) communicating just the variables on which monetary policy decisions are conditioned; and iii) communicating the inflation target. The first two strategies restore the Taylor principle as a sufficient condition for stabilizing expectations. In contrast, in economies with persistent shocks, communicating the inflation target fails to protect against expectations driven fluctuations. These results underscore the importance of communicating the systematic component of current and future monetary policy decisions: announcing an inflation target is not enough to stabilize expectations - one must also announce how this target will be achieved.