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Words Matter: Transparency, Communication, and Monetary Policy Effectiveness in Latin America

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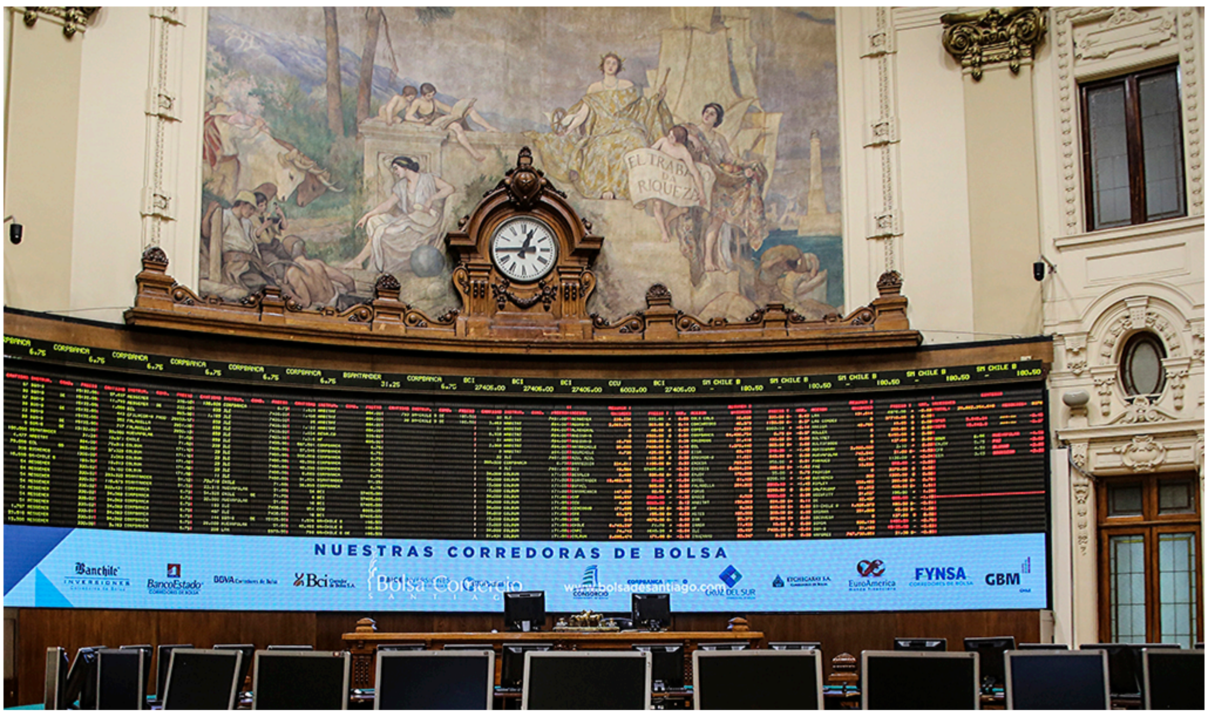


Inside the stock exchange in La Paz, Bolivia (photo: Meinzahn/iStock)

When it comes to central banks, effective communication is not just a matter of how much information is disseminated—the quality and clarity of messaging matter as well.

In our latest research from the [Regional Economic Outlook: Western Hemisphere](), we find that the degree to which inflation expectations are well anchored—meaning market participants, observers, and the general public understood the policy goals— is key in allowing central banks to see through a bad terms-of-trade shock by using their words instead of hiking their interest rates.

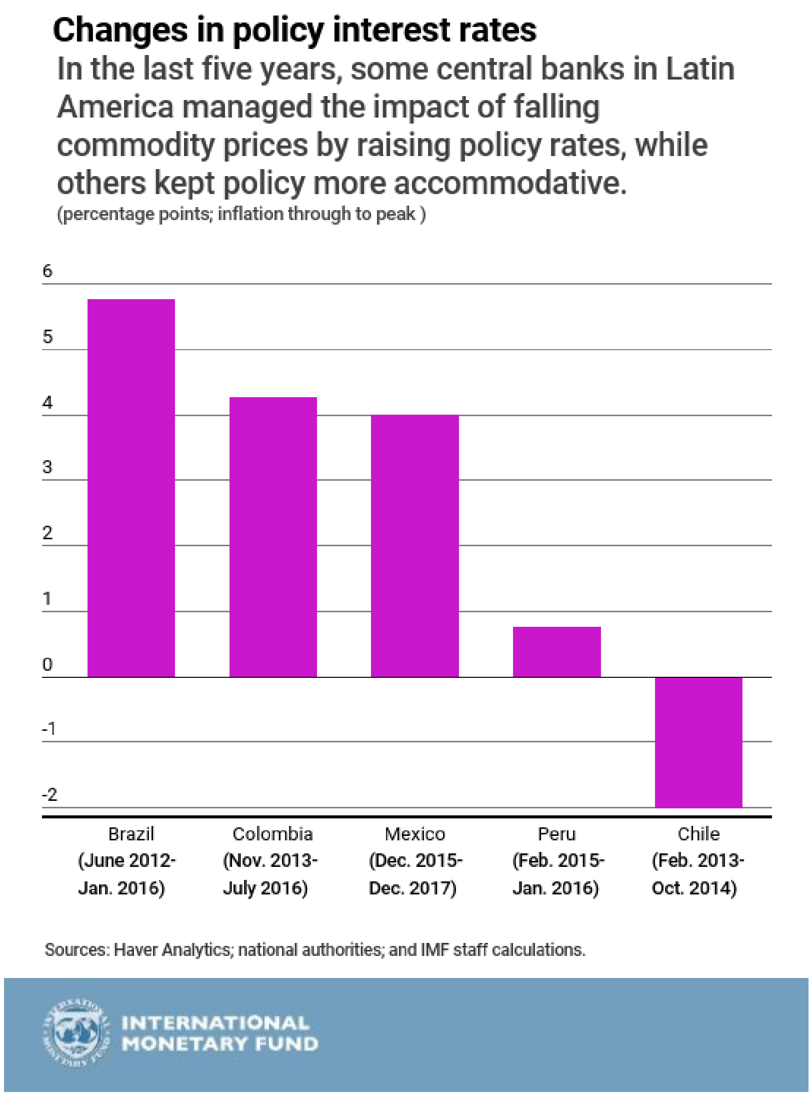
We also found that greater transparency about the central bank's objectives; its outlook for inflation and growth; its policy framework; and the direction of future policies all increase the central bank's ability to keep inflation expectations aligned to its target.

Great expectations: explaining the cyclicality of monetary policy in Latin America

In the last five years, falling commodity prices and historically large currency depreciations left central banks in Latin America faced with the challenge of dealing with accelerating inflation––in many instances rising well above targets—amid weaker economic growth.

Some central banks—namely Chile and Peru—decided to weather the storm without raising policy rates substantially. The surge in inflation was viewed as transitory, and could thus be allowed to run its course while policy was kept accommodative to support economic activity.

But elsewhere, central banks hiked rates aggressively—including Brazil, Colombia, and Mexico—which resulted, in some instances, in a deepening of the economic downturn.



Different responses

Several factors influenced the response of monetary policy during these turbulent times, but the degree of anchoring of inflation expectations was likely at the top of the list. We study the experience of 20 inflation targeting economies, including Latin America's largest commodity exporters, to understand how central banks have tended to respond to inflationary shocks caused by weaker terms of trade.

Where medium-term inflation expectations were initially well aligned with the central bank's target, central banks responded by *lowering* policy rates to provide countercyclical support to the economy.

But where expectations were above the central bank target, the response to the same shock was to *hike* rates despite weakening domestic demand—that is, to tighten policy in a procyclical fashion. In these countries, the transmission of policy rates to inflation was also considerably weaker, so policy rates were increased proportionately more to ensure that the nominal anchor holds. This response often aggravated the slowdown in economic activity triggered by the negative shock.

Central bank transparency and anchoring expectations

If well-anchored expectations are crucial in determining the way central banks respond to these types of events, it is important to understand how the private sector forms their expectations about future inflation. A large literature has found that expectations become anchored very gradually, as central banks gain credibility by consistently delivering low and stable inflation.

But additionally, we present new evidence that open and clear central bank communication helps align the public's expectations with the central bank's target.

Notably, we find that greater transparency about the central bank's objectives; its outlook for inflation and growth; its policy framework; and the direction of future policy changes all increase the central bank's ability to keep inflation expectations aligned to its target.

In line with recent Fund work, we find that the benefits of transparency accrue mainly to countries that boost transparency from low levels, and that returns to transparency begin to diminish at higher levels.

In Latin America, central banks are at different stages of development in their transparency frameworks, and scope for further improvement remains. Stronger transparency frameworks would allow the public to better anticipate policy decisions, and better align their medium-term inflation expectations with the central bank's objective.

It would also help to improve monetary policy transmission, and ultimately reduce the procyclicality of monetary policy.

From quantity to quality: communication strategies in Latin America

However, transparency is only a necessary condition. Good communication is not just a matter of *how much* information is disseminated, but also *how well* it is communicated in terms of its quality and clarity.

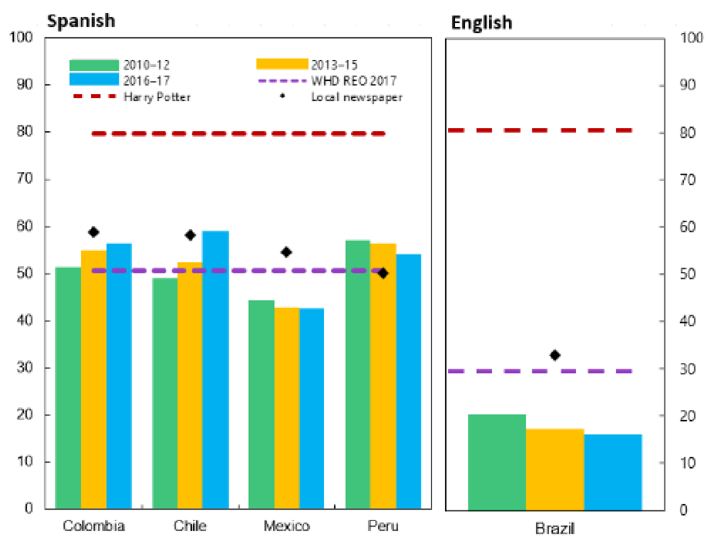
Central bank communications are broadly similar across Latin America—consisting mainly of press releases, minutes of policy meetings, quarterly reports presenting the balance of risks about the inflation outlook, and parliamentary hearings. However, there are big differences in informational content across countries.

What is critical to effectively communicate is to provide clear and essential information (i.e., “signal”) that markets can use to discern key policy considerations and likely actions from non-essential or conflicting information (i.e., “noise”) that may confuse, distract, or cloud the situation.

Understanding central bank press releases

Central bank press statements in Chile, Colombia, and Peru use similar language complexity as the business section of local newspapers.

(readability index)



Sources: Bloomberg Finance L.P.; and IMF staff calculations

Note: “Harry Potter” is the first book of the series by J.K. Rowling: Harry Potter and the Philosopher’s Stone (1997) and has a high ease of readability score, as the index indicates. Local newspapers correspond to business section articles in leading Latin America newspapers.

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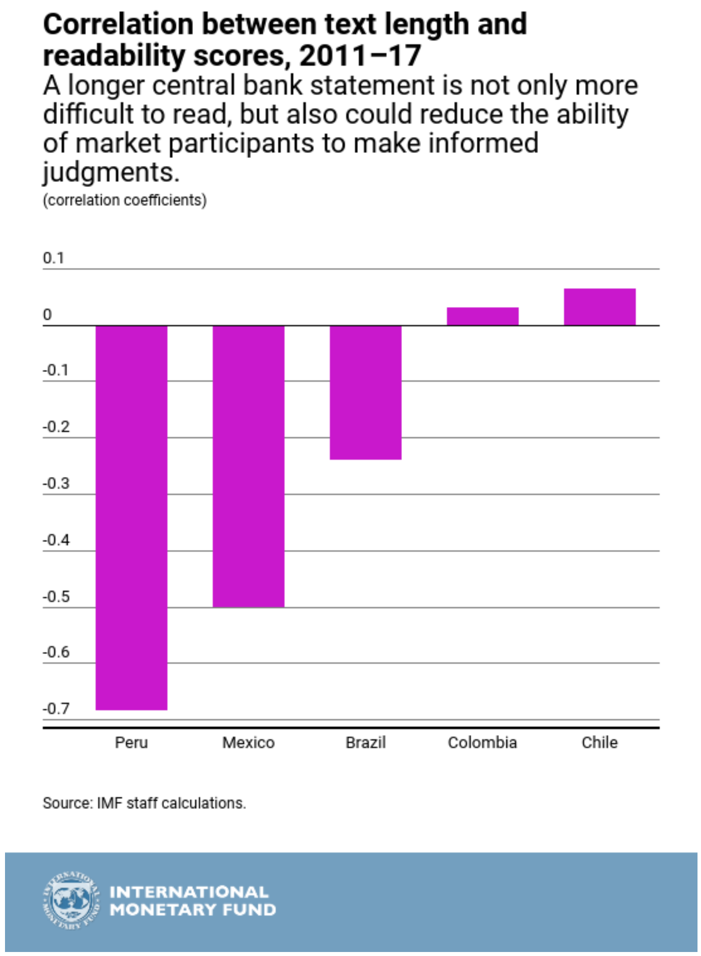
There has been a push across the region's central banks to increase the level of detail transmitted to the public, providing longer explanations regarding the state of the economy and the factors behind policy decisions. However, for many, longer documents have come hand in hand with lower clarity, and are generally more difficult to understand than the business section of the local newspaper, as shown in the chart below.



The way forward

We find that central bank communication strategies tend to be more effective when they provide markets with an explicit conditional guidance, improving the transmission of changes in the policy rate to market inflation expectations.

Also markets appear to listen to central banks as the tone of press releases and minutes affects not only the short end of the yield curve but also medium- and long-term interest rates.

These results indicate that, for a given level of central bank credibility, effective use of these communication strategies can provide greater room for maneuver in interest rate policy in the face of transitory inflation shocks.

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