“Faith-Based” Monetary Policy Frameworks

Randall S. Kroszner ©

Norman R. Bobins Professor of Economics

Booth School of Business, University of Chicago

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Impact of Central Bank Communications Relies on Three Key Linkages

- 1) Central Bank statements and actions → affect expectations and beliefs of households, businesses, and markets

- 2) Changed expectations and beliefs → affect behavior

- 3) Changed behavior → affects macroeconomic outcomes, e.g., inflation and employment

Evidence for Linkages #1 and #2?

- Do Central Bank statements and actions drive expectations and beliefs?

- Do those expectations and beliefs then drive behavior?

- Economists and central bankers traditionally take it on faith that the answers are YES but we have almost NO systematic evidence (today's conference is a welcome exception!).

- Hence, I call this *faith-based* monetary policy.

Statements/Actions → Expectations/Beliefs

- 1) Are the relevant actors paying attention?
- 2) Can the information be presented in an understandable way?
- 3) Do people trust Central Bank statements and the relevant government data?
- 4) Will people bring a strong prior, that is, will they update?

Prevalence of "Magical Thinking" may mean behavior won't change even if expectations and beliefs do (Risen 2017)

"A friend was visiting the home of Nobel Prize winner Niels Bohr…

The friend kept glancing at a horseshoe hanging over the door. Finally, unable to contain his curiosity any longer, he demanded: \`Niels, it can't possibly be that you, a brilliant scientist, believe that foolish horseshoe superstition!?!' \`Of course not,' replied the scientist. \`But I understand it's lucky whether you believe in it or not.'"

(Kenyon, 1956, pp.13)

“Lose the faith” and systematically gather data and study effectiveness

- A key goal of adopting an explicit inflation target by the Fed was “to increase the effectiveness of monetary policy” is achieved only if we devote substantial resources to analyzing these issues:
  - Credibility and clarity of targets? Price level vs Inflation vs GDP?
  - How are “price changes” and “inflation” interpreted?
  - Does a “symmetric” target help or cause confusion? Bygones?
  - What anchors expectations and affects behavior?
- This is a plea to “lose the faith” and gather data about the underlying behavioral assumptions.

Communication Conundrum: Monetary Policy vs Financial Stability

- Can communication problems lead central bankers to policy missteps? (Tail wags dog?)
- Example: Feb/Mar 2020, massive Fed purchase of Treasuries to alleviate dysfunction
  - Perfectly reasonably but not clearly articulated
  - How then to reduce rate of purchase with seeming to tighten monetary policy?
- Contrast: Sept 2022, Bank of England massive purchase of Gilts but extremely clear financial stability motivation for temporary and targeted action to alleviate dysfunction
- Communication may be as important for comfort of policy makers as for the markets and households