Central Banks

A clear message that central banks are not all-powerful

Credibility is mostly about managing expectations, writes Eswar Prasad

Eswar Prasad

© Bloomberg

SEPTEMBER 20, 2016 12:39 PM
by: **Eswar Prasad**

Once again, financial markets are on tenterhooks about potential interest rate hikes (http://next.ft.com/content/414f4320-7e96-11e6-bc52-0c7211ef3198) by the Federal Reserve (https://www.ft.com/topics/organisations/Federal_Reserve). The "will they or won't they" debate is approaching fever pitch, accompanied by criticism about confusion caused by various Fed governors voicing contrasting views about the right timing for rate rises.

This is partly the result of the new orthodoxy that central banks (https://www.ft.com

/topics/themes/Central_Banks) should be fully transparent. But the result has been as much confusion as clarity. Transparency has fed the belief that central banks control the destinies of economies and financial markets, and that there is a clear mapping between monetary policy decisions and economic outcomes, and vice versa.

The financial crisis and its aftermath entrenched this myth. The actions of the Fed and other major central banks prevented financial and economic implosions. Central banks have since tried almost single-handedly to prop up economic growth, fend off deflation and maintain financial stability.

The notion that central banks are economic saviours has taken hold. So when reality falls short of this exalted ideal, central bankers face opprobrium.

At a time of heightened economic uncertainty, financial markets look to central banks for certainty. The challenge for central bankers is to provide as much information as they can, but not set up unrealistic expectations about what they know and can deliver.

Central banks in emerging markets face heightened challenges. They have less credibility and little margin for error. In August 2015, China's central bank (http://next.ft.com/content/d42526ee-418c-11e5-b98b-87c7270955cf)freed up the renminbi to allow market forces a greater role in determining its exchange rate. This move unleashed mayhem in currency and stock markets worldwide. A press conference was held two days after the policy shift, a lifetime in financial markets. In the interim, markets assumed the worst.

Clearly, effective and timely communication is important. Sometimes, it can even substitute for action. But too much transparency has its own risks. Markets can create a one-way bet in currency or bond markets, complicating an already complex juggling act among multiple objectives. To prevent its currency's value from plummeting, a central bank has two options — raise interest rates or use foreign exchange reserves to support the currency.

Just the notion that the central bank might raise interest rates aggressively, at least briefly, in order to protect the currency helps fend off speculators. As a respected emerging market central banker once told me, some "creative ambiguity" about the central bank's policy reaction function generates room for manoeuvre.

The communication challenge becomes trickier when there is not a clear message. In the Fed's case, ambiguous messages (http://next.ft.com/content /f2fcf570-7123-11e6-9ac1-1055824ca907) about the timing of the next rate rise reflect the ambiguity in economic signals. Low unemployment indicates a tight labour market but wage and inflation data suggest otherwise.

Central bankers must not pay undue heed to media narratives, which are often dominated by the short-term horizons of bond traders, hedge funders and investment managers. It is of far greater consequence whether a central bank ensures price and financial stability over the longer horizons that affect ordinary peoples' lives.

Getting communication right is one of the biggest challenges for central bankers. For it affects both their credibility and effectiveness, which are as much about managing expectations as about direct effects on the economy and financial markets. The right approach may be to clarify where central banks plan to take the economy, but not exactly about how they plan to get there.

The writer is a professor at Cornell University and senior fellow at Brookings

---

Latest on Central Banks See all

News

Global debt sales eclipse $5tn in '16

FT View

The growing challenge to central banks' credibility

Ever more radical policies are meeting ever greater scepticism

The Long View

Wounds from the 2008 financial crisis are still bleeding

Investors and markets not positioned for the era of cheap money sparking growth and inflation

Latest in Opinion See all

FT View

Labour moderates must find a new argument against Jeremy Corbyn

MPs need to rethink their approach to winning back the party