Book Review: "Hawks and Doves: Deeds and Words. Economics and Politics of Monetary Policymaking." / Sylvester Eijffinger and Donato Masciandaro (eds.)

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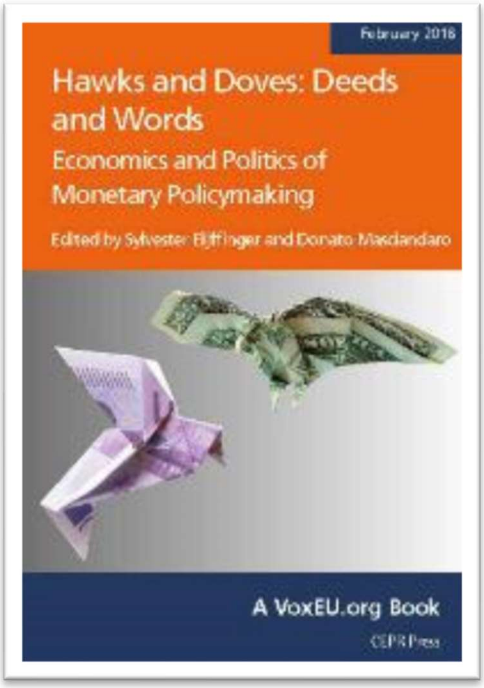

Review by Guy Verfaille

The 2008 financial crisis has spurred renewed interest in the role of central banks in the economy and in the way central bankers make policy decisions. This book delivers a fine contribution to the debate by presenting 15 contributions written by an impressive selection of renowned specialists. In these they highlight the most important conclusions of their recent research on the subject.

Topics are regrouped under two main headings. The bulk of the contributions dig into the issue of governance of monetary policy. How are policy objectives set (the rules of the game discussion) and more importantly how are decisions being reached within the central banks once the objectives have been set. The focus hereby is on the impact of personal preferences of the individual members of monetary policy committees (discussion on the institutional and behavioral aspects). The second part reviews the increasing role of communication of central banks in guiding and influencing financial markets. Not only what is done counts, also how it is ‘sold’ to the markets and how markets are prepared for action or inaction of the central bank is important. So in fact, not only deeds matter, but increasingly also words.

Regarding the rules of the game, both the contributions by Goodhart and Lastra and by Issing focus on the future of the independent status of central banks. They argue that this independence will become increasingly under pressure, mainly for two reasons. First, monetary policy is not neutral in the sense that it has distributional effects and that it impacts public finances and the management of public debt. Secondly, central banks have more and more become involved in supervision and financial regulation. This can potentially enforce the perception that they go beyond the mandate upon which their independent status was assigned. The danger is looming according to the authors that these two elements will incite the political world to limit the independence of central banks.

Regarding the institutional settings of monetary policy, the six chapters authored by Eijffinger and Raes, Riboni and Ruge-Murcia, Masciandaro, Bordo and Istrefi, Lombardi, Siklos and Amand, and finally Capie and Wood explore the recent field of the economics and political economy of monetary policy committees. The investigation focuses on the different interconnections between governance rules and the personalities of central bankers. The common starting point for all these chapters is the acknowledgement that monetary policy today is conducted by committees. This does not exclude that individual members of these committees bring their own preferences to the deliberation table. Hence the search for characteristics of these members in terms of education, reputation, ideological tendency etc… in order to rank them on a scale between a “dove” i.e. someone likely to prefer active and/or accommodative monetary policies and a “hawk” i.e. someone disliking such policies. The composition of the committees on this dove-hawk scale can determine the ultimate outcome of monetary policy decisions. But given the preferences of the individual members, also the role of the voting protocol actually implemented to bridge differences in opinion at committee level can have a huge impact on the final outcome. Besides, behavioral aspects such as a relatively high degree of loss aversion characterising central bankers can help to explain in some cases the inertia in policy decisions.

The last three chapters in the first part of the book by Blinder et alii, Cukierman and Orphanides offer new insights into the drivers and effects of both conventional and unconventional monetary policy decisions that central banks took in order to address the crisis in the advanced economies. Blinder et alii try to determine through surveys to what extent the changes introduced in monetary policy after the crisis such as expanded mandates and new policy tools are here to stay. The results tend to indicate that they are indeed expected to be permanent. Two chapters are devoted to exploring the cases of the Federal Reserve System (Cukierman) and the ECB (Orphanides), respectively. Cukierman concludes that the large-scale quantitative easing did not lead to a proportional expansion of bank credit since the start of the crisis. This implies that the transmission of expansionary monetary policy through the banking credit channel has weakened considerably over the past decade. Orphanides claims that the cause of the instability in euro area government bond markets can be traced to a discretionary decision taken by the ECB Governing Council in 2005. In the aftermath of the failure of the Stability and Growth Pact, the ECB decided on a drastic change in its collateral framework. Collateral eligibility for all assets would from then on be subject to a minimum credit-rating threshold. This would strengthen market discipline on governments. But according to Orphanides this created the potential for a destabilising cliff effect, thereby precipitating a crisis. During a panic, fears of downgrades and potential default would become self-fulfilling if investors projected that the ECB would refuse to accept government debt as collateral even for member states with sound fiscal fundamentals. In a monetary union, investors would then shift their portfolio towards better rated debt. According to Orphanides the ECB hereby went beyond its mandate and moreover paved the way for the euro crisis.

The second part of the book is shorter and contains three chapters on the evolution of central bank communication as well as the growing importance of such communication in influencing the overall effectiveness of monetary policy actions. There was a time that when you thought you had understood what the central banker had declared, you surely must have misunderstood him. Secrecy, ambiguity and a craving for mystery seemed to be key for monetary policy making. “Never apologise, never explain” appeared to be the motto of the typical central banker. This started changing in the 1990’s when some central banks adopted inflation targeting. The ECB adopted from the beginning a so-called two-pillar strategy with a monetary pillar focusing on monetary aggregates and an economic pillar taking account of drivers of inflationary expectations. A higher degree of independence of central banks calls for greater accountability which necessitates increased transparency and thus a more extensive communication policy.

The starting point of Coenen et alii is that when central banks resorted to unconventional monetary policy instruments after the crisis of 2008, they stepped up their communication efforts in order to define the scope and implementation of these policies as well as to build a common understanding of their limitations and expected degree of effectiveness. At the same time many central banks also became more explicit in signaling the direction of their policies through various forms of forward guidance. With this, communication itself became an explicit policy tool. Such forward guidance is mostly state-dependent i.e. the commitment of the central bank depends on some economic conditions to prevail. The advantage is that economic agents can better integrate the effects of changing economic conditions and that fewer re-adjustments of central bank communication are required. Using the example of inflation thresholds for the euro area, the authors indicate that such state-dependent forward guidance can indeed work.

Further in this second part there is a study by Takeda and Keida on the communication strategy of the Bank of Japan over the period from 2012 to 2016. They conclude that the Bank of Japan has made a misjudgement in its communication strategy by allowing an inconsistency between communication and effective policy. The final contribution of Hansen and McMahon looks at how central bank communication can also have longer term effects by shedding more light on the reasons of certain policy decisions, on the models used to determine policy actions, on how the central banks gauge the future evolution of key variables and other aspects pertaining to the internal central bank kitchen. The challenge for central banks is to ensure that it sends signals that are as clearly as possible. For current day central bankers, it may seem that the motto has become : “Explain extensively and well and no apologies will be needed”.

This publication provides a nice overview of some of the recent research done on the topic of how central banks arrive at their decisions and how they communicate with the markets. Most research underlying the contributions was recently published in academic journals or circulated in Working Papers Series that are not necessarily easily accessible to non-academics. These non-technical syntheses, together with the elaborate references to the literature, make it therefore a very useful publication.