

Central bank credibility:  
Why do we care?  
How do we build it?

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# Outline

## I. Introduction

- Whether credibility is important?
- Definitions for credibility

## II. Discuss the results from the questionnaires.

- 1<sup>st</sup> part-why is it important?
- 2<sup>nd</sup> part-how to build it?

## III. Conclusion

# Introduction

- The writer believed and found the evidence from academic and practical study that credibility affects central bankers as well as monetary policies.
- Key questions
  - “Why is credibility so important to a central banker?”
  - “How can a central banker create credibility?”
- Methodology
  - Questionnaire 2 parties
    - 84 of 127 Central bankers and 53 of 115 Macro Economists(U.S.)
  - How would the view of each party differ( theorists vs. practitioners)

# Pattern of questionnaires

- There are 7 reasons for these 2 questions.
  - 2 questions for introduction; importance check and definition
  - 7 questions for “Why is the credibility so important to a central banker?”
  - 7 questions for “How to build credibility?”
- Choose the rating number by five-point scale.
- Rank the most to the least important reasons among 7 issues.

# Q1: How important is credibility to a central banker?

- In the question, important and credibility are not defined.
  1. Unimportant
  2. Of minor important
  3. Moderately important
  4. Quite important
  5. Of the utmost important
- Result is both see credibility important.

|                 | Mean rating | Standard Deviation |
|-----------------|-------------|--------------------|
| Central bankers | 4.83        | 0.37               |
| Economists      | 4.23        | 0.85               |

# The matter of definition for credibility.

- General definition
  - People believe CBs will do what it says; matching deeds and words.
- Academic literature
  - I. Strong aversion to inflation
  - II. Incentive compatibility
    - An announcement is credible when a central bank gains positive expected utility from an action.
  - III. Precommitment
- Central bankers
  - Fighting inflation

## Q2: How closely the concepts of credibility and dedication to price stability?

### Five-point scale:

1. Unrelated
2. Slightly related
3. Moderately related
4. Quite closely related
5. Virtually the same

### Results:

- Central bankers: mean rating= 4.10
- Economist: mean rating= 3.31

1<sup>st</sup> question

**WHY IS CREDIBILITY SO IMPORTANT  
TO A CENTRAL BANKER?**

# 1<sup>st</sup> issue: 7 reasons why credibility might be important to a central bank?

- Five-point scale
  1. Strongly disagree
  2. Disagree
  3. Neutral
  4. Agree
  5. Strongly agree
- Observations
  - Central bankers agree on these reasons more than economists do.
  - Unanimous opinions among central bankers but economists does not.
  - Central bankers and Economists rank the reasons differently.

# Summarizing: Why credibility is important?

Table 1  
Reasons Why Credibility Is Important

| Survey Question | Method                             | Central Banks |     |                   | Economists |      |                   |
|-----------------|------------------------------------|---------------|-----|-------------------|------------|------|-------------------|
|                 |                                    | :             | F   | Rank <sup>a</sup> | :          | F    | Rank <sup>a</sup> |
| Q3              | Less costly disinflation           | 4.13          | .78 | 2                 | 3.83       | 1.12 | 2                 |
| Q4              | To keep inflation low              | 4.39          | .60 | 1                 | 4.17       | .83  | 1                 |
| Q5              | To change tactics                  | 4.38          | .54 | 5                 | 3.97       | 1.03 | 3                 |
| Q6              | To serve as lender of last resort  | 4.12          | .77 | 6                 | 3.74       | 1.07 | 4                 |
| Q7              | To defend the currency             | 4.29          | .70 | 3                 | 3.47       | 1.04 | 5                 |
| Q8              | Public servants should be truthful | 4.00          | .84 | 7                 | 3.30       | 1.07 | 6                 |
| Q9              | For support for independence       | 4.34          | .75 | 4                 | 3.19       | 1.00 | 7                 |

<sup>a</sup>These are based on ranks given explicitly by respondents, not by mean scores.

# 1.1. Reducing the costs of disinflation(Q3)

Phillip curve : 
$$\pi_t = \pi_t^e - \beta(u_t - u_t^*) + \gamma z_t + \varepsilon_t$$

$\pi$  = Inflation rate

$\pi^e$  = Expected inflation

$(U - U^*)$  = Unemployment gap ( actual- natural)

Z = Supply shock

- Credible announcement to reduce inflation would affect inflationary expectation without high unemployment trade off .

- Results

|                 | Mean rating | Rank            |
|-----------------|-------------|-----------------|
| Central bankers | 4.11        | 2 <sup>nd</sup> |
| Economists      | 3.83        | 2 <sup>nd</sup> |

Note: Economists: S.D.= 1.12 is the largest among 7 reasons

## 1.2. Helping to keep inflation low(Q4)

$$\pi_t = \pi_t^e - \beta(u_t - u_t^*) + \gamma z_t + \varepsilon_t$$

- Seems to be similar to Q3 but both respondents see Q3 and Q4 different( $\rho_{3,4}=0.5$ )
  - Q3 high inflation  $\rightarrow$  low inflation
  - Q4 low inflation  $\rightarrow$  low inflation
- The inflation shock has less impact on the expectation.
- CBs and economists put this is the most important reason.
- Results:

|                 | Mean rating | Rank            |
|-----------------|-------------|-----------------|
| Central bankers | 4.39        | 1 <sup>st</sup> |
| Economists      | 4.17        | 1 <sup>st</sup> |

## 1.3. Flexibility to change tactics(Q5)

- The ability to abandon monetarist operating procedures as Volcker Fed anti-inflation policy in 1982.
- In 1992, due to credibility of fighting inflation, Bank of England decided to leave ERM without high inflationary expectation.
- Results:

|                 | Mean rating | Rank            |
|-----------------|-------------|-----------------|
| Central bankers | 4.38        | 5 <sup>th</sup> |
| Economists      | 3.97        | 3 <sup>rd</sup> |

## 1.4.serving as a lender of last resort(Q6)

- Discount- window lending  $\rightarrow$  Expansionary  $\rightarrow \pi^e$  ?
- During the crisis, CBs can do so without losing faith in fighting inflation
  - The expectation would remain more or less the same.
- Results

|                 | Mean rating | Rank            |
|-----------------|-------------|-----------------|
| Central bankers | 4.12        | 6 <sup>th</sup> |
| Economists      | 3.74        | 4 <sup>th</sup> |

## 1.5. Defending the exchange rate(Q7)

- Defending in term of speculative attack and it is just ST intervention
- Credibility scared off speculators.
- Results:

|                 | Mean rating | Rank            |
|-----------------|-------------|-----------------|
| Central bankers | 4.29        | 3 <sup>rd</sup> |
| Economists      | 3.47        | 5 <sup>th</sup> |

## 1.6. A duty to be open and truthful<sub>(Q8)</sub>

- This is basically definition of credibility: matching deeds and words
- Results:

|                 | Mean rating | Rank            |
|-----------------|-------------|-----------------|
| Central bankers | 4.00        | 7 <sup>th</sup> |
| Economists      | 3.30        | 6 <sup>th</sup> |

## 1.7. Public support for central bank independence(Q9)

- Independence in taking action even unpleasant to the public.
- Results:

|                 | Mean rating | Rank            |
|-----------------|-------------|-----------------|
| Central bankers | 4.34        | 4 <sup>th</sup> |
| Economists      | 3.19        | 7 <sup>th</sup> |

2<sup>st</sup> question

**HOW COULD A CENTRAL BANKER  
CREATE CREDIBILITY?**

## 2<sup>nd</sup> issue: 7 reasons what makes a central bank credible?

- Five-point scale
  1. Unimportant
  2. Of minor importance
  3. Moderately importance
  4. Quite importance
  5. Of the utmost importance
- Observations
  - Both group rank the same order for all reasons.
  - Economists' ratings are lower and more disperse than CBs do.

## 2<sup>nd</sup> table for how central bank builds credibility?

Table 2  
How to Build Credibility

| <u>Survey Question</u> | <u>Method</u>                 | <u>Central Banks</u> |          |                         | <u>Economists</u> |          |                         |
|------------------------|-------------------------------|----------------------|----------|-------------------------|-------------------|----------|-------------------------|
|                        |                               | <u>:</u>             | <u>F</u> | <u>Rank<sup>a</sup></u> | <u>:</u>          | <u>F</u> | <u>Rank<sup>a</sup></u> |
| Q11                    | Central bank independence     | 4.51                 | .63      | 2                       | 3.99              | .86      | 2                       |
| Q12                    | Transparency                  | 4.13                 | .71      | 4                       | 3.44              | 1.18     | 4                       |
| Q13                    | History of honesty            | 4.58                 | .52      | 1                       | 4.30              | .80      | 1                       |
| Q14                    | History of fighting inflation | 4.15                 | .67      | 3                       | 3.83              | .86      | 3                       |
| Q15                    | Constrained by a rule         | 2.89                 | 1.01     | 6                       | 2.32              | 1.06     | 6                       |
| Q16                    | Incentives (personal loss)    | 2.15                 | 1.10     | 7                       | 1.95              | .96      | 7                       |
| Q17                    | Small fiscal deficit/debt     | 3.92                 | .93      | 5                       | 3.27              | 1.14     | 5                       |

<sup>a</sup>Ranked by mean scores.

## 2.1. A history of living up to its word(Q13)

- Economists do not follow the literature points such as CB independence, precommitment, and contract.
- Results
  - S.D. of both group is the lowest among 7 reasons

|                 | Mean rating | Rank |
|-----------------|-------------|------|
| Central bankers | 4.58        | 1st  |
| Economists      | 4.30        | 1st  |

## 2.2. Central bank independence(Q11)

- Track record is more important to create credibility than independence
- Results:

|                 | Mean rating | Rank            |
|-----------------|-------------|-----------------|
| Central bankers | 4.51        | 2 <sup>nd</sup> |
| Economists      | 3.99        | 2 <sup>nd</sup> |

## 2.3. A history of fighting inflation(Q14)

- Correlation between Q13(A history of living up to its word) and Q14 is ranged from 0.23 to 0.33.
- Results:

|                 | Mean rating | Rank            |
|-----------------|-------------|-----------------|
| Central bankers | 4.15        | 3 <sup>rd</sup> |
| Economists      | 3.83        | 3 <sup>rd</sup> |

## 2.4. Openness and transparency(Q12)

- This contrasts with the traditional way where it is implicit and secrecy.
- Secret can create credibility because no one can catch the changing mind.
- Results show the recent trend( transparency)

|                 | Mean rating | Rank            |
|-----------------|-------------|-----------------|
| Central bankers | 4.13        | 4 <sup>th</sup> |
| Economists      | 3.44        | 4 <sup>th</sup> |

## 2.5. Fiscal discipline by the government(Q17)

- Fiscal deficit can impact monetary policy.
- If deficit, CB may be forced to monetize the debt.
- This causes “inflation”= credibility.
- Credible central bankers should be able to pressure government fiscal discipline.
- Results:

|                 | Mean rating | Rank            |
|-----------------|-------------|-----------------|
| Central bankers | 3.92        | 5 <sup>th</sup> |
| Economists      | 3.27        | 5 <sup>th</sup> |

## 2.6. Precommitment(Q15)

- Constraints their decision making (rule vs constrained discretion)
- Results:

|                 | Mean rating | Rank            |
|-----------------|-------------|-----------------|
| Central bankers | 2.89        | 6 <sup>th</sup> |
| Economists      | 2.32        | 6 <sup>th</sup> |

## 2.7. Incentive compatible contracts(Q16)

- One will suffer from personal loss when inflation is too high.
- Results:

|                 | Mean rating | Rank            |
|-----------------|-------------|-----------------|
| Central bankers | 2.15        | 7 <sup>th</sup> |
| Economists      | 1.95        | 7 <sup>th</sup> |

# Conclusion

- The importance of credibility
  - Central bankers agree with all reasons.
  - The economists view are not conglomerated and put less score than the other.
  - Both rank the same for the first two reasons( keep inflation low and reducing the costs of the disinflation)
- How to build credibility
  - They both put the same rank
  - History of living up to its word is the most important
  - Independence is the second focused by academic literature
  - Precommitment and incentive compatible contract are the least important that followed Barro and Gordon (1983)

Thank you

Q&A