

PUBLIC TRUST AND CENTRAL BANKING

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Independence, Credibility, and Communication of Central Banking

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Dear colleagues and friends, distinguished guests: welcome to the XXIII Annual Conference of the Central Bank of Chile (CBC) entitled “Independence, Credibility, and Communication of Central Banking.”

Since 1997, the CBC has been convening prominent scholars and policymakers to this Conference to discuss major issues in central banking and their implications for emerging economies. This version is no exception; fresh and thoughtful research will support discussion over the next two days. We thank and welcome all participants, including representatives from 21 central banks around the World.

The Annual Conference this year has some features that make it special. First, it will be held back-to-back with the International Monetary Fund (IMF)-CBC-IMF Economic Review Summer Conference on “Current Policy Challenges Facing Emerging Markets”, so we expect many of you to stay in Santiago longer than usual, for a full week of rich discussions. Second, this year we commemorate 30 years of independence of the CBC, so we have devoted our Annual Conference to revisit the achievements and challenges of central bank independence around the globe.

Central bank independence: achievements, challenges and threats

Central bank independence is one of the most remarkable pieces of institutional architecture fostered by economic thinking in the last half century. Theoretical studies in the 1980s stressed central bank independence as a precondition to bringing inflation under lasting control, and support for reform soon spread from academia to

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policymaking. Professor Kenneth Rogoff was a major contributor to this process, so we are privileged to have him as keynote speaker at this Conference.

Central bank independence delivered upon expectations. As the countries with independent central banks grew to nearly 70 in recent years, average world inflation dropped to 4%, from more than 25% 30 years ago. Empirical studies are pretty conclusive on a strong correlation between central bank independence and low and stable inflation after controlling for other variables.

The Central Bank of Chile, as one of the pioneers of this remarkable process in the emerging world, provides a good example of the merits of institutional independence. Independence of the CBC ended 40 years of double-digit inflation and coincided with the return to democratic rule in 1990. Inflation fell from almost 30% to 3% through the 1990s while the economy expanded at an annual average 6% in the decade, doubling the average for the previous 40 years. This provided legitimacy, credibility and respect for the CBC under its independent status, encouraging it to maintain high technical standards and commitment to its statutory goals of controlled inflation and financial stability over the years.

Independence also helped many central banks to deal with the Global Financial Crisis of 2008 and its aftermath. The magnitude of the GFC demanded prompt and decisive action, while its global dimension required coordination across national borders. Independence from national governments and the authority to act swiftly were critical in containing the deepening of the crisis and its spillovers throughout the economy. Some of the largest independent central banks applied their powers to articulate unprecedented measures, like massive asset purchases, whose effects last until today.

Independent central banking has not been an easy ride, though. One thing is to be free from external interference, quite another is to build the policy frameworks, governance structures and standards to guide actions in a consistent and predictable way. Independent central banks have endorsed and benefitted the most from inflation targeting, have led the improvement in communications into forward guidance, have built reporting mechanisms, and have developed transparency and integrity standards beyond statutory requirements.

While policy frameworks, monitoring mechanisms and policy tools could rely on sound theoretical work and accumulated experience for monetary policy over the years, issues are not so well resolved with financial stability. This is not easy to measure, financial instability

may come from many sources, and there is still an open debate on who—central banks or government regulators—should command macroprudential policies. This is related to the potential tradeoffs between monetary policy and financial stability that were intensely debated in this venue two years ago.

The former is a good illustration of the difficulty for independent bodies to deal with multiple policy mandates and/or the distributional effects of policy decisions, which involve choices that are normally expected in the political process but not easy to tackle by nonelected officials. This was particularly exposed during the GFC, given the perception of unfairness in the distribution of the burden of the crisis and the actions to contain it.

Even success of independent central banking has come at a price. Controlling inflation has made the latter less of a concern to citizens and politicians. The effectiveness of central banks in securing macro and financial stability in the post-GFC years may have also removed responsibility from other actors and may have encouraged markets to rely too much on central banks as risk managers.

The current wave of political populism is a further source of risks. Threats to central bank independence usually do not come from the public but from political leaders that resent distributed governance as well as checks and balances. In the last few months, we have witnessed a number of attacks on central bankers for coming in the way of ambitious populist agendas.

Independence and credibility

This is a good reminder that independence of central banks cannot be taken for granted. No matter how deeply it is ingrained in the law, independence can always be taken away or significantly undermined, *de facto* or *de jure*. In the real world, central bank independence relies on the willingness of key stakeholders—most notably governments and legislatures—to play by the rules and by the ability of central banks to gain legitimacy and credibility from stakeholders.

Independence does not automatically guarantee credibility either. Being free from political interference of politicians does not make a central bank infallible nor free from undue influence from other actors. Credibility needs to be protected and cultivated amid social, political and technological change.

In a recent piece, the IMF illustrates the importance of central bank credibility (IMF, 2018). It shows that central banks can better

accommodate shocks with smaller output loss and social cost the more anchored are inflation expectations to the policy target, with lower pass-through from the exchange rate to consumer prices and lower persistence of inflation.

More generally, public policies should be more effective the more credible the institutions in charge of them, as it helps aligning the behavior of the public to the policy objectives pursued. This is surely more important for independent institutions that cannot rely of a broader set of incentives and controls to shape the behavior of their stakeholders. A key question then is how to build credibility.

This is an issue only partly addressed by Economics. The rational expectations school would suggest adopting a clear-cut policy rule, communicating it openly and clearly, and ensuring strict compliance, to exploit the learning capacities from economic agents. This certainly underlies the growing popularity of inflation targeting and the forward guidance that comes with it. But even this may be challenging in a changing environment, where the business cycle overlaps with structural changes, and more so in areas, like financial stability, where policy targets may be hard to design and explain.

From credibility to trust

So, a broader approach to credibility-building may be needed. To this end, it may be useful to acknowledge that credibility is an attribute of a certain individual or institution: that of being believed or trusted. So surely, credibility does not depend exclusively on your own actions but on how far others trust you.

Trust, in turn, is defined as a person's belief or expectation that another person or institution will act in favor of one's well-being (OECD, 2017). So we could think of credibility as an institutional asset that depends on the factors that influence trust from stakeholders and the public.

Credibility in a central bank refers to public's belief that future actions of monetary policy that are optimal today will be carried out even if they no longer seem optimal in the future. This is related to public trust, but the two concepts are not quite the same. One can imagine the public having trust in the central bank and at the same time the latter adopting a discretionary monetary policy strategy to retain full flexibility regardless of past promises. However, it is hard

to imagine the opposite situation of a central bank fully engaged in the management of expectations without trust from the public.¹

This also applies to communication. We can discuss alternative strategies to make sure that the message issued by a central bank is adequately understood and internalized. However, there is little that a good communication strategy can do if the public does not trust the central bank.²

Approaching institutional credibility from stakeholders' trust has a number of conceptual and operational advantages.

First, there is a large body of research assessing its value: trust is at the heart of societies and a major component of social capital. A number of studies have related interpersonal and institutional trust to lower transaction costs, social cohesion and wellbeing.

Second, trust is a livelier concept, which can respond to information and experience acquired by stakeholders, as compared to the more static notion of credibility. Trust is not an abstract concept, but an attitude developed by actual people based on their beliefs, information and actual experiences.

Third, by focusing on stakeholders, trust can help institutions to pay closer attention to their environment, changes in social values and standards, thus reinforcing their end beneficiaries rather than structures or procedures. This may be especially important for technocratic and independent organizations, like central banks, that may tend to isolate themselves despite mandates in the general interest.

Finally, as we will see below, recent work shows that trust can be deconstructed into a series of components that can be linked to institutional actions. This may provide a stronger lead to how trust can be protected, built, or eroded.

1. Christelis *et al.* (2016) have formally explored this for Europe using micro data, finding that higher trust in the European Central Bank (ECB) lowers inflation expectations on average, and significantly reduces uncertainty about future inflation, even after controlling for people's knowledge about the objectives of the ECB. Similarly, Mellina and Schmidt (2018) find that having greater trust increases the probability of expecting unchanged prices and decreases the likelihood of expecting either slightly or sharply rising prices over the medium term.

2. Through behavioral insights, Bholat *et al.* (2018) show that public's trust in the Bank of England can be further improved by enhancing the communication with the public, particularly at times when trust in public institutions has fallen and responsibilities delegated to central banks have increased.

In what remains, I will argue that public trust is the cornerstone for safeguarding central bank independence as a stable outcome of the way modern societies decide to allocate powers across institutions.³ A central bank that is not trusted is vulnerable to political pressure to deviate from its mandate, regardless of whether it is formally independent or not.

It is therefore crucial for modern central banks to understand better the concept of trust, the mechanisms for fostering and maintaining it, and to think about strategies and tools for the management of public trust.

What is public trust? What can be done about it?

Available data indicates that public trust in government differs substantially across countries, but it tended to deteriorate after the GFC. Within countries, trust may also vary significantly across specific public institutions, being stronger for social services than for political bodies. Cross-section evidence shows a strong, positive relationship between public trust and per capita income, suggesting an association between trust and development, albeit causality is unclear.⁴

To dig deeper into the drivers of public trust and its impact on institutional effectiveness we can draw on recent work developed by the OECD on the subject (OECD, 2017). This work proposes a taxonomy distinguishing five dimensions of trust: reliability, adaptability, integrity, openness, and fairness.

Reliability refers to the extent to which an institution can deliver on the expectations set upon it in an effective and predictable way, reducing uncertainty from the public. Reliability of an institution depends and can be assessed on the basis of the clarity of its mandates and specific goals; the quality of its organization, planning and decision-making process, and its operational efficiency, including its capacity to command the appropriate financial, technical and professional resources.

Adaptability refers to the capacity to recognize changes in the environment, either economic, social, technological or institutional,

3. The broader concept of trust in government institutions is not delinked from the more specific one on central banks. For the case of New Zealand, Hayo and Neumeier (2017) find a statistical connection between overall trust in government institutions and public trust in the Reserve Bank of New Zealand.

4. There is also evidence on the statistically positive relationship between trust and central bank independence, though the link is not linear (Berggren *et al.*, 2014).

and to adapt to them without compromising its commitments to the public. Long-term planning, research, market intelligence and risk management are important mechanisms in this regard. To be adaptable while remaining reliable, an institution should be able not only to identify changes, new trends and risks, but also to explain them to the public, including the adjustments that may be required from them.

Integrity means putting the general interest entrusted to the institution above the particular interests of its authorities, employees or other narrow groups. This means far more than strict regulations and effective control; it may require benchmarks, ethics, checks and balances and openness to scrutiny that can respond to changes in social standards of accepted behavior, which may move faster than legislation.

The latter entails with *accessibility*, which refers to the ability of an institution to understand people's needs, leverage a wide pool of information and achieve higher levels of compliance. To be accessible, an institution should develop active and passive transparency mechanisms, seek feedback from the public and to foster dialogue and consultation with stakeholders.

Lastly, *fairness* acknowledges differences across society and that institutional actions may be far from neutral. As a component of trust, fairness involves being aware of such differences and to find ways to prevent, mitigate or compensate redistributive effects that are particularly undesired. Within an institution, fairness also involves the creation of a working environment that fosters productive exchange of ideas, free of harassment and discrimination.

Fostering trust in a central bank

The OECD taxonomy may be useful in providing a conceptual basis to go beyond generalizations on public trust and to take a more proactive approach to nurture it. In particular, it provides a good framework to develop ways to assess trust and to identify concrete levers that an institution can use to foster trust. However, can this framework be applied to a central bank?

In my view, this is not only possible, but necessary as well. Assessing trust on a central bank by inserting a question in an opinion survey suffers from the same limitations as with government institutions and a few more. Answers to a broad question may be more reflective of prejudice than of attitudes that may shape the response

to future policy decisions or incoming information and may come too late in a process of social or market change to make any difference. In addition, experience with opinion surveys in different countries has shown that no more than half of respondents have some basic knowledge of central banks.

Adopting a more systematic and rigorous approach to assessing trust in the central bank may not only help address these shortcomings but also to acknowledge the full diversity of its responsibilities. I have already noted research stressing the relevance of credibility for the effectiveness of monetary policy, but credibility and public trust may be equally important for financial stability, the issuing of currency, or the generation of statistics.

Moreover, one can conceive that trust across these functions could be somewhat connected. Loss of trust from a misconceived financial intervention or from distorted statistics may spillover to the way stakeholders assess the credibility of monetary policy. To foster trust, a central bank must go beyond the conduct of monetary policy to focus on how to develop reliability, adaptability, integrity, openness and fairness in its different areas of work.

In the context of central banking, reliability is not equivalent to a dovish monetary policy giving priority to shortsighted demands to stimulate the economy, but to do the proper balancing of risks to align monetary policy with long-run social welfare. It means acting in a coherent way, showing thorough decision-making, carefully explaining reasons and arguments behind every action, conducting predictable decisions, and running efficiently the central bank as an organization. For this, I consider essential a clear framework for monetary and financial policy, data-driven decision making, unquestionable technical capacity and statistics, and skillful crisis management.

Reliability of a central bank, in turn, can be assessed based on the accuracy of its projections, its ability to identify financial risks, the quality of its statistics and the safety of the domestic currency and payment systems.

For adaptability, a central bank must develop its analytical skills to identify structural changes in the economy and emerging sources of risk, telling them apart from necessary innovation. To this end, it may need to deepen its knowledge of markets and agents, and to be on top of technological developments. Adaptability also depends on the preparedness to react to unforeseen events.

Central bank integrity requires appropriate access to information, control of conflicts of interest, strong middle office arrangements in

market operations, and effective auditing across different areas and processes. For accessibility, communication of monetary policy is essential, as well as analysis and communication of financial risk, consultation in the issuing of new regulations, and well-structured accountability. The fairness dimension of trust can be enhanced through prevention of crises and risk management, financial education and inclusion, and securing equal opportunities in staffing and promotion decisions.

Assessing public trust in a central bank across these dimensions does not need to start from scratch. Instead, it provides a framework to organize existing data in a more meaningful way. It can also shed a new light on how to read and use data coming from different streams of the literature. The substantial work on central bank transparency led by some of our participants in this Annual Conference is a good case in point.

In sum, after recognizing credibility as the main asset of a central bank, especially an independent one, we can conclude that drawing on parallel work on trust in institutions may provide a useful framework to assess the current situation and to guide action to address existing gaps and vulnerabilities.

Trust in the Central Bank of Chile

The experience of the Central Bank of Chile can illustrate some of the ideas above.

The IMF study on the importance of credibility for monetary policy underscored anchoring of inflation expectations in Chile as key to the effectiveness of its monetary policy and macro resilience in the face of external shocks. Deviations of long-term forecasts of headline inflation from target have been less than 0.1%—being the lowest for a sample of emerging countries, and even lower than a benchmark group of advanced economies. This is remarkable considering that inflation volatility in Chile has not been particularly low relative to other emerging economies.

Yet we do not see credibility as an immutable attribute, given the dynamism of trust in institutions in the public opinion and market perceptions. We believe that a positive past record helps, but trust can deteriorate in a number of ways, some of them pretty fast, in the face of new standards and developments. Therefore, trust needs to be protected and enhanced in a systematic way with different stakeholders in the different dimensions of activity of the CBC.

This is well reflected in the *2018-2022 Strategic Planning* under course. This was based on an unprecedented consultation of stakeholders and participatory internal process. It defined as a vision for the Bank to be a trustworthy technical institution, known for its high standards in achieving its institutional objectives. On this basis, we have launched a number of initiatives aimed at fostering public trust in terms by improving its reliability, adaptability, integrity, accessibility and fairness.

To improve its reliability, the CBC has taken a thoughtful process of revision of its framework of monetary policy and forward guidance. Great emphasis has also been given to strengthening the technical toolkit to identify and communicate sources of financial risk.

With a focus on adaptability, we have introduced special chapters, analytical boxes and companion studies to our flagship reports. We have also launched the Technological Observatory with the goal of identifying new sources of risk, and the creation of the *Corporate Risk Area* within the CBC.

For integrity, we have broadened the framework and coverage of declaration of interests among executives and staff in sensitive functions, and have strengthened our external auditing committee. Some initiatives to improve the Bank's accessibility include regular presentations of Bank reports throughout the country, the development of market intelligence mechanisms and the upgrading of communications by creating an Institutional Affairs Division. To foster fairness we are also deepening our analysis of the economic and financial behavior of households and raising our contribution to financial literacy and education to the highest world standards.

Last, but not least, the CBC launched an external evaluation of its performance in the two central areas of monetary policy and financial stability by convening a panel of reputed academics and central bankers, some of whom are here today. We have committed to present the report to the Chilean Senate next September and to take the panel's recommendations as a guidance to further strengthening reliability, adaptability and transparency of our work in the years to come.

Closing remarks and acknowledgements

In sum, I underscore the importance of public trust as foundation of modern monetary policy and for the legitimacy of independent central banks in performing their broader mandates. This is ingrained in the

agenda of our Annual Conference this year: new challenges to central bank independence, the management of central bank credibility, and the designing of the best communication strategies for an effective monetary policy.

I would like to thank Ricardo Reis for being the external organizer of this Conference, as well as to Ernesto Pastén and Diego Saravia for being our local counterparts. I also thank all presenters and contributors to our program and the conference volume that will be published thereafter. I also thank to our friends and colleagues from the IMF for being here and for organizing the conference further down the week.

Let me finish by thanking Alejandra Rozas, Camila Figueroa, Paloma Navarro, María José Reyes, Felipe Leal and both the Public Affairs Department and the Research Department for all their invaluable help managing the challenging logistics of organizing these two conferences together.

Thank you, have a pleasant stay in Santiago and a fruitful discussion over the next two days.

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