



[Click to download audio edition](#)
**Economist.com**

## SPECIAL REPORTS

### Talk is expensive

Oct 18th 2007

From The Economist print edition

#### The message is the medium-term

WHEN the Fed cut rates in September, it insisted that it would keep its eye on inflation. But markets did not quite believe it: long-term bond yields and the gold price moved up a bit after the rate cut. Given the Fed's record after the financial turbulence of 1998 and 2001, it is easy to see why the Fed wants to reassure the markets about inflation—and why it might not be believed.

Not long ago, central banks felt much less obliged to explain themselves. As recently as 1994 the Fed did not even bother to inform the outside world of a change in its target for the fed funds rate. Financial markets had to work it out for themselves.

But these days central bankers' words have become almost as important as the interest rates they set, because of their effect on what markets expect rates to be next month or next year. At the ECB, Mr Trichet knows that his every inflection will be examined. The same goes for officials at just about any central bank. The Fed, for instance, does not hold a press conference after its rate-setting meetings, but the statement of a few dozen words setting out its decision and the reasons for it is chewed and digested by an army of Fed-watchers in the financial industry and the media. Speeches, minutes of central-bank meetings (for those banks that publish them) and regular reports on policy are subjected to minute scrutiny.

Central banks use a variety of devices to convince markets of their inflation-fighting credentials. An explicit inflation target can itself be such a device. Mr Trichet's press conferences and the Fed's post-meeting statements are other examples. So are the inflation reports published by several central banks, pioneered by the Bank of England. The British central bank issues a report every quarter; Mr King, its governor, explains its content in a press conference. His chief pedagogical tools are "fan charts", showing the probability distributions of inflation and GDP growth for the next two years.

In effect, these are all ways of giving financial markets and the public an insight into what economic theory calls the central bank's "reaction function". The more clearly the central bank's objective is understood and the more its good intentions are believed, the better.

That a central bank has an explicit inflation target does not tell you how quickly it will try to bring inflation back into line when it has veered off course. Inflation is rarely the only thing that central banks care about. Prices do not adjust immediately, so bringing down inflation will cost output and jobs. A central bank balances deviations of inflation from the target against the output gap (the difference between output and capacity).

Lars Svensson, an academic at Princeton University who has recently become a deputy governor of the central bank in his native Sweden, formulates this trade-off as an equation. He supposes that the central bank wants to minimise the weighted sum of the square of the inflation gap and the square of the output gap. The relative weight given to the output gap is denoted by the Greek letter lambda. The higher lambda is, the more the central bank worries about output and the longer it is prepared to take to return inflation to target. Set lambda equal to nought, and the bank could not give a jot about output: it is run by "inflation nutters", in the phrase of Mr King. Set lambda equal to infinity, and inflation becomes irrelevant.

The question is, how explicit can central banks be? Mr Svensson thinks that they should publish lambda if they can.

Most other central banks think that although lambdas are useful theoretical devices, publishing them is unrealistic. For one thing, it gives the impression that the central bank knows more about the world, or even about its own reaction function, than it really does. For another, the weight banks give to output gaps may change over time—they may set a lower lambda, for instance, when they want to establish a reputation as inflation fighters. The tight-knit world of central banking will keep a close watch on Scandinavia.

---

Copyright © 2008 The Economist Newspaper and The Economist Group. All rights reserved.

---