Monetary Policy and the Paradox of Transparency

Striking the Right Balance

by

Emna Trabelsi

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Table of contents

Preface

In an era when transparency is often deemed essential for effective monetary policy, is there a point at which an overload of information becomes counterproductive? While numerous empirical studies highlight the benefits of transparency, such as enhancing economic performance, bolstering financial stability, and aiding market predictions of policy actions, an increasing body of theoretical research cautions that excessive transparency may adversely affect social welfare.

This book addresses a significant gap in the existing literature: not only what central banks should disclose but also how they should convey their information. The central challenge lies in identifying the optimal level of transparency—excessive transparency can provoke market overreactions, while insufficient transparency may hinder informed decision-making. Should central banks restrict the dissemination of certain information, reduce its specificity, or adopt a strategy of selective disclosure?

By examining various models of partial transparency, this work expands theoretical frameworks within a strategic context, exploring the relationship between central banks and the private sector. The book contends that, given the pervasive influence of media and the information age, a strategy of selective information sharing is more practical and effective than simply limiting the volume or detail of data released.

This book provides valuable insights for policymakers, researchers, and economists, enhancing the understanding of how transparency influences market behavior and economic stability. Through a

combination of empirical research and theoretical modeling, this book challenges conventional beliefs and offers a new perspective on the intricate relationship between information sharing and monetary policy.

About the Author

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List of acronyms

ADF Augmented Dickey Fuller

AIC Akaike Information Criterion

ARDL Autoregressive Distributed Lag

ARCH Autoregressive Conditional Heteroscedasticity

CBDC Central Bank Digital Currencies

CBI Central Bank Index

CBI_REGIME Central Bank Independence Regime (Dummy Variable)

CBT Central Bank Transparency

CBT2 Central Bank Transparency (Economic Dimension) Index

CD Cross-sectional Dependence

CNB Czech National Bank

COVID-19 Coronavirus Disease of 2019

CUSUM Cumulative Sum

CUSUMSQ Cumulative Sum of Squares

D(.) First-difference operator

DSGE Dynamic Stochastic General Equilibrium

ECB European Central Bank

ECM Error Correction Model

Fed Federal Reserve

FOMC Federal Open Market Committee

FPE Final Predication Error

GDP Gross Domestic Product

GDPG Gross Domestic Product Growth

GMM Generalized Method of Moments

HAC Heteroscedasticity and Autocorrelation Consistent

HQ Hannan-Quinn Criterion

IEL Individual Evolutionary Learning

IMF International Monetary Fund

IPI Industrial Production Index

LNGE Logarithm of Government Expenditures

LNGPR Logarithm of Geopolitical Risk Index

LNPIMI_D11 Logarithm of Price of Imports Index (Seasonally Adjusted)

LNPISI_D11 Logarithm of Price of Industrial Sales Index (Seasonally Adjusted)

LR Likelihood Ratio

LSDV Least Squares Dummy Variable

LSDVC Least Squares Dummy Variable Corrected

MENA Middle East North Africa

MMR Money Market Rate

MPC Monetary Policy Committee

MS-GARCH Markov-Switching Generalized Autoregressive Conditional Heteroscedasticity

NARDL Nonlinear Autoregressive Distributed Lag

NKPC New Keynesian Phillips Curve

NPL Non-Performing Loans

OECD Organization of Economic Cooperation and Development

PP Phillips Perron

REER Real Interest Rate

REXR Real Effective Exchange Rate

RQ1 Regulatory Quality

SC Schwarz Criterion

TRANS1 Central Bank Transparency

UK United Kingdom

US United States

VA1 Voice and Accountability

VAR Vector Autoregressive Model

VECM Vector Error Correction Mode

VOL_INF_MS Conditional Volatility of Inflation (Markov-Switching)

VOL_INF_YEAR Unconditional Volatility of Inflation

VOL_IPI_YEAR Volatility of Industrial Production Index

VOL_M3_YEAR Volatility of Monetary Aggregate M3

VOL_REER_YEAR Volatility of Real Effective Exchange Rate

WSI World Sentiment Index

@TREND Deterministic trend variable

List of figures

List of tables

List of boxes

Chapter 1
The Challenges of Central Bank Transparency

Economists widely agree that the availability of abundant information is generally beneficial, as it enhances the efficiency of decision-making processes among economic agents. Within this framework, a central bank that clearly and explicitly communicates its objectives and assessments of the macroeconomic environment is likely to improve overall welfare. Transparent communication enables agents to align their expectations more closely with the central bank's intentions, thereby facilitating smoother economic adjustments. Woodford (2005) emphasizes that the effectiveness of monetary policy is maximized when it is predictable, allowing financial markets to better anticipate the central bank's actions and strategic direction. Similarly, Svensson (2006) argues that the explicit disclosure of operational objectives, such as through a clearly defined intertemporal loss function, as well as greater openness in forecasts and policy communications, would enhance the credibility and performance of monetary policy. In general, increased transparency reduces uncertainty regarding future policy decisions, which in turn can strengthen the reputation, credibility, and balance sheet performance of central banks. The growing emphasis on monetary policy transparency has been closely linked to the global adoption of inflation targeting frameworks. The widespread implementation of this regime reflects its success in anchoring inflation expectations and reinforcing policy credibility. This shift has also been accompanied by the expansion of communication tools and an enhanced degree of accountability for monetary authorities in achieving their stated objectives. In this context, several countries have followed New Zealand's pioneering

model by formally adopting inflation targets as a cornerstone of their monetary policy strategy.[1]

This chapter is a quest for understanding central bank transparency, encompassing relevance and worldwide evolution, while attempting to provide a suitable definition.

The importance of Central Bank Transparency

Effective monetary policy increasingly relies on clear and timely communication of objectives to the public. For central banks, transparency not only enhances the quality of public understanding and market expectations but also reinforces institutional accountability. In recent years, both central banks and financial institutions have increasingly embraced the principle of clarity in articulating their goals and decisions. The efficacy of monetary policy is significantly strengthened when the public is well-informed about the objectives and instruments of central banks and when these institutions are credibly committed to achieving their stated goals.

Central bank transparency has become a cornerstone of modern central banking. Effective communication with the public and engagement with financial market participants enhance the credibility, predictability, and overall impact of monetary interventions. When the decision-making process behind monetary policy is clearly explained to the public, the media, and market participants, the resulting policies become more comprehensible, enabling financial markets to anticipate future developments better. This, in turn, contributes to a more stable and efficient monetary environment. Moreover, transparency supports the effective

1 New Zealand was the first country to formally adopt inflation targeting, with the Reserve Bank of New Zealand Act 1989 coming into effect in February 1990.

fulfillment of a central bank's mandate and provides a robust foundation for institutional accountability.

Technically speaking, transparency refers to an environment in which a central bank discloses timely, open, and comprehensive information regarding its strategic framework, economic assessments, policy decisions, and operational procedures. Crucially, such transparency is contingent upon a thorough understanding of the monetary policy-making process, both by policymakers and the broader public. It also involves explaining the rationale behind economic assessments and the analytical underpinnings of policy actions.

Several mechanisms explain how transparency can enhance the effectiveness of monetary policy. **First**, central bank transparency bolsters the credibility of a central bank by demonstrating its capacity and commitment to fulfilling its statutory mandate. When markets and the public believe that a central bank will act consistently with its objectives, inflation expectations become more firmly anchored. **Second**, central bank transparency imposes self-discipline on decision-makers, requiring consistency over time in both policy choices and their justification. **Third**, by publicly outlining its strategic approach and regularly communicating its interpretation of economic developments, the central bank provides forward guidance. This enables financial markets to form more accurate expectations and anticipate monetary policy responses to various economic shocks. As a result, monetary policy becomes more effective in achieving medium-term stability and macroeconomic objectives.

Central Bank Transparency as a premise of a credible monetary policy

A growing body of literature emphasizes the crucial role of transparency in enhancing the credibility of monetary policy (De Haan *et al.*, 2004). In this respect, transparency refers not only to clear policy objectives but also to the systematic publication of meeting minutes, official reports, and public communications, particularly those issued by the central bank governor (Ngomba Bodi *et al.*, 2020). The central premise is that transparent communication allows monetary authorities to credibly signal their commitment to price stability, thereby fostering public trust. A central banker operating within a transparent institutional environment is likely to internalize this constraint, aligning behavior with publicly stated objectives and, as a result, bolstering the credibility of the institution. From the standpoint of central banking practice, transparency is frequently regarded as the most critical complement to institutional independence, arguably even surpassing formal accountability mechanisms (Geraats, 2002; Mamoon *et al.*, 2025). It has thus been identified as a core pillar of contemporary monetary governance, alongside independence and the objective of maintaining low and stable inflation (Geraats, 2002). The fundamental rationale is that monetary policy decisions and strategic orientations should be transparent and accessible to the public and elected officials, thereby enabling meaningful oversight and evaluation (Dincer & Eichengreen, 2008). The consolidation of central bank independence, combined with broader shifts toward democratic accountability, has intensified calls for greater openness in the conduct of monetary policy (Dincer & Eichengreen, 2008).

Moreover, transparency constitutes a central dimension of social accountability. It is operationalized through several mechanisms, including the publication of policy meeting records, timely

responsiveness to legislative bodies, dissemination of comprehensive analytical reports, regular coordination with fiscal authorities, and frequent press conferences. These practices not only enhance the legitimacy of monetary institutions but also contribute to the effectiveness and predictability of monetary policy actions. In section 1.2, we examine in detail how central bank transparency has been debated through the lens of "rule" versus "discretionary" monetary policy.

Central Bank Transparency to address democratic deficit

Central bank transparency fosters self-discipline among policymakers by embedding accountability, coherence, and ethical rigor into the formulation and justification of monetary policy. Public scrutiny, enabled by transparent communication channels, exerts a disciplining effect, compelling central banks to adhere to their declared objectives and policy frameworks. Such visibility reduces the scope for arbitrary deviations, thereby safeguarding institutional credibility (Monteagudo, 2019). When monetary decisions are exposed to public evaluation, central bankers are incentivized to maintain consistency and avoid reputational risks. Clear articulation of policy goals further establishes explicit benchmarks, requiring decisions to be logically justified and aligned with previously stated commitments. Additionally, transparency enhances institutional memory by documenting the rationale behind past choices, which not only facilitates historical accountability but also guides future policymaking through greater continuity and strategic alignment (Brunswicker *et al.*, 2019). Transparent communication also anchors market expectations by conveying the systematic nature of policy responses. Markets value predictability; thus, unjustified shifts in policy can heighten uncertainty and financial volatility. In this context, transparency acts as an external constraint, reinforcing the alignment

between announced strategies and actual implementation. Moreover, formal policy frameworks and procedural guidelines institutionalize rational deliberation, thereby mitigating the effects of ad hoc decision-making. Ultimately, transparency is grounded in ethical imperatives, as it holds central banks accountable to the public and legislative scrutiny, thereby reinforcing normative standards of governance and deterring opportunistic behavior (Boylan, 2001). Collectively, these mechanisms demonstrate that transparency functions not only as an informational tool but also as a core component of effective institutional design, thereby enhancing the credibility, accountability, and overall integrity of monetary policy.

Central Bank Transparency during unconventional episodes: The role of forward guidance

Forward guidance has emerged as a pivotal communication instrument within the broader framework of central bank transparency, aimed at shaping market expectations and enhancing the effectiveness of monetary policy (Andrade *et al.*, 2019; Sutherland, 2023). By explicitly communicating the anticipated trajectory of monetary policy, forward guidance reduces uncertainty and improves the predictability of central bank actions (Barthélemy *et al.*, 2019). It typically takes two forms: Odyssean guidance, which entails a commitment to future policy actions contingent upon specific conditions, and Delphic guidance, which reflects the central bank's economic outlook without binding commitments. Both approaches serve to signal the central bank's reaction function and manage expectations regarding the future stance of policy, core objectives of a transparent monetary regime.

By clarifying the likely path of interest rates or macroeconomic conditions, forward guidance mitigates informational frictions and facilitates the smooth adjustment of financial markets to evolving

economic shocks (Claessens & Kose, 2018). Empirical evidence suggests that forward guidance affects both short- and long-term interest rates, reduces corporate loan spreads, and enhances credit availability by influencing lending standards and non-price terms. As such, forward guidance functions not only as a stabilizing instrument but also as an important channel for the transmission of counter-cyclical monetary policy (Campbell *et al.*, 2012; Bernanke, 2020).

The effectiveness of forward guidance, however, is critically dependent on the credibility and transparency of the central bank issuing it (Kool & Thornton, 2015). Transparent communication disciplines policymakers by aligning their actions with previously stated objectives and enhancing accountability to market participants and the broader public. Moreover, forward guidance serves as a mechanism for disclosing the central bank's information set and implicit policy rule, thereby reducing uncertainty surrounding future decisions. This alignment of expectations can enhance production efficiency and economic planning, though it may also result in increased cross-sectional price dispersion due to heterogeneous interpretation of the disclosed information.

The formation of expectations plays a central role in mediating the impact of forward guidance. Under rational expectations, the effects of guidance are more pronounced, particularly under regimes such as inflation targeting or price-level targeting (Woodford, 2013; Honkapohja & Mitra, 2015). In contrast, when expectations are formed through adaptive learning or are influenced by bounded rationality, the transmission of guidance may be weaker or subject to misinterpretation. Financial markets tend to react more strongly to pre-announced communication than to the policy decisions themselves, highlighting the anticipatory and preparatory function of forward guidance.

Nevertheless, several limitations persist. Excessive transparency, especially when forecasts are uncertain or complex, can undermine policy flexibility, provoke misinterpretations, and, in some cases, reduce overall welfare. Insights from behavioral economics suggest that cognitive biases such as overconfidence, anchoring, or limited attention may distort the reception of guidance, particularly during episodes of heightened market volatility or crisis (Gavin *et al.*, 2014; Campbell *et al.*, 2019).[2] In this context, forward guidance should be understood not as an isolated instrument but as an integral component of a comprehensive transparency strategy. Its effectiveness depends on the coherence, clarity, and credibility of communication, as well as its alignment with the central bank's institutional mandates. When embedded within a robust framework of transparency, forward guidance enhances the overall credibility, accountability, and policy coherence of the monetary authority, thereby reinforcing its capacity to stabilize expectations and support macroeconomic objectives in uncertain environments (Athanasakou & Hussainey, 2014).

Central Bank Transparency: Revisiting the "rule" *versus* "discretion" monetary policy regime

The debate on monetary policy transparency is intrinsically tied to the broader macroeconomic discourse on "rules versus discretion." (refer to Box 1-1). This debate centers on the effectiveness, predictability, and credibility of monetary policy frameworks, as well as their influence on macroeconomic stability and the behavior of economic agents.

[2] We argue that there might be an intermediate level of central bank transparency (refer to Chapter 4). Alternative strategies to full transparency will be discussed in detail in Chapter 5.

Theoretical Foundations: Rules and Discretion

A central bank is said to follow a rule-based monetary policy when its decisions are governed by a predetermined principle that is consistently applied over time or under specific conditions. This framework aims to reduce arbitrariness and align policy actions with a clear, forward-looking strategy. Conversely, discretionary policy allows central banks the flexibility to make situational decisions without strict adherence to pre-established rules, enabling responsiveness to evolving economic conditions.

While the distinction between rules and discretion may appear conceptually straightforward, it becomes nuanced and complex upon closer examination. Rules can be simple, such as maintaining a constant growth rate of a monetary aggregate irrespective of economic fluctuations, as famously advocated by Milton Friedman in the 1950s, or contingent, adapting policy actions based on specific economic indicators or states of the economy. These contingent rules may be derived from theoretical or econometric models (model-dependent) or designed to be robust across various frameworks (model-independent). They may also vary in their rigidity, ranging from systematic prescriptions for a wide array of scenarios to more flexible guidelines allowing for limited discretion.

Additionally, the communication strategy of a central bank plays a crucial role in enhancing transparency. A rule may be publicly announced to guide expectations or kept confidential as an internal benchmark. The former approach is generally considered more transparent and credibility-enhancing, particularly when the rule is well understood and consistently followed (Peytrignet, 1993).

Rules-Based Monetary Policy: Predictability, Performance, and Credibility

A rules-based monetary policy is frequently praised for its ability to deliver predictability and stability. By committing to a clearly defined framework, central banks reduce uncertainty for households, firms, and financial markets. This predictability enhances the credibility of the central bank and helps anchor inflation expectations more effectively (Taylor, 2015, 2019; Shultz, 2017; Salter, 2017; Hetzel, 2025).

Empirical studies suggest that macroeconomic performance tends to be more stable during periods characterized by rules-based policies. Such frameworks are typically associated with lower inflation rates and reduced volatility in output and interest rates (Nikolsko-Rzhevskyy *et al.*, 2014). Transparency is a cornerstone of this approach: the clear articulation of policy objectives and the strategy for achieving them strengthens the central bank's reputation and enhances policy effectiveness (Hakkio & Cecchetti, 2010; Kartaev & Ledneva, 2021). Well-communicated rules contribute to lower inflation and interest rate uncertainty, thereby facilitating informed decision-making by economic agents (Jitmaneeroj *et al.*, 2019).

Discretionary Monetary Policy: Flexibility and Its Limits

In contrast, discretionary monetary policy offers the advantage of flexibility (Wray, 2007; Small & Sinha, 2022). It enables central banks to respond in real-time to unforeseen shocks and changing economic conditions. This attribute can be crucial during crises, such as financial turmoil or geopolitical disruptions. This flexibility supports a more nuanced and context-sensitive policy approach, particularly in the presence of structural changes or uncertainty.

However, discretionary frameworks also face important criticisms. Without a clear and consistent policy anchor, they may lead to excessive inflation, unstable expectations, and a loss of credibility (Taylor, 2015; Barro & Gordon, 1983, 2019). The inherent unpredictability of discretion can undermine the central bank's ability to guide expectations and maintain macroeconomic stability. Furthermore, achieving transparency in a discretionary setting is inherently more challenging. The qualitative nature of decision-making and the complexity of real-time economic assessments often limit the clarity and accountability of policy actions (Furton & Salter, 2017).

Constrained Discretion: A Balanced Framework

To reconcile the strengths of both paradigms, some economists advocate for a hybrid framework known as "constrained discretion." This approach combines rule-based elements—such as adopting a nominal anchor, typically an inflation target—with the flexibility to respond to economic shocks in a discretionary manner (Mishkin, 2018). Central to this model is the transparent communication of the central bank's reaction function: by clearly outlining how policy will respond to changing conditions, the institution can preserve credibility while retaining operational flexibility.

Empirical evidence supports the effectiveness of constrained discretion in delivering favorable macroeconomic outcomes. It has been associated with lower and more stable inflation rates, reduced output volatility, and enhanced policy credibility (Nikolsko-Rzhevskyy *et al.*, 2021). By explicitly anchoring expectations while preserving room for maneuver, constrained discretion offers a practical and robust alternative to the extremes of rigid rule-following

or unfettered discretion. In Table 1-1, we summarize the different features of monetary policy regimes.

Table 1-1 Characteristics of monetary policy regimes according to different aspects

Aspect	Rules-Based Policy	Discretionary Policy	Constrained Discretion
Predictability	High	Low	Moderate
Economic Performance	Better	Variable	Improved
Transparency	Clear and strong	Challenging	Balanced
Flexibility	Limited	High	Moderate
Credibility	Enhanced	Variable	Balanced

Box 1-1 Rule-based versus discretionary monetary policy: Definitions adapted from Pollin (2005)

Rules vs. Discretion in Monetary Policy: Definitions and Theoretical Foundations

The distinction between rules-based and discretionary approaches to monetary policy constitutes a central axis of debate in macroeconomics. A **rules-based policy** refers to a strategy wherein monetary authorities commit ex ante to a predefined medium- or long-term trajectory. A classic example is a central bank targeting a steady annual growth rate of the money supply—e.g., 5% per year—over a fixed horizon. This approach prioritizes consistency, predictability, and the anchoring of expectations. It is characterized by its forward guidance and low tolerance for deviation from the rule once set.

Conversely, **discretionary policy** involves active, period-by-period decision-making in response to evolving macroeconomic

conditions. It does not preclude the existence of a long-term strategic vision, but it allows policymakers to adapt instruments dynamically based on real-time assessments. This approach is typically associated with counter-cyclical interventions and "fine-tuning" designed to offset temporary fluctuations in demand or supply.

Competing Paradigms: Monetarist and Keynesian Views

The divergence between rules and discretion is often mapped onto the broader intellectual divide between monetarist and Keynesian schools of thought.

Monetarists, most notably Milton Friedman, are staunch advocates of rules. They argue that monetary policy should be governed by simple, transparent rules to reduce uncertainty and enhance the efficiency of market adjustment. Once such a framework is in place, market participants can coordinate their expectations and behaviors accordingly, thereby allowing endogenous mechanisms to achieve macroeconomic equilibrium.

In contrast, **Keynesian economists** emphasize the importance of discretion. From this perspective, economic systems are prone to persistent disequilibria due to rigidities and informational frictions. As such, discretionary interventions are not only feasible but necessary. Policymakers are encouraged to exploit all available data and instruments to steer the economy toward a socially optimal path, particularly during downturns or periods of crisis.

Historical Antecedents of Rule-Based Thinking

The idea of rule-based policy predates the modern era. Under the gold standard, monetary issuance was constrained by the quantity of gold reserves held by the central bank, and convertibility at a fixed parity served as an institutional commitment device. These

arrangements exemplified early attempts to depoliticize monetary control and limit discretion.

The Friedman Rule and the Timing Problem

Friedman (1995) revitalized the case for monetary rules in the context of modern macroeconomic theory. He proposed a fixed growth rule for the money supply, arguing that discretionary interventions are inherently mistimed. This results from three types of lags: (i) recognition lag, due to delays in detecting economic trends; (ii) implementation lag, associated with decision-making processes; and (iii) impact lag, reflecting the time required for policy effects to materialize in the real economy. Friedman warned that these lags could induce pro-cyclicality, where policy responses aggravate rather than dampen fluctuations. Consequently, he favored automatic mechanisms over active interventions, placing his confidence in the natural self-correcting properties of markets.

While compelling in theory, Friedman's argument has been subject to empirical scrutiny. The effectiveness of rules depends critically on the structure, frequency, and duration of economic shocks. Furthermore, modern central banks—most notably the U.S. Federal Reserve—have demonstrated that discretionary policy, informed by forward-looking models and credible communication, can effectively anticipate economic shifts and stabilize expectations.

The Time Inconsistency Problem and the Credibility Argument

A second major rationale for rule-based policy stems from the **time inconsistency** problem, as formalized by Kydland & Prescott (1977) and later extended by Barro & Gordon (1983). The core idea is that optimal policy choices made today may no longer be optimal tomorrow, leading to dynamic inconsistency and loss of credibility.

This phenomenon is illustrated through several examples:

- A professor announces a difficult final exam to motivate students to study. Once the effort has been made, the exam becomes redundant, yet not holding it would undermine the credibility of future announcements.

- A mayor sells land in flood-prone areas with a disclaimer that no compensation will be provided in the event of a disaster. When flooding occurs, public pressure renders non-compensation politically infeasible, undermining the original commitment.

- A government warns foreign banks that excessive risk-taking will not be bailed out. However, when a large bank faces insolvency, the systemic risk compels the government to intervene, thereby creating moral hazard. Anticipating such behavior, banks may take even greater risks.

In each case, the **credibility of the initial commitment** is compromised by incentives to deviate ex post. In monetary policy, this leads to inflationary bias and a weakening of the central bank's ability to anchor expectations. Hence, a rules-based framework—such as inflation targeting or a Taylor-type rule—is seen as a solution to mitigate these incentive problems by binding policymakers to ex ante commitments.

Are Central Bank Transparency and Communication Alike?

While communication is commonly regarded as a channel through which monetary authorities enhance transparency, it is crucial to distinguish between the two concepts. A clear delineation of communication and transparency is therefore essential to establish the analytical foundation of this study.