Understanding and interpreting the pronouncements of independent central banks has become an increasingly sophisticated art, akin to Kremlinology, and the economists involved often plead for more, or better, information to help them understand what interest rate-setters are thinking. In particular, there have been growing calls for central banks to publish forecasts of how they expect interest rates to move, so that firms and households can adjust their behaviour accordingly.

A new paper by CEPR Research Fellow Hans Gersbach and Volker Hahn suggests, however, that central bank watchers should be careful what they wish for, because the advantages of rate-setters pre-committing to a certain plan of action are outweighed by the disadvantages.

Some central banks, including those in Norway and New Zealand, already publish their expectations for the path of future interest rates, and a number of analysts, including Simon Woodford and Charles Wyplosz, have recommended that others follow suit – because the more information the public have about the banks’ thinking, the better; and where policymakers have a clear direction in mind – such as the ECB’s determination to increase rates towards what it saw as more normal levels since 2005 – markets should know about it, to avoid unnecessary shocks.

Other monetary policy experts, such as former Bank of England Monetary Policy Committee (MPC) member Charles Goodhart, have argued that deciding on a one-off change to interest rates among a group with potentially differing views is difficult enough, without also having to agree collectively to where rates are likely to go over the coming months. To take a recent example, in April, the MPC split three ways, with seven members agreeing on a 25 basis point rate cut, one voting for a deeper, 50 basis point reduction, and two suggesting rates should remain unchanged. That suggests that the difficulties of getting all members signed up to the same expectation of future rates could be formidable.

Gersbach and Hahn carry out a more formal analysis of this question, using a standard New Keynesian model of the economy, but introducing an extra factor – a ‘central bank loss function’ – to represent the potential disadvantages of forecasting policy in advance.

By publicly pre-committing to a certain course of action, the central bank ties its reputation to it, which in itself makes the forecast more credible. That may help to anchor the public’s expectations, and underline their belief that inflation will not be allowed to get out of control.

Deviating from that published course of action, because of unexpected shocks, will, by the same token, undermine the bank’s credibility – and this risk may make it less flexible in responding to shocks as they arise.

If it deviates from its published plan, the bank will also have to spend time and resources carefully constructing explanations as to why. This may be relatively simple where there has been an obvious exogenous shock, such as a sharp rise in global oil prices; but where, for example, policymakers judge that the systemic risks to the financial sector have risen, necessitating a shift in interest rate policy, that may be difficult and time-consuming to explain to the public, and require special research and information-gathering, which implies costs.

Having incorporated a term for the losses to the central bank sustained by deviating from their published forecasts, the authors use their dynamic model of the economy to analyse four distinct scenarios. A central bank might publish only short-term forecasts, covering the near future, so that it is too late
to dislodge the public’s expectations; or it might publish medium-term forecasts, which could change the public’s expectations about the future. And those forecasts might predict inflation, or they might reveal the bank’s expectations for the path of interest rates.

When they use their model to test these four options, Gersbach and Hahn find that where only short-term forecasts are published, whether of interest rates or inflation, there is no social advantage to be gained. It is too late to influence the public’s expectations so they can adapt their behaviour, for example by refraining from making excessive wage-claims; but nevertheless, there is a potential loss of credibility, either from forecasting inflation wrongly or from failing to act in accordance with the interest rate forecast. The authors say this is likely to make central bankers less flexible in dealing with shocks, because they will have one eye on whether they are damaging their own reputation with the public.

For medium term forecasts, the results differ according to what the central bank chooses to predict. If it forecasts the medium-term path of inflation, the authors find there is a positive social gain, as long as the credibility costs of missing the forecast are not too large. Consumers’ and businesses’ inflation expectations will be anchored and they should adapt their behaviour accordingly, helping to keep inflation under control. The central bank’s credibility will be tied to hitting its inflation target, not to following a specific course of action.

Where the bank is forecasting its own future interest rate policy, however, the model finds that the potential social gains are always outweighed by the disadvantages. Faced with a shock, instead of thinking about how best to keep inflation on track, policymakers will have to have one eye on the credibility costs of adopting a different interest rate path to the one they had pledged to take – and that is likely to make them less flexible.

The US Federal Reserve introduced an expression of its own policy ‘bias’ – whether it was planning to tighten or loosen policy – in 1999, but swiftly removed it just a year later, and since then has stuck to more vague statements about the direction of interest rates. The authors suggest this may be because they soon realised the disadvantages of giving pointers to their near-term plans: sometimes, plans have to change.

Publishing forecasts of any kind is, as Gersbach and Hahn suggest, a ‘double-edged sword’ for central banks. Announcing a plan and sticking to it could help to underpin their credibility; but announcing a plan, and then doing something completely different, could create a serious problem and reduce policymakers’ room for manoeuvre just when they most need it: in the face of an unexpected macroeconomic shock.

CEPR DP6761 Monetary Policy Inclinations by Hans Gersbach and Volker Hahn

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Doing the best they can?

With hindsight, governments’ tax and spending policies can often be seen to have made a bad situation worse – by fuelling an economic boom, or exacerbating a downturn. As a result, politicians are frequently accused of using fiscal policy irresponsibly. But even the most virtuous policymakers can only act on the information they have at the time, and a new CEPR paper shows that in many cases, decision-makers are simply misinformed, rather than irresponsible.

Economists often analyse fiscal policy over time by using real-life data to construct imaginary rules, to characterise the way governments respond to changes in the macroeconomic environment. But CEPR Research Fellow Andrew Hughes Hallett and co-authors Kerstin Bernoth and John Lewis point out that these fiscal policy rules are often constructed using data that was only available afterwards – sometimes long afterwards.

It can often be very difficult to judge whether the economy is operating above or below its long-run potential, and whether fiscal policy should be used as an accelerator or a brake.

Bernoth et al. use data about fiscal policy in all EU member countries, from 1995 to 2006, to test how policymakers responded to the information they had at the time. In order to judge whether they were irresponsible, or just misled, the authors use contemporaneous estimates of the output gap – the extent to which the economy is running above or below trend – from successive editions of the OECD’s regular Economic Outlook publication.

The conventional approach is to use the cyclically-adjusted budget deficit, which takes into account the economic cycle, as the key measure of fiscal policy. But that requires economists to ‘filter’ the data according to the stage of the economic cycle, and the authors say
that this fails to take into account the mistakes policymakers may make in judging where in the cycle they are at a particular time.

Instead, they construct an equation which measures how fiscal policy shifts in response to changes in GDP. Those tax-and-spending changes which track the OECD estimates of the output gap — in other words, those which could have been deliberate responses to perceptions of the economy’s health at the time — they characterise as discretionary. But the equation also includes an ‘error term,’ characterising the gap between the contemporaneous estimates of the output gap, and subsequent data revisions. Changes which track the revised, ex post data but could not have been deliberate decisions, because the information was not available, are characterised as ‘automatic’. These are what are known as the ‘automatic stabilisers’: unemployment and other social benefits increase as the economy turns down, which helps to boost spending and offset a slowdown, without any new decisions being made.

When Bernoth et al. use their equations to carry out a regression analysis, using more than a decade’s-worth of fiscal policy data from across the EU, they discover that beleaguered policymakers are in fact trying their best to use tax and spending to boost the economy in downturns, and lean against excessive booms. In general, the results show that for every euro that GDP shifts below potential, governments tended to spend 21 cents in offsetting measures — and for every euro it moves above potential, they tighten the public purse-strings by 21 cents. On their non cyclically-adjusted way of looking at policy, discretionary countercyclical policy looks even stronger: 56 cents for each euro’s-worth in either direction.

However, these admirable efforts to use fiscal policy in a counter-cyclical way are overshadowed, because the contemporaneous forecasts turn out to be so badly wrong. Using the same analysis, the authors also find other important factors determining how strongly fiscal policy responds to changes in the economy. Elections tend to lead to slightly looser policy; and euro area countries made a special effort to tighten their belts in the run-up to EMU entry. In general, though, it seems governments are faithfully striving to follow the rule that they should try to use fiscal policy as an extra lever of control to moderate the macro-economy, but are struggling to do so effectively because economic forecasting is such an inexact science.

These findings cast doubt on the usefulness of rules such as Gordon Brown’s ‘Golden Rule’, which is meant to force the Treasury to balance current spending and revenues over the course of an economic cycle. As has been illustrated by repeated revisions of how long the latest cycle has been, there is often insufficient knowledge at the time for it to constrain spending behaviour. Bernoth et al.’s analysis shows that where fiscal policy is concerned, politicians are hampered not just by short-term electoral concerns, but also by their own lack of knowledge.

CEPR DP6758 Did Fiscal Policymakers Know What They Were Doing? Reassessing Fiscal Policy With Real-Time Data by Kerstin Bernoth, Andrew Hughes Hallett and John Lewis

Immigration: the real losers

When a wave of new immigrants arrives to seek a new life, native workers often feel under threat, fearing that their jobs and livelihoods will be jeopardised by the influx of rivals. But a new paper from CEPR suggests that instead of the local-born workforce, it is earlier waves of immigrants who should feel most at risk.

The fall of the Berlin Wall in 1989, and the reunification of Germany the following year created huge flows of migrants. Over the next decade, two million Germans moved from the East to the West; and almost three million ‘ethnic Germans’ — people of German origin who had often lived abroad, mainly in the eastern bloc countries — returned to what had been West Germany.

For many, it was a long-awaited opportunity to put their family back together, or to look for economic advancement in a country which had been closed to them for decades. But for economists, it also created a fascinating ‘natural experiment,’ allowing them to observe what happens to the fortunes of existing workers amid such a large number of newcomers.

In particular, these new migrants to Germany followed much earlier arrivals, many from Turkey and southern
Europe, who had joined the workforce from the 1950s to the 1970s, often initially as temporary ‘guest workers’.

In order to test how the labour market was changed by the post-reunification wave of migration, CEPR Research Fellow Gianmarco I.P. Ottaviano and co-authors Francesco D’Amuri and Giovanni Peri use a general equilibrium model of the economy, in which firms use inputs of capital and labour to maximise their profits.

Crucially, the authors allow for different groups of workers to be included in this equation. They follow other recent economic analyses in arguing that immigrants need not be perfect substitutes for native workers. The unemployment rate may be higher among immigrants, for example, or they may have more limited access to state unemployment benefits, making them keener to accept a job, perhaps at lower wages. They may also have a different pattern of skills, education and experience.

For these reasons, in their model the authors allow the ‘labour’ input to the equation to be made up of distinct groups, whose members may behave differently.

Because the German labour market is less flexible than, for example, in the US, making it harder for employers simply to adjust wages to respond to changes in the labour market, the authors also adapt their model to allow for an ‘employment’ response to immigration – a shift in the number of jobs being created – as well as a ‘wage’ response.

Having set up the model, the authors use data from the German Institute for Employment Research – covering the years 1975 to 2001 and giving the wage rates, education levels and employment status of around 500,000 people a year – to carry out a series of regression analyses, and test the impact of newcomers.

D’Amuri et al. take 1992 to be a watershed. From that year onwards, most immigrants were either ‘ethnic Germans’ from abroad, or came from elsewhere in the newly reunified Germany and the authors classify these as ‘new immigrants’, in contrast with pre-1992 ‘old immigrants’.

And it is these ‘old immigrants,’ the results of the analysis show, who have been most affected by the post-1992 wave of often highly-skilled, highly-educated arrivals. The regressions show that in general, for every ten new immigrants who joined the workforce from 1992 to 2001, two old immigrants lost their jobs as a result.

When the same analysis is carried out for native German workers, they do not seem to have suffered any effects in terms of lost jobs from the new immigrants: native workers and immigrants do not seem to be direct substitutes; or rivals, to each other.

As far as wage-levels are concerned, it is old immigrants, again, who are hardest hit. In general, those who were already in Germany before 1992 saw, on average, a 1.6% reduction in their real wage-levels when the post-1992 immigrants joined the workforce. The highest losses were suffered by those with higher education levels – because the new arrivals were often highly educated. These workers suffered an average 4% fall in their real wages.

For native German workers, the pattern is completely different: in fact, they saw, on average, a very small improvement of 0.33% in their wage levels after the new immigrants arrived.

Having established how the ‘natural experiment’ of five million immigrants flooding into Western Germany affected the existing workforce, the authors carry out a brief ‘thought experiment’, asking how things might have been different had a more flexible labour market policy been in place. That might have allowed employers to respond to the increasing supply of workers by reducing the real wages of their existing staff, instead of laying people off.

The authors calculate the cost, in unemployment insurance, of supporting the 21,700 old immigrants they calculate as having lost their jobs since 1992, as a result of new immigration. They then compare this with the reduction in wages those employees would instead have suffered if the labour market had been more flexible. They find that the cost to taxpayers of supporting the unemployed - €313.5m a year - outweighs the wage-loss to workers, which would have been €261.7m.

That suggests, they argue, that if regulations were changed to make the labour market more flexible, a Pareto optimal scheme could have been devised under which fewer old immigrants would have lost their jobs; wage reductions could have been offset by a state-funded scheme; and taxpayers would have been better off.

The results of this analysis of the German labour market in recent decades helps to overturn some of the fears of native workers, that their jobs and wages will automatically be imperilled by the arrival of large numbers of workers from overseas. But they also help to unpick some of the costs of having a more inflexible labour market policy, by demonstrating that the cost of safeguarding existing workers’ standard of living can sometimes be job losses for others.

CEPR DP6736: The Labour Market Impact of Immigration in Western Germany in the 1990s by Francesco D’Amuri, Gianmarco Ottaviano and Giovanni Peri

www.cepr.org/bulletin
Is best practice always best?

Encouraging developing countries to learn from many decades worth of experience from elsewhere in the world may seem to be an obviously good idea, but CEPR Research Fellow Dani Rodrik argues in a new paper that spreading what the IMF, World Bank and other multilateral institutions call 'best practice' can be unhelpful, and even damaging. Sometimes, he argues, second-best may actually be better.

Creating the institutions that help free markets to develop - such as courts, regulators, social safety nets and so on - has become a fashionable theme in contemporary economic development; but they take widely varying forms across different developed countries, which underlines the difficulty of applying a one-size-fits-all approach in the developing world.

Rodrik argues that finding the right institutions in developing countries may instead require a 'second-best mindset,' which works within the specific context of a particular country, instead of trying to transplant a blueprint from elsewhere.

He discusses four policy areas to flesh out his argument. First, it can seem obvious that in countries where firms cannot depend on their contracts being enforced in a court of law - because courts are slow, inefficient, or too easily corruptible, for example - it would be a good idea to reform and improve the court-system, perhaps using a model from elsewhere. In sub-Saharan Africa, for example, many small entrepreneurs are forced to depend on so-called 'relational' contracts, through repeated interactions with partners and clients, often over many years, so that they can build up trust.

However, Rodrik points to the example of Vietnam, which has achieved extraordinarily strong economic growth of 8% a year, and is widely seen as a development success story; yet where the courts are just as unreliable as in sub-Saharan Africa, and exactly these kinds of relational contract prevail.

Improving the court-system might make these countries look more like a text-book model of best practice, but it is not necessarily what is holding back growth in Africa.

Second, barriers to entry for up-and-coming firms are often cited as bad for economic development - by the World Bank in its 'Doing Business' reports, for example - because they create excess profits for the incumbents, which would be eroded away if new entrants were able to come into the market.

But where there are few existing businesses in a particular sector, pioneering entrepreneurs may perform what Rodrik calls a 'cost-mapping' function, demonstrating that new types of enterprise can be successful and profitable. Without these rents, the rewards of taking the risk of entering a new industry may simply be too small.

Lowering entry requirements may actually backfire, then, if the result is that no one wants to put their livelihood on the line for such measly rewards. Again, it's important to know what the binding constraint is - what exactly is holding back economic growth. Just because the institutions of a particular country do not mirror those of the affluent north, this does not mean that introducing them would suddenly create a successful economy.

Third, cutting tariffs on imports and removing state subsidies from domestic industries is actively promoted - in the multilateral World Trade Organisation negotiations, for example. It is regarded as an essential tool for stimulating domestic industries, by exposing them to outside competition and helping developing economies to specialise in industries where they have a comparative advantage.

However, Rodrik argues that few countries that have made a success of export-led development have actually followed this model of leaving domestic firms to face the full force of global competition alone. South Korea and Taiwan targeted specific industries with subsidies in the 1960s, to help them develop and become ready to compete internationally. Malaysia and Thailand created export-processing zones, with special support for firms; and China had export incentives and Special Economic Zones.

This gradual approach also had political benefits, Rodrik argues - because as the economies shifted to become more outward-facing, and imports began to flow in, the tariffs and subsidies helped to protect jobs, rather than creating the risk that local demand was satisfied by cheap goods from outside before exporting firms were ready to pick up the slack. Moving piecemeal in this way helped to maintain public support for free trade in these countries.

Finally, developing countries have been encouraged to adopt the model of an independent, inflation-targeting central bank, to win credibility for their monetary policy. However, Rodrik argues that tackling inflation is not always the key challenge for developing economies in transition. In fact, an under-valued currency - which makes inflation higher than otherwise - can actually be an advantage for an economy such as China, which is keen to stimulate export-led demand as it moves towards full integration with the global economy.

Creating an independent central bank can be a hostage to fortune if there are good reasons, at a later stage, for the government to exert control over monetary policy - for example to bring down the value of the currency. The problem with this kind of 'pre-commitment,' is that it can box in policymakers when what they really need is flexibility. Rodrik gives the extreme example of Argentina, which suffered an
economic and political crisis after it pegged the peso to the dollar, but then watched in horror as a slew of Asian countries, and then Brazil, devalued. Instead of bringing credibility, the currency-peg simply made Argentina unsustainably uncompetitive.

Distilling the experience of hundreds of countries around the world to design financial, legal and economic institutions for the best of all possible worlds seems sensible, and governments are often keen to learn from each other. But Rodrik shows that this cut-and-paste approach fails to take account of the specific context in a given country. That means many of the recommendations of the IMF and World Bank can simply be ineffectual; and others can even be counterproductive, because they conflict with the reality on the ground. Sometimes, second best can actually be better.

CEPR DP6764 Second-Best Institutions by Dani Rodrik