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Costly Communication

A monetary authority is not limited to use messages that imply no direct payoff costs – *i.e. cheap-talk* messages. In fact, inflation targeting Central Banks use the basic interest rate as their main instrument of monetary policy. One might argue that changes in this rate imposes direct costs to the Central Banker, and may therefore, on top of its direct influence on policy, convey credible information. In this section, we briefly discuss how costly communication instruments might coexist with *cheap-talk* instruments.

Two conditions are needed for cheap talk to coexist with costly signalling. First, there has to be some pooling regarding the costly action chosen. Second, the Central Banker must have incentives to provide more information than that conveyed by the choice of the costly action.
We can think of a couple of settings in which both conditions would hold. Consider, for example, the case in which the economy may be either in recession or booming, but there are different degrees of recessions and booms. Each state, boom or recession, calls for a (different) optimal interest rate (costly action). In such a case, irrespective of the degree of recession, a single interest rate will be set. Hence, while this allows the public to infer that the Economy is in recession, one cannot infer its degree. This would make room for cheap-talk messages that could convey a better idea of the degrees of recession.

Another example is one in which it is very costly to signal a certain set of states through interest rates (costly communication). Suppose, for example, the Central Banker is facing an exogenous inflationary shock (commodities prices are going up due to greater world demand). But, at the same time, financial institutions are facing a lack of liquidity (they need money to attend to their cash balances needs). The inflationary shock would call for the Central Banker to raise interest rates so the inflation might be tamed, but that action could bankrupt some financial market institutions, which would in turn, cause a great welfare loss. The Central Banker, in this situation, could increase liquidity with *lower* interest rates and at the same time use its communication policy

to influence market expectations.

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