Otmar Issing: Monetary policy and financial markets

Speech by Professor Otmar Issing, Member of the Executive Board of the European Central Bank, at the ECB Watchers Conference, Frankfurt am Main, 18 June 2001.

*   *   *

In my remarks today I would like to discuss the conduct of monetary policy and its interaction with the financial markets. As we know, monetary policy is effective by working through financial markets and therefore the markets are a key part of the transmission process. The smooth conduct of monetary policy is therefore supported by well functioning financial markets. Thus one major challenge for monetary authorities is to interact with the financial markets in a way which fosters the effective conduct of monetary policy in pursuit of its objective of price stability.

My remarks will be concentrated on three main aspects of the relationship between the monetary authority and the financial markets.

- Firstly, I will begin by addressing the question of whether it is financial markets that should react to the monetary authority or the monetary authority that should react to financial markets. Perhaps not surprisingly, I will argue that leadership on the part of the monetary authority is key in order to ensure price stability over the medium term. However, it should be clear – to paraphrase Alan Meltzer – that when policy is conducted in the context of a consistent strategy it leads to a systematic decision-making process that uses information in a consistent and predictable way.
- This links to my second point when I will review the evidence from the financial markets on the predictability and credibility of ECB policy since the start of Stage 3. I shall argue that the evidence strongly suggests that ECB policy has been credible throughout and – by and large – also predictable.
- Thirdly, I shall discuss the motivation behind the decision to cut official interest rates on the 10th of May this year as I believe that this offers an interesting example of when surprising the markets is unavoidable.

In the discussion of the interrelationship between monetary policy and financial markets one can see two distinct strands in the argument. The first is that the monetary authority leads the financial markets. In this case monetary policy leads by signalling its intentions to – and impacting on – the financial markets. In the case of the ECB our intentions are clearly signalled to market participants via our stability oriented monetary policy strategy. The commitment to price stability over the medium term and a systematic analysis of all the available information should induce ‘rule like’ behaviour on behalf of market participants. This leads them to react to new developments in a manner consistent with the monetary policy strategy, thus aiding the smooth conduct of monetary policy. For example, where the markets correctly anticipate that a new piece of information will lead to a change in official interest rates they will do ‘much of the work’ themselves through a change in the term structure.

In such an environment, communication by the monetary authority is of the utmost importance and is directed towards informing the markets of its assessment of the outlook for price stability and preparing the markets for future policy moves, thereby avoiding unnecessary volatility and supporting the smooth conduct of policy.

Another idea is that the financial markets lead and the monetary authority follows. In such a world, the monetary authority will seek to satisfy the expectations of financial markets – in the extreme case: whatever they are – by never surprising them. If the monetary authority does not do what is expected the financial markets will ‘punish’ it – for example by demanding higher risk premia to cover the greater uncertainty. An important point to bear in mind here is that it can sometimes appear that the financial markets are leading the monetary authority when in fact the reverse is true. This is because the ‘rule like’ behaviour I mentioned earlier will lead the markets to correctly anticipate monetary policy decisions and hence to react in advance of the monetary authorities. Nevertheless, it is still the monetary policy strategy of the monetary authority that determines the reaction.

As I have already indicated I do not support the idea that the monetary authority should ‘follow the markets’. To explain why I will rely on a quote from Allan Blinder, who puts the argument very succinctly:

"...Following the markets may be a nice way to avoid unsettling financial surprises, which is a legitimate end in itself. But I fear it may produce rather poor monetary policy, for several reasons. One is that speculative markets tend to run in herds and to overreact to almost everything. Central bankers need to be more cautious and prudent. Another is that financial markets seem extremely susceptible to fads and speculative bubbles, which sometimes stray far from fundamentals. Central bankers must inoculate themselves against whimsy and keep their eyes on the fundamentals. Finally, traders in financial markets – even those for long-term instruments – often behave as if they have ludicrously short time horizons, whereas maintaining a long time horizon is the essence of proper central banking."

Obviously there are few people who would argue that it makes sense for monetary authorities to slavishly follow the expectations of financial markets. Nevertheless, it is clearly desirable for policy to be predictable in order to reduce uncertainty and volatility in financial markets. So, why does the monetary authority not always satisfy the expectations of financial markets? There are a number of possible explanations that I would like to highlight. However, before doing so, there is one point that I would like to emphasise most strongly. This is that there can be no interest in the monetary authority deliberately aiming to surprise the financial markets. It is sometimes suggested that central bankers occasionally set out to 'trick' the markets into expecting one policy outcome and then deliver a quite different one. Let us be quite clear that a monetary authority which did this would merely increase volatility in the financial markets and damage its own credibility. It would do nothing to aid the smooth conduct of monetary policy and the pursuit of price stability.

Turning to more plausible reasons why financial markets can sometimes be surprised by monetary policy decisions, the first point I would like to highlight is that of informational asymmetry between the markets and the monetary authority. More specifically, the monetary authority has some piece of information at its disposal which market participants do not. With the rapid and effective methods of information dissemination that are now available this is not a situation that is likely to emerge very often. Nonetheless, as I shall discuss a little later, asymmetric information can sometimes explain why market expectations are not fulfilled.

The second point is that – even with the same information sets – the monetary authority and the financial markets may not share the same assessment of the economic, financial or monetary situation. There may simply be a difference between the dominant view in the markets and the view of the monetary authority with regard to the significance of new pieces of information and their implications for the conduct of monetary policy. The occasional emergence of such differences of view is inevitable and may lead to the central bank surprising markets with its policy moves.

A third reason relates to credibility – perhaps the financial markets do not believe that the monetary authority is deciding policy according to its announced decision making framework. Maybe they think that it is vulnerable to outside pressure which may lead it to deviate from its stated objectives.

One way of addressing all of these points is through good communication with the markets. This leads to the fourth reason why the monetary authority may sometimes surprise markets – that there is some form of communication problem between the monetary authority and the markets. Perhaps the financial markets do not fully understand the decision framework used by the monetary authority and/or its assessment of current and prospective economic, monetary and financial developments. I would argue that some 'teething problems' in communication with financial markets are inevitable for a new institution. The ECB is still learning about how best to communicate its message to the markets. The financial markets are still learning – from our track record – about the application of the ECB's monetary policy strategy.

I will now turn my attention to the evidence on the extent to which ECB monetary policy has been both credible and predictable in the eyes of the financial markets.

A key indicator of credibility of ECB monetary policy comes from expectations of inflation implied by the differences between the returns on real and nominal bonds. In this regard, the break-even inflation rate French index linked bonds has been consistently been in line with the ECB's quantitative definition of price stability, indicating a persistently high degree of credibility for ECB monetary policy.

Moving to the question of predictability it seems fair to say that policy moves have generally been anticipated by the money markets. This can be seen if one looks at the implied short term interest rates and the subsequent official interest rate moves which seem to exhibit a high degree correspondence. According to work undertaken by Gaspar, Perez-Quiros & Sicilia (2001) who examine the behaviour of overnight interest rates, the markets do not appear to make systematic errors with respect to monetary policy announcements. Furthermore, developments in the volatility implied by options on 3-month EURIBOR futures indicate that the degree of uncertainty among investors with respect to future developments in short-term interest rates generally declines following an interest rate change by the ECB. Indeed, the extent of this uncertainty around the time of interest rate changes seems to have diminished in magnitude over time. This is consistent with the notion that investors have become more confident in their forecasts of future short-term interest rate developments prior to ECB monetary policy announcements.

Nevertheless, one could not claim that on every single occasion policy has always been well anticipated by the money markets. This can be seen in the fact that on two occasions this year – on the 21st and 22nd of February and the 12th and 17th of April – there was underbidding in the Eurosystem's Main Refinancing Operations. It appears that most market participants were expecting a reduction in interest rates and therefore preferred not to participate in the auctions. When these expectations were not fulfilled there was a shortage of liquidity in the market.

Policy moves also seem to have been generally well anticipated in the bond markets. Since the start of Stage Three of EMU, official ECB interest rate changes appear to have had only a limited immediate impact on nominal bond yields as measured by the average yield on 10-year government bonds issued in the euro area.

Furthermore, ECB rate changes do not appear to have induced any noticeable additional volatility in the break-even inflation rate on French index linked bonds. This would seem to suggest that the monetary policy actions of the ECB have not brought about any significant revisions among investors with respect to the objectives of the ECB. In this sense, the actions by the ECB appear to have been transparent to the markets. Bond market volatility has also declined. Implied volatility on 10-year German Bund futures fell markedly during the course of 2000 and has subsequently stabilised.

In sum, I would argue that the evidence from the financial markets supports the idea that since the start of the Stage 3, ECB policy has always been credible and has usually been predictable. By and large the communication strategy with the markets has worked surprisingly well for a new institution.

Nevertheless, it is occasionally necessary for central banks to surprise the markets. As I have already mentioned, some recent monetary policy decisions have attracted attention because it was felt that they were not well anticipated by the markets. Most notably the decision to lower official interest rates on the 10th of May this year came as a surprise to financial markets.

The decision to make a 25-basis-point rate in interest rates was seen by the ECB as an adjustment of the level of interest rates to somewhat lower inflationary pressure over the medium term. As regards the first pillar of the monetary policy strategy, it was felt that monetary developments no longer posed a risk to price stability. As regards the second pillar, it was felt that upward risks to price stability over the medium term had diminished somewhat.

The change in assessment of the risks to price stability under the first pillar provides an interesting illustration of the problems faced by a central bank in communicating policy through financial markets.

However, the circumstances of this monetary policy decision were unusual because the change in assessment came after it became possible to quantify significant upward distortions in M3 money supply growth. For some time, there have been indications that the monetary growth figures are distorted upwards by non-euro area residents' purchases of negotiable paper included in M3. Around the time of the preparation for the Governing Council meeting, it became clear that the magnitudes of this distortion were both significant and higher than previously expected. As regards holdings of money market fund units/shares by non-euro residents the distortion has become greater in recent months and currently amounts to around 0.5 percentage points in the annual growth rate of M3. There have also been non-negligible distortions to the annual rate of growth of M3 as a result of non-euro area residents' holdings of other marketable paper included in M3. Precise statistical information on this is still being developed. Nevertheless, preliminary evidence indicates that this distortion may have been similar in size to that related to non-resident holdings of money market fund units/shares.

Given the magnitude of these distortions it was clear that such information needed to be placed in the public domain without delay. However, this created a dilemma – whether to release such information and consider the policy implications immediately or to give financial markets time to 'digest' the information before reappraising policy.

If the information had been released first then the ECB may not have surprised the markets with a subsequent policy move. However, imagine the press conference following the Governing Council meeting when the revised M3 data were released. You can be sure that one of the first questions to the President would have been: ‘Against the background of this new and important information – why did you not act today? Was it impossible to reach a consensus?...etc, etc’.

Market participants may – quite reasonably – have wondered why the ECB had not reacted to this new information. They may even have drawn erroneous conclusions as to the relative importance of the first pillar in the ECB’s monetary strategy. There would have been weeks of uncertainty and speculation about the likelihood of a policy easing and how large such an easing might turn out to be. Another risk from delaying would have been the possible re-emergence of underbidding.

To conclude, I would argue that it is not always possible or desirable for a monetary authority to satisfy the expectations of financial markets. Nevertheless, the evidence from the financial markets indicates that ECB monetary policy has always been credible and also – for the most part – has been well anticipated by the markets. There is also some evidence that volatility in financial markets at the time of interest rate decisions has been declining over time.

The ECB has, on occasions, been forced to surprise markets with policy decisions. However ‘surprise’ is never the goal or deliberate intention of monetary policy. Nevertheless, as indicated by the monetary policy decision of the 10th of May this year, when new and important information becomes available it is sometimes necessary to act in a way which was not expected by market participants.