Lucas Papademos: Monetary policy communication and effectiveness

Speech by Mr Lucas Papademos, Vice President of the European Central Bank, at the Annual Meeting of the Allied Social Science Associations, New Orleans, 5 January 2008.

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I. Introduction

It is a great pleasure for me to join this distinguished panel and address a topic which is both important and challenging for monetary policy. Views and practices concerning transparency and communication have evolved dramatically in recent years. It is not an exaggeration to say that transparency and communication have not traditionally been considered a top priority for monetary policy-makers. Only until a couple of decades ago, the conventional wisdom in central banking circles was that monetary policy-makers should say as little as possible and say it rather cryptically.

Nowadays, it is widely recognised that increased transparency and enhanced communication are essential and beneficial ingredients of an effective monetary policy. There are several reasons for this. These are related to the democratic legitimacy of independent central banks, the efficient functioning of the economy and the effectiveness with which monetary policy can attain its objectives. As a result, the majority of central banks have steadily increased their degree of transparency and have placed greater emphasis on communicating their objectives, assessments, actions and intentions.

Despite the growing recognition of the importance of transparency in monetary policy-making, no consensus has emerged – either among academics or among central banks – on what the appropriate degree of transparency is and what constitutes an "optimal" communication strategy, in the sense that these two factors can contribute to the effective attainment of policy objectives and the efficient functioning of markets. Differences in views and practices need not be surprising, as the "best practice" in central bank communication is likely to depend, among other things, upon (i) the size, structure and complexity of the economy, (ii) the objectives and strategy of monetary policy, (iii) the political environment and institutional characteristics of the central bank, including its decision-making committee, and (iv) different assessments of the extent and nature of uncertainty faced by policy-makers. Central banks may therefore pursue, successfully, different communication strategies, which can be appropriate and be considered optimal given the aforementioned factors and assessments. Consequently, when comparing and evaluating the features and effectiveness of the different communication strategies pursued by central banks, we should take into account the various economic, political and institutional factors as well as the elements of uncertainty a central bank faces.

In the remainder of my presentation, I will focus on four issues:

- first, I will review the role of central bank communication in the conduct of monetary policy and assess both its benefits and limitations;
- second, I will discuss the appropriate content and means of monetary policy communication, with reference to the practice and experience of the European Central Bank;
- third, I will address an issue which has received much attention recently, but which continues to be controversial, namely the potential usefulness of announcing the likely future path of future policy interest rates; and
- fourth, I will assess the available empirical evidence about the effectiveness of the ECB's communication policy and conclude by highlighting two issues concerning central bank communication and policy effectiveness.

II. Role and importance of monetary policy transparency and communication

It is generally agreed that a high degree of transparency and an effective communication of policy are necessary for the successful performance of central bank tasks. Several arguments and a wealth of empirical evidence support this proposition. At a fundamental level, increased transparency is a key element of the greater accountability that accompanies central bank independence. In other words, a high degree of transparency is essential for safeguarding the democratic legitimacy of independent central banks. At policy level, increased transparency and good communication about the objectives, the policy strategy, assessments and decisions of a central bank can contribute to policy effectiveness and market efficiency. This is the reason why most central banks have steadily exceeded the accountability standards required by law and have become more open and improved their communication.

Good communication can enhance policy effectiveness by influencing expectations and by reducing uncertainty. Expectations of future developments and policies influence the actions of economic agents and, consequently, help determine current economic conditions as well as aggregate output and price dynamics. Inflation expectations, in particular, are a key determinant of wage and price-setting and of the concomitant dynamic adjustment of employment and output. Moreover, expectations of inflation and of the future path of short-term (real) interest rates determine, given risks and liquidity premia, the longer-term interest rates that influence investment and consumption decisions and, ultimately, medium and long-term price developments. By communicating clearly its policy objectives and its strategy for achieving them and by explaining convincingly the rationale for its decisions – and their consistency with its objectives and strategy – a central bank can help anchor medium and long-term inflation expectations to price stability. The anchoring of expectations facilitates the preservation of price stability and improves the effectiveness with which monetary policy can secure this goal in the presence of shocks and in view of potential inflation risks. In this way, price stability can be maintained more efficiently and output volatility reduced.

Although clear communication of the objectives, the policy strategy and of the decisions taken is necessary to anchor inflation expectations, it is not sufficient. A central bank must demonstrate its commitment and ability to achieve its objectives by the systematic implementation of its policies. Markets and the general public need to be convinced by central bank communication and policy action that are both consistent and effective. This will ensure the predictability and credibility of monetary policy, which are vital for the effective management of expectations. Moreover, a predictable and credible monetary policy, underpinned by high transparency and clear communication, will reduce uncertainty, thus facilitating decision-making and the efficient pricing of assets in a manner that contributes to the attainment of policy objectives.

There is a growing body of empirical evidence that supports the validity of the previous arguments concerning the value of high transparency and good communication for policy effectiveness and market efficiency.[1] I will elaborate on this with regard to the ECB's communication strategy. But before doing this, I would like to make one additional general remark about the extent of central bank transparency and the desirable features of policy communication.

Monetary policy transparency and communication are beneficial when they help the central bank to achieve its objectives by enhancing the understanding of the markets and the public of the policy aims, strategy and decisions, thereby offering clear guidance for the formation of expectations as well as reducing uncertainty. Transparency means more than simply releasing information. The provision of more information does not necessarily lead to a better

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1 See, for example, Levin, Natalucci and Piger (2004); Castelnuovo, Nicoletti-Altimari, and Rodriguez Palenzuela (2003); Gürkaynak, Levin and Swanson (2006); and Lange, Sack and Whitesell (2003).

understanding of monetary policy. What is needed is the provision of comprehensive and relevant information in a clear and timely manner. The challenge is to strike the right balance between the quantity and quality of information and to communicate the relevant messages with clarity so as to contribute to the understanding, predictability and credibility of monetary policy, and thus to its effectiveness.

III. The ECB's concept and practice of transparency and communication

III.1 Communicating the monetary policy objective and strategy

Let me now turn to the ECB's concept and practice of transparency and communication. The EU Treaty and the ECB Statute clearly state that the primary objective of monetary policy is to maintain price stability. But they do not define a strategy to achieve that goal. The ECB announced its monetary policy strategy in October 1998, well before the launch of the euro on 1 January 1999. The strategy includes a quantitative definition of price stability and a two-pillar, medium-term oriented, analytical framework, employing economic and monetary analyses, to assess risks to price stability. By defining and communicating its policy strategy, the ECB adopted a framework for internal analysis and decision-making which also provides the basis for explaining policy decisions to the public. The quantitative definition of price stability serves as a yardstick by which the ECB can be held accountable and as a guide to the public in respect of expected future price developments.

The clarification of aspects of the strategy in May 2003 contributed to better communication in two respects: first, it clarified the ECB's aim in terms of price stability – namely, an increase in consumer prices of below, but close to, 2% over the medium term – thus giving more precise guidance to private sector inflation expectations, which have remained solidly anchored to that quantitative definition; second, it helped enhance the market's understanding of the use of monetary analysis to cross-check the assessment of risks to price stability over the medium and longer term.

More generally, communication of the ECB's strategy emphasises the bank's commitment to conduct its policy in a systematic manner following a well-defined approach (analytical framework) and to be open and transparent about its analysis and decision-making. In addition, communicating the strategy helps markets to better understand how monetary policy is likely to respond to adverse shocks and potential risks to price stability, thus establishing a basis for assessing the predictability and credibility of monetary policy. For all these reasons, the announcement of, and consistent commitment to, our monetary policy strategy constitute a milestone in our communication activities.

III. 2 Communicating the monetary policy stance

Nevertheless, in a world of uncertainty, with incomplete information about the state of and prospects for the economy, knowledge of our strategy is a necessary, albeit insufficient, condition for the general public – and in particular market participants – to understand the decisions taken and to form expectations about the future course of monetary policy. We therefore aim to explain clearly and systematically the economic rationale underlying each monetary policy decision by providing detailed and comprehensive analyses of the current economic and monetary conditions and of the Governing Council's assessment of the medium and longer-term risks to price stability on the basis of our strategy. Several forms and channels of communication are employed.

The President's introductory statement at the monthly press conference is the main channel of the ECB's communication in this respect. It explains in depth the monetary policy decision taken jointly by the Governing Council on the monetary policy stance in real time. By organising a press conference, we also reach out to a much wider audience than by issuing a press release.

The introductory statement is followed by questions posed by representatives of the media. These provide an opportunity for explanations and clarifications as well as for further insights into our outlook assessments and the policy decision taken. I would like to emphasise that the Q&A session is a valuable vehicle for communication and a good example of our transparency policy in action. A wide variety of issues are raised which are addressed in a direct, open, unfiltered and timely manner.

The ECB's Monthly Bulletin, which is published one week after the press conference, offers more comprehensive and detailed information and analysis pertaining to the monetary policy decisions. Four times a year, it also includes the ECB/Eurosystem staff macroeconomic projections for the euro area. These projections, which incorporate the uncertainty and risk assessment of the ECB/Eurosystem staff, are an important input into our economic analysis, but not the only one.

The speeches and interviews given by the Governing Council members to many different audiences in the inter-meeting period are another important channel of communication. These provide additional opportunities to explain our monetary policy decisions and to comment on other topics within the ECB's sphere of competence. The speeches are an especially useful means of communicating, across the euro area, the single monetary policy formulated by the ECB, which is a supra-national institution. They allow Governing Council members to convey the collegial view of the Council in their own languages, thereby overcoming potential cultural, linguistic and other national barriers of communication. However, this kind of communication is guided by the "single voice" principle, that is, the views expressed on monetary policy reflect the position of the Governing Council as a whole. This approach has worked well. It reflects our collective responsibility and it has efficiently reduced the potential "noise" in our communication. This principle is becoming more important as the euro area expands. As you know, on 1 January 2008 two more countries – Cyprus and Malta – adopted the euro and their central banks joined the Eurosystem.

III.3 Communication in periods of uncertainty

Apart from these communication tools that we regularly use to convey our economic outlook and risk assessment, and to explain the current monetary policy stance, the ECB, like other central banks, at times has to adapt its communication and actions to exceptional or unanticipated developments. Effective central bank communication is especially important in periods of heightened uncertainty – like the geopolitical tensions that followed the tragic events of September 11, or the recent turmoil in global financial markets, or occasionally in response to the uncertainties and misperceptions surrounding the outlook for future monetary policy. While such situations may pose unprecedented communication challenges to central banks and may require different policy responses, central bank communication in these circumstances should aim to restore trust and preserve confidence among financial market participants, and to indicate, if necessary, that the monetary authorities are alert and ready to act promptly and effectively, in line with the statutory objectives and assigned tasks, to preserve price stability and safeguard financial stability.

Let me provide two examples. The first goes back to November 2005 and May 2006. On both occasions, market expectations about the need for, or the size of, future policy adjustments were out of line with those of the ECB. So, on both occasions, we made market participants aware of these misperceptions, through appropriate communication, and thus avoided surprises and market volatility. The second example is provided by the recent period of financial market tensions. Two messages had to be clearly conveyed. One was that the ECB stood ready to take the necessary measures to ensure the orderly functioning of the interbank money market. The other message was to make it perfectly clear that special market operations to reduce the volatility of very short-term rates around the key policy rate and to contain elevated pressures in the term money market would not undermine the price stability objective and would not involve any risk of tolerating or encouraging imprudent behaviour by market participants. It is therefore essential, at least in the ECB's experience, that a clear distinction be made in central bank communication between actions that belong to the monetary policy implementation sphere and those that aim to ensure the orderly functioning of the money market and the safeguarding of financial stability. Such messages about the objective and nature of the ECB's recent money market operations helped to stabilise longer-term inflation expectations at levels consistent with our price stability objective and to restore orderly conditions in the money market.

III.4 Minutes and voting records

With these and other forms of communication in place, the ECB has achieved a high level of transparency over time. Nevertheless, the ECB does not subscribe to the view that unlimited transparency is always beneficial. Our position has at times triggered criticism of one aspect of our communication policy by some observers, mainly academics, which concerns the non-disclosure of the minutes and voting records of the Governing Council meetings. Let me briefly comment on this issue.

The introductory statement made by the President at the monthly press conference contains the key information about our outlook and risk assessment, as well as the rationale for the respective policy decision, in real time. The information conveyed in the introductory statement is, in essence, similar to that published by other central banks in "summary minutes" and this is further elaborated by the more comprehensive economic and monetary analysis contained in the ECB's Monthly Bulletin, which is published in the week following the first Governing Council meeting of the month. Moreover, the introductory statement is provided in a timely manner: the press conference takes place 45 minutes after the decision on the key interest rates for the euro area has been announced in a press release, while the minutes of the decision-making committees of other major central banks take, on average, two to six weeks to be published. And as I mentioned before, the press conference gives the media a chance to ask probing questions and we can reach a wider audience than by publishing minutes.

With regard to publishing the votes, two points should be made. First, decisions on the appropriate monetary stance are taken by forging a consensus, which means that those members of the Governing Council that may hold a minority view agree to adopt the position of the majority. Second, if votes were published, this would entail a particular risk for the ECB – one that is often ignored or underestimated. This risk is fundamentally related to the institutional and political environment of the multi-country euro area economy within which the ECB – as a supranational institution – operates. The voting behaviour of Governing Council members, and in particular the Governors of the national central banks, could be judged in the light of national economic conditions and considerations which might seem to support a different monetary policy decision. As a result, the Governors could become vulnerable to criticism for their voting behaviour from the national media as well as politicians. Such a public discourse on the single monetary policy of the euro area could have undesirable effects on the Governing Council's deliberations.

IV. Communication of the likely future path of policy interest rates

I will now consider another issue that is currently debated among academics and central bankers alike: whether, to what extent and how the central bank should signal its future policy intentions. At a theoretical level, as a number of prominent academics have emphasised in recent years, it may be argued, and may seem appealing, that the central bank should provide market participants with fairly precise quantitative indications about the likely future path of policy interest rates, as these will align market expectations more closely with those of the central bank.[2] However, at a practical level, there are serious concerns about the feasibility and desirability of announcing a specific likely future path of policy rates.[3] In a world of uncertainty – and the current period of heightened uncertainty and financial market volatility offers a characteristic example – providing markets with a likely future path of policy rates, particularly beyond the short term, may entail a number of risks that may ultimately undermine the initial intention to further reduce financial market and aggregate output volatility.

Let me highlight some factors and risks that raise doubts about the feasibility and desirability of announcing, as a general rule, the likely future path of policy rates:

- The first factor is the uncertainty faced by policy-makers which makes it very difficult, in general and particularly in certain circumstances, to define in a reasonably precise and reliable manner the likely future path of policy rates, or to put it differently, the extent and timing of future adjustments of the monetary policy stance. The uncertainty faced is not limited to that surrounding the future evolution of a large number of exogenous variables that will affect the economic outlook and the risks to the attainment of the policy objectives. This type of uncertainty is considerable and increases with the length of the forecast horizon. More significantly, there is uncertainty about the economy's structure and functioning which may be changing over time in ways that are difficult to predict. This model or parameter uncertainty makes it hard to define and announce conditional intentions about the likely future path of policy rates, especially over a relatively long-time horizon. In extreme cases, it may be impossible to announce a path if, in fact, no explicit path can be determined in a reasonably precise and reliable manner.[4] The current economic situation provides a relevant example both with regard to the uncertainty surrounding the lending policies of banks and with regard to the functioning of the wage-and-price setting mechanism in some countries.[5]
- A second factor is the difficulty to reach agreement about the appropriate path of future policy rates in the decision-making committee, especially in periods of heightened uncertainty and perceived structural change. This difficulty is potentially greater the larger the size of the decision-making body is, and particularly if the committee endeavours to forge a consensus on the economic outlook, the balance of risks to the policy objectives and the appropriate course of monetary policy in the future.
- A third issue relates to the risk that the markets and the public will not fully understand the conditionality of the announced future policy path on forecasts or assumptions about the future evolution of exogenous variables that will influence the choice of the policy path. The potential problem is likely to be greater given the implicit or explicit assumption about the time invariance of the underlying structural relations. Communication of the likely future path of policy rates may be

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[2] See Woodford (2005).

[3] See, for example, Mishkin (2004); Morris and Shin (2002), and Kahn (2007).

[4] There may be periods of greater certainty and perceived stability of the underlying structural model when it is relatively easy to formulate a future policy path. There may also be exceptional situations, such as when the economy faces deflation risks and the policy rate approaches the lower zero bound, when it may be appropriate to provide a clear signal of future policy intentions. But such situations, by their very nature, do not justify the adoption, as a general rule, of a pre-announcement of the future monetary policy stance.

[5] For instance, the recent financial market turmoil may result in a reassessment of banks' business models – at least by some banks – and may affect their lending practices and the stability of the relationships between policy rates, bank lending rates and credit availability.

misinterpreted as a quasi-promise or commitment and could lead to a disorderly adjustment of interest-rate expectations.

- Fourth, another problem is the potential effect on the central bank's credibility if its communication of future policy rates often deviates from the subsequent actual path of interest rates. In this respect, policy-makers may also be concerned that frequent revisions of a previously announced policy path may weaken the public's confidence in their forecasting ability or in their commitment to follow through. In particular, policy-makers may hesitate to reverse the direction of such a path, e.g. from an accommodative to a restrictive stance and this could lead to the implementation of a policy path that does not take fully into account new, incoming information and is therefore sub-optimal.

There are some factors and risks that call for great caution to be exercised in respect of any pre-announcement of future policy intentions. Ultimately, the benefits and drawbacks of communicating the likely future policy rates will depend on the economy's structure and complexity, the nature and extent of the uncertainty faced by policy-makers and the institutional framework of the central bank. While it might prove to be a useful communication tool for some central banks, others, including the ECB, have concluded that the potential problems outweigh the potential benefits. The ECB has therefore adopted a rather pragmatic and flexible approach when providing forward guidance to financial markets about its future policy intentions. In the light of our risk assessment and by taking into account the specific environment in which monetary policy has been conducted, we have given implicit guidance at times to the markets about the likely direction of policy rates in the short term, without however pre-committing or compromising our flexibility with regard to future policy decisions.

V. The effectiveness of the ECB's communication strategy

Has the ECB's approach to transparency and communication been successful since its establishment in 1999? The conceptual considerations underlying our approach, which I outlined earlier on, point to a number of potential gains that can arise from transparent and effective communication. And there is indeed a wealth of empirical evidence indicating that the ECB's communication strategy has helped increase the predictability, credibility and effectiveness of its monetary policy. Let me briefly present some of the empirical findings:

First, by defining the overriding price stability objective in quantitative terms and adopting and announcing a monetary policy strategy, the ECB has provided clear guidance for market participants to form expectations about inflation and a basis for understanding and anticipating the likely response of monetary policy to shocks or to new incoming information. As a consequence, both survey-based and market-based medium to long-term inflation expectations in the euro area have remained well anchored at levels consistent with the ECB's quantitative definition of price stability, even at times when inflation outcomes were volatile as a result of adverse shocks that affected aggregate demand or supply.

A second finding concerns the extent to which longer-term inflation expectations react to fluctuations in actual inflation, and this provides further insight into how well the central bank's objective is incorporated into the expectations of market participants and the public. Recent studies have shown that longer-term inflation expectations in the euro area are decoupled from developments in actual inflation and do not respond at all to macroeconomic news, further pointing to the solid anchoring of expectations in the euro area.[6]

Moreover, there is considerable empirical evidence indicating that the short-term predictability of the ECB's monetary policy – namely the ability of financial market

[6] See Deutsche Bundesbank (2006) and Ehrmann et al. (2007).

participants to correctly anticipate the next monetary policy decision – has increased over time. For example, it has been found that, out of a total of 142 days on which Governing Council meetings were held from 1999 to December 2007, financial markets were surprised – according to a common definition of the surprise element in this literature – on only eight occasions. Furthermore, the biggest surprises occurred in the first three years of Economic and Monetary Union, indicating that the short-term predictability of the ECB has increased over time. This evidence may reflect the fact that financial markets have gradually learned about the ECB's monetary policy framework and communication.

Similar results on the degree of short-term predictability were found by a recent survey conducted by Barclays Capital among financial market analysts and central bank observers worldwide.[7] A sizeable majority (60%) of survey respondents felt either "very confident" (15%) or "confident" (45%) in the way the ECB reacts to changing economic circumstances.

Lastly, empirical evidence has also confirmed the benefits that stem from the "single voice" principle adopted by the Governing Council. More divergent communication by decision-makers reduces the ability of financial markets to anticipate future monetary policy decisions and raises the degree of market uncertainty.[8] The high level of short-term predictability of our policy decisions is therefore also a result of our "single voice" communication policy.

VI. Conclusion

Let me conclude by emphasising two points:

First, notwithstanding the successes I have mentioned, it should be stressed that effective central bank communication is an ongoing challenge. The ECB, like other central banks, continuously reviews and refines its communication policy, and adapts it if necessary. In any event, effective central bank communication will always be characterised by a degree of flexibility and adaptability in order to respond to a rapidly changing economic environment and exceptional circumstances. One communication challenge for the ECB concerns the apparent divergence between actual inflation and that perceived by the public in a number of euro area countries. Although this divergence has declined over time, it is important to deepen our understanding and to address the causes of the apparent misperceptions in order to maintain and strengthen the confidence of the euro area public in the single European currency.

Second, although a high degree of transparency and effective communication are essential ingredients for a successful monetary policy – in order to anchor inflation expectations, reduce uncertainty and thus enhance policy effectiveness – they are not sufficient. A central bank must continuously demonstrate its commitment to, and ability to achieve, its price stability objective by the systematic implementation of its policies. This requires consistency between words and deeds, and a track record of policy decisions that will ensure the predictability, credibility and effectiveness of monetary policy.

Thank you for your attention.

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7 See Barclays Capital (2007).

8 Ehrmann and Fratzscher (2005 and 2007).

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