Jean-Claude Trichet: Central banks and the public – the importance of communication

Text of The Lord Roll Memorial Lecture by Mr Jean-Claude Trichet, President of the European Central Bank, organised by the Daiwa Anglo-Japanese Foundation, London, 18 November 2008.

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Ladies and gentlemen,

First of all let me express my gratitude for being invited today by the Daiwa Anglo-Japanese Foundation to give the Lord Roll Memorial Lecture in front of such a distinguished audience.

Throughout his extraordinary life, Lord Roll embodied the classic virtues of an outstanding international negotiator and a sophisticated economist. He held many influential appointments at the heart of international affairs – both as a public servant and a merchant banker. At the same time, Lord Roll was also a remarkably accomplished thinker, a philanthropist, and – not least – the author of an important book reflecting on two hundred years of economic thinking. No doubt, he was the rarest incarnation of an applied scientist who served his country and Europe – he himself was born in the Continent – with dedication and realism. I am convinced that the intense and far-ranging negotiations of the past days and months on the future global financial architecture would have undoubtedly benefited from his exceptional intellectual skills and his experience.

In introducing my remarks this evening, I would like to quote from a report which was drafted in 1993 by a panel of highly recognised and reputable economic experts – and chaired by the late Eric Roll – on the occasion of the debate on the political independence of the Bank of England.[1] In the preface of this report, Lord Roll concludes that "[t]he Bank [of England], specifically charged with the objective of stable money, *independent* in carrying out this task yet *accountable* within our democratic system for its action, can, we believe, make an important contribution to the better ordering of our economic affairs". Four years later – in line with the recommendations of this report – the Bank of England, like many of the world's other central banks, has been granted full operational independence and nowadays it ranks among the most transparent central banks in the world.

Why did central banks decide to become transparent?

The Bank of England and virtually all its peers used to communicate very little and with great caution. Prior to the 1990s, a long-standing conviction in central banking circles held that monetary policy should be wrapped in mystery.[2] The theoretical case for secrecy was founded on two economic propositions:

- "successful monetary policy making acts by surprises", and
- "central banks should try to achieve the benefits of an economy running above or close to its potential".

The first proposition has been subjected to thorough theoretical scrutiny over the last fifteen years and is now close to oblivion. The last has been fully discredited in theory and practice.

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[1] Roll, E. et al. (1993), "Independent and Accountable – A new mandate for the Bank of England", A report of an independent panel chaired by Eric Roll, Centre of Economic Policy Research, 1993.

[2] This characterisation is due to Karl Brunner, in "The art of central-banking" (1981), Center for Research in Government Policy and Business, University of Rochester, WP GPB 81-6.

The old belief – embodied in the first proposition – that monetary policy is made of a sequence of isolated steps, disconnected from one another and possibly randomised owed a great part of its theoretical appeal to the notion that rational agents do not suffer from money illusion. The logic went that if rational individuals effectively adjust their economic behaviours to insure against money illusion – as indeed they are likely to do over time – then only a central bank acting by unexpected moves can claim some success in steering economic conditions.[3]

But how is "success" measured? Here is where the case for unanticipated policy actions – and the systematic retention of information that would support this policy – built critically on the second proposition: that a central bank would measure the effectiveness and success of its actions by the extent to which economic activity could be raised and maintained above potential.

Indeed, the time-inconsistency paradigm articulated by Nobel-prize winners Finn Kydland and Edward Prescott, and applied to central banking by Robert Barro and David Gordon, offered a positive theory for monetary policy-making by surprises.[4] Barro and Gordon showed that policy makers – under certain institutional conditions – might have an incentive to exploit the short-run trade-off between inflation and employment. In a world in which money illusion cannot last for long, such a policy is only viable if the central bank releases no hints about its objectives, its intentions, and the timing of its actions. It is solely by deviating from the plan that agents expect to be followed that central banks of this sort can be successful in stimulating the economy above its limits.

Kydland and Prescott and Barro and Gordon exposed the sub-optimality of such policies at the same time that they provided a positive theory for monetary surprises and obfuscation. Once the public recognises the incentives that motivate the monetary authority, they will adjust their expectations accordingly and unexpected monetary impulses will bear no lasting effects. In the long run, output will return to its natural level and the economy will suffer from a permanently higher inflation.

The recognition of the time consistency problem spelled the demise of activist monetary policies subordinated to short-term objectives. At the same time, it lifted one necessary condition for considering secrecy the defining and somehow indispensable style of central bankers.

The drive toward independence provided an additional, positive encouragement for openness and transparency. In the quarter of a century since the start of the time inconsistency literature an overwhelming majority of central banks across the globe have been made independent. The political and functional independence of central banks – now made immune from political influence – has been an important milestone in the way towards separating the authority to tax and spend from the power to control credit conditions. This separation has been the critical factor behind the general decline in trend inflation that we have observed over the past decades.[5] At the same time, the separation has imposed transparency and frequent communications on the side of the monetary authority as a manifestation of democratic accountability.

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[3] See Cukierman, A. and A. Meltzer (1986), 'A Theory of Ambiguity, Credibility and Inflation under Discrection and Asymmetric information', *Econometrica* 54: 1099-128.

[4] See Kydland, F. and E. Prescott (1977), 'Rules Rather Than Discretion: The Inconsistency of Optimal Plans', *Journal of Political Economy* 85, 473-90, and Barro, R. and D. Gordon (1983) 'A positive theory of monetary policy in a natural rate model,' *Journal of Political Economy* 91, 589-510.

[5] See, for example, Alesina, A. and L. Summers (1993), 'Central bank independence and macroeconomic performance: some comparative evidence', *Journal of Money, Credit and Banking*, Vol. 25, No. 2, May.

As monetary policy has raised in stature vis-à-vis the fiscal authority – from the ancillary role to which it was relegated in earlier days – its obligations of democratic reporting have also increased. But many central banks have gone well beyond strict legal requirements with respect to both their communication and transparency duties. Why?

Communication about the objective and strategy

Transparency is not only the price monetary authorities had to pay to earn an enhanced constitutional role as safeguards of macroeconomic stability. It soon became clear that communication is an instrument to make monetary policy itself more powerful. Once the inflation bias is eradicated from central bank preferences, wide knowledge of those preferences can only serve as a coordination device for private beliefs. In a world in which policy-making by surprises has lost purpose, anchoring expectations around the objectives of policy help coordinate the reactions of economic behaviours to the macroeconomic shocks along the appropriate path of adjustment that the central bank wants the economy to follow.

Many central banks have therefore started to communicate their firm commitment to a nominal anchor, through the announcement of a precise arithmetic definition of price stability. In many cases, central banks have gone further in their quest for openness and have spelled out a more general monetary policy strategy, and the analytical framework that is used by policy makers to assess the risks to the achievement of the central bank's objectives.

Communication about the *objective* helps nail down the steady state of the economy, the end point to which the economy spontaneously tends after shocks fade. Communication about the *strategy* helps explain the way monetary policy behaves outside the steady state, how it responds to shocks and frictions to facilitate the economic convergence back to steady state. Communicating about the principles that govern the strategy makes the process of adjustment more rapid and less painful.

A growing body of empirical evidence supports the conjecture that transparent quantitative objectives and communication about the strategy reinforces monetary policy. Empirical findings confirm that a precise definition of price stability, or the announcement of an inflation target, lowers inflation expectations, helps to anchor them at levels consistent with the central bank's preferences and reduces the sensitivity of inflation expectations to past inflation and other macroeconomic news.[6]

The anchoring power of a quantitative objective is indeed remarkable. A recent ECB study has shown that, following the introduction of a quantitative definition of price stability, inflation persistence – defined as the tendency for inflation to deviate from its mean following a shock, rather than quickly reverting to it – has essentially disappeared in the euro area, in Switzerland and in five inflation-targeting countries.[7] While a large component of the switch in expectations formation is due to the genuine regime change, the exceptional *speed* of the adjustment would not have been possible without extensive communication about the onset of a new regime.

Financial market data – a more elastic, if sometimes noisy indicator of public perceptions than survey data – confirms the existence of a link between communication about the

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[6] Levin, A. T., F. M. Natalucci and J. M. Piger (2004), "Explicit inflation objectives and macroeconomic outcomes", ECB Working Paper, No 383. See also Johnson, D. (2002), "The effect of inflation targeting on the behaviour of expected inflation: evidence from an 11 country panel", *Journal of Monetary Economics* 49, pp. 1521-1538.

[7] Benati, L. (2008), "Investigating inflation persistence across monetary regimes", *Quarterly Journal of Economics*, 123:3, August 2008, 1005 - 1060. For instance, estimates of the inflation persistence in the euro area fell by around two-thirds from the period before (until the Bretton Woods arrangement) and after the launch of EMU.

ultimate objectives of policy and expectations. Both a Fed Board case study on the United Kingdom and Sweden, and an ECB study on the euro area show that market-based inflation expectations for these countries are generally unresponsive to macroeconomic news, a sign that they tend to remain unperturbed when the economic environment changes.[8]

Communication about actions and prospects

The adoption of a clear and deliberate monetary policy strategy has added two further dimensions to communication: the announcement and explanation of monetary policy decisions when these are made, and the regular exposition of the central bank's assessment of the current economic situation and its most likely evolution.

In the absence of frequent disclosures about policy and the economic situation, market participants may not be in a position to attribute fluctuations in inflation either to exogenous disturbances outside the control of the central bank or to changes in policy intentions. Adverse adjustments in expectations could lead to an increase in inflation today and to a slower and more painful reversal later in the process.[9]

A central bank has two instruments in these situations, which are not substitutes, but rather complement each other. It can react to misconceptions once they manifest themselves, by enacting a particularly strong response to the threats that they pose. As inflation tends to persist once it is set in motion, the policy response might need to be sizeable and disruptive. In the "old world" in which central banks minimised their pronouncements and made no efforts to disclose their views on an ongoing basis, this reactive and demonstrative pattern of monetary policy response was indeed the only option open. It is difficult not to associate the systematic disconnect between the views entertained by the policy-makers and the information set accessible to the public that prevailed in the old days with the recurrent pattern of stop-go episodes that plagued the monetary policy history of the 1970s.

In the new regime, in which policy-makers are dedicated to being open and transparent, communication channels offer some more lines of defence in the face of such situations. Providing the economic interpretation of the situation, the judgement and economic thinking around it, and the central bank's assessment of future directions can correct faulty expectations *at source*. This can minimise the risk that inaccurate forecasts might induce misallocations of resources and derail the economic course.

Communication does not substitute for action. But it can help fill the information gap on which the need for action is sometimes predicated.

The ECB's approach to communication and its efficacy

Communication is a constituent part of the institutional design for monetary policy and needs to be styled according to the principles and constraints that shape those institutions. There are recognizable differences in the ways central banks communicate to their publics. These differences are not accidental: they can be traced to the economic, political and institutional factors that face individual central banks.

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[8] Gürkaynak, R., A. Levin, and E. Swanson (2006), "Does inflation targeting anchor long-run inflation expectations? Evidence from long-term bond yields in the US, UK and Sweden", Federal Reserve Bank of San Francisco Working Paper No 2006-09. Ehrmann et al. (2007), "Convergence and Anchoring of Yield Curves in the Euro Area", ECB Working Paper No 817.

[9] Orphanides A., and J. Williams (2005), "Imperfect knowledge, inflation expectations, and monetary policy", in B. Bernanke and M. Woodford (eds.): The inflation targeting debate, Chicago: University of Chicago Press, pp. 201-234.

The ECB is no exception and it has elaborated its own communication framework. Since the very start in October 1998, the ECB has announced its monetary policy strategy – a quantitative definition of price stability and a two-pillar, medium-term orientated analytical framework, comprising of an economic and monetary analysis for the assessment of risks to price stability. In doing so, it laid the foundations for a high degree of credibility and emphasised its commitment to being open and transparent. In particular, by formulating and publishing a quantitative definition of price stability – below, but close to 2% – the ECB has provided the basis for the public to form expectations efficiently and to reduce the sensitivity of inflation expectations to short-term shocks.

The decision has paid off. Long-term inflation expectations for the euro area, as – for example – compiled by Consensus Economics Forecast, have remained in a range between 1.7 and 2 per cent since the introduction of the euro in 1999. Inflation expectations as derived from financial markets were more volatile over the same period and even though – at times – they showed weak signs of divergence from our definition of price stability – as for example during the recent period of strong increases in food and energy prices – we succeeded in rapidly regaining control over inflation expectations due to our open and strong commitment to the achievement of our primary objective. Similarly, recent empirical findings show that longer-term inflation expectations in the euro area are to a large extent unresponsive to developments in actual inflation outcomes, further pointing to a solid anchoring of inflation expectations at levels consistent with our definition of price stability. This is an important achievement, in particular against the background of the numerous adverse supply-side shocks that hit the euro area over the past years. At the same time, the quantitative definition provides a clear yardstick to be compared to the observed inflation by all observers and market participants and against which our fellow citizens can hold the ECB accountable.

Despite the extraordinary role of the ECB’s strategic framework in our communication policy, in a world of uncertainty with incomplete information on the state of and prospects for the economy, genuine understanding of our strategy is a necessary, albeit insufficient, condition for the public to form pertinent expectations regarding the future course of monetary policy. Discrepancies between the expectations of the private sector and those of the central bank may emerge at any point in time because of differences in the interpretation and assessment of the state of the economy and the associated policy reactions. The ECB therefore makes considerable efforts to explain the economic rationale underlying monetary policy decisions 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. The challenge in this type of communication is to strike the right balance between the need to provide guidance to the markets while preserving the flexibility to always re-assess the appropriateness of the monetary policy stance in the light of changing circumstances and to never pre-commit to a medium term sequence of future interest rates.

The introductory statement at the monthly press conference after the first Governing Council meeting in each month is an important vehicle of our communication in this respect. It explains in depth the monetary policy decisions taken, it is structured along the lines of our strategy and it conveys the collective view of the Governing Council on the monetary policy stance. The information conveyed in this way is therefore – in essence – similar to what other central banks publish in “summary minutes”. The ECB practice – however – has the two key advantages of offering better timeliness and more flexibility as compared to the disclosure of collegial minutes, while – at the same time – we reach out to a broader audience. In particular, the press conference not only provides detailed information on our policy deliberations at a much earlier time than minutes – the press conference takes place 45 minutes after the decision on the key interest rates has been announced in a press release – but it also offers the media an opportunity to address a variety of issues in a direct, open and totally unfiltered manner. The extent of our press conference – that, at times, can last for an hour or more – is a lucid reflection of the need and demand for an open and frank exchange of views between policy-makers on the one side and representatives of the media on the other.

The decision of the Governing Council not to publish voting records has been made to stress the collegial nature of the ECB's decision-making process and the specific institutional circumstances under which the ECB operates as a supranational institution. Publishing information on the individual voting behaviour would entail the risk that the votes of Governing Council members – and in particular of the Governors of National Central Banks – might be interpreted from a "national" perspective, irrespective of their genuine underlying rationale. This could jeopardise the credibility of our decisions and undermine the area-wide perspective that we unanimously internalise in our meetings.

The importance of the ECB's press conference as a relevant source of policy-related information can be gauged by its real-time effect on financial markets. The ECB's case provides a particularly interesting opportunity to extract the different signals of central bank communication, as unlike other central banks that release their decisions and explanatory statements simultaneously, there is a short time difference between the release of the decision and the underlying explanation delivered at the press conference. Changes in forward rates during the press conference can therefore only be due to news related to the future path of short-term interest rates and cannot be contaminated by news relating to the announcement of the policy decision. A recent ECB study shows that there has been not only a general reduction in market reactions on Governing Council meeting days over time, but that the small remaining reactions relate much less to the surprise component for any given decision and much more to the surrounding communication and its implications for the future path of interest rates.[10] In a similar vein, a related research study finds that the ECB's press conferences have – on average – larger effects on asset prices than do announcements of policy decisions.[11] At the same time, these larger effects on interest rates are accompanied by smaller effects on the volatility of asset prices, indicating that the signal to noise ratio of the press conference is high. This is not a surprising result at all. In fact, the Q&A session allows journalists to pose clarifying questions and provides them with the opportunity to digest the information provided.

Accurate communication has yielded high predictability. There is compelling empirical evidence indicating that the ability of financial market participants to correctly anticipate the next monetary policy decision is – both in absolute terms and relative to other central banks – remarkably high.[12] For instance, out of a total of 153 days on which Governing Council meetings were held from 1999 to October 2008, financial markets were surprised – according to a common definition of the surprise element in this literature – on only eight occasions. The last surprise occurred in March 2003 when markets had actually perfectly anticipated that we would decrease our main policy rates, but they were rather surprised about the size of the change, which was smaller than expected at that time. Market participants appear to have been able gradually to converge to a thorough understanding of the ECB's monetary policy framework and communication mode. Similar results on the degree of short-term predictability were found by a recent survey conducted by Barclays Capital among financial market participants. A sizeable majority of survey participants – 60% – felt either "very confident" or "confident" in the way they were able to anticipate policy decisions by the ECB.

[10] Brand, C., D. Buncic and J. Turunen (2006), "The impact of ECB monetary policy decisions and communication on the yield curve", ECB Working Paper, No 657.

[11] Ehrmann, M. and M. Fratzscher (2007), "Explaining Monetary Policy in Press Conferences", ECB Working Paper No. 767.

[12] See Blattner et. al (2008), "The Predictability of Monetary Policy", ECB Occasional Paper No. 83.

For a supra-national institution such as the ECB, speeches are a particularly important communication tool as they allow the Governing Council members to convey the view of the Council in their own languages, thereby overcoming potential cultural, linguistic or other national barriers of communication and bringing our policy closer to the people. The delivery of speeches by policy-makers is an opportunity for the public to test whether the policy-making committee is a truly collegial body, rather than a collection of individuals, and whether its members share a sense of common ownership of decisions. The principle of speaking with a "single voice", to which the members of the Governing Council adhere when talking publicly is meant to ensure that the views expressed individually always convey those of the Council as a whole. This policy is a manifestation of our collective responsibility; it raises the clarity of our message and has – according to the empirical literature – efficiently reduced the potential "noise" in our communication. The importance of this policy will certainly increase as the euro area expands. In this respect, an ECB study shows that a higher degree of communication dispersion among committee members about the conduct of monetary policy lessens the ability of financial markets to anticipate future monetary policy decisions and raises the degree of uncertainty.[13]

Communication in difficult times

Quoting from Alan Blinder, "perhaps the best a central bank can do is to teach the markets its way of thinking."[14] This didactical role of central bank communication – if supported by an established strategy – is often a quiet and uneventful activity. As I mentioned, the strategy and the founding principles of monetary policy largely take care of aligning the "transmitter" and the "receiver" and make the broadcast a reassuring repetition of known facts and principles.

In difficult times, however, when the economic outlook darkens exceptionally and confidence falters, communication becomes even more important to explain how the central bank intends to control the inevitable trade-off that such testing circumstances pose: the need to take swift action – on the one hand – and the need to communicate the complete adherence to its long-term objectives and the way it intends to steer the policy course back to a normal path once those circumstances have subsided.

The resolution of this trade-off is inherently challenging for all central banks. However, it is facilitated by two fundamental components of the ECB's monetary policy strategy.

The first is the quantification of a price stability objective. This grants predictability even in the absence of explicit communication about the future path of policy. Agents can draw inference about the most likely direction of policy by comparing the most likely evolution of inflation – which is part of the information that the ECB conveys to the market – with the objective of the ECB.

The second component of the strategy which helps in times when expectations become disoriented is the agility of action in the management of the money market combined with a measured, medium-term oriented approach to the reassessment of the stance. The latter ensures that the ECB keeps – and communicates – a sense of direction when markets are gripped by a sudden loss of confidence. The former reassures markets that any temporary disfunctionalities in the way markets work will not impede the transmission of the ECB's monetary policy intentions to the economy.

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[13] Ehrmann, M. and M. Fratzscher (2005), "How Should Central Banks Communicate?", ECB Working Paper, No 557.

[14] See Blinder (2004), "The Quiet Revolution: Central Banking goes modern", New Haven, CN, Yale University Press.

The two components of the strategy have afforded the ECB a flexible management of its operational instruments and procedures in the midst of extreme conditions, most notably during the recent turmoil in global financial markets. They have allowed a robust supporting role for solvent banks while at the same time preserving the long-term focus on price stability.

When the risks to our financial system – which we had repeatedly highlighted in open communication – materialised last summer and threatened to impair the orderly functioning of the euro money market, two messages had to be clearly conveyed. One was that the ECB was determined – from the onset of the financial crises in August 2007 – to ensure the orderly functioning of the euro area interbank money market by offering supplementary liquidity-providing refinancing operations or – more recently – by widening the collateral framework to facilitate the provision of liquidity to merchant banks and to engage in unlimited provision of liquidity for all our refinancing operations at a fixed rate.

The other message was to raise the public's awareness that the exceptional interventions aimed to alleviate the tensions in the money market would not compromise in any respect the longer-term achievement of the price stability objective and that the ECB would not tolerate or encourage imprudent behaviour by market participants.

Conclusions

Let me conclude. The fundamental changes in central bank communication have helped to enhance the effectiveness, predictability and credibility of monetary policy and have notably contributed to lowering both inflation rates and volatility in the real economy. For its part, the ECB has established a practise of making its policy transparent and in setting new benchmarks in the area of central banking communication. That being said, in each occasion, a central bank has to carefully assess the relevance, clarity and timeliness of the information as ill-designed communication has the power to harm the economy. Transparency is a key ingredient of an effective monetary policy, but not an end in itself. Communication is an ongoing challenge and effective communication will always be characterised by a high degree of flexibility and adaptability in order to respond swiftly to a rapidly changing economic environment.