Jean-Claude Trichet: The changing role of communication

Introductory remarks by Mr Jean-Claude Trichet, President of the European Central Bank, at a dinner with members of the "Internationaler Club Frankfurter Wirtschaftsjournalisten", Frankfurt am Main, 15 December 2008.

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Ladies and gentlemen,

A very warm welcome to all of you and thank you very much for your invitation to this club evening. I am happy to see many familiar faces in the audience tonight.

Communication is a very important issue for all times. Being here in Frankfurt I am thinking of the very profound remark by Goethe: "Niemand würde in Gesellschaften viel sprechen, wenn er sich bewuβt wäre, wie oft er die anderen missversteht". Nevertheless let me be bold enough to share with you some thoughts on communication and central banks.

Communication is a key element for central banks to enhance the effectiveness, predictability and credibility of their monetary policy decisions. It becomes even more important in difficult times, when the economic outlook darkens and confidence weakens.

It seems to me that central banks have improved their communication significantly in good times – and also in bad times – while some years ago communication was almost seen as a breach of their professional code. Why this change?

Why did central banks decide to become transparent?

Prior to the 1990s, central banks were very much working on the assumption that monetary policy effectiveness is greatest when the central bank systematically surprises the markets. The old belief was based on the notion that a central bank would measure the success of its actions by the extent to which economic activity could be raised and maintained above potential. If rational individuals already expect a certain change, they adjust their behaviour to that expectation. And that means that a monetary policy change would have no effect.

In the past fifteen years, however, two important developments changed the theory and practice of central banking. First, the assumption that successful monetary policy acts by surprises and is made by a sequence of isolated steps has been the subject of thorough theoretical scrutiny and is now close to oblivion.

It became clear that policy-making by surprises and isolated steps will bear no lasting effect on the economy once the public recognises the intentions that motivate the monetary authority. A monetary policy strategy made of isolated actions with the intention of boosting output above potential is bound to lose effectiveness because the short-term inflationary impact of that policy soon becomes embedded in price and wage expectations. Output and employment react in the very short-run, but in the medium term the economy suffers from a permanently higher inflation.

The drive toward central bank independence provided an additional encouragement for transparency. Today an overwhelming majority of central banks across the globe is independent. The political and functional independence of central banks 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 inflation that we have observed over the past decades.[1] But independence makes democratic accountability by the monetary authority all the more important.

Many central banks have gone well beyond strict legal requirements in their pronouncements and communications than imposed by statutory accountability duties. The question is: Why?

The reason rests on a simple though powerful insight: transparency renders monetary policy more effective. In a world in which policy-making by surprises has lost purpose, wide knowledge of the central bank's preferences and objectives can only serve as a coordination device for private beliefs. 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 definition of price stability. In many cases, central banks have gone further and 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.

A growing body of empirical evidence supports the assumption that transparent quantitative objectives and communication about the strategy reinforces monetary policy. For instance, a recent ECB study has shown that, following the introduction of a quantitative definition of price stability, inflation persistence has considerably diminished in the euro area, in Switzerland and in five inflation-targeting countries.[2] 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.

Communication in difficult times

Central bank communication – if supported by an established strategy – might well be a quiet and uneventful activity.

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 gear its policy. We have, on the one hand, the need to take and communicate swift action in implementing the appropriate monetary policy and in refinancing commercial banks. On the other hand, we need to communicate clearly the adherence of the central bank to the long-term objectives of policy and the way it intends to steer the policy course back to a normal path once the abnormal circumstances and risks have subsided.

Communication in difficult times 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 a very significant level of predictability. The monetary policy easing that we enacted in the last two months – on a scale that is unprecedented in such a short period of time – was motivated by a sharp easing of inflation pressures looking into the future. The fact that markets could predict our moves with a fair degree of precision – despite the exceptional cloud of uncertainty that surrounds economic projections in present conditions – is a proof that our main mode of

[1] 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.

[2] 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.

communication, via disclosure of the economic outlook as we perceive it, is effective and robust to extreme occurrences.

The second component of the strategy which helps in times when expectations become disoriented is what we have called the "separation principle". In view of safeguarding its credibility and firmly anchoring long-term inflation expectations, it is crucial that the Governing Council sets the appropriate monetary policy stance on the basis of no other considerations than the delivery of price stability in the medium term. Once the appropriate level of the key interest rates has been set, the Executive Board of the ECB implements its monetary policy stance so that the effects of its interest rate decisions are transmitted to the financial markets and the real economy effectively. In this sense, the ECB had to act swiftly and decisively to avoid that tensions in the money market would spill-over to other markets and adversely affect the real economy.

So we had to clearly convey two complementary messages. 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 inter-bank 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 which is fundamental was to raise the public's awareness that the exceptional interventions aimed to alleviate the tensions in the money market would not compromise the longer-term achievement of price stability in line with our definition less than 2%, but close to 2%.

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, on each occasion, a central bank has to carefully assess the relevance, clarity and timeliness of the information. Transparency is a key ingredient of an effective monetary policy. Communication is an ongoing challenge and effective communication will always be characterised by a degree of flexibility and adaptability in order to respond swiftly to a rapidly changing economic environment.

Thank you very much for your attention.