Mario Draghi: Monetary policy communication in turbulent times

Speech by Mr Mario Draghi, President of the European Central Bank, at the Conference "De Nederlandsche Bank 200 years: central banking in the next two decades", Amsterdam, 24 April 2014.

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Summary

Communication and transparency have become more important for central banks like the ECB in recent decades, and will become even more important in the decades to come. A transparent central bank is not only more accountable, but also more effective in implementing its monetary policy. If the general public and financial markets can understand how the ECB is likely to respond in a given situation – its so-called "reaction function" – they can form reasonable expectations about future monetary policy. This in turn gives the ECB the capacity to influence interest rates at longer maturities and steer broader financial and economic conditions.

While such "management by expectations" worked relatively well in normal times, the crisis inevitably made our decision-making process more complicated and our policies more difficult to understand. For example, the use of unconventional measures implied a wider range of possible monetary policy responses to a given shock. To continue to steer expectations in this environment, the ECB had to be more explicit in its communication. This involved reaffirming our mandate and explaining its medium-turn orientation and euro area perspective. Furthermore, the Governing Council will be equally active in guarding against inflation and deflation. And, faced with the effective lower bound and different contingencies, we had to explain our future policy intentions and clarify our more complex reaction function.

With our forward guidance, we aim to give guidance on the expected level of future interest rates, and to remove uncertainty about that level by strengthening communication on our reaction function. We have also further simplified our reaction function by laying out some contingencies that would warrant a monetary policy reaction. These are, first, an unwarranted tightening of monetary policy stance (from developments in short-term money markets, global bond markets or foreign exchange markets) that could be tackled through more conventional measures. Second, a further impairment in the transmission of our stance, in particular via the bank lending channel, for which a targeted LTRO or an ABS purchase programme might be the right response. Third, a worsening of the medium-term outlook for inflation, which would warrant a more broad-based asset purchase programme. The Governing Council is committed – unanimously – to using both unconventional and conventional instruments to deal effectively with the risks of a too prolonged period of low inflation.

Despite these efforts to enhance transparency, the predictability of the past will not readily return. Hence, judgement is likely to play a greater role in decision-making, and this involves trade-offs that need to be explained. That is why the Governing Council has been reflecting on the publication of a record or account of its policy deliberations. Such a written account would provide a more detailed explanation of the reasoning behind the Governing Council's decisions, and give a sense of the discussion and the main arguments.

Any written account needs to preserve the independence of the Governing Council members and the collegiality of their decision-making. Releasing an account of the main arguments considered, in a non-attributed form, should on balance achieve these goals. Such a release should complement the real-time messages conveyed in the press conferences and offer additional information to improve understanding of our reaction function.

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Dear Klaas,

Ladies and gentlemen,

Thank you very much for inviting me to speak at this conference marking the bicentenary of De Nederlandsche Bank (DNB). Congratulations to you, Klaas, and to all the staff of the DNB!

We are tasked today with reflecting on central banking in the next two decades, and the theme I would like to talk about is central bank transparency and communication. This is not only because transparency and communication has grown ever more important for central banks over the past twenty years, and look set to become even more important over the two decades to come. It is also because the Netherlands seems a fitting setting for such a discussion.

As you know well, this country has a long history of transparency – households in the Netherlands are renowned for keeping open their curtains. The classic explanation is that people do this for the benefit of others: with nothing to hide, they are happy to grant passers-by a look inside. Another explanation I have heard is that people do it for themselves: in dark Northern European climates, they simply want to let more light into their houses. But whatever the motivation, what matters is that an open curtain benefits both those on the outside and those on the inside. The same is true for us as central banks.

A transparent central bank serves the general public, by improving understanding of its actions and accountability for its decisions. And a transparent central bank contributes to its own mission, by steering expectations and making its monetary policy more effective. Let me therefore begin by explaining how central banks across advanced economies, and the ECB in particular, have taken up the challenge of transparency and openness.

Transparency and monetary policy effectiveness

Up until the early 1990s, central banks tended to be rather secretive institutions, inclined to lock away their thinking like the gold in their vaults[1]. Remember that it was only in 1994 that the Federal Reserve decided to make its interest rate decisions public. Before that, markets had to guess whether or not the FOMC had changed its federal funds rate target.

Today, however, central banks have realised they are more likely to fulfil their mandates if they inform the public and the markets about their strategies, assessments and policy decisions in an open, clear and timely manner.[2] Also, the granting of more independence to central banks called for a commensurate increase in accountability to the wider public. Central banks responded and opened up.

The ECB has faced the same expectations of openness, not least given the particular challenges for democratic legitimacy in a multi-country monetary union. From the start, we have fully embraced the merits of being transparent and accountable. For example, we were the first major central bank to hold a regular press conference immediately after our monthly policy meetings to explain our decisions in real-time. We also report regularly to the European Parliament.

Moreover, we have recognised that, in a market economy, transparency and communication are central to the effectiveness of our monetary policy.[3] First, having a clear objective supports credibility and helps anchor inflation expectations. Second, adopting an explicit

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1 See Brunner (1981), Cook and Hahn (1989) and Goodfriend (1986).

2 For an overview of the way central banks have been providing more information about their monetary policy making, see for example Geraats (2014). For a survey of empirical evidence on the effects of communication, see Blinder et al. (2008).

3 A body of empirical evidence supports the view that high transparency and good communication reinforce policy effectiveness and market efficiency. See, for example, Levin, Natalucci, and Piger (2004); Gürkaynak, Levin, and Swanson (2006); and Castelnuovo, Nicoletti-Altimari, and Rodriguez Palenzuela (2003).

monetary policy strategy helps markets and the public understand how the central bank is likely to respond to economic and monetary developments – its so-called “reaction function”.

Together, a credible objective and a well-understood reaction function allow financial markets and the public to form reasonable expectations about our future interest rate policy. This in turn gives us the capacity to influence interest rates at longer maturities and steer broader financial and economic conditions. This is what Mike Woodford has called “management by expectations”.[4]

In the pre-crisis times, these expectation effects worked relatively smoothly. We had – and still have – a clear objective given to us by the Treaty, price stability. In 1998 we provided a quantitative definition of price stability, clarifying in 2003 that we aimed at inflation rates “below, but close to, 2%” over the medium-term. We deployed a single standard monetary policy instrument to reach that objective – the main ECB interest rates. And our reaction function could be understood well, based on our strategy and actions, and *ex post* could be broadly captured by simple policy rules, such as the Taylor rule, in the same way as for other central banks.[5]

The need for more communication during the crisis

In crisis conditions, however, the implementation of monetary policy inevitably changed. We were forced to turn to unconventional measures to fulfil our mandate, for two main reasons.

First, we faced severe impairments to the transmission of monetary policy across the euro area, with marked heterogeneity from country to country. This called for unconventional measures tailored to the specific frictions at hand. Second, like many other central banks, we had to operate in an environment where our standard monetary policy instruments, the short-term policy-controlled interest rates, became increasingly inhibited in the vicinity of the so-called zero lower bound.

In these circumstances, understanding our decision-making process became more complicated – and this was true for all major central banks. Simple policy rules became less useful to describe our policies, meaning signals were harder to extract. And the use of unconventional measures implied that there was a wider range of possible monetary policy responses to a given shock. Thus, to continue to steer expectations about future policy, we had to be more explicit about how we understood this new environment.

Our response was to place more emphasis on enhanced communication – both regarding our commitment to our price stability objective, and regarding our assessment of and response to the rapidly changing economic and financial situation. Let me explain why both were necessary.

Reaffirming the price stability objective

The crisis has of course not altered our price stability mandate, which is defined in primary law, in the Treaty. Nonetheless, the events of recent years have made it important for the ECB to reaffirm that mandate – specifically, to explain its medium-term orientation and its euro area perspective. Furthermore, the Governing Council will be equally active in responding to medium-term developments in inflation that fall short of our objective as to those that exceed it.

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[4] On the role of expectations for monetary policy, see, for example, Woodford (2005).

[5] See, for example, Taylor (2012) for a historical account of monetary policy in the US from 1985 to 2003 using policy rules as a benchmark. For a survey of available evidence in the euro area, see Blattner and Margaritov (2010).

This is especially important given the unique features of this crisis. It is a crisis that originated from excessive leverage and has bequeathed a debt overhang in many developed economies, and, in the case of the euro area, also a loss of competitiveness in a number of countries. Students of economic history know that in past episodes debt overhangs have been reduced through higher inflation. Higher inflation also makes competitiveness adjustments easier. Thus, fears might easily have arisen that we might be tempted to do the same, especially in the light of some of the unconventional measures we have taken. Underlining our price stability mandate is essential to remove any doubt about future excess inflation.

By the same token, the aftermath of a debt crisis often leads to a prolonged period of balance sheet adjustment, low economic growth and possible risks of a debt deflation spiral. Such broad-based deflation risks are not what we see in the euro area today, where it is mainly falling food and energy prices combined with weak demand that have pushed inflation into low territory. In these circumstances, inflation nonetheless becomes more vulnerable to any further downward shock. Reiterating our price stability objective helps here, too, by firmly anchoring medium-term inflation expectations near 2%. In other words, emphasis on the symmetry of our objective helps contain both inflationary and deflationary expectations.

With this heightened vulnerability to shocks, equally important has been emphasising the medium-term orientation of our monetary policy. This orientation implies that there are types of shocks that are relevant for our price stability assessment, and those that are not. The relevant type of shocks are those that are likely to persist into the medium-term and affect medium-term inflation expectations. Communicating clearly this distinction allows the public to understand how monetary policy will respond when a given shock hits, and in turn to have well-anchored inflation expectations. While inflation will remain low for a prolonged period, we see it gradually rising back to 2%. The delay is largely explained by the impairments in the transmission mechanism that lengthen the lag between our accommodative policy stance and price developments.

Finally, given the need for relative wage and price adjustments between parts of the euro area, the crisis has made it more necessary to recall that monetary policy is geared to the euro area as a whole. During an adjustment in relative prices, there will always be some jurisdictions where inflation rates fall substantially below the euro area-wide objective, while inflation rates will naturally have to exceed the objective elsewhere. In this context, our role is to remain clearly focused on achieving price stability for the euro area; we cannot make policy in favour of subsets of countries. This is because our legitimacy flows from the Treaty, which establishes our constituency as the whole euro area. And it is only by respecting this that we justify our powers and independence.

Explaining a more complex reaction function

Nevertheless, even with a transparent and credible objective, crisis conditions make it unavoidably harder for observers to predict how we will respond to unusual and sometimes unforeseeable circumstances, and which measures could be deployed. This in turn makes it harder for monetary policy to steer expectations about future policy. There are two main challenges here.

First, when central banks come up against the effective lower bound, the possibility disappears to use current changes in the short rate to signal the policy response to a changing inflation outlook. There is therefore less information on which to base future interest rate expectations, which in turn implies that the central bank has less traction over the shape of the yield curve and economic conditions. Thus, it becomes more important to communicate directly about future interest changes and their response to a changing economy, i.e. to give forward guidance.

Second, the different contingencies in crisis conditions and the policy measures associated with them are unfamiliar to the public. This makes understanding our reaction function more complex. Hence, the probability distribution of outcomes tends to widen, the number of economic and financial variables that observers consider relevant for monetary policy and its transmission increases, while the yield curve becomes less informative as a summary indicator. To accurately steer expectations across a wider array of measures, more active communication on our reaction function is needed.

The purpose of enhanced transparency is to respond to these challenges: to reduce uncertainty about our future policy intentions and to clarify our reaction function in unusual circumstances. Let me explain.

First, forward guidance enhances transparency through two channels. It gives guidance on the expected level of future interest rates, conditional on the outlook for price stability. And it reduces uncertainty about that level by strengthening communication on our reaction function. Specifically, we have communicated that, given low inflation and broad-based economic weakness, we expect interest rates to stay at present or lower levels for an extended period of time.

This communication has indeed had the overall effect of lowering longer-term rates and partly insulating euro area money markets against developments elsewhere. Forward guidance has also reduced uncertainty related to our reaction function. Implied densities extracted from EURIBOR options and used to gauge expectations of the forward OIS rate show that the dispersion of short-term rate expectations has declined to levels closer to those observed in early May 2013, after we cut interest rates. The sensitivity of money market forward rates to macroeconomic data releases has declined as well. And note that by cutting rates in November last year we followed up words with actions, which effectively strengthened our forward guidance.

We have also recently helped further clarify our reaction function by laying out some contingencies that would warrant a monetary policy reaction. These contingencies illustrate well the multiple dimensions of our reaction function, both as regards the risks to price stability, and as regards the array of instruments we have at hand to deal with those risks.

One contingency would be an *unwarranted tightening of the policy stance*. Such a change in the policy stance could emanate from at least three sources.

First, a need for action could emanate from renewed tensions in short-term money markets to the extent that these are propagated to the medium-term curve, in particular in an environment of receding excess liquidity in the euro area. This is distinct from the type of short-term money market volatility we saw towards the end of last year that was associated with technical factors.

Second, a tightening of the policy stance may arise from developments in global bond markets that unduly spill over to the interest rate term structure in the euro area. So far our forward guidance has managed to decouple euro area forward curves somewhat from developments in the US.

Third, the policy stance may also be affected by a continued appreciation of the exchange rate. The exchange rate is not in itself a policy target, but a rise in the exchange rate, all else being equal, implies a tightening of monetary conditions, a downward impact on inflation and potentially a threat to the ongoing recovery. If so, this would call for policy action to maintain the current accommodative stance. This is why we have said that the exchange rate is an increasingly important factor in our assessment of the outlook for price stability.

This assessment, however, needs to take in the whole picture. To the extent that the exchange rate is rising because confidence in the euro area is returning and capital inflows are increasing, this leads also to looser financing conditions. While exchange rate appreciation contributes to low inflation in the short run, falling long-term rates support rising inflation over time, insofar as they are passed on into lower bank lending rates and stimulate demand. As a result, the overall policy stance has to take this balance of forces into account.

What would be our policy response should this contingency arise? In our view an undue tightening of the policy stance can be addressed through a variety of more conventional measures. These include a further lowering of the interest rate corridor, including a negative deposit rate. They include a further extension of the fixed-rate full allotment procedure, beyond the period currently envisaged. Remember that in November 2013 we announced our decision to continue conducting the main refinancing operations (MROs) as fixed-rate tender procedures, with full allotment, at least until July 2015. Finally, if necessary, the measures could include new liquidity injections via our liquidity operations, including longer-term fixed-rate operations.

Another contingency that would warrant a monetary policy reaction would be *further impairments in the transmission of our stance*, in particular via the bank lending channel. Given the reduction in bank funding costs over the last year and the ongoing clean-up of the banking sector through the comprehensive assessment, our assessment is that bank lending conditions are improving and will continue to improve.[6] Yet if this scenario does not materialise, we may have to respond. This could take several forms, including a longer-term refinancing operation targeted towards encouraging bank lending or an ABS purchase programme, supported by the necessary regulatory changes aimed at revitalising high quality securitisation in Europe.

A third contingency would be a *worsening of the medium-term outlook for inflation*. One cause for this could be by a broad-based weakening of aggregate demand that derails our baseline scenario of a moderate recovery. Another cause could be a substantial positive supply shock that, given the current low level of inflation, loosens the anchoring of medium-term inflation expectations. Unlike the other contingencies, the objective here would not be to defend the current stance, but rather to increase meaningfully the degree of monetary accommodation. Hence, the limited margin for manoeuvre that remains over short-term interest rates would not be sufficient. This would be the context for a more broad-based asset purchase programme.

Ultimately, all these contingencies point to the same conclusion: in order to fulfil its mandate, the Governing Council is committed – unanimously – to using both unconventional and conventional instruments to deal effectively with the risks of a too prolonged period of low inflation.

Opening up the ECB's decision-making

In spite of these efforts to enhance transparency, and their observable effectiveness, there is little doubt that our simpler understanding of monetary policy in the past will not readily return. Policymakers are operating in a more complex and heterogeneous environment. Structural breaks and model uncertainty imply that the regularities of the past can no longer be relied upon. This in turn means that judgement plays a greater role in decision-making.

Yet, judgement always involves trade-offs, which are important for the public to understand and for policy-makers to be accountable for. And while trade-offs exist in normal times, in crisis conditions they become both more complex and more consequential. For example, each of the unconventional measures that I discussed above could be effective in addressing specific impairments in monetary transmission and risks to price stability, but could also have side effects that need to be considered.

This is why last August I reported that the Governing Council felt a need for a "richer communication of the rationale behind its decisions" so as to give a sense of the discussion that has taken place. The Governing Council has since been reflecting on the publication of

[6] For more details see lecture by M. Draghi, "A consistent strategy for a sustained recovery", at Sciences Po, Paris, 25 March 2014, http://www.ecb.europa.eu/press/key/date/2014/html/sp140325.en.html.

some record or account of its policy deliberations. I would like to share with you my views on this matter today.

A written account of our policy deliberations would provide a more detailed explanation of the reasoning behind the Governing Council's decisions, and give a sense of the discussion and the main arguments. This would allow the public and markets to further improve their understanding of the Governing Council's reaction function, our assessment of the economy and our policy responses in light of evolving conditions. For this reason, I am convinced that it would be useful. Yet, we need also to be careful. We need to take proper account of the specific institutional setting of the euro area and the unique communication challenges in a multi-country monetary union.[7]

This implies, first, that any modifications we introduce in reporting on our monetary policy deliberations must not put at risk or call into question the independence of the members of the Governing Council. They act in a personal capacity in the interest of the euro area, rather than as representatives of their countries of origin. To my mind this precludes the attribution of positions to individual Council members, which could all too easily be misconstrued or misinterpreted through a national perspective and expose the members to external pressures, perceived or real.

Second, we need to ensure that any account of our proceedings preserves the collegiality of the Governing Council's deliberations. For good reason Article 10.4 of the Statute stipulates that the proceedings of the Governing Council meetings shall be confidential, while the Council may decide to make the outcome of its deliberations public. This not only protects the independence of the Council members, but also ensures an open and frank exchange of views inside the Governing Council, which is essential for the effectiveness of our collegiate decision-making.

Like any committee, the Governing Council benefits from the diversity of views and perspectives that are brought to the table. At the same time, decision-making by committee reflects more than the sum of the pre-established views of its individual members. What counts is the quality of the arguments and the contributions made towards reaching a common decision. There needs to be scope for a give-and-take in these discussions to reach the best decisions. This implies a readiness to re-consider positions in the light of all considerations brought forward in the course of the meeting – an approach that helps to forge a consensus. An account should not limit the flexibility of Council members to reach such a collective view. It should support collegiality, which comes at a premium in a multi-country context.

My view is that releasing a more complete account of the main arguments considered in our monetary policy deliberations, in a non-attributed form, will on balance serve to strengthen the Governing Council's collegiate decision-making and communication. Such a release should naturally complement the real-time messages conveyed in the press conferences. It should offer additional information that improves understanding of our reaction function, with respect to the relevant medium-term horizon, while taking care to avoid triggering short-term market noise.

Conclusion

Let me conclude.

From the time the ECB was set up, not two centuries, but just 16 years ago, its commitment to its price stability mandate has not wavered. But its conduct and communication of monetary policy have evolved. The ECB's reporting obligations have, unsurprisingly, grown.

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7 For earlier discussions and evidence on ECB communication, see, for example, Issing (2005), Winkler (2000), Ehrmann and Fratzscher (2007a,b).

And as we take on banking supervisory powers later this year, there is a need for even greater accountability and transparency, which has been reflected in our inter-institutional agreement with the European Parliament.

The publication of a richer account of our monetary policy deliberations represents a logical next step in the ECB's evolving communications. After 16 years of operation and seven years of crisis, the Eurosystem has matured enough to engage more fully with the public about how we go about fulfilling our mandate. Such an interaction is ultimately the best basis for an effective monetary policy and for maintaining credibility and trust in our institution – which hopefully, like the DNB, will last for centuries to come.

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