Macroprudential policy and central bank communication

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1. Introduction

In response to the financial crisis, many central banks are taking on significant new responsibilities for macroprudential supervision. Based on the experience of central banks with financial stability reports (FSRs) and other financial stability-related statements, this article argues that such central bank communication can be highly effective, especially during periods of financial stress. The findings underline the importance of designing a well differentiated communication strategy on macroprudential issues.

2. Theoretical considerations

Several arguments have been put forward to justify why central banks are taking on a prominent role in macroprudential supervision: combining financial supervision with monetary policy tasks can lead to synergies and a more effective conduct of monetary policy (Borio (2009)); it may be usefully connected to the central banks' lender of last resort function (Blinder (2010)); or because central banks could benefit from incorporating systemic risk considerations in the monetary policy process given the costs of asset price bubbles (Feldstein (2010)).

Yet numerous risks in assigning such a task to central banks have also been emphasised: it may at times lead to conflicts among different goals (Goodhart and Shoenmaker (2005), De Grauwe and Gros (2009)); and it may be costly for the reputation of central banks if they fail in their macroprudential tasks, a point that was originally made in the context of microprudential tasks (Goodhart (2002)), but is equally valid here.

However, what has been missing in this debate so far is evidence about whether, and under what conditions, central banks may actually be effective in guiding financial markets through their role in macroprudential supervision. New research (Born et al (2010)) attempts to address this question by exploiting the fact that many central banks have had some financial stability role in the past, and have communicated extensively on this through the publication of FSRs and financial stability-related speeches and interviews.

3. Empirical results

This research creates a novel database comprising more than 1,000 FSRs and speeches/interviews by central bank governors across 36 countries, and based on their semantic features, grades these along optimism and activity dimensions. In line with the aims put forward by Blinder et al (2008), such communication is defined to be effective if the views

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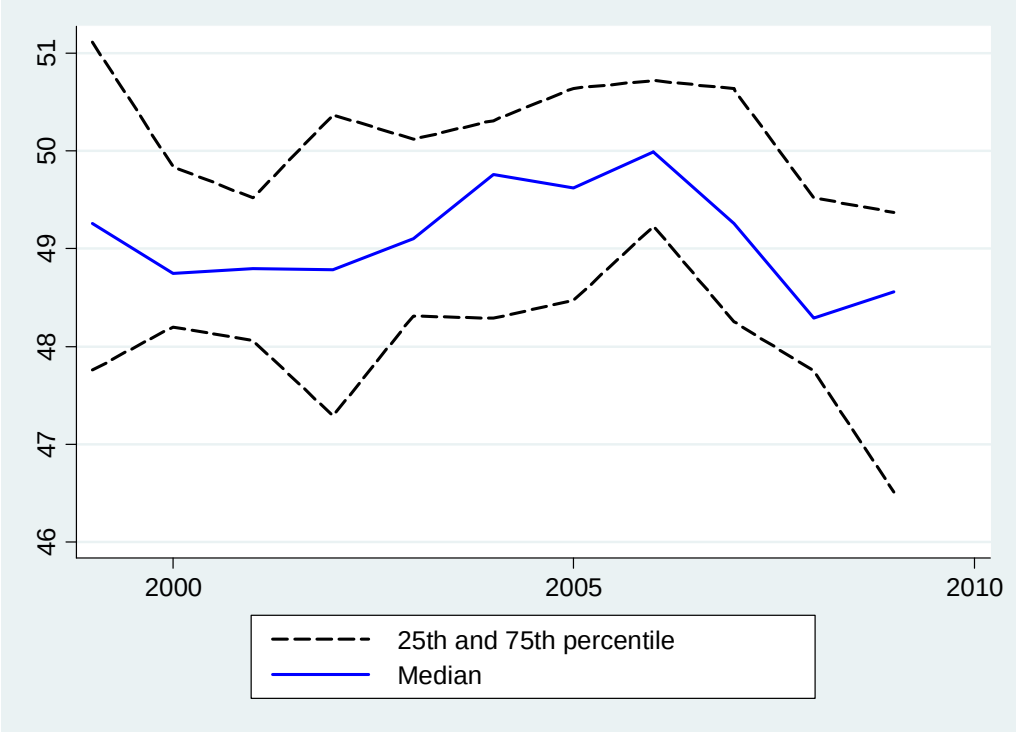
that it contains are reflected in the markets; either by "creating news" – moving the level of asset prices – or by "reducing noise" – reducing market volatility and uncertainty.

A first striking finding from this classification is that the tone of FSRs became continuously more optimistic after 2000, but reached a peak in early 2006, thereafter becoming more pessimistic (see Figure 1). This suggests that FSRs, across the 36 countries in the sample, may also contain a forward-looking assessment of risks and vulnerabilities, which flagged a weakening financial stability environment well before the start of the financial crisis in August 2007.

Figure 1

The evolution of optimism in FSRs over time



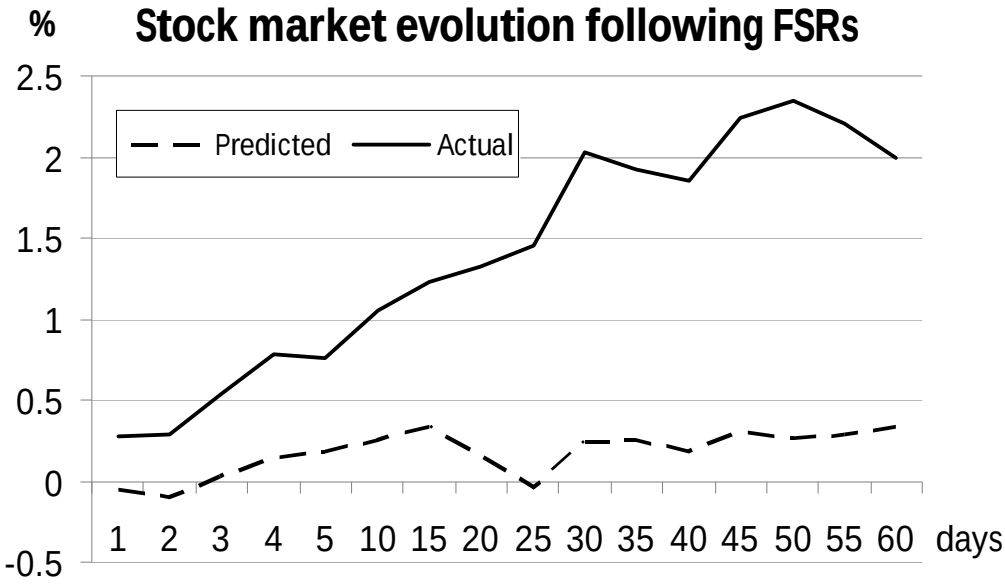
Notes: The figure plots the median, 25th and 75th percentile of the optimism scores for FSRs in any given year.

Moreover, the empirical findings of this work suggest that communication about financial stability has important repercussions for financial sector stock prices. FSRs clearly create news in the sense that stock markets move in line with the views expressed in FSRs. This effect is quite sizeable as, on average, FSR releases move equity markets by 2% during the subsequent month, as shown in Figure 2, relative to the counterfactual. Another important finding is that FSRs also reduce noise, as market volatility tends to decline in response to FSRs.

By contrast, speeches and interviews are, on average, less effective instruments. In particular, while having only modest effects on stock market returns, they tend to *increase* rather than reduce market volatility (in particular during the crisis). However, the effectiveness of FSRs and speeches crucially depends on market conditions. Importantly, speeches by central bank governors were effective in guiding financial markets during times of financial stress. Moreover, the results indicate that the financial stability communication of central banks influences financial markets primarily via a coordination channel, ie it provides relevant information which exerts a significant and persistent effect on markets.

Figure 2

Predicted versus actual evolution of stock markets after FSR releases



Notes: The figure compares the actual evolution of cumulated stock market returns (in per cent) following the release of FSRs to the predicted trend on the basis of the benchmark model. The solid line plots the average actual cumulated returns starting from day 1 after the FSR release and up to day 60. The dashed line shows the expected cumulative returns that would result from the benchmark model in the absence of an FSR. The cumulative returns are multiplied by –1 for pessimistic FSRs, whereas they are left unchanged for optimistic FSRs.

How can we explain that FSRs overall reduce noise, ie lower stock market volatility, whereas speeches and interviews generally have the opposite effect? A crucial difference between these communication tools is that the release schedule of FSRs is typically pre-announced, whereas the timing of speeches and interviews is much more flexible. Given this flexibility, speeches and interviews might carry some surprise element, simply due to the fact that a governor feels compelled to raise financial stability issues in a speech or an interview. In contrast, due to the fixed release schedule for FSRs, financial markets expect statements about financial stability issues on the release days. There might be surprising elements in their content, but the mere fact that the FSR is released does not come as a surprise. This difference might be at the heart of the different effects of the two instruments on market volatility.

4. Conclusion

The empirical findings of this new work raise a number of important policy issues. Communication on financial stability issues by a central bank with a macroprudential policy role will certainly be watched very closely by financial markets, and thus are potentially an important influence on financial markets. Does this imply that central banks should limit transparency and their communication on certain macroprudential risks, as argued by Cukierman (2009), or does this make the case for enhanced transparency and accountability, as argued by others? The findings of the work show that communication by monetary authorities on financial stability issues can indeed influence financial market developments. Yet the findings also show that such communication entails risks as it may unsettle markets. Hence central bank communication on macroprudential issues needs to be employed with the utmost care, underlining the difficulty of designing a successful communication strategy on financial stability.

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