Jens Weidmann: Central bank communication as an instrument of monetary policy

Lecture by Dr Jens Weidmann, President of the Deutsche Bundesbank and Chairman of the Board of Directors of the Bank for International Settlements, at the Centre for European Economic Research, Mannheim, 2 May 2018.

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1 Introductory remarks

Professor Wambach,

ladies and gentlemen

I would first like to thank you very much for inviting me to speak here at the Centre for European Economic Research as part of the "First-Hand Information on Economic Policy" series of lectures.

When I hear the phrases "economic policy" and "hand", I can't help but think of Harry Truman's famous demand for a one-handed economist. By always assessing everything "on the one hand ... on the other hand", the economists clearly got on the then US president's nerves.

In this case, it goes without saying that "First-Hand Information on Economic Policy" has little to do with "one-handed" economists.

No, "first-hand" in this sense means "directly from decision-makers". With that definition in mind, as Bundesbank President and member of the ECB Governing Council, I should obviously talk about monetary policy.

It has now been seven years since I delivered my first speech as Bundesbank President, and I have given a few more in the meantime. I haven't been keeping count, but the database of public speeches on the Bundesbank website now contains more than 150 entries.

Not all of my speeches, but a large number of them, are partially or even primarily about matters of monetary policy. Speeches have become a vital means of communication for monetary policy decision-makers. The six members of the ECB Executive Board alone have given 150 public speeches over the past year. And speeches are just one means of communication. Other channels of central bank communication are interviews, press conferences, and regular publications of reports.

Close attention is paid, in particular, to the ECB President's introductory statement at the beginning of the press conferences following ECB Governing Council monetary policy meetings. ECB watchers scrutinise every word. Changes in communication are very keenly noticed and analysed. And it is not only what is said but also what is left unsaid that can send a message.

"One cannot not communicate." From that perspective, this well-known quote by communication theorist Paul Watzlawick also applies to monetary policy.

In my speech today, I would like to discuss the significance of communication as an instrument of monetary policy in greater detail and provide some insight into what makes good central bank communication and how important good central bank communication is for the success of monetary policy.

I will cover these topics in three steps, starting with the development of central bank communication and its significance in general. I will then outline the particular challenges in communicating a monetary policy operating at the zero lower bound. And finally, I would like to give an outlook on how communication can help renormalise monetary policy without causing any market disruptions in the process.

2 The significance of communication in monetary policy

Just a few decades ago, central banks were still somewhat tight-lipped when it came to communication – you could almost say non-transparent. Up until the early 1990s, central banks were still shrouded in secrecy. Economist and influential monetary theorist Karl Brunner decried central banking as an esoteric art known only to a few select elites; incidentally, in his opinion, this esotericism was also manifest in their inherent inability to express themselves clearly.

In this vein, the warning from former Chairman of the Federal Reserve Alan Greenspan is almost legendary: “If I seem unduly clear to you, you must have misunderstood what I said.” And it was not without reason that a book about the Federal Reserve, which topped US bestseller lists 30 years ago, was titled Secrets of the Temple.

The example of the Fed also vividly illustrates how the communication of monetary policy has been in constant flux. Before 1994, the Federal Open Market Committee (FOMC) provided no information on the federal funds target rate – the Fed’s key interest rate. From 1994 onwards, statements were published for each change in the target rate.

From the end of 1999, the FOMC issued a statement after every meeting, which also revealed voting results from 2002 onwards. From 2003, the statements also contained explicit information, or forward guidance, on the likely course of inflation.

Since 2007, the FOMC has published individual projections for its members’ growth, unemployment, inflation and interest rates four times per year. And, in 2011, a press conference was held for the first time following an FOMC meeting; this now also takes place four times each year.

The aim of more intensive central bank communication is to ensure a greater degree of transparency.

First, this allows central banks to be more accountable to the public. An independent central banks is not a state within a state and, in a democracy, it needs to explain its monetary policy. By explaining its decisions in an understandable way, it strengthens public confidence in its ability to fulfil its task of ensuring price stability. This trust is the most valuable asset that a central bank has.

Second, communication can also make monetary policy. If people are economically active – whether as an entrepreneur, employee, consumer or however – they act in a forward-looking way. They form expectations and can influence central banks via communication. Or, as American economist Michael Woodford put it:

“Because the key decision-makers in an economy are forward-looking, central banks affect the economy as much through their influence on expectations as through any direct, mechanical effects of central bank trading in the market for overnight cash.”[1]

In this context, the impact of monetary policy relies even less on short-term money market rates and much more on expectations regarding the future course of key interest rates and, above all, long-term interest rates. The entrepreneurs and banks among you will be able to confirm that decisions regarding savings and investments do not depend on three-month money market rates, but on five-year or ten-year interest rates. However, monetary policy normally only affects them indirectly.

So, communication serves to steer expectations, and the better expectations are steered in line with the monetary policy mandate, the better the central bank will stabilise aggregate demand and therefore price developments, too.[2]

But how do central banks steer monetary policy expectations today? Announcing an inflation target plays a key role, as this leads to stability gains.[3] It helps to anchor economic agents' inflation expectations, which pays off in the form lower inflation volatility, amongst other things. In this respect, it is no coincidence that the expansion of central banks' communication was accompanied by the emergence of an inflation targeting strategy.

Even before the introduction of the euro, the ECB Governing Council had already published and then refined a quantitative definition of price stability. However, the communication activities of the ECB and the national central banks in the euro area went above and beyond that from the start.

Alongside the arguments of accountability and steering expectations, the fact that the ECB, as a new institution, did not yet have a reputation in monetary policy also played a role. Understandable communication was used as a way of allaying any doubts regarding the Eurosystem's commitment to stability.

Through the aforementioned press conference, the ECB has a means of communication at its disposal that provides the opportunity to explain monetary policy decisions in a timely and comprehensive manner.

The introductory statements are not designed to provide a comprehensive view of the range of opinions held by the members of the ECB's Governing Council. For this purpose, the Governing Council has, since 2015, published what it calls "accounts" – detailed written summaries of its monetary policy meetings. These also show the range of arguments put forward.

Certain other central banks also publish the minutes of their meetings, naming who voted for what; however, the ECB Governing Council has avoided doing this from the outset, for good reason. This is intended to prevent the decisions made by members of the Governing Council being judged from a national perspective in their home countries and thus to ward off the risk of monetary policy becoming politicised.

As it happens, the Bundesbank set great store by communication with the public even at a fairly early stage, back in the days of the Deutsche Mark. One reason for this was its marked independence, which, as I already mentioned, compels it to be accountable. At the same time, however, the Bundesbank was quick to recognise how much the success of a stability-oriented monetary policy hinges on a well-informed public understanding the monetary policy strategy and appreciating the value of a stable currency.

Had the German public been less appreciative of its stable currency, it would have been harder for the Bundesbank to implement its policy, especially as it was not always welcomed by all.

Thus, central bank communication in the days of the Deutsche Mark was not so much aimed at steering expectations. This would have put the Bundesbank far ahead of its time; after all, the importance of steering expectations as a monetary policy strategy was only recognised in the mid-1990s. On the contrary: until well into the 1990s, central bankers did not shy away from springing a surprise interest rate decision on the markets now and then.

Nowadays, preparations for monetary policy decisions are communicated so far in advance that often the decision itself barely comes as a surprise.

Good central bank communication is also characterised by its emphasis on the state contingency of monetary policy decisions – in other words, it clarifies that the monetary policy stance is contingent on the economic setting, and specifies how.

The communication should explain and convey, as clearly and precisely as possible, the objective and how it will react to any deviations from that objective. Put simply, it should convey monetary policy's reaction function, so as to avoid unnecessary uncertainty.

This should give economic participants a better understanding of how monetary policy will respond to new information. Thus, they can adjust their expectations about interest rates and inflation of their own accord, and hence their response to new information, such as an unexpected oil price hike. And because they do this, the central bank itself does not have to react as much to the changed economic setting.

But what exactly does good central bank communication look like? How extensive and detailed does it have to be?

It goes without saying that more communication is not necessarily better communication. Complete transparency could also cause confusion more than it helps to shed light on things, simply because of the sheer amount of information.[4]

Nonetheless, central banks should communicate as precisely as possible, because if their signals are not clear enough, the result can be unwanted volatility in the markets, which can also spread to developments in the real economy.

Precise communication is especially important in times of great uncertainty, for example if, in response to a crisis, unconventional measures are introduced, used and finally terminated. By having a broad communication approach which uses various channels, the central bank can also prevent specific means of communication, such as the press conference, from receiving too much attention.[5]

The press conference, in particular, shows that the financial markets react very sensitively to central bank communication. At the same time, however, monetary policymakers also keep a close eye on financial market indicators as key factors in the monetary policy transmission process. This mutual dependence between monetary policy and the financial markets can cause a problem.[6]

This problem has already been vividly described by Nobel Prize winner Paul Samuelson, who once compared monetary policy to a monkey seeing its reflection in the mirror for the first time: the monkey thinks that by looking at that other monkey it is getting new information, when really it is just looking at its own reflection.[7]

When the financial markets largely reflect central bank communication, the informative value of market signals is limited – and this increases the risk of incorrect monetary policy decisions if a blind eye is turned to these interdependencies.

The BIS's economic adviser, Hyun Song Shin, has also addressed the interplay between financial markets and monetary policy communication, and rightly points out that – despite the undisputed importance of the financial markets for monetary policy – the central banks should not end up like a rabbit caught in headlights.

If central banks use communication as a monetary policy instrument, they cannot shy away from giving the necessary guidance simply because they fear a counter-reaction from the markets. Otherwise, communication could become an infinite loop, he noted. Mr Shin's warning was this: "The more the central bank whispers in order not to upset markets, the more market participants lean in to hear better."[8]

3 Monetary policy communication at the zero lower bound

Reaching the effective zero lower bound on interest rates presents monetary policymakers with particular communication challenges. Since this situation is very exceptional, it is harder than usual for economic players to predict how the central bank will act. The central bank therefore has to explain its monetary policy reaction function even more clearly.

Since July 2013, before the effective zero lower bound was even reached, the ECB Governing Council has been issuing forward guidance to provide information on the future path of key interest rates. It communicated that it "expects the key ECB interest rates to remain at present or lower levels for an extended period of time". In actual fact, the key interest rates were subsequently lowered in multiple small increments.

Using forward guidance, the central banks did more than just make it easier to understand their decisions. It was also possible to generate additional downward pressure on the long-term interest rates at the zero lower bound. Forward guidance is by no means limited to information about the future path of key interest rates, as I will explain. Rather, it encompasses all information about future monetary policy decisions.

Forward guidance was new to the Eurosystem, but a number of other central banks had already been using it for some time as part of their standard monetary policy toolkit. New Zealand's central bank has been publishing projections of future interest rate developments for two decades, while Norway and Sweden were the pioneers in Europe.

Thus, forward guidance should not be mistaken for an instrument that can only be used in times of crisis – even though it only became known to a broader public after the 2007–08 crisis. And there is a certain disparity between forward guidance and the state contingency of monetary policy decisions, which I mentioned just before.

The literature is keen to make a distinction between Delphic and Odyssean forward guidance. The first alludes to the Oracle of Delphi, who made predictions but no promises. The second refers to Odysseus, who had himself tied to the mast of his ship and plugged his sailors' ears with wax so they would not succumb to the lure of the Sirens' song.

A central bank that uses Odyssean forward guidance would not let itself stray from its path, once announced, under any circumstances. It follows its announcement without fail – hence why this is also referred to as "unconditional" forward guidance.

The forward guidance issued by the ECB Governing Council, on the other hand, was always conditional. The announcement was based on the assessment of the overall subdued outlook for inflation extending into the medium term. If inflation had picked up faster than expected, the Eurosystem would have been able to deviate from its announced path, albeit with certain efforts to justify this. Anything else would have been incompatible with the ECB's mandate.[9]

To further loosen monetary policy despite the limited scope for action at the zero lower bound, the central banks ultimately opted for unconventional measures; an extensive asset purchase programme was adopted in the Eurosystem.

When the asset purchases began, the forward guidance was expanded to include a pledge that the net purchases would continue until a certain point in time or beyond, if necessary. In any case, they were to continue "until the Governing Council sees a sustained adjustment in the path of inflation consistent with its inflation aim".

In due course, a statement was added to the forward guidance which raised the prospect that the Governing Council would increase the size and/or duration of the programme if the outlook became less favourable.

This sentence is referred to as “easing bias”: by only stating that it could further loosen the reins if need be, it underlined the expansionary monetary policy stance. I alluded to the dropping of this sentence in March 2018 at the start of my speech, when I said that central bank communication can also send a message when something is not said, or no longer mentioned.

Regardless of what one may think of the purchase programme – and you know that I take a critical view of government bond purchases in the context of monetary union, especially – it is safe to assume that the forward guidance reinforced the expansionary effect of the purchase programme. However, expert estimates of the exact scale on which this occurred vary widely.

4 Communicating the normalisation process

To sum up, central banks’ communication, especially around the effective zero lower bound, explains not only their monetary policy but also a considerable number of separate monetary policy stimuli.

In the last part of my speech, I would like to give an outlook on how communication can help renormalise monetary policy without causing any market disruptions in the process.

According to the latest ECB staff projections, the euro area inflation rate will rise to around 1.7% by 2020 – in other words, a rate that is, on the whole, compatible with our definition of price stability. “Below, but close to, 2% in the medium term” is the objective the ECB Governing Council set itself. It does not, therefore, come as a surprise that financial market participants have been expecting for some time now that net asset purchases will end before 2018 is out; as previously announced, the purchases will continue until at least September.

An end to the net purchases would represent only the beginning of monetary policy normalisation, which will take some time. It is precisely for this reason that it is so important not to put it off for much longer. In addition, normalising monetary policy would give policymakers leeway again to respond to any economic slumps in the future – because the current upswing won’t last forever.

Some observers have already interpreted the latest economic slowdown as a sign that an end to the upswing is imminent. But I think this is an exaggeration.

Following extremely high growth last year, which saw euro area growth exceed potential growth for a number of quarters, the slowdown at the start of this year should not be understood as a turning point in economic activity but as a dent in an upward trend. And it should be seen as such, in particular, given the impact of certain one-off effects such as the flu outbreak, which probably drove up sickness-related absences among your employees too.

Meanwhile, cause for concern is warranted with regard to the protectionist tendencies which can currently be observed worldwide. These tendencies really do pose an economic risk – and yes, ultimately also a risk to growth and welfare. It is therefore all the more important that the current trade dispute does not escalate into a full-blown trade war.

Forward guidance is also proving useful with respect to communicating the approaching end of the asset purchases.

Very helpful in this context are the Fed’s experiences with the process of normalisation. The comparatively vague announcement of a potential step-down of its asset purchases in May 2015 caused strong reactions in the financial markets, in the context of which the term “taper tantrum” was coined. The expression is a combination of the term “temper tantrum”, often used when referring to ill-tempered children, and the word “tapering”, which describes the process of slowly phasing something out.

The taper tantrum highlighted that it is crucial for central banks to prepare their exit from non-standard monetary policy measures well in terms of communication. Just over a year later, the Fed provided a good example of how this is done by publishing its Policy Normalization Principles, based on which all decisions have been made since. This shows how the balancing act between providing rough guidelines while maintaining a sufficient degree of flexibility for monetary policy can be successful even in practice.

On the one hand, the ECB Governing Council's forward guidance contains an announcement that the principal payments from maturing securities will be reinvested "for an extended period of time, and in any case for as long as necessary" after the end of the net asset purchases. So, when a security matures, the Eurosystem reinvests the principal amount in another security upon repayment.

In simplified terms, by ending net purchases, the Eurosystem is refraining from keeping the monetary policy to the floor, but it is not taking its foot off the accelerator either for the time being.

On the other hand, the ECB Governing Council has stated its expectation that key interest rates will remain at their present levels "for aor n extended period of time, and well past the horizon" of the net purchases.

In other words, not only is the Eurosystem keeping its foot on the accelerator, it has also promised not to put on the brakes on interest rates right away.

When the normalisation process is initiated, the economic state of the euro area will presumably be considerably ahead of the state in which the United States found itself when it started tapering. The first interest rate increase could therefore happen much sooner after net purchases end than was the case in the United States, where more than a year passed between the end of the asset purchases and the first interest rate hike.

Market participants are expecting the first interest rate rise around the middle of 2019, which is not wholly unrealistic in my opinion. At the same time, the wording "for an extended period of time, and well past the horizon" of net asset purchases is relatively vague and raises the question of if and when the exact point in time should be specified.

Putting an end to the net purchases eliminates the timing element of forward guidance in a way, as a date has thus far only been named for the purchase programme. In addition, the link between the end of the net purchases and a sustainable correction of inflation consistent with the inflation aim is severed. However, the interest rate path and the point at which reinvestment is to come to an end will evidently depend on prospective inflation developments.

Moreover, the Eurosystem's forward guidance has thus far not focused explicitly on the sequence of the first interest rate hike and the end of reinvestment. If we take the Fed's sequencing as a blueprint, the interest rate hike comes first. In any case, that is the order most financial market participants are expecting, and the ECB Governing Council has not considered it necessary to correct this expectation until now. At the same time, the Governing Council has not committed itself either.

There are, consequently, several options for the Eurosystem to adjust its forward guidance after the net purchases have been discontinued. The following trade-off should be borne in mind here. The more comprehensively any future steps are outlined, the more accurately market expectations can be steered. As a result, uncertainty decreases as market participants' room for interpretation regarding future interest rates diminishes.

However, this also increases the risk of the Eurosystem having to deviate from the communicated path at a later date due to new information and a revised assessment regarding future inflation developments.

Here we have it again. In the words of Harry Truman: “On the one hand ... on the other hand."

Furthermore, the ECB Governing Council is faced with the question of how it can provide the markets with greater clarity on the trajectory of interest rate increases during the normalisation process and beyond.

In my view, publishing detailed interest rate paths, as some central banks already do, including those of Sweden and Norway or the United States, would be taking things too far. While Sweden and Norway create what are known as fan charts on changes in key interest rates, the Fed publishes what it calls dot plots illustrating the interest rate level the individual FOMC members deem realistic for the next few years and in the long term.

If the forecasting uncertainty is high, publishing point forecasts on the interest rate path could prove more confusing than beneficial – even scientific studies are unable to paint a clear picture.

5 Outlook

Ladies and gentlemen

In my speech, I have highlighted the importance of central bank communication as an instrument of monetary policy. Communication is vital not only to make a central bank more transparent, but also, and above all, to steer expectations.

The Eurosystem’s forward guidance meant that the introduction and implementation of non-standard policy measures could be flanked by communication. Forward guidance will also prove valuable when phasing out non-standard monetary policy measures, without the ECB Governing Council having its hands tied for the future.

Over the next few weeks and months, the Governing Council will have to address the issue of how to prepare a communication strategy for the normalisation process.

The times when central banks could allow themselves to be shrouded in secrecy are long gone.

Thank you for your attention. I look forward to the discussion.

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3 See, for example, C J Erceg and A T Levin (2003), Imperfect credibility and inflation persistence, Journal of Monetary Economics 50, pp 915–944.

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[9] B Cœuré (2017), Central bank communication in a low interest rate environment, Speech at Bruegel, Brussels, 31 March 2017.