Luis de Guindos: Communication, expectations and monetary policy

Intervention by Mr Luis de Guindos, Vice-President of the European Central Bank, at the ECB policy panel of the Annual Congress of the European Economic Association, Manchester, 27 August 2019.

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Introduction

Ladies and Gentlemen,

Every year, the ECB organises a policy panel at the Annual Congress of the European Economic Association.[1]

The intention of these panels is to combine the results of research and the views of policy makers to advance our thinking on a topic of great policy relevance. This year, it has been straightforward to decide on such a topic. Communication and expectations are central to the conduct of monetary policy, and there is a substantial body of research that allows us to have an informed discussion on the topic. It is therefore a great pleasure for me to speak at this year's policy panel.

Central banks communicate with many different groups of economic actors. Let me focus my remarks on two such groups, both of which are essential to the conduct of monetary policy, namely participants in financial markets on the one hand, and the general public on the other hand.

The central role of financial market expectations in the conduct of monetary policy

There is a tight two-way relationship between central banks and financial markets. Extensive research has dealt with the flow of information from central banks to financial markets, and has shown that central bank communication exerts strong effects on financial markets.[2]

For instance, as central banks have become transparent about their objectives and their reaction functions, the inflation expectations that are priced into financial assets have become better anchored. They have become less volatile and broadly aligned with the central banks' inflation aims. Beyond this, markets also react strongly to the communication of the central bank's assessment of the current conjunctural situation and the economic outlook.[3]

At the same time, the influence also goes in the other direction: financial markets send signals to the central bank, which constitute a central input to decision-making. It is important for us to get the market view about where the economy stands, and where it is heading. This helps us cross-checking our own views, and it provides us with a benchmark against which we can communicate our own assessment. For instance, our projections are based on market expectations about the future path of short-term interest rates, oil and non-oil commodity prices and stock market prices – effectively, we are therefore telling the markets where, in our view, the economy is heading if their expectations were to materialise.

To put it in other words, central bank communication has to be two-way. The central bank talks and listens to financial markets at the same time. There are two points in this relationship which I want to highlight.

First, by influencing asset prices and expectations of financial market participants, the central bank affects the very signals which it wants to use as input to its policy making. This has

become known as the "echo chamber effect". As Hyun Shin from the BIS has put it, "the louder the central bank talks, the more likely it is to hear its own echo."[4]

This is particularly prominent in times when the central bank gives strong forward guidance. ECB research has shown that in such circumstances, market expectations become "cemented", i.e. they do no longer respond to news about the macro economy.[5]

This is something we need to keep in mind when designing our communication strategy and when reading the signals from financial markets – the more forward guidance we give, the less informative are market signals for gauging the state and the expected evolution of the economy.

A second point is that even if central bank transparency and communication has helped anchoring market-based inflation expectations, they do remain rather volatile. The volatility itself is a signal that is useful for us to understand. However, even if markets are volatile, central bank policy cannot be volatile. Hence, we need to look through some of this volatility to get a feeling for the underlying pricing that would result in the absence of short-term market moves that are likely to revert quickly.

The echo chamber effect and the inherent noisiness of market signals are reasons why we need to take the expectations that are priced in financial markets with a pinch of salt. This means that we need to also rely on other sources of information to ensure that we conduct a robust monetary policy. The incoming macroeconomic data are one such source. As we keep stressing, our monetary policy is data dependent, not market dependent: indications from market expectations cannot replace our policy judgement. Another way of robustifying our analysis is to look for expectations beyond those expressed in financial market prices.[6]

The importance of communication with the general public

This brings me to the second group of actors I want to mention, the general public. Central bank communication with the general public has only more recently gained the attention of academic research. Also here, we need to think of the interaction as a two-way street.

On the one hand, central banks have a lot to learn from consumers. For instance, consumers form inflation expectations that can tell us to what extent the central bank's inflation aim is perceived to be credible. Variations in consumer inflation expectations are also an indicator that central banks monitor, because these affect household decision-making and do therefore shape economic outcomes.[7]

While we have ample data available on expectations formed in financial markets, we know much less about those of consumers. To bridge this gap, we have just recently started to develop a new consumer expectations survey. This project is still in its early stages (we will soon implement a pilot survey), but it will provide us with a tool to collect information at regular intervals on household expectations and decisions, covering a broad range of topics including household income and finances, consumption, inflation, labour and housing markets. This will allow deepening our understanding of consumer behaviour in the euro area and give us up-to-date information on expectations that can feed into our policy analysis.

On the other hand, central banks do not only want to learn from the general public, they also actively reach out to it, making this a two-way interaction. They do so for several reasons. First, to manage expectations about economic outcomes – inflation expectations, but also expectations about financial stability and the safety of individual banks. Second, independent central banks need to make sure they are accountable to the public.

For both objectives, first-order importance should be given to making sure the general public understands the mandate of the central bank, and trusts its commitment and ability to deliver on its mandate. There is ample evidence that this matters.

ECB research finds that general trust in the ECB has an impact on consumers' inflation expectations, in two ways.[8]

First, it lowers their uncertainty about future price developments. Second, those who trust are less likely to have inflation expectations that are far from the ECB's inflation objective. In other words, trust in the ECB helps anchoring inflation expectations around the ECB's inflation objective, as agents are more likely to view deviations of inflation from the target as temporary. And it matters how the central bank drafts its communications – research has shown that relatively simple, but targeted messages, are particularly effective in shaping consumers' inflation expectations.[9]

So it is important to increase awareness about the central bank mandate and to enhance trust in the central bank. Just as an aside – the ECB's task here is particularly challenging, as we need to communicate in 24 different languages. In any case, we have stepped up our efforts along these lines in several dimensions. Let me highlight three of them:

First, we have developed educational material about the ECB and its policies that is made available on our website – for the young generation in particular, but also more generally: there are educational games and videos, and we have published a large number of "explainers" where we give answers to frequently asked questions. Just to give one example – with our Euro@20 game, we reached 1.6million people.

Second, we are now much more present in the social media. This is an important channel whereby central banks can reach out a relatively broader audience directly, without intermediaries, and interact with the public, for instance through our Q&A sessions on Twitter.

Third, we are also working to make our regular policy publications more accessible to the general public. Our most recent Financial Stability Review, with a streamlined structure and clear focus on core messages, is presented on the ECB's website in a way that makes the content more easily understood, for instance by using visuals. Our efforts are already bearing fruit – with a significant increase in its readership.

Conclusion

Let me conclude by reiterating the central role of expectations in the conduct of monetary policy. We are well aware that our communication influences the very expectations that we want to use as input into our decision-making. We do therefore need to ensure that we base our decisions on a multitude of information, covering not only financial markets and experts, but also the general public. At the ECB, we are enhancing our toolkit for the communication with the general public in two ways – both by collecting more information about consumers, and by targeting some of our communication efforts more directly at the general public. I am confident that this investment will pay off and help us achieving three objectives at the same time – being a trusted institution, being accountable to the public, and maintaining price stability.

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[1] Prepared by M. Ehrmann (DG-R/MPR), with input and comments from Dimitris Georgarakos, Gabriel Glöckler, Jean-Francois Jamet, Marek Jarocinski, Eric Persson, Hanni Schölermann and Stefania Secola.

[2] Blinder, A, M. Ehrmann, M. Fratzscher, J. de Haan, and D.-J. Jansen (2008), Central Bank Communication and Monetary Policy: A Survey of Theory and Evidence. *Journal of Economic Literature* 46(4), 910–945.

[3] See, inter alia, Jarocinski, M. and P. Karadi (2019). Deconstructing Monetary Policy Shocks: The Role of Information Shocks. Forthcoming, *American Economic Journal: Macroeconomics*.

[4] Shin, H.S. (2017). Can Central Banks Talk too Much? Speech at the ECB conference on "Communications Challenges for Policy Effectiveness, Accountability and Reputation".

[5] Ehrmann, M. G. Gaballo, P. Hoffmann and G. Strasser (2019). Can More Public Information Raise Uncertainty?

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[6] See also Cœuré, B. (2019). Inflation Expectations and the Conduct of Monetary Policy. Speech at an event organised by the SAFE Policy Center.

[7] Duca, I., Kenny, G. and Reuter, A. (2017). Inflation Expectation, Consumption and the Lower Bound: Micro Evidence from a Large Euro Area Survey. ECB Working Paper No. 2196.

[8] Christelis, D., D. Georgarakos, T. Jappelli and M. van Rooij (2019). Trust in the Central Bank and Inflation Expectations. Forthcoming, *International Journal of Central Banking*.

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