

Professor Axel A Weber
President
of the Deutsche Bundesbank

Monetary policy strategy and communication

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1 Introduction

Ladies and gentlemen

Welcome to this conference on “Monetary policy strategy: old issues and new challenges”.

The general thinking on monetary policy strategy has undergone some important changes in most countries over the past few decades. There has been a considerable convergence of some core principles concerning monetary policy across countries. To name just the most important aspect: Central banks should concentrate on price stability. The principle of “price stability first” enhances monetary policy credibility, and credibility is a prerequisite for successfully anchoring inflation expectations at levels consistent with price stability.

It is therefore certainly true that there is much more commonality and shared interest between the largest central banks than is sometimes assumed in the public debates about our respective policies. However, different approaches and open questions continue to exist. Against this background, a conference on monetary policy strategy will undoubtedly be enriched by the various perspectives which different central banks can provide. Ideally, such a joint effort will enhance our knowledge about common challenges as well as develop a beneficial, mutual insight into issues on which we take a more idiosyncratic course.

I am therefore very pleased that the Deutsche Bundesbank and the Federal Reserve Bank of Cleveland have been able to organise this joint conference on research issues related to monetary policy strategy and communication. So thank you to the organisers from both central banks for bringing together an impressive array of outstanding researchers.

And, of course, thank you also to the Bundesbank's conferences division which has, as always, successfully mastered all of the logistical and organisational challenges that such an event involves.

In my remarks I would like to focus on a matter of direct relevance to this research conference, namely the relationship between communication and strategy.

2 Communication and monetary policy strategy

2.1 Some general aspects

Nowadays, it is widely accepted that public institutions have to be transparent and accountable. This is even more the case for central banks with a guaranteed independence. There is no question that transparency and accountability of monetary policy are rightly regarded as indispensable elements of public policy in a democratic society. However, central banks' communication efforts usually go far beyond merely fulfilling such legal requirements. This is because communication is also an important element in fostering the effectiveness of monetary policy.

The importance of communication for the effectiveness of monetary policy rests on the fact that monetary policy measures influence only current short-term interest rates. The success of monetary policy to a very large extent depends on the degree to which it can affect expectations about future developments, for instance, the expected rate of inflation and the expected sequence of future short-term interest rates. The key aspect in this respect is the anchoring of inflation expectations at levels consistent with price stability.

Communication and transparency therefore have to be structured in a way that helps to achieve this primary objective. So, leaving aside the aspect of transparency in a democratic system, communication and transparency have no intrinsic value of their own. Consequently, monetary policy has to balance carefully the respective benefits and costs in order to reap possible gains in terms of improved policy effectiveness and credibility.

And while it is true that, ultimately, words have to be followed and confirmed by actions as they otherwise remain empty, it is equally true that explaining monetary policy in addition to merely announcing decisions taken is always important. Consequently, in my view, communication has to be analysed as an integral part the overall monetary policy framework – and not in isolation

This is where the monetary policy strategy becomes important. An explicit strategy is basically the tool with which central banks provide an analytical

framework to establish consistency between a sequence of short-term monetary policy measures derived from current economic conditions and long-term objectives.

An explicit rule-based strategic framework fulfils many important tasks. It enables observers to understand how economic data are analysed and transformed into the central bank's assessment of the current policy stance and risks. At the same time, in doing so, it reduces the need for more continuous direct communication. Moreover, an explicit strategy helps to de-personalise the monetary policy framework and thereby to provide continuity of the decision-making process. This offers clear advantages compared with an implicit strategy of "just do it".

However, since the specific way by which economic data is transformed into a coherent policy choice is by no means self-explanatory, and thus communication has a key role to play in order to explain the analysis underlying policy decisions, and to avoid that external observers have to adopt a complex learning process in order to understand the policy framework. Both aspects should help to limit market participants' uncertainty about the conduct of monetary policy, thereby reducing inflation persistence and lowering macroeconomic volatility.

2.2 Communication and strategy: some issues related to the Eurosystem

2.2.1 Communication about monetary policy objectives

The price stability focus and the quantification of price stability as year-on-year increase in the harmonised index of consumer prices (HICP) below but close to 2% over the medium term is one defining element in the Eurosystem's strategy.

Empirical research shows that in countries where central banks have adopted an explicit inflation objective, inflation is lower, inflation persistence is reduced and long-term inflation expectations are not correlated with lagged inflation.^{1 2} Interestingly, long-term inflation expectations are also less responsive to macroeconomic news and monetary policy announcements than in countries where no explicit inflation objective has been announced.³

¹ A Fatas, I Mihov and A Rose (2006), *Quantitative Goals for Monetary Policy*, forthcoming, Journal of Money, Credit and Banking; A T Levin, F M Natalucci and J M Piger (2004), *Explicit inflation objectives and macroeconomic outcomes*, ECB Working Paper No 383.

² L Benati (2006), *Investigating Inflation Persistence Across Monetary Regimes*, mimeo.

³ R Gürkaynak, A Levin and E Swanson (2006), *Does Inflation Targeting Anchor Long-Run Inflation Expectations? Evidence from Long-Term Bond Yields in the US, UK and Sweden*, Federal Reserve Bank of San Francisco Working Paper No 2006-09.

For the euro area, the short time span since the beginning of EMU does not yet allow for an in-depth empirical analysis comparable with these studies. However, empirical work has found that inflation persistence has been lower in those euro area countries that had an independent central bank and a clear price stability objective already before monetary union.⁴ Survey results for the euro area furthermore indicate that our definition of price stability is well understood and perceived as being credible. However, there are some indications that the general understanding of the monetary policy strategy could be further improved.

2.2.2 Communication about the monetary policy stance

Central banks devote significant resources not only to explaining their objective and the general strategic framework to the public, but also to communicating the current policy stance.

This is achieved through a wealth of different communication tools, but one important aspect is the communication on the days when decisions are taken. Owing to the high degree of predictability in the case of both the Eurosystem and the Federal Reserve, the main market reactions on meeting days are not due to any announcements per se, but rather to the information which accompanies them, in particular when there is an unexpected component in the announcement or indications about the future course of policy are given.⁵

Both the Eurosystem and the Federal Reserve do provide additional information on those days. However, the detailedness of explanations given differs: The Federal Reserve offers a brief explanatory note; the Eurosystem publishes an introductory statement and conducts real-time communication via a press conference of the ECB president with an intensive Q&A session.

The approach used by the Eurosystem enables observers to digest in real time the information provided and to clarify any issues if necessary.

In my opinion, this demanding communication exercise is highly valuable for external observers as it improves their understanding of the Governing Council's reasoning and deliberations. I will come back to this point later.

Over the past few years, there have been repeated calls for the Eurosystem to publish the minutes of its meetings because this is often seen as a means to

⁴ G Coenen and A Levin (2004), *Identifying the Influences of Nominal and Real Rigidities in Aggregate-Price-Setting Behaviour*, ECB Working Paper No 418.

⁵ C Brand, D Buncic and J Turunen (2006), *The impact of ECB monetary policy decisions and communication on the yield curve*, ECB Working Paper 657; R Gürkaynak, B Sack and E Swanson (2005), *Do Actions Speak Louder than Words? The Response of Asset Prices to Monetary Policy Actions and Statements*, *International Journal of Central Banking*, 1, pp 55-94.

enhance transparency. I would like to emphasise here that the market responses to published minutes in the United States and the United Kingdom result mainly from the timeliness with which this information is provided. This view is supported by the fact that the market responses to the minutes increased considerably after the publication schedule was changed; minutes are now published before the next meeting.⁶

Markets therefore seem to be more interested in a timely assessment of how the latest economic information is transformed into a coherent narrative by the decision-making bodies, rather than in deducing the specific opinions of Board members. Insofar as this is the case, the current Eurosystem practice of providing real-time transparency through introductory statements and press conferences appears to be especially well-tailored to this particular need.

I thus do not see that the benefits of publishing additional minutes outweigh the inherent risks, which are especially pronounced for a new and supranational body like the Eurosystem.

2.2.3 Providing information about the future

One additional issue that has received increased interest over the past few years is information about the future course of monetary policy. A number of central banks recently started to provide some form of guidance on future interest rates. The potential advantages of such disclosure could lie in an increased predictability of monetary policy, which should ultimately enhance the policy's effectiveness due to a stronger effect on expectations.

The most far-reaching approach is taken by a few central banks that communicate a quantified future own interest rate path (and the uncertainty surrounding it). With regard to the latter, the "own instrument projection" is supposed to be the interest rate path that is best able to achieve the central bank's objectives under certain model and judgement-based assumptions concerning the functioning of the economy.

This approach has the property of being fully consistent with the central bank's targets and other inputs. However, it also entails several problems. It is highly dependent on the specific analytical framework from which it is derived. In the light of model uncertainty and the unavoidable use of judgement in the forecasting process, the optimal interest rate path involves considerable communication challenges. In particular, communicating a future subjective path for the policy rate might be interpreted as an unconditional commitment – which in turn could reduce the necessary flexibility of monetary policy.

⁶ V Reinhart and B Sack (2006), *Grading the Federal Open Market Committee's Communications*, paper presented at the 2006 AEA meetings, Boston; Bank of England (2005), *Do Financial Markets React to Bank of England Communication?*, Quarterly Bulletin, Winter 2005, pp 431-39

Therefore, communicating the conditional nature of the interest rate path is of key importance.

From an empirical point of view, it is certainly too early to reach a definitive conclusion regarding the overall costs and benefits of this approach. However, existing empirical analysis does not indicate that this approach delivers an uniquely superior predictability of monetary policy outcomes.

As regards forward guidance, I prefer the approach of “letting the strategy speak for itself”. In my view the most beneficial role of communication in fostering monetary policy effectiveness lies in improving medium-term to long-term predictability and credibility. And here, our explicit strategy must play the central role.

Conditioning any forward guidance on the strategy helps making clear that we do not act in an unconditional and pre-committed way whilst at the same time lending credibility to the attitude that we will do what is necessary to guarantee price stability. This contributes to anchoring inflation expectations at levels consistent with price stability.

2.2.4 Communication and the introductory statement

The introductory statement of the Eurosystem published shortly after the policy decision is announced provides the policy relevant information in a structured manner to the public in real time.

It is the Governing Council's main instrument of context-specific communication. The wording of the statement is agreed upon in the foregoing meeting, and thus it presents the consensual assessment of the Governing Council. It portrays the Council's deliberations through the lenses of the two pillar strategy.

And it puts into perspective the linkages between data, decisions and stated medium-term policy objectives. The time lags in the transmission of monetary policy and the medium-term orientation of the Eurosystem require describing how present and future information that comes in is processed. In this respect, we offer guidance about what academics would call the reaction function of the Governing Council.

The introductory statement specifies the way we react to economic and monetary developments, analyse and judge shocks hitting the euro area, and view the outlook for economic growth and inflation as well as the associated risks over different time horizons. In doing so we constantly emphasise the forward-looking nature of our policy framework and the medium-term orientation with regard to our price stability objective.

The first part of the statement entails our combined broad assessment of the information from both pillars. In the subsequent parts economic and monetary analysis is presented in greater detail and cross-checked with one another. I will only make some remarks on the latter sections.

Our assessment keeps economic and monetary analysis distinct because from an empirical perspective the information content of both pillars relates to different time horizons regarding the risks to price stability. Having both, monetary and economic analysis instead of just cyclical information, one avoids the mistake of taking a too narrow view of the data. Our broad-based and robust strategy thus prevents us from ignoring potentially relevant information.

Let me put these general remarks into a more specific context by referring to the statement we published today. As the President of the ECB announced today we decided to increase the key ECB interest rate by 25bp to 4 %. This decision was based on our assessment of the risks to price stability which we have identified from our economic and monetary analysis.

Our economic analysis suggests the following: Regarding growth, incoming information clearly confirms that the euro area economy continues to expand at a pace significantly stronger than expected. The medium-term outlook is that the solid and broad based economic recovery is likely to continue at sustained growth rates around potential. This outlook is also reflected in the new Eurosystem staff macroeconomic projections. The projections foresee average annual real GDP growth in a range between 2.3% and 2.9% in 2007 and between 1.8% and 2.8% in 2008. In comparison with the previous ECB staff projections, the ranges projected for real GDP growth in 2007 are within the upper part of the ranges from March. For 2008, the ranges have been revised marginally downwards, following the increase in oil prices over recent months.

Risks to the outlook for growth are overall balanced on a short-term perspective, whereas longer term risks remain on the downside due to external factors, most notably oil prices, global imbalances and potential shifts in financial market sentiment.

Regarding inflation, the short-term profile of annual inflation rates continues to be determined largely by current and past energy price developments due to significant base effects. Annual inflation rates are likely to fall slightly in the months ahead before rising again significantly towards the end of the year. Eurosystem staff projects average annual HICP inflation of between 1.8% and 2.2% in 2007 and between 1.4% and 2.6% in 2008. Compared with the March 2007 projections the range projected for inflation in 2007 is somewhat higher, largely reflecting higher oil prices. The projected range for inflation in 2008 is unchanged.

Risks to the outlook for price stability over the medium-term are on the upside. This is most notably due to domestic factors, in particular, increasing capacity utilisation, gradually improving labour markets and the associated risk of higher than expected wage developments.

Our monetary analysis suggests clear upward risks to price stability in the medium to long-term due to the underlying trend of continued vigorous money and credit growth in an environment of already ample liquidity.

The cross-check of the monetary and the economic analysis supports the assessment that the overall risks to price stability over the medium to longer term are therefore on the upside.

I leave it up to you what this means for the future course of monetary policy in the euro area.

3 Conclusion

The issues I touched upon in this dinner speech clearly require more research efforts to improve the empirical basis for some of the conclusions and interpretations I have referred to.

Naturally, the mere fact that there are still more unresolved issues than resolved ones explains why conferences like this one are so useful.

In this respect I hope that you have many stimulating discussions and a productive conference.

Thank you for your attention.

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