



# Managing financial market expectations: The role of central bank transparency and central bank communication

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## ABSTRACT

In this paper, we study the influence of central bank transparency and informal central bank communication on the formation of money market expectations. The sample covers nine major central banks from January 1999 to July 2007. We find, first, that transparency reduces the bias in money market expectations and dampens their variation. Second, informal communications help manage financial market expectations by reducing the variation of expectations. Third, various subcategories of the Eijffinger and Geraats (2006) transparency index lead to a smaller bias in expectations (in particular, evaluation of policy outcome and explanation of interest rate decisions) and to a reduction in the variation of expectations (in particular, explicit prioritization of objectives and provision of information on unanticipated macroeconomic disturbances).

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## 1. Introduction

Since the 1990s, central banks across the world have worked hard to increase their transparency: objectives and goals are specified and quantified, macroeconomic forecasts are published, interest rate decisions are announced and immediately explained, and some central banks provide indications of the likely course of monetary policy in the near future.<sup>1</sup> Geraats (2002) provides a theoretical framework to explain the rationale for increasing central bank transparency and the effects of different types of transparency. She differentiates between five types of transparency (see Fig. 1). Political, economic, and operational transparency have the potential to enhance the credibility of a low inflation monetary policy. Procedural transparency is an obvious determinant of the quality of decision-making, and policy transparency can boost the effectiveness of interest rate setting.

The empirical literature mostly finds beneficial effects of transparency. Van der Cruysen and Eijffinger (2010) review the literature and conclude that transparency (1) improves consensus across forecasters, (2) lowers inflation and anchors inflation expectations, (3) improves the credibility, reputation, and flexibility of central banks, (4) has no obvious influence on output and output variability, and (5) improves policy anticipation.<sup>2</sup> The objective of this paper is related to the last point, 'policy anticipation.' We examine the

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<sup>1</sup> These inclinations can be provided via qualitative statements, e.g., as given by the European Central Bank and the Federal Reserve after every interest rate decision, or be even more sophisticated, e.g., as by the repo rate charts provided by the Sveriges Riksbank. The latter provides an explicit figure for the future repo rate over the next years in reference to different macroeconomic conditions.

<sup>2</sup> A more detailed and stylised overview of the empirical results can be found in van der Cruysen (2008, 30).

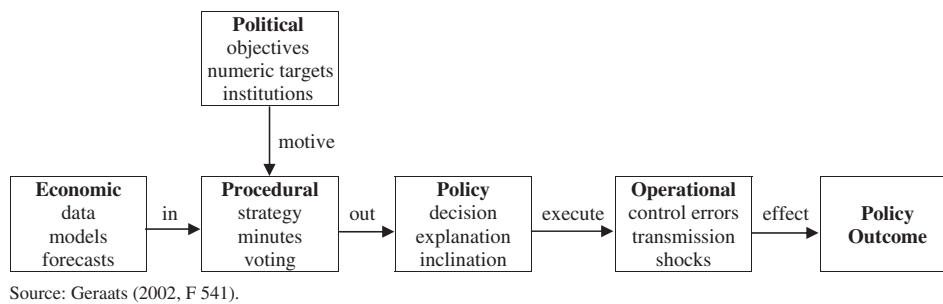


Fig. 1. Theoretical framework for central bank transparency.

impact of transparency on the course of short-term interest rates. One question is of particular interest: Does a higher degree of transparency improve the formation of expectations in the money market in the period between two interest rate decisions?

Our survey starts in January 1999 with the inception of the ECB and ends in July 2007.<sup>3</sup> We focus on nine countries in this survey: Australia (AUS), Canada (CAN), the Euro area (EMU), Japan (JAP), New Zealand (NZ), Sweden (SWE), Switzerland (SUI), the United Kingdom (UK), and the United States (US). Econometrically, we employ country-specific OLS models and a pooled OLS model to assess the following research questions: (1) Does transparency decrease the expectation bias in money markets? (2) Is the variation of money market expectations reduced by a higher degree of transparency? (3) Is transparency the only factor improving the formation of expectations in money markets or can central banks use frequent informal communication with the public as a substitute for transparency? As endogenous variables, we employ two newly constructed indicators that measure the bias and variation of money market expectations over the entire intermeeting period.

The remainder of this paper is organised as follows. Section 2 reviews the literature and explains the paper's contribution. Section 3 introduces the data set and explains our econometric methodology. Section 4 presents the country-specific results for the influence of transparency and communication on central banks' ability to manage financial market expectations. Section 5 shows the corresponding pooled model results. Section 6 concludes.

## 2. Related literature and contribution

In the recent literature, the effectiveness of central banking is measured by focussing on decision anticipation only, i.e., whether or not the actual interest rate decision was anticipated by financial markets. For example, Coppel and Connolly (2003) find that the extent to which market participants anticipate changes in the policy rate has gradually increased since the late 1980s, as has the speed of reaction to interest rate announcements. The results are quite similar across the countries in their sample (AUS, CAN, EMU, JAP, NZ, SWE, UK, and US). Thus, it is difficult to discover the specific contribution of a certain transparency type or to isolate any specific preferred model of monetary policy transparency. In a more recent paper, Andersson and Hoffmann (2009) compare the performances of the forward guidance strategies adopted by the Reserve Bank of New Zealand, the Norges Bank, and the Riksbank. They find evidence that all three central banks have been highly predictable in their monetary policy decisions, regardless of whether forward guidance involved publication of an own interest rate path.

Many papers focus on the predictability of the Federal Reserve's interest rate setting. Demiralp (2001) documents that most market rates adjust to anticipated policy actions prior to the actual announcement. Rafferty and Tomljanovich (2002) find that the forecasting error has decreased since 1994 for interest rates on US bonds for most maturity lengths. Lange et al. (2003) obtain similar results and identify two contributors to the enhanced predictability: gradualism in adjusting the Federal Funds interest rate target (i.e., autoregressive interest rate setting) and transparency regarding setting the target and future policy intentions. Finally, Swanson (2006) shows that since the late 1980s, US financial markets and private-sector forecasters have become less surprised by Federal Reserve announcements.

Lildholdt and Wetherilt (2004) show that the Bank of England's predictability improved over the period 1975–2003, most markedly after the introduction of inflation targeting in 1992. They posit that this is due to greater transparency in the monetary policy process, in combination with the bank's greater credibility. Finally, the Bank of Canada's efforts to increase its transparency also have helped market participants more accurately anticipate pending monetary policy actions (Muller and Zelmer, 1999).

Our work improves on the current literature in at least three ways. First, the impact of different transparency regimes is often measured only roughly by splitting the time series into subsamples. However, changes in transparency are often made gradually. Thus, splitting the observations into two or three subsamples fails to capture the effects of incremental change in monetary policy transparency. All central banks examined in this paper (Reserve Bank of Australia (RBA), Bank of Canada (BOC), European Central Bank (ECB), Bank of Japan (BOJ), Reserve Bank of New Zealand (RBNZ), Sveriges Riksbank (Riksbank), Swiss National Bank (SNB), Bank of England (BOE), and Federal Reserve (Fed)) have increased their transparency at least once in the past 15 years. We thus provide a continuous test of the effects of transparency on the money market adjustment process between two interest rate

<sup>3</sup> Since the beginning of the recent financial crisis, money market rates are no longer aligned with the respective country's target rate and, therefore, are no longer an appropriate indicator for the effectiveness of monetary policy.

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