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Quest for central bank communication: Does it pay to be "talkative"?

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Abstract

On the basis of a unique database of policy makers' verbal comments, we find that central bank "talk" in the Czech Republic, Hungary, and Poland influences behavior of financial markets. This effect, however, differs among the countries. The CEC3 central banks' communication strategies are far from uniform. The CNB does a better job than the other central banks in matching words with deeds. Communication affects monetary policy predictability, but results depend on the committee structure and communication style. Finally, we provide evidence that pursuance of too many targets leads to inconsistencies in central bank communication.

JEL classification: C32; E43; E52; E58; G12
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1. Introduction

Since the beginning of the 1990s central banking practice has shifted from secrecy towards more transparency about monetary policy strategy and objectives. Indeed, three out of four central banks consider transparency as a vital or very important component of their monetary policy framework (Fry et al., 2000). One underlying factor behind this trend is undoubtedly the link between transparency, credibility, and policy effectiveness.

On the one hand, central bank power seems to be limited, since the short-term interest rate, which constitutes the main instrument of monetary policy in most industrialized economies, matters very little for the future inflation outlook and for prospective economic activity (Svensson, 2005). On the other hand, efficiency of monetary policy may greatly be improved

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through its impact on private sector expectations. Expectations about the entire future path of interest rate shape the yield curve and thus determine long-term rates, which, in turn, largely affect private sector consumption and investment decisions. In this respect, monetary policy is increasingly becoming an art of managing private sector expectations.

Since central bank communication serves as a means to remove asymmetric information between markets and policy makers, it may influence market *expectations* regarding *future* inflation and *future* interest rate changes. Consequently, it is of paramount importance that in the decision-making process central banks account for the effects of their actions, including communication, on both short and long-term interest rates.[1]

The central bank's power to manage private sector expectations depends on its ability to communicate intentions in an intelligible manner. Therefore, the effectiveness of monetary policy should benefit from transparency the most, when it is accompanied by good communication policy (Issing, 2005; Winkler, 2000). In this sense, good communication is an indispensable element of transparency. Its importance has been emphasized by Woodford (2005) who argues that good communication, preferably a history dependent one, could replace policy action itself.

On the other hand, Amato et al. (2003) point to the double-edged nature of public information, which may suppress the private information of individual agents and thus crowd out an important source of information for a central bank.[2] The question that then arises is whether more "talkative" policy makers help to dispel doubts or rather add to confusion as regards prospective interest rate decisions? The relevance of this issue seems to be supported by the recent efforts of central bankers around the world not only to achieve more, but rather better transparency.

Despite the recent proliferation of literature on transparency and communication, including the way these concepts are measured and their role in monetary policy effectiveness, the topic is far from being exhausted, not least in the field of empirical research.[3] In particular, very few attempts have been made to assess central bank transparency in emerging economies; still less has been done to investigate the effects of central bank communication in this group of countries.[4] This paper aims to fill this gap.

In our study we assess monetary policy communication in the CEC3 countries, i.e. the Czech Republic, Hungary, and Poland. All the CEC3 central banks have conducted monetary policy under an inflation targeting (IT) strategy. Nevertheless, their frameworks are not uniform. In particular, the National Bank of Hungary (MNB), in addition to the inflation goal, has an exchange rate target.

[1] The role of communication for the effectiveness of monetary policy is stressed, *inter alia*, by Blinder (1998), Issing (2005), and King (1997).

[2] Svensson (2006) indicates, however, that Amato et al. (2003) findings have been misinterpreted as antitransparency results, whereas–he argues–they are actually pro transparency. Svensson stresses that except in very special circumstances, more public information is good.

[3] The role of transparency in monetary policy was examined, *inter alia*, by Canzoneri (1985), Faust and Svensson (1998), Eijffinger et al. (2000), Jensen (2002). A comprehensive overview of theoretical studies on central bank transparency is presented by: Geraats (2002), Hahn (2002), Carpenter (2004). For empirical studies on the reaction of financial assets to communication see, for example: Conolly and Kohler (2004), Ehrmann and Fratzscher (2005a), Kohn and Sack (2003), Gürkaynak et al. (2005). Research focusing on explanation of central bank decisions via its communication instruments include: Gerlach (2005), Heinemann and Ulrich (2005), and Ehrmann and Fratzscher (2005b).

[4] Central bank transparency in CEE countries was analyzed, for example, by Matousek (2001), Jarmużek et al. (2004), Czogała et al. (2005), and Łyziak et al. (2006). To our knowledge, no research has been done on the effects of central bank communication on asset prices in CEC3 countries.