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On the consistency and effectiveness of central bank communication: Evidence from the ECB

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Abstract

In this paper we analyse the introductory statement of the ECB President in his monthly press conference held on Governing Council meeting days. We provide a glossary that translates the qualitative information of the press conferences into an ordered scale. We find that the predictive ability of these statements is similar to that implied by market-based measures of monetary policy expectations. Moreover, ECB words provide complementary, rather than substitutable, information with respect to macroeconomic variables. Finally, we show that market expectations react to the unexpected component of the information released by the ECB, after controlling for the monetary policy shock.

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1. Introduction

"If you understood what I just said, you must not have heard me correctly"
Alan Greenspan, Testimony to a Congressional committee

"To me, that is the hallmark of credibility: matching deeds to words. (…) Credibility means that your pronouncements are believed — even though you are bound by no rule and may even have a short-run incentive to renege. In the real world, such credibility is not normally

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created by incentive compatible compensation schemes nor by rigid precommitment. Rather, it is painstakingly built up by a history of matching deeds to words. A central bank that consistently does what it says will acquire credibility by this definition almost regardless of the institutional structure."
Alan Blinder, Central Bank in Theory and Practice (1998, page 64)

What is European Central Bank (ECB) communication about? More generally, is the ECB transparent about its future monetary policy stance? What will the level of its policy rate be in three months from now? Do financial intermediaries understand the messages sent by the ECB about the future path of European monetary policy? Are these messages credible and, thus, promptly incorporated in market expectations? These are some of the questions this paper attempts to answer.

To put it differently, our goal is to analyse central bank communication, focusing in particular on ECB practices, its consistency (are words subsequently matched by actions?) and effectiveness (how effective are ECB's words in moving financial markets?).

Blinder et al. (2001, page 9) first ask: "Does [central bank] communication really matter?" They then answer: "To date there is no research to report on, so we can only call upon casual experience to back our claim that it does, and quite a lot". This paper tries to support their claim econometrically.[1] In particular, this paper contributes to the empirical literature on central bank transparency in three important ways.[2] First, from a methodological point of view, we analyse the semantic content of ECB communication in an explicit way: we provide a glossary to rank the information contained in the ECB President's monthly press conference into an ordered scale about the danger to European price stability and sustained economic growth. Second, we test the ECB's consistency between words and deeds. Third, we verify empirically whether, and to what extent, the public not only understand but also believe the signals sent by the European monetary authority.

Our main findings can be summarized as follows. First, by looking at the semantic content of the ECB President's introductory statement to the monthly press conference, we can predict the ECB near future monetary policy moves. Therefore, ECB words are usually followed by facts (i.e., a monetary policy move consistent with what the ECB has previously announced). For instance, when the introductory statement states that "the overall prospects remain in line [or "are appropriate"] with price stability over the medium term", the Governing Council will not normally change the official rate at its next meeting.

Second, the informational content of ECB rhetoric is substantial. On the one hand, the forecasting ability of European monetary authority words is similar to the one implied by market-based measures of monetary policy expectations. On the other, we find that words and data on macroeconomic variables are essentially complementary, rather than substitutable, pieces of information to correctly predict the future Repo rate (which is the key ECB policy rate).

Third, we show that innovations (due to ECB's announcements) in market expectations about future monetary policy can be explained by the unexpected component of the information released by the ECB, after controlling for the monetary policy shock. Hence, we infer that even if

[1] Since 2001 the empirical literature on central bank communication has been rapidly expanding (cf. Sections 2 and 6 and references provided thereafter). Examples include Clare and Courtenay (2001), Jansen and de Haan (2005, 2006), Lasaosa (2000), Lildholt and Vila Wetherilt (2004), Rosa and Verga (2005a, b).

[2] Carpenter (2004) and Geraats (2002) provide an excellent overview of the theoretical and empirical literature on the transparency of monetary policy. Eijffinger and Geraats (2006) propose and construct an explicit transparency index for nine major central banks for the period 1998–2002. Geraats et al. (2006) use this index to investigate the effect of transparency on the level of both short and long nominal interest rates (i.e., to empirically analyse the flexibility and reputation effects of transparency).