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The timing of central bank communication

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Abstract

This paper explores whether there are systematic patterns as to when members of the decision-making committees of the Federal Reserve, the Bank of England and the European Central Bank communicate with the public, and under what circumstances such communication has the ability to move financial markets. The findings suggest that communication is generally seen as a tool to prepare markets for upcoming decisions, as it becomes more intense before committee meetings, and particularly so prior to interest rate changes. At the same time, markets react more strongly to communication prior to policy changes. Other instances where communication becomes more intense, or where financial markets become more responsive are also identified; even though these are more specific to the individual central banks, they are consistent with differences in the central banks' monetary policy strategies and communication policies.

JEL classification: E43; E52; E58; G12
Keywords: Communication; Central bank; Monetary policy; Timing

1. Introduction

Along with, and partially due to the recent trend towards central bank independence around the globe, central banks have become remarkably more transparent in the last decades. One trigger for increased transparency has likely been the requirement for greater accountability of independent central banks (Issing, 1999). At the same time, however, it has been increasingly understood that transparency can enhance the effectiveness of policy (Blinder 1998; Woodford 2003). Accordingly, central banks put a much larger weight on their communication with the public nowadays than they used to some years ago.

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This paper adds to a young, but rapidly growing literature on central bank communication by focusing on the *timing* of such communication. The paper does so from two perspectives. First, it asks the question whether the timing of communication of central banks shows some systematic patterns, in the sense that we look for occasions when the intensity of communication increases. We suggest several scenarios where such an increased intensity could be useful for a central bank, and explore whether communication does indeed intensify. Second, the paper addresses the issue whether central bank communication exerts differential effects on financial markets, depending on its timing or the circumstances. Again, various cases are suggested and tested. By combining these two approaches, it is possible to check whether they are interrelated; this would be the case, for example, if market reactions are stronger in times of more intense communication.

The paper analyses three of the world's major central banks: the Federal Reserve, the Bank of England and the European Central Bank (ECB). Based on *quantitative* measures of communication, it identifies circumstances in which communication intensifies. This is most notably the case prior to interest rate changes, although we find more generally a higher frequency of communication in preparation of committee meetings, regardless of the upcoming decision. Beyond this, communication becomes more frequent also in other circumstances, although these differ across the three central banks. The detection of differences in the intensity of communication suggests that its timing is chosen endogenously. Based on *qualitative* measures of communication, the paper finds substantial evidence about time-varying market responsiveness. For example, asset returns respond significantly stronger to Federal Reserve and ECB communication prior to interest rate changes. Combining the increased frequency of communication and the stronger market responsiveness suggests that communication is a particularly important policy tool in such circumstances. Other differences exist; although they are more specific to individual central banks, they are consistent with differences in monetary policy strategies and communication policies.

The paper starts by reviewing the literature on central bank communication in Section 2. Section 3 then discusses our data source. This is followed by the empirical analysis as to the timing of communication and its ability to move financial markets in Section 4. Section 5 concludes.

2. Literature on central bank communication and decision-making

Monetary policy has a relatively direct leverage over very short-term (i.e., overnight) interest rates. To steer the behaviour of economic agents, however, it is necessary to affect longer-term interest rates, where the central bank influence is much more indirect. Blinder (1998) and Bernanke (2004) emphasise the importance for communication as a means for central banks to influence these asset prices, provided that the central bank has acquired a credible reputation. In that respect, communication is an important tool for the effectiveness of monetary policy implementation (Buiter 1999; Eijffinger and Hoeberichts 2004; Issing 2005). It is important that communication manages to influence the expectations of economic agents, such that the desired reaction of longer-term interest rates is achieved.

In principle, communication can in parts even substitute policy action. Demiralp and Jorda (2004) provide evidence that by announcing changes in the intended federal funds rate since 1994, it was possible for the Federal Reserve to move the federal funds rate with a smaller volume of open-market operations, which indicates clearly that increased transparency and more communication can indeed be beneficial for the efficiency of policy implementation. Moving one step further, there might even be an effect on financial markets if the central bank communicates its views about the intended level of asset prices and signals its intention to make the necessary adjustments in policy rates if asset prices deviate from this target, a policy that has frequently been labelled “open-mouth operations” (Guthrie and Wright 2000; Thornton 2004).