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# Do actions speak louder than words? Evaluating monetary policy at the Bundesbank ☆

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**Abstract**

This paper proposes that an important instrument of monetary policy of the Bundesbank is how it communicates with the public. We argue that communication by senior central bank officials represents an instrument of monetary policy that complements changes in interest rates. Moreover, the communications instrument can partly explain how a central bank can respond to real economic developments even as it focuses on an inflation objective. Using monthly data, we show how speeches by the Bundesbank's President dealing with inflation help explain both interest rate movements as well as the central bank's response to the unemployment rate.


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## 1. Introduction

Historically, the Bundesbank ranks as one of the most successful central banks. One measure of its success is how the Bundesbank sets interest rates in response to economic shocks, especially of the inflationary variety (e.g., Bernanke and Mihov, 1997; Clarida and Gertler, 1997; Deutsche Bundesbank, 1999). However, interpreting central bank behavior, including that of the Bundesbank, via a reaction function approach of the Taylor variety, does not tell the whole story. Goodhart (1999), for example, points out that standard reaction functions do not incorporate variables other than economic shocks. He argues that there must be additional factors in the conduct of monetary policy that are not adequately modeled using the standard reaction function approach.

Indeed, the usual interest rate rules do not capture what may be a crucial element that explains the conduct of monetary policy in Germany (and, likely, elsewhere), namely the vital role of public communication by senior central bank officials.[1] For example, Goodfriend (1999) emphasizes the communication function of the US Federal Reserve, and traces the use of this instrument as a tool to enhance the credibility of its policies to the Volcker era of the 1980s. We show empirically that public communication is an important element in understanding the conduct of German monetary policy. It can serve to signal monetary policy intentions and influence expectations. By implication, this type of "open mouth operation", if successful, can also enhance a central bank's credibility or help maintain its reputation.

Although there is a small but important literature on the subject of how central banks communicate with the public, it is largely theoretical. Our main conclusion is that communication with the public acts as an instrument of monetary policy. We document such a result via the estimation of reaction functions for the Bundesbank that include a variable proxying communication by central bank officials. In demonstrating this result we construct a novel data set.

The paper is organized as follows. The next section briefly describes the conduct of monetary policy at the Bundesbank, and the role of communication with the public and government. Section 3 develops a forward-looking reaction function for the Bundesbank that incorporates a role for public communication. We argue that a separate reaction function for public communication by central bank officials serves to supplement a standard type of reaction function. We also examine, in so far as it is possible, the potential role of using real-time data in this context. Section 4 discusses the data and the choice of instruments used to implement the GMM estimation approach. The empirical evidence is discussed in Section 5. The conclusions summarize our results and its implications for the conduct of monetary policy more generally.

[1] As this is written, the topic is gaining more recognition. See, for example, Blinder et al. (2001), Cecchetti (2003) and Fracasso et al. (2003).