North American Journal of Economics and Finance 19 (2008) 93–108

Contents lists available at ScienceDirect

North American Journal of Economics and Finance

Inflation expectations of experts and ECB communication

Katrin Ullrich*

European Economic Research (ZEW) Mannheim, 'WIN-Kolleg' of the Heidelberg Academy of Sciences, P.O. Box 10 34 43, D-68034 Mannheim, Germany

ARTICLE INFO

Article history:
Available online 28 March 2008

JEL classification:
E52
E58
D83
D84

Keywords:
Inflation expectations formation
Central bank communication
Carlson–Parkin method
Survey expectations

ABSTRACT

The communication policy of the European Central Bank (ECB) attracts a lot of attention from financial markets. This paper analyses the informational content of the monthly introductory statements of the ECB president explaining interest rate decisions with regard to inflation expectations of financial market experts for the euro area from February 1999 to July 2006. Tests were conducted for the influence of ECB communication on expectations formation besides other macroeconomic variables. As the results indicate, the indicator measuring the informational content of ECB rhetoric contributes to the explanation of inflation expectations formation.

1. Introduction

The transparency of monetary policy and the communication policy of central banks are gaining weight in discussions about good monetary policy because both measures affect the effectiveness of monetary policy by providing information for the public. The assumption is that a heightened transparency increases monetary policy effectiveness. If interest rates are close to zero, e.g., the leeway for actual policy decisions will be limited and communication would play an important role in influencing expectations. Also, under normal circumstances, transparency helps to improve the transmission of monetary policy impulses. An increased transparency enables financial markets to interpret the monetary signals of the central bank in a correct manner, because it provides markets with the necessary information and the possibility to learn the strategy of the central bank, the interpretation of a changing economic environment by the bank, and the respective policy reactions. In this manner, the central

* Tel.: +49 612 1235 145; fax: +49 612 1235 223.
E-mail address: ullrich@zew.de.

1062-9408/$ – see front matter © 2008 Published by Elsevier Inc.
doi:10.1016/j.najef.2008.03.002

bank influences expectations formation by private agents. Moreover, the ability to influence expectations provides the link between the short-term interest rate, which the central bank can influence more or less directly, and the long-term interest rates, asset prices, and exchange rates. Furthermore, inflation expectations play a crucial role in determining wage and price setting.

We investigate the influence of the ECB communication on the inflation expectations of experts. To measure the informational content of communication, we concentrate on the ECB press conferences following the Governing Council meetings where decisions about the interest rate are taken. These statements are complemented by analysing the editorial of the ECB *Monthly Bulletins* in months where no statement was given. To measure the informational content of ECB statements, an updated version of the wording indicator of Heinemann and Ullrich (2005) is used. We assume that the statements and the *Monthly Bulletins* are sources of information that are intended for the informed public—central bank watchers in the broader sense. Since financial market experts watch the central bank very closely, we would expect that an influence on their expectations formation is more likely than an influence on expectations of, e.g., consumers. If an effect takes place, we could argue that ECB communication must at least influence the informed public and that ECB wording differs from noise.

To measure expert inflation expectations, we use data from the ZEW Financial Markets Test. The qualitative answers of experts with regard to the development of inflation in the following 6 months are transformed into quantitative inflation expectations using the standard Carlson–Parkin method with asymmetric thresholds which are also results from the survey. To investigate the influence of the wording indicator we rely on two approaches. First, we estimate the influence of the indicator on the difference between inflation and inflation expectations. The estimation equation is based on a theoretical setup that relies on a model by Svensson (2003) explaining why communication should have an impact on the gap between the two variables. In a second approach, we explicitly model expectations formation as partly forward-looking and partly backward-looking. For the forward-looking part, we use a set of explanatory variables including the wording indicator to capture the influence of different macroeconomic variables on inflation expectations.

The estimation results allow for the conclusion that the ECB statements given at the press conferences following the interest rate decisions influence inflation expectations of experts. If the rhetoric is rather hawkish, communicating concern about inflation risks, this induces financial market experts to adjust inflation expectations with a 6-month horizon upwards. At the same time, the decisions of the ECB do not seem to have an impact on expectations formation. Most probably the time horizon of 6 months is to short to capture effects of interest rate decisions on inflation and therefore inflation expectations.

We proceed as follows: first, we give a short motivation arising from gaps in the existing literature regarding communication of the ECB. Next, the two crucial time series, inflation expectations and the wording indicator to measure the informational content of ECB rhetoric are introduced. There is a broad theoretical literature taking into account transparency, but a common model to include communication seems to be missing to our knowledge. Therefore, we use the model of Svensson (2003) to develop a rationale for the effects of communication on inflation expectations in the fourth section. The theoretical results built the basis for the estimation approach. The fifth section deals with the explicit expectations formation and the respective estimation results. The last section concludes.

2. Motivation

The literature concerned with economic transparency does not provide an unambiguous answer to the question regarding the advantages of economic transparency. Depending on the target of transparency and the modelling framework, especially the assumed transmission mechanism, proposals for more or less transparency have emerged from the literature (Geraats, 2002). However, there is a rapidly growing amount of empirical literature investigating the influence of communication in different areas of financial markets.

One strand of the literature deals with the influence on the exchange rate (e.g., Jansen & de Haan, 2003 and the papers cited therein, Jansen & de Haan, 2005), and, more generally, on financial markets and the predictability of monetary policy decisions (Bernoth, 2004; Gaspar, Quiros, & Sicilia, 2001;