ARTICLES

COMMUNICATING MONETARY POLICY TO FINANCIAL MARKETS

Communication with the general public and financial markets is crucial for any central bank because it can help to enhance the effectiveness and credibility of monetary policy. This article reviews the main effects of the ECB's external communication on monetary policy, with a focus on expert audiences in financial markets and the media. The ECB has published its monetary policy strategy – i.e. a quantitative definition of price stability and a two-pillar approach for the analysis of the risks to price stability – since the very start in October 1998. In doing so, it laid the foundation for a high degree of credibility and emphasised its commitment to being open and transparent. Consequently, the strategy has contributed to the successful anchoring of inflation expectations at levels consistent with the ECB's definition of price stability. The introductory statement at the monthly press conference is the principal vehicle of the ECB's communication. It explains in depth the monetary policy decisions taken, it conveys the collective view of the Governing Council on the monetary policy stance in real time and attracts substantial interest from financial market participants, while at the same time reaching out to a wider audience through the media. The Monthly Bulletin provides a more detailed and comprehensive economic, financial and monetary analysis one week after the first Governing Council meeting each month. Furthermore, the members of the Governing Council give interviews and speeches to many different audiences during the inter-meeting period, explaining the decisions taken and commenting on topics within the ECB's sphere of competence. Overall, empirical evidence confirms that the ECB's open and timely communication on its objectives, strategy and assessment of the economic outlook has been reflected in a high level of predictability for its monetary policy decisions. Moreover, reduced market volatility in recent years supports the view that the understanding of the ECB's monetary policy framework and its communication has improved over time.

1 INTRODUCTION

Communication is fundamental to central bank transparency. Along with, and partially as a result of, the recent trend towards worldwide central bank independence, transparency regarding monetary policy is nowadays considered best practice in central banking.[1] This has been triggered by the corresponding need for greater accountability of independent central banks as well as increasing awareness that transparency and openness can enhance the effectiveness of monetary policy. Accordingly, central banks are now placing more emphasis on communicating directly with the public than in the past. In turn, this has affected all facets of communication, such as the announcement and clarification (and often quantification) of a central bank's objectives, the announcement and explanation of monetary policy decisions and the communication of the central bank's current assessment of the economic situation and its outlook.

While the ECB communicates with a large number of target groups, such as the general public, political bodies and organisations, financial markets and the media, this article will focus on the impact of standard channels of monetary policy communication with expert audiences in financial markets and the media. The main purpose of this article is to give an account of the role of such communication as a device to enhance the overall effectiveness of monetary policy. Section 2 discusses this issue from a conceptual perspective. On the one hand, since uncertainty on the part of private agents regarding the workings of the economy and the conduct of monetary policy could entail substantial negative consequences, there are strong arguments in favour of extensive communication. On the other hand, there is a need for consistency between "words and

1 See the article entitled "Transparency in the monetary policy of the ECB" in the November 2002 issue of the ECB Monthly Bulletin.

deeds", and this article draws attention to the limits of central bank communication when there is a risk that central bank views might crowd out private information, as aggregated by financial market prices. Moreover, it outlines the pros and cons of widening the degree of central bank transparency as regards communicating the monetary policy stance and future policy inclinations. Section 3 synthesises the available empirical evidence by, first, looking at the impact of the announcement of a central bank objective on inflation expectations and economic performance, and second, presenting in some detail the financial market impact of specific communication tools. Section 4 summarises the article and concludes.

2 THE EFFECTS OF COMMUNICATION – A CONCEPTUAL BACKGROUND

Central bank transparency and its main instrument, communication, are important for the effectiveness, credibility and also for the predictability of monetary policy. Modern central banks employ a variety of communication channels, such as press conferences, bulletins, speeches or minutes, that aim to enhance the transparency, and hence also the effectiveness, of monetary policy within a well-defined communication strategy. This requires a central bank to provide in an open, clear and timely manner all relevant information on its mandate, strategy and the rationale underlying its policy decisions to the general public and financial markets.

Transparency renders monetary policy more effective for at least two reasons. First, clarity about its mandate and the means of pursuing it helps a central bank to foster credibility. When a central bank is perceived as being able and determined to fulfil its mandate, price expectations are likely to be well anchored. Second, transparency helps market participants to understand the systematic response pattern of monetary policy to economic developments and shocks, thereby making policy decisions more predictable. Predictability is desirable for central banks as it reduces uncertainty about interest rates and thereby facilitates the pricing of assets. A distinction can be made between the notions of short-term and longer-term predictability.[2] Short-term predictability is achieved when financial markets can correctly anticipate a central bank's upcoming monetary policy decisions, while longer-term predictability encompasses the ability of financial market participants and the public to understand the monetary policy framework, i.e. its objectives and consistent pursuit thereof, over time. Longer-term predictability therefore requires a transparent and credible monetary policy strategy. This, in turn, increases the effectiveness of monetary policy by providing guidance to market participants, who are thus able to form expectations about future price developments more accurately.

The solid anchoring of inflation expectations at levels consistent with a central bank's definition of price stability is of critical importance to the conduct of monetary policy. Central banks can directly influence only very short-term interest rates through their monetary policy actions. However, consumption and investment decisions and, ultimately, medium-term price developments, are taken on the basis of inter-temporal considerations that are to a large extent influenced by longer-term interest rates. These, in turn, largely depend on private expectations regarding future central bank decisions and on the public's assessment of a central bank's ability and determination to achieve its objective in the medium to long term. In this sense, high levels of long-term predictability, and hence credibility, are desirable for central banks as this can lead to a more immediate transmission of monetary policy intentions to investment and consumption decisions and thus accelerate the necessary economic adjustments.

Therefore, a high level of longer-term predictability in an evolving macroeconomic environment does not entail communication of

2 See the article entitled "The predictability of the ECB's monetary policy" in the January 2006 issue of the ECB Monthly Bulletin.

the exact timing or size of monetary policy decisions, as these are conditional and cannot be pre-committed. Predictability over those horizons rather depends on the private sector's ability to map the changing economic circumstances into anticipations of a central bank's broad policy direction within a well-defined and credible strategy.

COMMUNICATING THE MONETARY POLICY STRATEGY

To achieve longer-term predictability, it is essential that the central bank is transparent and credible regarding its objective, and that its communication supports the markets' understanding of the systematic response of monetary policy to the changing economic developments.

Without firm guidance on the strategy and the objective of monetary policy, a central bank risks that market participants adjust their longer-term expectations as a mere reflection of current circumstances. For example, without information concerning the central bank's objective, short-term shocks to inflation would likely unsettle expectations and result in a re-appraisal of the inflation rate that the public expects to prevail in the future. This could force the central bank into overly aggressive patterns of reaction to inflationary risks in order to signal its determination to secure price stability.[3] By contrast, precise and consistent communication of the central bank's ultimate objective and the strategy which governs its behaviour in the face of risks that might threaten the achievement of that objective minimises the sensitivity of expectations to short-term shocks. Long-term inflation expectations will remain in line with the central bank's objective and this, in turn, will facilitate the conduct of monetary policy.

In this context, another important task of a central bank is to explain the limits of its mandate and abilities to the public so as to avoid raising false expectations that result in a loss of credibility.[4] Put differently, a central bank should communicate what monetary policy can, and cannot, achieve. For example, given the long and variable lags of monetary policy, the central bank can control inflation only in the medium to longer term and cannot offset short-term changes in the inflation rate that are caused by more volatile components of the price index (e.g. energy and food prices). At the same time, monetary policy cannot directly affect the growth rate of productivity and potential output. It can, however, contribute to creating a favourable macroeconomic environment for consumption and investment decisions by delivering low and stable inflation, thereby reducing overall uncertainty in the economy. Hence, through effective and consistent communication on its monetary policy strategy, objectives and constraints, the central bank can reduce the costs associated with such uncertainty for consumers and investors, and promote economic growth and welfare.

On this score, the publication of the ECB's monetary policy strategy in October 1998, i.e. the quantitative definition of price stability to be maintained over the medium term and a two-pillar approach to the analysis of the risks to price stability, constituted the basis for open and consistent communication in the years thereafter.[5] The thorough evaluation of the ECB's strategy in May 2003 led to a further clarification of these key elements and facilitated the future communication and understanding of the ECB's monetary policy strategy. In particular, the Governing Council clarified the communication on the cross-checking of information stemming from the monetary and economic analysis in coming to its unified overall judgement on the risks to price stability.

3 See Orphanides A., and J. Williams (2002), "Imperfect knowledge, inflation expectations, and monetary policy", in B. Bernanke and M. Woodford (eds.): *The inflation targeting debate,* Chicago: University of Chicago Press, pp. 201-234.

4 See Issing, O. (2005), "Communication, transparency, accountability: Monetary policy in the twenty-first century", Federal Reserve Bank of St. Louis Review, March/April 2005, pp. 65-83.

5 See the article entitled "The external communication of the European Central Bank" in the February 2001 issue of the ECB Monthly Bulletin.

In this sense, the strategy has served both as a framework for the policy discussions in the decision-making bodies and, at the same time, as a vehicle for explaining the conduct of monetary policy to the public. From the start, it has helped to ensure consistency between internal analysis and external communication, which is the essence of transparency. Moreover, the quantitative definition of price stability also serves the purpose of accountability by setting a benchmark against which the ECB's performance in maintaining price stability can be measured.[6]

Importantly, by formulating the overriding objective of monetary policy in quantitative terms and announcing an explicit monetary policy strategy, the ECB has provided the basis for market participants to form expectations more efficiently. As a consequence, both survey and market-based medium to long-term inflation expectations in the euro area have remained relatively well anchored at levels consistent with the ECB's quantitative objective, even at times in which inflation outturns were subject to temporary volatility introduced by adverse shocks on the supply and demand side.

COMMUNICATING THE MONETARY POLICY STANCE

In an environment of incomplete information on the state of the economy and its functioning, genuine understanding of the central bank's strategy and objective is a necessary, but insufficient, condition for market participants to form pertinent expectations regarding the future course of monetary policy. Discrepancies between the expectations of the private sector and those of the central bank may emerge at any point in time because of differences in the interpretation and assessment of the state of the economy and the associated policy reactions. Central banks therefore make considerable efforts to explain the economic rationale underlying monetary policy decisions by providing detailed and comprehensive analyses of the current economic and monetary conditions and their conditional expectations of the most likely evolution of the economy in the future. In doing so, the central bank combines its interpretation of the most recent evidence with its assessment of the implications of the prevailing state of the economy for the strategic direction of monetary policy. Based on such explanations, observers can continuously develop a deeper understanding of the systematic behaviour of monetary policy, resulting in a high level of short and long-term predictability.

This high level of transparency and predictability notwithstanding, central banks face ever increasing demands for further indications about future monetary policy inclinations. It is claimed that this can reduce risk and volatility in financial markets and allow for a smoother adjustment of the economy and the money market, in particular, to policy rate changes. Also, it may reduce the complexity of explaining the process of monetary policy-making.[7] In practice, central banks make use of different types of forward guidance that may change over time and largely depend on the monetary policy strategy and the state of the economy. Three types of forward guidance can be broadly distinguished. First, a central bank may provide qualitative indications that entail the use of implicit forward-looking language to financial markets on the future direction of monetary policy in its external communication. These conditional indications are mainly provided through the comprehensive explanation of economic and monetary developments and the assessment of their likely implications for the objective of price stability in the medium-term future. Second, a central bank may issue bias statements or balance of risk assessments that provide indirect guidance about the likely future policy direction conditional on the available information. Finally, central banks can provide conditional inflation forecasts, constructed around a specific assumption for future short-term interest rates, or publish a quantified path for the evolution of short-term interest rates consistent with their internal projection exercise.

6 See the article entitled "The accountability of the ECB" in the November 2002 issue of the ECB Monthly Bulletin.
7 See Woodford, M. (2005), "Central bank communication and policy effectiveness", NBER Working Paper No 11898.

A number of risks are also associated with these various types of forward guidance. For example, financial market participants and the public may perceive the indications as a quasi-promise or a high degree of commitment, failing to understand the conditionality of the sequence of short-term rates that is signalled.[8] If a central bank is forced to act in a manner contrary to what it had previously indicated, in response to new incoming information and a reassessment of the state of the economy, this may be viewed as a failure of the central bank and may harm its reputation and credibility, even though the central bank may have convincing arguments to justify its reassessment of the underlying economic conditions. Furthermore, a central bank may face a trade-off between managing market expectations and learning from them.[9] Market-based measures of growth and inflation expectations serve as important cross-checks of monetary policy in the central bank's assessment of the state of the economy and its likely future evolution. By providing direct forward guidance on the future path of policy rates, central banks risk reducing the value of these indicators as an independent source of information.

The central bank therefore has to choose an appropriate communication strategy, and, in particular, the degree of explicit forward guidance in the light of its assessment of the impact of communication on the efficiency of monetary policy. Communication is by itself insufficient to ensure a lasting impact on the formation of expectations by financial market participants. Ultimately, guiding interest rate expectations requires not only forward-looking communication, but also consistency between "words and deeds" and a track record of monetary policy decisions that supports the central bank's credibility. Furthermore, forward guidance should be designed so as not to discourage a fundamental activity undertaken in financial markets, namely an ongoing refinement of financial markets' understanding of the systematic pattern by which monetary policy reacts to different economic and monetary conditions. Finally, in some circumstances, central bank communication may result in a crowding-out of private information. This may, at least temporarily, hinder the extraction of meaningful signals from financial market indicators that usually feed back into the monetary policy-making process.[10]

3 EMPIRICAL EVIDENCE ON THE EFFECTS OF COMMUNICATION

The conceptual considerations outlined in the preceding section have highlighted a number of potential gains that can arise from clear and transparent communication. Whether these gains do indeed materialise remains, however, an empirical issue. This section synthesises the available empirical evidence by, first, looking at the impact of the announcement of a central bank's objective and strategy on inflation expectations and economic performance, and second, presenting in some detail the financial market impact of selected ECB communication tools.

3.1 COMMUNICATING THE MONETARY POLICY OBJECTIVE AND STRATEGY

As mentioned in Section 2, the adoption and announcement of the monetary policy strategy and policy objectives constitutes in itself a major step towards monetary policy transparency. In particular, the announcement of a quantitative definition of price stability provides a clear and measurable yardstick against which the central bank can be held accountable and, at the same time, provides guidance to the public so that expectations of future price developments can be formed more efficiently and accurately. In practice, a majority of industrialised countries have either adopted

8 See Goodhart, C.A.E. (2001), "Monetary transmission lags and the formulation of the policy decision on interest rates", Federal Reserve Bank of St. Louis Economic Review, July/August 2001, pp. 165-182.

9 See Morris, S. and H. Shin (2002), "Social value of public information", American Economic Review 92(5), pp.1521-1534.

10 Amato, J., Morris, S. and H. Shin (2002), "Communication and monetary policy", Oxford Review of Economic Policy, Vol. 18, No 4, pp. 495-503.

some form of inflation targeting or, most notably for the ECB, provided a precise quantitative definition of price stability as a key element of its monetary policy framework.

There is compelling empirical evidence that inflation expectations are indeed affected by the announcement of a quantitative definition of price stability, lending support to the idea that a clear and transparent objective can serve as a focal point for agents' inflation expectations. Central banks have established a good track record in that regard. In fact, empirical findings confirm that the precise definition of price stability, or the announcement of an inflation target, lowers inflation expectations. Moreover, inflation expectations are no longer correlated with past inflation and, at the same time, tend not to react to macroeconomic news.[11] The empirical evidence thus clearly suggests that a clear and transparent objective helps to anchor inflation expectations at levels consistent with the central bank's definition of price stability.

However, this does not automatically imply that there will also be an effect on current inflation and its dynamics. Again, this question needs to be settled empirically. In cross-country analyses, it has been found that the existence of a quantified objective has a measurable impact on inflation outcomes. In that regard, it is primarily the quantification of the objective that matters, more than its exact form. While quantified monetary or exchange rate objectives also tend to lower actual inflation, the largest effects were found for central banks that announced a precise definition of price stability. Moreover, inflation has not only been found to be lower, it is also significantly less affected by its past values in the presence of a quantified definition of price stability.[12]

In short, the empirical evidence strongly suggests that the announcement and, in particular, the quantification of a central bank's objective is beneficial, since it eases the conduct of monetary policy through its effect on private agents' expectations and helps to achieve sound macroeconomic outcomes. The successful anchoring of inflation expectations by the ECB is a case in point: the publication of the ECB's monetary policy strategy, containing a quantitative definition of price stability and a two-pillar approach for the analysis of the risks to price stability, has evidently served as a focal point for inflation expectations.[13]

3.2 COMMUNICATING THE MONETARY POLICY STANCE

It is impossible for a central bank to communicate *ex ante* all contingencies in such a way that the public can always deduce perfectly the central bank's assessment just by interpreting the incoming macroeconomic data. Hence, even if a central bank's monetary policy objective and its strategy are generally well understood, it must still regularly communicate its assessment of the current economic situation and the monetary policy stance.

The effects of such communication can best be analysed by means of financial market reactions, for three reasons. First, financial market participants are likely to attach importance to this type of communication, as the information conveyed might allow them to fine-tune their market positions taken in expectation of upcoming monetary policy decisions. Second, financial markets show timely and speedy reactions, which allows a response pattern to be identified in empirical analyses. Third, intra-day high frequency data allows the financial

11 See Johnson, D. (2002), "The effect of inflation targeting on the behavior of expected inflation: evidence from an 11 country panel", Journal of Monetary Economics 49, pp. 1521-1538; Levin, A. T., F. M. Natalucci and J. M. Piger (2004), "Explicit inflation objectives and macroeconomic outcomes", ECB Working Paper No 383 and Gürkaynak, R., A. Levin, and E. Swanson (2006), "Does inflation targeting anchor long-run inflation expectations? Evidence from long-term bond yields in the US, UK and Sweden", Federal Reserve Bank of San Francisco Working Paper No 2006-09.

12 See Fatas, A., Mihov, I. and A. Rose (2007), "Quantitative goals for monetary policy", forthcoming, Journal of Money, Credit and Banking; Levin, A. T., F. M. Natalucci and J. M. Piger (2004), "Explicit inflation objectives and macroeconomic outcomes", ECB Working Paper No 383.

13 For a comprehensive overview of the various measures of inflation expectations available for the euro area and their performance, see the article entitled "Measures of inflation expectations" in the July 2006 issue of the ECB Monthly Bulletin.

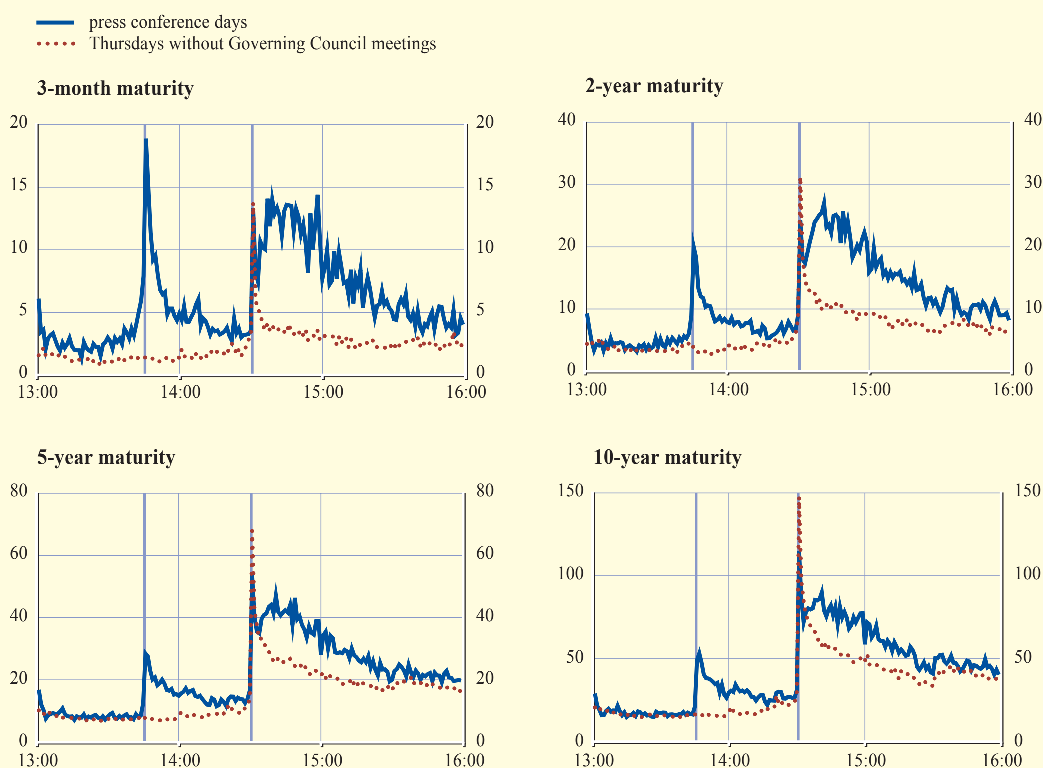
market impact of the communication to be isolated. As a consequence, studying the effects of central banks' communication on the monetary policy stance is closely related to measuring the predictability of monetary policy decisions. However, at the same time, the effectiveness of communication is difficult to judge using this approach. Financial market reactions can be triggered through effective as well as ineffective communication. In the former case, information would be conveyed properly and as intended, whereas in the latter, communication would mainly result in increasing volatility in financial markets. It is therefore important to bear in mind that the effects of central bank communication on financial markets can be interpreted differently when it comes to measuring effectiveness.

From a conceptual point of view, it is possible and useful to distinguish various types of communication containing the central bank's regular assessment of economic conditions, such as announcements and explanations of a given monetary policy decision on the days of the Governing Council meetings, information provided during the inter-meeting period, and the communication of the Governing Council's policy inclinations.

ANNOUNCEMENT AND EXPLANATION OF MONETARY POLICY DECISIONS

It is common practice among central banks to inform the public about monetary policy decisions as soon as they have been taken. While most central banks also provide same-day explanations for a given decision, they do

Chart 1 Average number of trades per minute, on press conference days compared with Thursdays without Governing Council meetings, 1999-2006



Source: ECB calculations.
Notes: Thick vertical bars indicate 13:45, the time of the announcement of the monetary policy decision, and 14:30, the beginning of the ECB press conference. 3-month maturity: three-month Euribor futures traded on LIFFE; 2-year maturity: German two-year Schatz futures traded on EUREX; 5-year maturity: German five-year Bobl futures traded on EUREX; 10-year maturity: German ten-year Bund futures traded on EUREX. The marked increase in trading activity at 14:30 on press conference days as well as on other Thursdays is related to the opening of US markets and the weekly release of data on US jobless claims.

so to a different extent, with the ECB's press conference being among the most timely and in-depth approaches. The introductory statement constitutes the principal communication tool in that regard as it conveys the collective view of the ECB's Governing Council on the monetary policy stance in real time. This is followed by a questions and answers session with media representatives.

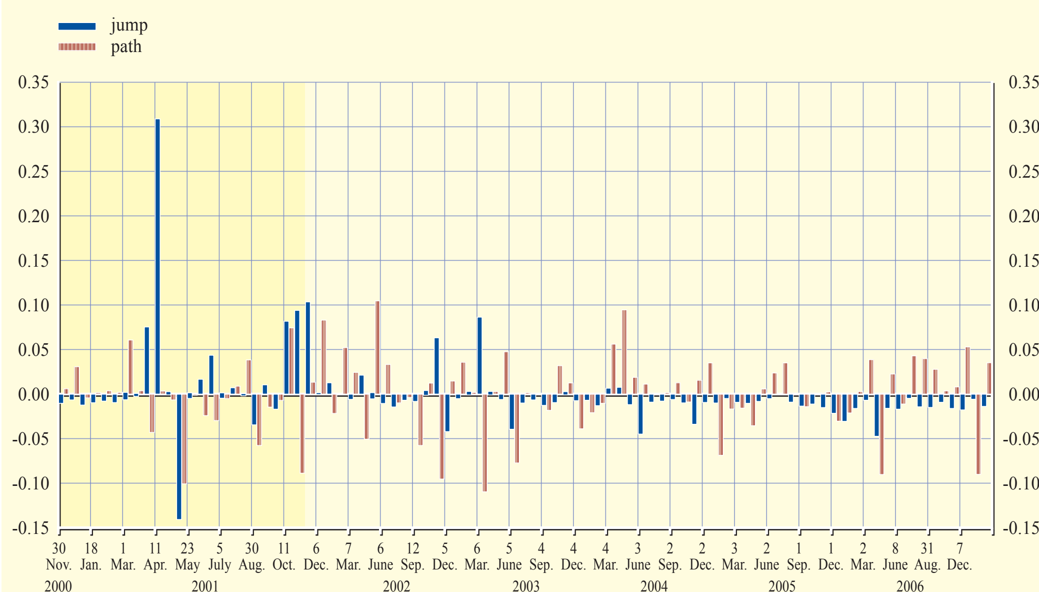
Chart 1 shows trading activity on a number of futures markets in a time window ranging from 13:00 to 16:00 on the days of the monthly press conference (blue line) and on Thursdays (i.e. the same days of the week) without Governing Council meetings (red dotted line), expressed as averages per minute over the time period 1999-2006.[14] It is apparent that trading rises markedly in response to the announcement of the monetary policy decision at 13:45, but also during the time window of the press conference, i.e. in the time after 14:30. This figure gives a first indication that both the announcement of the decision and the related communication provide news to financial markets.

This indication is corroborated if one separates "jump news" and "path news" contained in the ECB's communication on Governing Council meeting days, as can be seen in Chart 2. Jump news indicates the degree to which a given monetary policy decision has led to financial market reactions, based on changes in the short-end of the money market yield curve (around one month out). A positive (negative) indicator in Chart 2 implies that short-term money market rates were increasing (decreasing) on Governing Council meeting days; the size of the indicator corresponds to the magnitude of the market reaction. Path news, instead, is based on changes in the medium-term segment of the money market yield curve (at a time horizon of about half a year or more), which are unexplained

14 For related evidence, see Andersson, M. (2007), "Using intraday data to gauge financial market responses to Fed and ECB monetary policy decisions", ECB Working Paper No 726.

Chart 2 Decomposition of changes in the money market yield curve on Governing Council meeting days

(percentages per annum)



Source: Brand, C., D. Buncic and J. Turunen (2006), "The impact of ECB monetary policy decisions and communication on the yield curve", ECB Working Paper No 657.
Notes: Shaded area indicates fortnightly meeting frequency, except for the meeting on 30 August 2001 where there were four weeks between consecutive meetings. The indicators are statistical measures constructed on the basis of changes in the money market forward rate curve on Governing Council meeting days.

by changes in expectations at short horizons. Such changes reflect revisions of the expected path of monetary policy in the medium term. Interestingly, the path news is closely related to market movements during the ECB press conference, suggesting that the communication surrounding the announcement of the decision may result in significant changes in market expectations regarding the path of monetary policy. Chart 2 clearly indicates that surprises about monetary policy decisions, as proxied by the jump news, have considerably decreased over time, thus leaving a larger role for the forward-looking part of the communication.

This evidence suggests that financial markets react to the ECB press conference. As the press conference targets the general media in addition to financial markets and financial newswire services, an interesting question relates to how it is reflected in the media, in particular because this allows the ECB communication to reach a wider audience. Quantitative analysis of press reporting in response to the ECB press conference based on a sample of 57 international and national newspapers shows that, on average, reporting is extensive, yet subject to substantial variation. Most of the variation in the reporting is found over time, and can be explained by the characteristics of the monetary policy decision, market expectations and reactions as well as the macroeconomic environment.[15]

COMMUNICATION DURING THE INTER-MEETING PERIOD

Even though the ECB's press conference is the most important communication channel for the explanation of monetary policy decisions and the communication of the ECB's current assessment of the economic situation and the monetary policy stance, further information is provided during the inter-meeting period by means of speeches, interviews and public statements. The table reveals that speeches and interviews by Governing Council members have the potential to affect interest rates throughout almost the entire maturity spectrum, from very short maturities up to 5-year rates. If they are perceived by the markets as including statements suggesting a policy tightening inclination, they lead to increasing rates, and if perceived as suggesting an easing inclination, they lead to lower rates. Given that the evidence is based on a selected set of speeches and interviews that are more likely to move financial markets,[16] the effects portrayed in the table appear particularly sizable, with statements moving three-month to five-year interest rates on average by 1.5-2.5 basis points.

A guiding principle in this kind of communication by Governing Council members is the "single voice" policy, whereby the views expressed are those of the Governing Council as a whole. The adoption of this principle was originally based on conceptual considerations, whereby a collegial communication can provide greater clarity and common understanding among the public. The importance of this policy has recently been supported by international comparative empirical evidence, which has established that the predictability of monetary policy decisions, as well as market volatility,

Market reaction of euro area interest rates to speeches and interviews by Governing Council members (1999-2004)

(basis points)

3-month interest rates	2.05 1)
6-month interest rates	1.57 1)
1-year interest rates	2.47 1)
2-year interest rates	2.48 1)
5-year interest rates	1.96 1)
10-year interest rates	0.61
20-year interest rates	0.44

Source: Ehrmann, M. and M. Fratzscher (2005), "Communication and decision-making by central bank committees: different strategies, same effectiveness?", ECB Working Paper No 488, forthcoming, Journal of Money, Credit and Banking.
Notes: The table shows the response of interest rates in basis points to speeches and interviews given by Governing Council members. Based on daily data.
1) Denotes statistical significance at the 99% level.

15 For more details see Berger, H., M. Ehrmann, and M. Fratzscher (2006), "Monetary policy in the media", ECB Working Paper No 679.

16 The selected statements have been reported upon by financial newswires and contain the words "interest rates", "inflation" or "monetary policy". Furthermore, they are included only if they are forward-looking.

are affected by more divergent communication among central bank committee members. Controlling for the degree of market uncertainty and macroeconomic uncertainty (both of which might have an independent effect on the degree to which a particular policy decision is predictable), it is found that more divergent communication of central bank committee members worsens the ability of financial markets to anticipate future monetary policy decisions and raises the degree of market uncertainty.[17]

COMMUNICATION OF POLICY INTENTIONS

As mentioned in Section 2, central banks may at times find it desirable to give forward guidance to financial markets about their future policy intentions. Examples are turning points in monetary policy, such as the recent adjustment phase, which started in December 2005, after the extended period of stable policy rates, as these pose a particular challenge to monetary policy and to financial markets. In that regard, the ECB has followed a pragmatic and flexible approach. By taking into account the specific context in which monetary policy operated, the ECB gave implicit guidance to the markets in the shorter term, without pre-committing and compromising on its flexibility with regard to future policy decisions. Also, the ECB has stated that future policy decisions are always conditional on the outcome of the ECB's regular economic and monetary analyses.

As can be seen from the minor magnitude of jump and path news lately (see Chart 2), a review of the recent experience indicates that, overall, the ECB's communication approach continued to support a high level of short-term predictability, with overall market uncertainty about the future path of policy rates reaching a rather low level by historical standards. This also supports the view that the understanding of the ECB's monetary policy framework and its communication has improved over time.

4 CONCLUSION

Communication is an integral part of monetary policy. Effective communication contributes considerably to the effectiveness, credibility and predictability of monetary policy. This helps to reduce inflation uncertainty and thereby to secure a solid anchoring of inflation expectations. From the start, the ECB has been open and transparent regarding its monetary policy strategy and objective, clear about its definition of price stability and predictable in its decisions. The monthly press conference, particularly with its introductory statement, provides a detailed and timely explanation of its monetary policy decisions and is structured along the lines of the ECB's monetary policy strategy. It conveys the collective view of the ECB's Governing Council on the monetary policy stance in real time, thus avoiding the risk that a delay in the announcement of the thinking and views underlying policy decisions could affect market participants and increase volatility.

Empirical evidence confirms that the publication of the ECB's monetary policy strategy, comprising a quantitative definition of price stability and a two-pillar approach for the analysis of the risks to price stability, has supported the successful anchoring of inflation expectations in the euro area. Central banks with quantified objectives and sound strategies manage to anchor inflation expectations more firmly. The practice of announcing and explaining monetary policy decisions as soon as they have been taken has been found to improve the market's understanding of monetary policy and make policy implementation more efficient. With highly predictable central banks, the main market effects on announcement days, particularly in the longer-term segments of the yield curve, arise less from the announcement of the decision and more from the related communication.

17 See Ehrmann, M. and M. Fratzscher (2005), "How should central banks communicate?", ECB Working Paper No 557.

As regards speeches and interviews, these have the potential to affect interest rates throughout almost the entire maturity spectrum. Empirical evidence has also confirmed the benefits that stem from the "single voice" principle adopted by the Governing Council. It has been found that more divergent communication by decision-makers reduces the ability of financial markets to anticipate future monetary policy decisions and raises the degree of market uncertainty.

Finally, through the flexible use of implicit forward language in its regular economic and monetary assessment, the ECB has managed to give implicit guidance on its inclinations over very short horizons, while avoiding any kind of pre-commitment with regard to future policy decisions and enhancing financial market participants' understanding of the ECB's broad policy direction.