Communication Tool in Central Banking. Increasing its Role for the New Reality

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Abstract

The central banks started to give more importance to their communication with the public even before the onset of the global financial crisis, but the use of this complementary instrument of monetary policy intensified significantly both during the period of the financial crisis, and during the post-crisis period. While the communication policy was essential during the financial crisis, it is no less important in the post-crisis period characterized by several challenges and by the increasing incertitude about the evolution of the economy. The paper shows the way in which the central banks consider their communication policy with the public and with the market during the post-crisis period, highlighting that the challenges facing recently these institutions require refining and expanding the communication instruments.

Key words: complementary instrument of monetary policy, communication policy, financial crisis
J.E.L. classification: E52, E58

1. Introduction

In order to maximize their discretionary authority, the central banks did not communicate very detailed their intentions at first, but they subsequently noticed that the anticipation of the public reactions was one of the main instruments that can improve de efficiency of the central bank's policy. Therefore, the decisions and communication with the public of an increasing number of central banks are data dependent.

An efficient communication policy presumes a high level of central bank credibility, while sending messages that can be poorly understood or messages that leave room for interpretations can yield adverse effects and unexpected reactions of the market – not just "surprises" from the policy, but also from the market. By communication, the central bank provides essential information to the market and public, orienting their further decisions.

Most central banks publications focus not just on the description of the problems pertaining to the monetary policy, but also provide data and analysis on the overall economic situation, including the international evolutions (Criste and Lupu, 2015a).

Due to credibility reasons and assumed responsibility, the central banks cannot make statements that are not true, but they can be selective about the information they issue, particularly when the objectives of the central bank are not fully in line with those of the market actors, or even with those of the government.

Besides the classical ways of communication (press releases and press conferences) and the newer ones (forward guidance), the central banks are frequently communicating with the market through price and production predictions in order to reduce the incertitude and the possible errors that the public can make regarding the forecasts and the interpretation of the future policies.

2. Forward Guidance – communication of the perspectives and intentions of the central bank

At the beginning of the post-crisis period, the monetary authorities from the advanced countries aggressively reduced the interest rate for the monetary policy and used several nonconventional measures to correct the financial problems and to support the economy (Criste and Lupu, 2015b). Gradually, the unconventional measures expanded the operational monetary policy framework as the monetary policy interest rate area of manoeuvre narrowed (zero lower bound).

Initially, these unconventional measures were quantitative easing (changes of central bank portfolio size) and qualitative easing (changes in the central bank portfolio structure). The qualitative easing was meant to support certain segments of the asset market that were not efficiently functioning, while the quantitative easing relied on the idea that the increase of the central bank balance itself will support the aggregate demand. The efficacy of these measures is not yet sufficiently clear, which is why many central banks introduced a further unconventional instrument – the forward guidance. It relies mostly on a more intense communication of the central bank with the market in order to form market expectations about maintaining lower interest rates for a specific period, which reduced the medium- and long-term interest rates.

The forward guidance presumes a high level of central bank's credibility and a higher specialization in quantitative evaluations and prognosis of the macroeconomic and financial variables. De Graeve et al (2014) highlight that the effects of using this instrument, measured by event studies, of decreasing the nominal interest rate in the long run, should be interpreted with caution, since forward guidance announcements are many times combined with other unconventional measures of monetary policy.

During the post-crisis period, some central banks used different forms of forward guidance, under zero lower bound conditions (Charbonneau and Rennison, 2015). For instance, the Bank of Canada and the Fed maintained the interest rate at a specific level for a period of time (see Table no. 1), while other central banks (Bank of England and also Fed) preferred to maintain the interest rate at a particular level until a specific event occurred or until meeting specific conditions.

Table no. 1 Forward guidance measures adopted during the post-crisis period

Central banks	Type of forward guidance	Sent messages
Federal Reserve	• Time contingent, qualitative	• 2009: the interest rate will be kept at low level for a longer period
	• Time contingent, quantitative	• 2011: the interest rate will be kept at low level at least until mid-2013
	• Condition dependent, qualitative	• 2012: the interest rate will be maintained at least until unemployment remains above 6.5%; the forecast inflation for the next 1-2 years must not exceed 2.5%; the long-term inflationist expectations continue to be properly anchored • 2013: the interest rate will be maintained even after unemployment decreases below 6.5%, particularly if the forecast inflation continues to be below the 2% target
Bank of Canada	• Time contingent, quantitative	• 2009: maintaining the interest rate at 0.25 pp up to a specific date, depending on the perspective of inflation
European Central Bank	• Time contingent, quantitative	• 2013: the key-interest rate is expected to be maintained or reduced for a long period of time
Czech National Bank	• Time contingent, quantitative	• 2013: maintaining the interest rate at minim level (technically, zero) for a long period, until the pressure of inflation increases significantly
Bank of Japan	• Condition dependent, qualitative	• 2012: maintaining the interest rate at zero until the objective of annual 2% Consumer Price Index target becomes "visible"
	• Condition dependent, quantitative	• 2013: accomplishing the price stability objective, with 2% target, as soon as possible, in a time horizon of 2 years

Central banks	Type of forward guidance	Sent messages
Bank of England	• Condition dependent, qualitative	• 2013: the interest rate will be maintained until unemployment falls to 7%. The purchase of assets might increase as long as the unemployment rate is above 7%. The stock of purchased assets will be maintained until the 7% target is reached.
	• Condition dependent, quantitative	• 2014: unemployment must decrease further before increasing the interest rate
Sveriges Bank	• Time contingent, quantitative	• 2009-2010: maintain the interest rate at a low level until the fall of 2010
	• Publishing the forecasts for the interest rate	• 2013-2014: supplying guiding information on the evolution of the interest rate

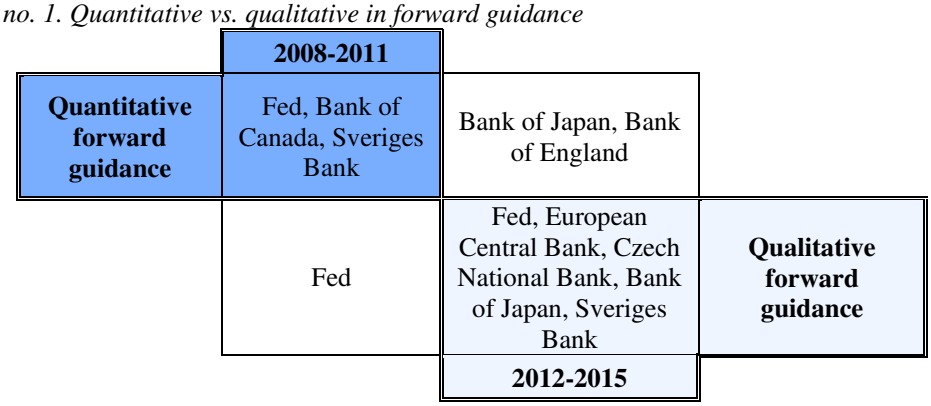
Source: processing the information from the annual reports of the central banks

The *forward guidance* policy tends to become a standard and permanent instrument of the monetary policy framework during the post-crisis period, particularly for those central banks which have inflation targeting as nominal anchor and which publish the expected path of the interest rate for the subsequent period. However, the mechanism of transmitting this decision is, yet, not fully studied and known.

3. Qualitative, time contingent and state contingent

The quantitative type of forward guidance measures such as time contingent or set interest rate levels (use of numeric information) dominated in the early post-crisis period, while the qualitative measures predominated in the second part, after 2013 (see Figure no. 1), associating adjectives such as "stable", "significant", "considerable", to some macroeconomic variables, what reflects the cautionary conduit of the central banks under conditions of incertitude.

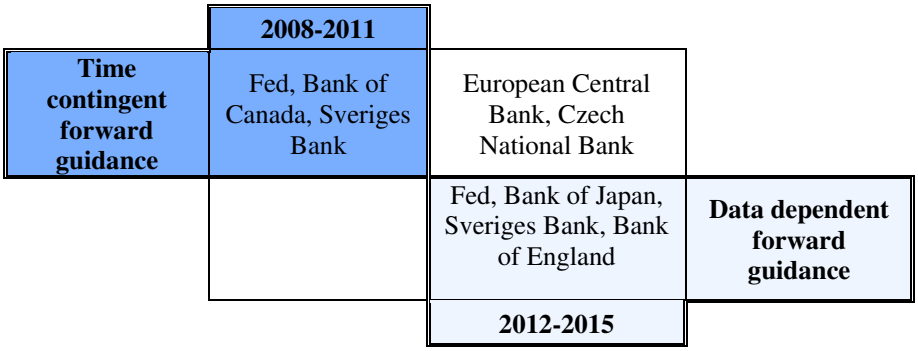
Figure no. 1. Quantitative vs. qualitative in forward guidance



Source: authors' representation, based on central banks reports

From another perspective, the forward guidance policy may be communicated either specifying a particular time horizon to maintain the monetary policy interest rate (the so-called time contingent forward guidance), or considering the economic situation and the evolution of the macroeconomic variables in the subsequent period. The central banks which use forward guidance intensified the latter variant in the post-crisis period, after 2012, the stress shifting thus from the concrete approach, with specified moments in time, to a data dependent approach depending on the evolution of particular macroeconomic variables (see Figure no. 2).

Figure no. 2. Time contingent forward guidance vs. data dependent forward guidance during the post-crisis period



Source: authors' representation, based on central banks reports

The credible formulation of the forward guidance announcements, showing their contingency, based on the forecast economic situation, designs a more stable and predictable macroeconomic environment, thus avoiding risks generated by the "uncertain" environment, while the communication policy of the central bank might be more readily applicable, focusing on the evolution of the medium- and long-term nominal interest rates.

4. Publication of the forecasted interest rate trajectory

The communication policy becomes important for the future because it is the instrument used to communicate the prognoses developed by the central bank on the macroeconomic and financial variables.

The prognoses regarding the macroeconomic variables are a useful instrument for the monetary policy decisions, as the central bank considers more and more the perspective and anticipation. The reason behind the forward looking monetary policy and behind monitoring the medium-term evolution of the macroeconomic variables is given by the existence of lags in the transmission of the monetary policy decisions towards the real economy. The central bank cannot influence the inflation and the current production, but can identify the paths of the variables in the future, thus directing the expectations of the public towards specific targets. Hence, the medium-term prognoses on the interest rate and inflation are many times the basis for the formulation of the monetary policy strategy, and their publication contributes to the anchoring of the public expectations (Hubert, 2011), essential element in the accomplishment of the proposed objectives.

Starting from the monitored objectives and understanding the mechanism of transmission that connects the actions and the objectives, the interest rate forecasts give to the central bank's management the possibility to identify the best path for this instrument of monetary policy. The publication of such forecasts gives more information that contribute to a better alignment of the financial assets' yields with the policy objectives and clarify the concrete implications of the data contingent policy. There are empiric studies (Alichi et al., 2015) supporting the idea that the financial markets adapted better to the post-crisis realities in the countries where the central bank publishes the forecast path of the interest rate using an adequate prognosis pattern.

One of the central banks that recently adopted such a measure is the Czech National Bank that, in 2008, started to publish the forecast path of the interest rate, with intervals of trust. This is a sophisticated form of forward guidance, in agreement with the basic principles of inflation targeting, which increases the transparency of the monetary policy and gives a more concrete variant (based on figures) for the expected interest rate evolution. Such decision came not just because of the post-crisis challenges such as reaching the minimum interest rate level, but also because this central bank is rather advanced in matter of macroeconomic prognoses (Criste, 2015).

Irrespective of the objective targeted by the central bank, the speed of reaction and adaptation to unexpected events is one of the factors that increase the quality of the communication policy. The fast reaction of the central bank, which essentially has a discretionary character, aims to limit the systematic risks from the whole economy. Those who develop the policy try to respond as well as possible, and in a predictable manner, to the events that occur within the macroeconomic

environment (shocks), so that the decisions that are taken are not, by themselves, sources of instability.

Compared to the unconventional instrument of data dependent forward guidance, which operates on the basis of the principle that the new information or future shocks can ignore or cancel these monetary policy decisions, the publishing of the predicted interest rate path for the basic scenario and of alternative prognoses, send a more clear signal regarding the "pattern" of the future evolutions that might lead to deviations in the monetary policy interest rate from the minimal level of interest.

5. Final remarks

The incertitude characteristic to the post-crisis period requires the continuous improvement of the communication policy of the central bank, not just by selecting the used language and the formulation of the message to be transmitted, but also by refining the instrument which make prognoses for the macroeconomic variables and by thoroughly understanding the economic phenomena and realities which are submitted permanently to new challenges.

Besides the classical ways, the forward guidance type of communication plays an increasingly important role, as well as the communication of prognoses for the different macroeconomic variables (inflation, potential GDP, endogenous interest rate, etc.). The forward guidance policy seems to become a standard and permanent instrument of the monetary policy framework during the post-crisis period, with a predominant qualitative data dependent forward guidance, which reflects the cautionary conduit of the central banks under conditions of incertitude, as well as the interest for higher speed of reaction to emerging events.

Through the levers of the communication policy, the central bank sends messages to the public in order to guide its reactions in a particular way to the new evolutions, and the prognoses of the macroeconomic variables is s useful guide to this.

A more refined communication of the central bank's intentions presumes improving the technical prognosis mechanism, whose precondition is enhancing the professional quality of the staff having this specialization. The central banks which have advanced prognosis instruments and which publish prognoses for the endogenous interest rate may be benchmarks for the other central banks.

The communication policy, that also presumes a high level of central bank credibility, is a "delicate" instrument to use, however, given the potential risk that poorly understood and interpreted messages cause unexpected market reactions. This observation shows the importance of generating "surprises" not just on the side of the monetary policy towards the market, but vice versa too, on the side of the market towards the monetary policy.

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