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When Communication becomes the Policy

Monetary Dialogue September 2018

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When Communication becomes the Policy

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Abstract

Non-standard policy measures are intended to work via financial markets. Their effectiveness thus depends on how ECB communication affects the expectations of market participants far into the future. Communication has become as important as the details of the policy measures itself. The success of communication is often measured by short term market reactions, increasingly using advanced statistical techniques to interpret them. But this 'policy making by the markets' lacks a strong anchor because financial markets often anticipate policy and the assessments of investors change all the time, often independently of monetary policy actions.

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EXECUTIVE SUMMARY

The ultimate aim of the ECB is to safeguard price stability. Until the financial crisis, it pursued this goal by setting short-term (policy) interest rates. When its rates reached zero, the ECB had to switch to 'non-standard' policy measures, with the aim of influencing financial markets in other ways.

But measuring the success of 'non-standard' measures is difficult and sometimes their communication is more important than the details of the policy itself. This was the case for the so-called 'forward guidance', which has been largely abandoned. But new policy measures like bond purchase programs also require special communication to establish their effectiveness.

Central bankers themselves often measure the success of their policies and their communication by the short-term reaction of financial indicators, such as long-term interest rates, stock prices, exchange rates or financial market based measures of inflation expectations. This is to some extent unavoidable, but has disadvantages, mainly because asset prices change all the time, and for many reasons, unrelated to monetary policy.

The tendency to measure the impact of communication by the immediate reaction of financial market to ECB announcement has disadvantages. First of all, it remains always difficult to judge whether a policy has achieved its purpose if the immediate reaction was as expected, but markets later reversed.

Second, sometimes the reaction of financial markets might not be due to the (announcement of) policy measures, but because market participants infer new information about the state of the economy from the very fact that the central bank deems non-standard measures necessary.

In principle, the ECB should mainly focus on medium term inflation expectations as they measure the degree to which financial market participants believe that the ECB will reach its price stability target. In the run-up to the PSPP decision, the ECB has indeed done this, but this focus was lost during the implementation phase. The focus on longer-term inflation expectations has returned only more recently with the discussion on the end of the bond purchases. In the meantime, the ECB has tended to focus on the improving state of the economy.

This is how the ECB has been very successful in communicating the idea that the PSPP has been instrumental in the overall improvement of the euro area economy over the last years; although medium term inflation expectations (measured by five year forward rates) are today at the same level (around 1.7 %) as they were in 2014/5, at the start of the PSPP.

1. INTRODUCTION

KEY FINDINGS

- Most unconventional measures are intended to work through markets for longer-term assets, where prices are based on expectations far into the future. Communication becomes an essential tool to influence these expectations.
- Communicating the effectiveness of the PSPP has relied heavily on financial market indicators, often interpreted through highly technical analytical methods.
- The ECB has succeeded in convincing financial market operators that its bond buying program was instrumental in stabilizing financial markets and that the end of this bond buying will be a non-event.
- Medium term inflation expectations (as measured by 5Y/5Y forward swaps) are today at the same level (around 1.7 %) as end-2014, when the PSPP was deemed necessary to prevent a de-anchoring of inflation expectations.

With unconventional measures, central banks usually attempt to influence asset prices. But these prices depend more on expectations than the state of the economy today. The purpose of central bank communication thus becomes to influence these expectations.

Forward guidance constitutes an extreme case in that the policy consists only of communication (about intentions regarding future policy measures, without any action today). However, the limits of forward guidance became quickly apparent (how can today's central bankers make a commitment for their successors) and it has been largely discarded as an independent policy tool.

Bond purchase programs, like the PSPP (Public Sector Purchase Programme) involve action, but require extensive communication to convince the public and financial markets that this measure has actually the desired impact. Moreover, the impact is expected to materialize with the announcement. The details of the actual implementation often appear secondary.

There exists a large literature on central bank communication (see Blinder et al. (2008) for a pre-crisis survey). This literature has not come to any conclusions on what constitutes 'best practice'.

This contribution will concentrate on one specific aspect of the general problem of central bank communication, namely how the ECB has communicated the PSPP, its major non-standard policy referring to inflation expectations.

Communication played a vital role in the success of the PSPP because there is no widely accepted theoretical model as to why central bank purchases of long-term bonds should permanently lower long-term interest rates. This uncertainty about the channels by which balance sheet policies work was succinctly expressed by the former Chairman of the Federal Reserve, Ben Bernanke, who is reported to have quipped, "[t]he problem with QE is that it works in practice, but it doesn't work in theory" (Saft, 2014).

The ECB has itself dealt with this issue in two recent important speeches (Cœuré (2017) and Cœuré (2018). Cœuré (2017) puts it very succinctly:

"Indeed, with frictionless capital markets, at the effective lower bound forward guidance would be the only way to ease the monetary policy stance.[5] In this setup, central bank asset purchases would be ineffective:

whether assets are held on the balance sheet of the public or private sector would not affect term premia and, hence, long-term interest rates."

At first sight, it might appear obvious that central bank purchases of government bonds should lead to lower interest rates since an additional buyer in the market should lead to higher prices (and thus lower yields). However, the ultimate investors often hold bonds because they have certain expectations about inflation, interest rates and other relevant variables. If these expectations do not change, these investors might sell their holdings as yields fall. The initial impact of central bank purchases would then dissipate over time. This is what lies behind the assertion by Cœuré (2017) that in a frictionless market central bank purchases would be ineffective (and Bernanke's quip that 'QE doesn't work in theory')

The PSPP (as other asset purchase programs) thus posed a particular challenge for central bank communication. The ECB had to convince the public and financial market participants that that market are not frictionless, and that asset purchases[1] would be effective in lowering interest rates.

However, it is by now widely accepted that the PSPP has been effective in lowering long-term interest rates and risk premia and thus contributing significantly to the ongoing recovery of the euro area. This is based mainly on a growing empirical literature[2] on the impact of various forms of bond buying by central banks on interest rates; which are then combined with macroeconomic models to trace out the impact of lower rates on the economy.

[1] As an aside, it is interesting to note that most discussions of the PSPP by members of the eurosystem tend not to mention the fact that 80 % of the PSPP concern purchases by national central banks of the bonds of their own government and on their own account. Strictly speaking, it is thus not correct to describe the PSPP as bond buying by the ECB. See Gros (2016 a,b,c).

[2] Borio and Zabai (2016) provide a critical survey. Altavilla et al. (2015) is a first important reference for the PSPP. Urbschat and Watzka (2017) provide a more recent survey.

2. INFLATION EXPECTATIONS AND COMMUNICATING THE PSPP

It is interesting that few studies have measured the impact of the PSPP on inflation expectations. In principle the main aim of the unconventional policy measures, as the PSPP, should have been to stabilize or 'anchor' longer-term inflation expectations. However, most studies have concentrated on the impact of the announcement of the PSPP on interest rates. One reason for this might have been that there was a visible jump in interest rates on the days the PSPP was announcement (or a bond purchasing program became more probably), whereas inflation expectations seemed to have moved much less.

This applies in particular to one important measure of medium future inflation expectations, namely 5 year/5 year forward inflation swaps. This indicator is calculated from financial instruments, called 'inflation swaps', which are basically pure bets on future HICP inflation rates[3]. The 5 year/5 year forwards measure the inflation rate expected in five years for following five years (i.e. years 6-10 from the present).

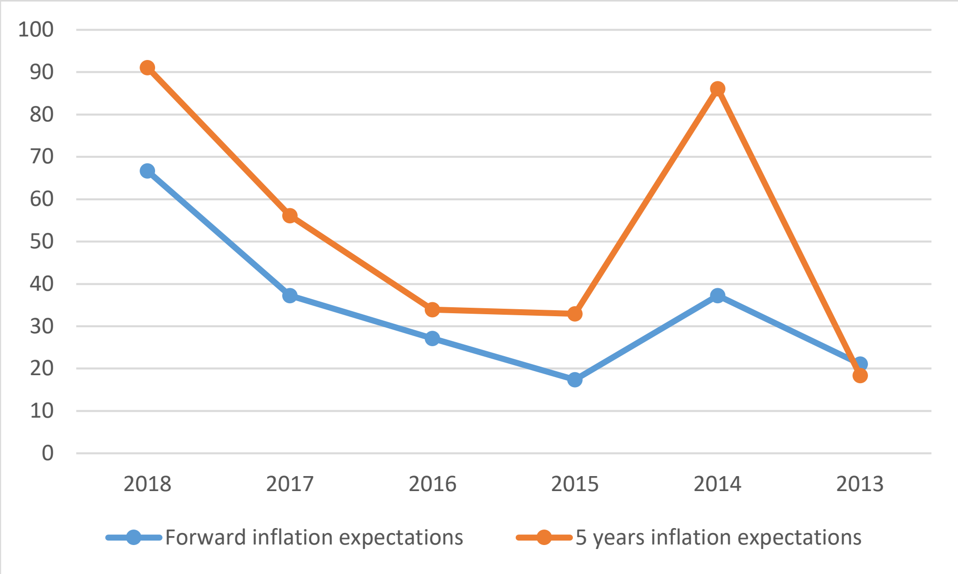
The ECB referred to this indicator rather frequently in 2014, when the decision to go for the PSPP was maturing. The central argument at the time was that these indicators of future inflation were becoming 'de-anchored'. The importance of future inflation in the thinking of the ECB at the time is illustrated in the chart below.

The chart shows that in 2014 close to 90 % of all the speeches by members of the ECB Board contained the term '5 year inflation expectations' and about 40 % used the more generic term 'forward inflation expectations'.

In the following year, when the PSPP had already been decided and was being implemented, the frequency of these two terms fell markedly. It is only more recently, when the decision on ending the bond purchases was being prepared, that these two terms have become again a paramount topic in ECB speeches.

[3] One can also use the difference in the yield between indexed and non-indexed bonds to infer expected inflation. But yields on bonds are also affected by default expectations and liquidity considerations. The inflation swap rate have the advantage that they are not affected by counterparty risk and similar issues.

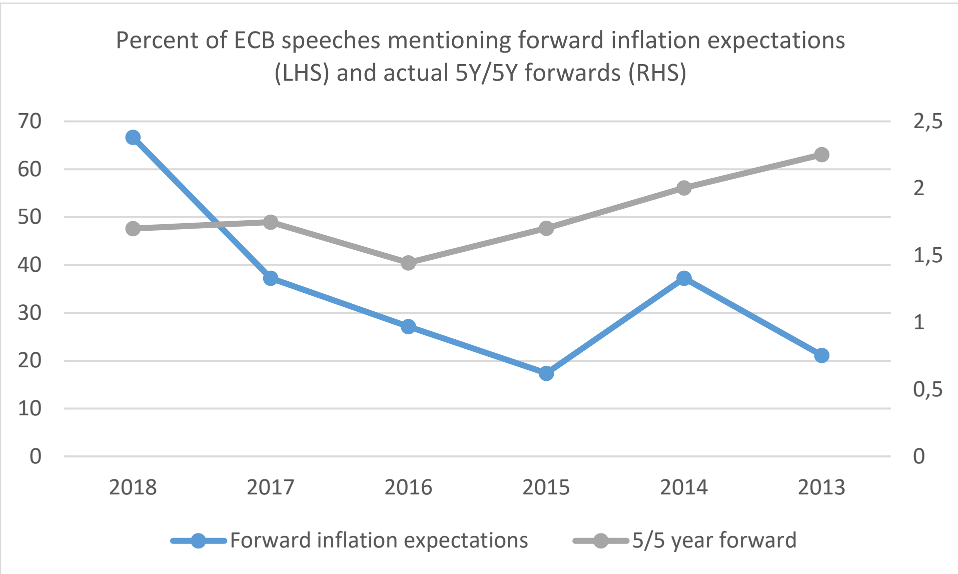
Figure 1: Percent of ECB speeches mentioning forward and future (5Y/5Y) inflation expectations



Source: Own elaboration based on google search of the category 'speeches' on the ECB website.

While medium term inflation expectations incorporated in forwards clearly played a key role in motivating the PSPP, it seems that the subsequent evolution of this indicator had little impact on the importance given to it in ECB thinking. Chart 2 shows that actual 5year/5year inflation swaps continued to decline in 2015 and 2016, but the term forward inflation expectations was used less in these years. It is only more recently that the ECB has begun again to put more emphasis on forward inflation expectations, which were mentioned in over 60 % of all speeches.

Figure 2: Forward inflation expectations in ECB speeches versus market data



Source: Own elaborations, based on google search of the category 'speeches' on the ECB website and Bloomberg.

This example shows that the emphasis on financial market indicators of medium term inflation expectations has shifted over time. One reason (apart from expediency) might be that in reality it is often difficult to interpret market reactions to monetary policy announcements.

A first general problem is, of course, that it is always difficult to measure to what extent a certain announcement was anticipated. It is thus possible that an announcement has the opposite of the intended impact because it falls short of market expectations. However, it is unlikely that this 'over-anticipation' was a major element when the PSPP was announced towards the end of 2014.

However, even for announcements which come as surprise (at least partially), one encounters another difficulty because the fact that interest rates fell upon the announcement of the PSPP can be interpreted in a number of very different ways. For example, it could be argued that (reluctant) decision of the ECB to embark on government bond purchase was the reaction to negative shocks to inflation during the second half of 2014, which convinced the ECB that 'something has to be done'. The emphasis on forward inflation expectations and the actual fall in market indicators documented above support this interpretation. The corollary of this line of thought would be that the PSPP should be viewed as a (predictable) reaction of ECB to a negative inflation shock.

This view of the PSPP as endogenous would still be compatible with the observation that interest rates fell around dates when the ECB's major asset purchase plan was announced. The fact that the ECB felt it necessary, after months of hesitation, to adopt this unconventional policy tool could be interpreted by investors as new information about how the ECB views the state of the economy. Given that the ECB can well be assumed to have inside information on the state of the euro area economy, this could induce market participants to modify their own views as well. If investors revise their expectations towards a more deflationary future they should also expect lower interest rates (nominal and real).

The reduction in long-term market interest rates observed when the PSPP was announcement could thus be interpreted in two ways: a success of the ECB, or a shift of market expectations towards a more deflationary future. The latter hypothesis does not seem to have been considered in ECB communications.[4]

4 Gros (2018) documents that the announcement of the PSPP was followed by a slight increase in very near term inflation expectations, but also a small fall in medium term (5/5 forward) inflations swaps. This makes it difficult to determine which interpretation should be considered more important.

3. CONCLUDING REMARKS

Central banks have been grappling for a long time with the problem how to communicate their policy to the markets and to the public at large. There is wide agreement that communication has become even more critical once non-standard measures are being used.

The success of communication is often measured by the instantaneous market reaction to announcements. However, this can led to an excessive concentration on the short term and to an over-interpretation of market movements.

This short contribution has concentrated on ECB communication surrounding the specific case of the PSPP. The success of the PSPP is usually asserted on the strength of the observation that interest rates and some risk premia fell on the day of the announcement of the PSPP. However, this simple observation can be interpreted in many different ways and it is not clear how permanent this immediate impact has been.

The ECB has overcome these difficulties and has been very skilful in communicating its narrative, which is now widely accepted. In doing so, its leading exponents emphasize medium inflation expectations whenever it is necessary to justify major policy shifts. However, the emphasis on medium inflation expectations seems to shift considerably over time.

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