Transparency in the monetary policy of the ECB

This article addresses the importance of transparency for modern central banking. It stresses that effective communication and proper interaction with the public, i.e. the public at large, the media and market participants, is important for the credibility, predictability and effectiveness of monetary policy. By explaining the process of monetary policy-making and the rationale behind policy decisions to the public, the central bank enhances understanding of its mandate, policy strategy and decisions, which in turn allows the markets and the general public to better anticipate the future course of monetary policy. Greater transparency not only helps the central bank to carry out its mandate more effectively, but also enables it to be more easily held accountable for its actions. The latter aspect is discussed in greater detail in the article entitled "The accountability of the ECB" in this issue of the Monthly Bulletin.

1 Introduction

Over the past decades, there has been a global trend in central banking towards greater transparency and openness. Today, transparency is widely acknowledged as a fundamental principle of sound economic governance. Most central banks around the globe have given strategic priority to effective communication and proper interaction with the public, considering transparency a very important component of their monetary policy framework. In this vein, many central banks, including the ECB, have made considerable efforts to present and explain monetary policy actions and the economic rationale underlying their decisions to the public in an open, clear and timely manner. All these activities are aimed at ensuring that monetary policy is better understood by the public and therefore becomes more credible and effective.

The importance of transparency for central banks has also become a topical issue in the context of strengthening the international monetary and financial system. For instance, based on the recognition that the transparency of policy frameworks is beneficial, internationally agreed transparency standards have been set for central banks by the International Monetary Fund (IMF) in its "Code of Good Practices on Transparency in Monetary and Financial Policies".

2 What is transparency?

Transparency can be defined as an environment in which the central bank provides in an open, clear and timely manner all relevant information on its mandate, strategy, assessments and policy decisions as well as its procedures to the general public and the markets. Transparency is ultimately about the genuine understanding by the public of the entire process of monetary policy-making.

In the economic literature the following areas are identified. First and foremost, transparency requires that the central bank make the interpretation of its mandate clear and is consequently forthcoming about its policy goals. This helps the public to monitor and evaluate the central bank's performance. In addition, it needs to explain the analytical framework for its internal decision-making (e.g. methods, models, and indicators) as well as its assessment of the state of the economy and the economic rationale underlying its monetary policy decisions. In this respect, transparency can be enhanced by a systematic approach to monetary policy-making, in particular by means of a publicly announced monetary policy strategy. Moreover, in order to accomplish its mandate, the central bank should release all the data it collects which may be relevant to taking monetary policy decisions. Finally, a prompt disclosure of policy decisions and the related information with regard to the internal decision-making process are also important elements of transparency.

In practice, however, it is also recognised that it is difficult to provide a completely exhaustive and understandable description of all elements and aspects relevant to the decision-making process while, at the same time, being clear. Rather, a balance has to be struck between the different and partly conflicting dimensions of transparency, in particular openness and clarity.[1]

Therefore, transparency means more than simply releasing information, as this does not by itself translate into a better understanding of monetary policy. The potential problem of information overload contrasts with the need for clarity, which becomes even more important when information is to be communicated to different audiences across different environments. Proper interaction with the public requires that the central bank as "sender" and the public as an active "receiver" share a common framework and language – a common understanding – with which both are comfortable. Consequently, it is important that the central bank organises and presents the information available in a structured manner.

At the same time, efforts to convey a message with clarity should not detract from the need to be honest about the complex nature of policy-making. This means first and foremost a high degree of correspondence between the internal decision-making and external communication. Moreover, any communication aimed at contributing to a genuine understanding of monetary policy must reflect the fact that monetary policy has to operate in a complex and uncertain environment which is constantly changing.

Finally, the institutional context also plays an important role in the design of the procedure to enhance transparency. For instance, it makes a difference whether a central bank operates for a single country or a group of countries, as is the case for the ECB. There are in fact different possible routes to transparency in monetary policy.

3 Reasons for greater transparency in monetary policy

There are two main reasons for the move towards greater transparency in monetary policy. The first is more political in nature and linked to a move towards greater central bank independence in a number of countries and the corresponding need for greater accountability. The second is related to the notion that monetary policy can be made more effective in influencing the economy via private sector expectations and their impact on financial markets if the public has a better understanding of monetary policy objectives, procedures and decisions.

Transparency, independence and accountability

Across the world, there has been a trend towards establishing independent central banks whose clear mandate is first and foremost to achieve price stability. This development is based on the broad consensus that any attempts to sacrifice the medium-term goal of price stability for efforts to meet other, short-term objectives will adversely affect the credibility and effectiveness of monetary policy and ultimately weaken long-term economic growth and welfare. To help the central bank to carry out its mandate to guarantee price stability, monetary policy needs to be made and kept independent of pressures potentially arising from short-term political and electoral objectives. In this sense, central bank independence has become a fundamental principle of modern economic governance.

1 *For a discussion of the definition of transparency, see B. Winkler (2000): "Which kind of transparency? On the need for clarity in monetary policy-making", ECB Working Paper No. 26.*

The recent trend towards independent central banks has led to a strong demand for transparency from the public. Transparency serves accountability, which in democratic societies is the quid pro quo of independence (see the article entitled "The accountability of the European Central Bank" in this issue of the Monthly Bulletin). A proper understanding by the public of the central bank's objectives, behaviour and decisions is crucial for any meaningful evaluation of its performance.

Ultimately, any central bank's monetary policy will be judged by the public on the basis of its ability and track record in fulfilling its mandate. This is the basis for accountability. At the same time, the effectiveness of monetary policy in meeting its statutory objectives must remain the overriding concern with regard to transparency and the role of communication with the public and the markets.

Transparency and policy effectiveness

Effective communication with the public has become more important for central banks as expectations of future monetary policy decisions have an increasing impact on the monetary policy transmission process. Profound changes in the financial markets over the past few decades, the rapid progress in information technology and the associated close links between expectations and current decisions of economic agents, as well as growing economic and financial interdependencies between countries are factors behind this development.

Transparency renders monetary policy more effective for several reasons. First of all, being clear about its mandate and how it goes about fulfilling it helps a central bank to foster credibility. When a central bank is perceived as being able and willing to achieve its policy mandate, price expectations are well anchored. This ensures that economic decisions, for example wage and price setting, are taken in the belief that price stability will be maintained over the medium term. This creates a virtuous circle conducive to an environment of stable prices in which economic activity can flourish.

In this respect, it is crucial for central banks to be open and realistic about what monetary policy can do and, even more importantly, what monetary policy cannot do. For instance, monetary policy cannot solve the structural problems of the economy. Similarly, it cannot steer price developments with a high degree of precision, but needs to look ahead with a medium-term orientation.

Second, a strong commitment to transparency imposes self-discipline on policy-makers, which helps to ensure that their policy decisions and explanations are consistent over time. By facilitating public scrutiny of monetary policy actions, such a commitment enhances the incentives of the decision-making bodies to fulfil their mandate in an appropriate manner.

Third, a publicly announced monetary policy strategy provides guidance to the markets so that expectations can be formed more efficiently and accurately. Transparency helps the markets to understand the systematic response pattern of monetary policy to economic developments and shocks and thus to anticipate the broad direction of monetary policy over the medium term, making policy moves more predictable.

This anticipation effect is important for the conduct of monetary policy, given that central banks directly control only very short-term interest rates, while the expected path of short-term interest rates over longer horizons and premia for uncertainty are also significant for the transmission of monetary policy to the economy. If agents can broadly anticipate policy responses, this can shorten the process by which monetary policy is transmitted into investment and consumption decisions and accelerate needed economic adjustments. This allows a rapid incorporation of any (expected) changes in monetary policy into financial variables, thus potentially enhancing the effectiveness of monetary policy. For example, if there is increasing evidence of rising inflationary pressures, interest rates at the shorter end of the maturity spectrum may increase in anticipation of a rise in the policy interest rates. If these expectations turn out correct, the market rates will then not react much when the central bank, in response to these inflationary pressures, actually increases its policy interest rates.

In addition, transparency can help to reduce uncertainty and volatility in financial markets. A correct interpretation by the market of the monetary policy decisions taken by the central bank reduces the volatility of interest rates both ex ante and ex post. Ex ante because a proper understanding of the monetary policy strategy and clear views about the assessment of incoming information make market rates react only to information signalling a need for monetary policy to be changed in order to safeguard price stability. Ex post because transparency reduces the likelihood of the market being surprised as a consequence of an incorrect interpretation of a monetary policy decision. A good understanding of monetary policy also allows private agents to better manage and hedge their risks, which may contribute to reducing market uncertainty and enhancing economic welfare.

Transparency and predictability

As mentioned above, a systematic and transparent approach to monetary policy-making oriented towards price stability tends to enhance predictability, i.e. the ability of the public to correctly anticipate future monetary policy decisions.

Ex post measures of predictability are sometimes viewed in the available literature as a way of assessing the transparency of a central bank. On the basis of the above definition of transparency, it is natural that a higher degree of transparency be connected with greater predictability. However, perfect predictability of monetary policy decisions might be hard or even impossible to achieve in a world of uncertainty.

One of the reasons for this is the steady flow of new data that have to be taken into account. Notably, at longer horizons, unexpected developments are always likely to change the future path of policy rates. Furthermore, the monetary policy decision-making process is a complex one in which all relevant pieces of information have to be assessed in the light of their implications for the monetary policy mandate. Moreover, the outcome of the process of mapping all the information on the state and the functioning of the economy into policy decisions is also based on judgement. As there is always uncertainty about the state and prospects of the economy, the analysis of how monetary policy should react to ensure the fulfilment of its mandate cannot be done in a mechanistic way.

Furthermore, at very short horizons, it may be argued that, even in the absence of unexpected developments, the precise timing of monetary policy decisions may be hard to anticipate perfectly, especially if monetary policy meetings are held very frequently, as was the case for the Governing Council of the ECB before November 2001.[2] At any rate, what matters in economic terms is not the predictability of the exact timing or size of a monetary policy decision but rather good anticipation of the broad direction of monetary policy decisions.

It is sometimes argued that in order to be more transparent, central banks should provide precise indications of their future policy intentions as well as their current policy stance. However, there are clear limitations to the central bank's ability to follow this suggestion. Owing to general uncertainty about present and future developments in the state of the economy,

2 *Until 8 November 2001 the Governing Council of the ECB held monetary policy discussions at all of its meetings, i.e. generally every two weeks, whereas since then it has discussed monetary policy issues only once a month.*

any central bank must always remain in a position to reconsider its assessment when circumstances change. It is important to clarify that future monetary policy depends not only on current and past developments but also on new and future information. Therefore, statements about future policy plans can only be of a general and conditional nature; at the same time, it is impossible to give a full description of all relevant contingencies.

While predictability in broad terms will be the natural result of a transparent monetary policy framework, it cannot be an independent objective of monetary policy. In particular, monetary policy cannot simply follow market expectations when setting interest rates, but must always be governed by its commitment to fulfil its mandate.

At the same time, central banks do not have an interest in surprising the markets for the sake of doing so. However, on certain occasions when the central bank and the markets hold different views on the risks to price stability, some surprises for the market, especially with regard to the timing, may be unavoidable.

4 The ECB's approach to transparency

Given that transparency ultimately increases the public's understanding of its monetary policy, the ECB has always been committed to a high level of transparency. Since the beginning of the ECB's existence, communication with the general public and the financial markets has played an important role in its policy-making (for further details see also the article entitled "The external communication of the European Central Bank" in the February 2001 issue of the Monthly Bulletin).

The ECB's monetary policy strategy, which includes a definition of price stability and a framework for the analysis of risks to price stability, guides its monetary policy decisions and sets out a systematic framework for the conduct of monetary policy. In 1998, in order to specify its price stability objective more precisely, the Governing Council of the ECB announced a quantitative definition: "… as a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%". The quantitative definition of price stability adds to transparency because it clarifies how the ECB interprets the task it was assigned by the Treaty establishing the European Community and helps to make the monetary policy framework easier for the public to understand. Moreover, the definition provides a clear yardstick against which the public can hold the ECB accountable. Finally, it anchors market expectations of future price developments, thereby enhancing clarity and public trust in the overall policy framework.

Moreover, this publicly announced strategy sets out a clear framework for internal decision-making and external communication alike. The organisation and presentation of the available information in the framework of the two-pillar strategy ensures that all information relevant to monetary policy is included in the Governing Council's analysis, at the same time facilitating the cross-checking of various indicators, thereby enhancing the robustness of monetary policy decisions (see the article entitled "The two pillars of the ECB's monetary policy strategy" in the November 2000 issue of the Monthly Bulletin). This approach ensures that all information is taken into account in a systematic way in the decision-making process of the Governing Council, reflecting the uncertainty surrounding the monetary policy-making process. Indeed, monetary policy always needs to take a broad perspective on the economy, the structure of which is complex and characterised by uncertain relationships. This is why the ECB has refrained from relying on a commitment to simple policy rules, which link interest rates to selected economic indicators in a predefined manner, for both internal use and external communication. Pretending that the world is more simply structured or more certain than it actually is does not make for a good recipe for monetary policy, foster a genuine understanding of monetary policy or achieve genuine transparency or predictability.

The ECB has always taken a very active approach to communicating with the public, and one, which suits the specific circumstances of its institutional environment. It shares with the public the information discussed by the Governing Council of the ECB and describes in detail the economic rationale behind policy decisions. This demonstrates a strong institutional commitment to transparency. The IMF, in its "Report on observance of Standards and Codes" (ROSC) for the euro area, found that overall the Eurosystem maintains a high level of transparency in all aspects of its operations and a high degree of respect for the relevant Codes. Box 1 provides a brief overview of the key communication channels used by the ECB.

There is some evidence suggesting that the ECB's monetary policy framework – including

Box 1

Key communication channels used by the ECB

The monthly press conferences held by the President and the Vice-President and the Monthly Bulletin are two of the most important communication channels adopted by the ECB. The President's introductory statement at the press conference provides a comprehensive summary of the policy-relevant assessment of economic developments. It is structured along the lines of the ECB's monetary policy strategy and agreed by the Governing Council. The monthly press conference includes a question and answer session, which is attended by various media representatives from across the euro area and beyond and provides a platform for the timely explanation of monetary policy decisions to the public. Transcripts are made available on the ECB's website only a few hours later. The press conference is thus an effective means of presenting and explaining the discussion in the Governing Council and therefore the monetary policy decision-making process.

A central role in the ECB's communication policy is played by the Monthly Bulletin, which is intended to provide the general public and the financial markets with a more detailed and comprehensive analysis of the economic environment. However, it also provides an insight to the analytical tools used by the Eurosystem within the framework of the stability-oriented monetary policy strategy. Articles published in the Monthly Bulletin have served to explain the role of the two pillars in the strategy, i.e. the analysis of monetary developments in the first pillar and the analysis of non-monetary indicators under the second pillar (see, for example, the May 2001 article entitled "Framework and tools of monetary analysis" or more specialised articles such as "Measures of underlying inflation in the euro area" in July 2001 and "The stock market and monetary policy" in February 2002).

An important complement to the set of information released to the public occurred in December 2000 when the Eurosystem staff macroeconomic projections were published for the first time. The Governing Council decided to publish these projections twice a year (June and December) as they constitute important input in the policy process and should therefore be released to the public. For the sake of transparency, the ECB explained very clearly the role of the projections in the policy process, namely as an important piece of information under the second pillar of the ECB's strategy.

Given that the Eurosystem, namely the ECB and the 12 NCBs of the euro area, is obliged to communicate in a multicultural and multilingual environment, the NCBs are essential players in the communication strategy. They maintain close contact with national and regional audiences and translate, not just literally, the policy signals into different languages tailoring them to the national context.

Box 2

Predictability of the monetary policy decisions of the ECB

Predictability can be defined as the ability of the public to correctly anticipate the monetary policy decisions of a central bank. Easy as it sounds, there is no single way of measuring this in practice, as, for example, the horizon over which predictability is assessed (given by the maturity of the interest rates used) and the technique employed may render different results.

Given that participants in financial markets closely follow the central banks' policy decisions and continuously analyse the economic outlook, market rates summarise a vast amount of information. While polls among market participants or ECB-watchers may also be a good approximation, market rates have the advantage of incorporating all the information available to the markets at a given point in time.

As noted in the text, the horizon at which monetary policy decisions have been anticipated has to be chosen. While a long horizon would allow an assessment of how the markets have anticipated the interest rate cycle, unexpected changes in economic conditions will not be reflected. At the same time, a short horizon allows market rates to incorporate all information analysed by the Governing Council.

Given the short track record of the ECB, relatively few pieces of work have been published on the predictability of monetary policy decisions in the euro area. Pérez-Quirós and Sicilia (2002)[1] have recently applied a set of measures to analyse the short-term predictability of the monetary policy decisions of the ECB. It is worth mentioning, however, that the sample is very short, and more evidence might be needed to reach definitive conclusions. In fact, the literature typically finds that predictability is an evolving process and that it tends to increase over time as markets learn more about the central bank's behaviour and change when institutional arrangements and procedures are modified. In this regard, the decision of the Governing Council of the ECB in November 2001 to switch from bimonthly to monthly discussions of monetary policy may have affected the predictability of the ECB, as the timing of its interest rate changes can be anticipated more easily by the markets.

Since at near-term horizons money market interest rates mainly reflect market expectations about the near-term path of monetary policy, the one-month forward rates for one, two and three months ahead can be used to evaluate whether the market broadly expected the monetary policy decisions taken. Pérez-Quirós and Sicilia (2002) find that market interest rates have predicted euro area interest rates comparatively well up to three months in advance (similar results are obtained for the United States).

This approach does not however capture the extent to which the decision was anticipated on the precise day of the meeting. This in turn means that the expectations of the market are not calculated with the same set of information as that available to the Governing Council when the monetary policy meeting takes place. In order to take this consideration into account, one of the routes followed by Pérez-Quirós and Sicilia (2002) is to use the level of market rates one day before the meeting to calculate the probability of a change of at least 25 basis points in the key ECB interest rates, and to compare this with the decision to change them or not. According to this approach, the market is assumed to be expecting a change in key ECB interest rates if short-term market interest rates anticipate a change of 25 basis points in key ECB interest rates with a probability of more than 50%. The results obtained indicate that over the period between 4 January 1999 and 6 June 2002, which included 78 meetings of the Governing Council of the ECB, the market correctly anticipated 94% of the decisions. More specifically, of the 12 occasions on which the key ECB interest rates

1 *Pérez-Quirós and Sicilia (2002), "Is the European Central Bank (and the United States Federal Reserve) predictable?", ECB Working Paper No. 192. See also Gaspar, Pérez-Quirós and Sicilia (2001) "The ECB monetary policy strategy and the money market", International Journal of Finance and Economics 6, 2001, pp. 325-342.*

were changed, 11 (92%) were anticipated by the market, while of the 66 occasions on which rates were left unchanged, the market correctly anticipated that outcome 94% of the time.

It is also worth noting that since 8 November 2001, when the ECB announced that from that day, monetary policy would be discussed only once a month, none of the decisions have come as a surprise. Overall, these results are broadly similar to the ones calculated in the United States for the same period.

its commitment to transparency – has been conducive to the ECB's credibility. Various indications of medium and long-term inflation expectations suggest that the commitment to lastingly maintain price stability in the euro area remained credible in Stage Three of Economic and Monetary Union (EMU). Measures of long-term inflation expectations, as indicated by bond yields and surveys conducted among private sector economists, have indicated, since the beginning of Stage Three, that HICP inflation in the euro area is generally expected to remain within the definition of price stability adopted by the Governing Council of the ECB.

Furthermore, there are also clear indications that the transparency of the ECB has contributed to a high degree of predictability concerning its monetary policy decisions. Box 2 summarises the results concerning the short-term predictability of the monetary policy decisions in the euro area from January 1999 to June 2002, and draws the conclusion that these decisions were very predictable for this period.

5 Conclusions

The ECB is responsible for fulfilling the mandate assigned to it by the Treaty and to honour the trust placed in it by the people of Europe. In order to be successful on a sustainable basis, the ECB must make itself understood to the general public. In this respect, honesty, openness and clarity when communicating with the markets and the general public are important means of enhancing the effectiveness and the credibility of the ECB's monetary policy.

During the first few years of the single monetary policy the ECB has striven to meet the highest standards of transparency. Its approach to communication with the public has thereby aimed to meet the diverse needs and specific challenges of the uncertain environment in which the ECB operates. The effectiveness of this approach can be seen in the fact that policy moves by the ECB have generally been well understood and anticipated by the markets.