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Communication is not just talking

Policy Department for Economic, Scientific and Quality of Life Policies
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Communication is not just talking

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Abstract

Central bank communication has been developed over the last decades. Much has been learned over time, revealing both the complexity and usefulness of communication. This is an area where there is room for significant improvements. Most of the possible improvements question the way the ECB operates. Only seeking to better talk will not be enough to meet this important challenge.

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CONTENTS

LIST OF ABBREVIATIONS

ECB	European Central Bank
EP	European Parliament
EU	European Union
FOMC	Federal Reserve Open Market Committee
MPC	Monetary Policy Committee
SPF	Survey of Professional Forecasters
US	United States

LIST OF FIGURES

EXECUTIVE SUMMARY

- **Central bank communication has made huge strides over the last decades but has faced serious challenges**. Communication has been focused on financial markets, explicitly to improve the transmission of monetary policy actions. Other stakeholders, like households and businesses, cannot make use of highly technical statements and yet, as price and wage setters, they determine whether price stability, the primary objective of the ECB, is achieved. Democratic accountability is also adversely affected when the central bank resorts to bland statements in order to avoid destabilizing the financial markets.
- **Central bank communication directed at the financial markets allows the exchange of crucial information, but it can create a hall-of-mirrors effect.** This effect occurs when the financial markets fully absorb what they are told by the central bank, which in turn receives market signals that merely reflect its own views. As a result, both the central bank and the financial markets may become driven by potentially erroneous expectations. The inflation forecasting debacle of 2021 is a good example.
- **Communicating with price and wage-setters is not only a matter of using broadly understandable words and concepts.** The central banks must first attract the interest of the broad public. To that effect, they must share their intentions and their doubts, including disagreements. This, in turn, challenges the official consensus culture that prevails at the ECB.
- **Accountability requires going beyond the ECB representatives repeating earlier published statements.** The ECB needs to engage the parliamentarians who, in turn, must go beyond prepared statements.
- **Uncertainty represents a crucial challenge for central bank communication.** Quite often central banks do not know precisely what will happen over the next couple of years, which is what most interests both the financial markets and the broad public. Presenting forecasts cannot be the only strategy. The central banks must accept that their knowledge is imperfect. The must make efforts to publicly explain how uncertain they are. Most importantly, they must explain what their reasoning is rather than outlining possible actions that reflect their current expectations.
- **Having accepted responsibility for financial stability, the ECB must now explain how it plans to position this objective relatively to its primary objective of price stability.** To some extent, nonstandard policies may help as they often are an additional instrument to the interest rate. Yet, many trade-offs are bound to emerge. Here again, the ECB needs to share its reasoning when facing such trade-offs.

1. INTRODUCTION

Central bank communication is now considered as an essential tool of monetary policy. The importance of proper communication has been advocated long ago by Woodford (2005, 2007). His argument was that a central bank is more effective when its intentions are clearly communicated. In particular, since monetary policy is mostly transmitted to the economy through long-term interest rates while a central bank only controls the very short-term interest rate, policy effectiveness rests on the central bank's ability to influence the financial markets. While the work of Woodford has been very influential in convincing central banks to devote great efforts to develop their communications, the actual implementation has revealed many shortcomings, to the point that the question has been raised whether central banks now talk too much. The answer is that it is not a question of volume but of talking adequately to the right people.

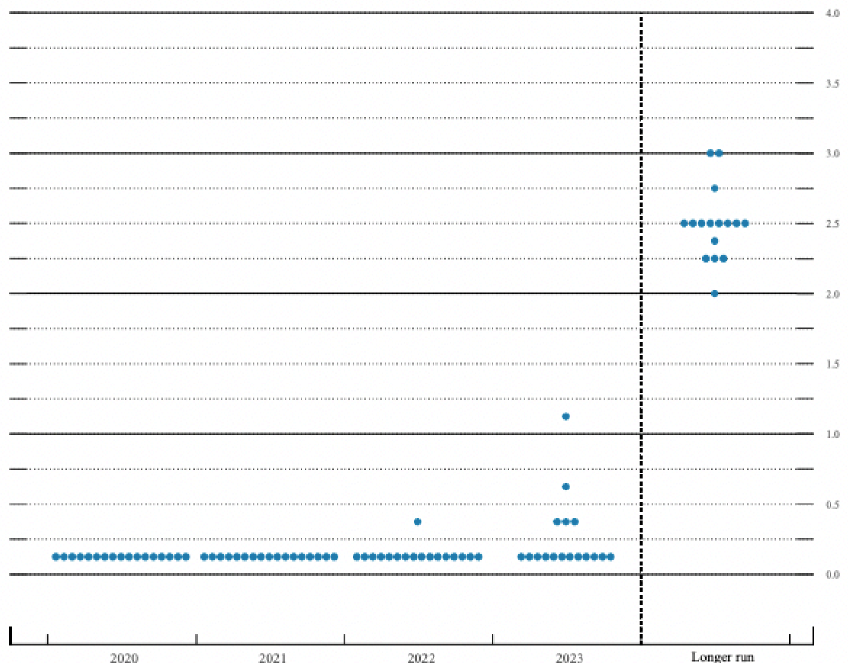
An example can set the stage. Early adopters of modern communication, the central banks of Norway and Sweden, publish the interest rates that they envision over the following few years. But the economic situation is bound to change over these years, so it is most unlikely that central banks will follow through on these statements. These central banks were keenly aware of this problem. They insisted that these announcements were not meant to be forecasts, just statements of intentions at the time when they were made. Recognising the importance of uncertainty, the Bank of England promoted the practice of presenting not just the path of future interest rate but also a measure of the associated range of uncertainty, the fan charts. The range of uncertainty was computed on the basis of the history of fluctuations in the policy interest rates, a mechanical approach that was entirely backward-looking, which could not take into account future factors and events. In other words, the precision of the announcements, including the range of uncertainty, was illusory. Trusting such central bank announcements was bound to be disappointing. This would hurt the credibility of central banks, unless they would carry out their announcements in the hope of upholding their credibility, but at the cost of inappropriate policy decisions. A good idea turned to be a hornet's nest.

These were the years when central banks became "professionalised". They developed mathematical models to forecast the evolution of the economy. They used these forecasts to form an opinion of what their future decisions would be and of the range uncertainty that they faced. Although central banks were always keen to say that the forecasts were not adopted mechanically from their models, the influence of the models has been downplayed. The COVID-19 crisis has shown just that. The models have nothing to say about a world pandemic, simply because none has been observed since 1918. Yet, the forecasts by central banks and all economic forecasters have been driven by "what the models say". Predictably, they failed, and communication reached its limits.

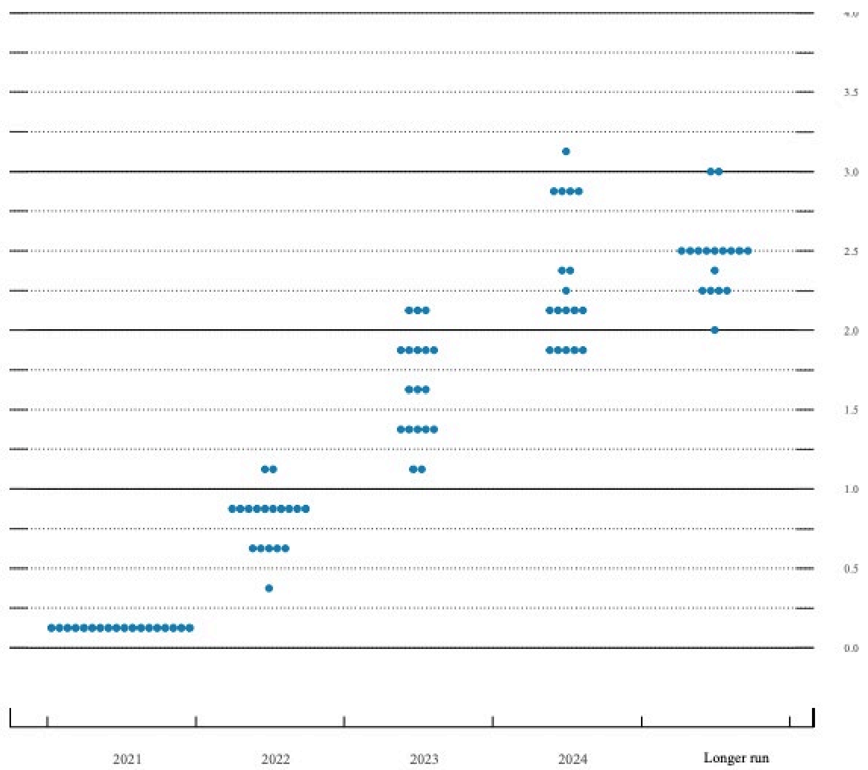
The Federal Reserve has adopted an original approach which establishes some distance from the models. It is publishing the projections and intentions of its policy makers, the members of the Federal Open Market Committee (FOMC). The resulting dots plots from the FOMC meetings of December 2020 and December 2021 are shown in Figure 1. The dot plots display a surprisingly high degree of conformity within the FOMC in December 2020 when looking at years 2020 to 2023, with few dissenting views. One year later, looking at years 2021 to 2024, they radically changed their views and disagreed. The changes were in response to a sharp increase in inflation, from 1.2% in 2020 to 7.0% in 2021. The December 2020 projections turned out be badly wrong, which casts doubt on those of December 2021. Note that there is no change for the "longer run", presumably because the FOMC members consider that the impact of the COVID-19 pandemic will have disappeared.

Figure 1: FOMC dot plots, December 2020 and December 2021

Meeting of December 2020



Meeting of December 2021



Source: Federal Reserve Board.

Note: Each dot represents the interest rate projected by one member of the FOMC for the current year and the 3 subsequent years.

It is a good time to draw lessons from the experience of the last decade. Communication has been driven by central bank efforts at shaping financial market expectations, which is desirable but should not be the alpha and the omega of the strategy. Over time, central banks and financial markets have become close to each other but estranged from the rest of the economy. Central banks need to address several other constituencies. Since their main task is price stability, they have to talk to price and wage setters, businesses and their employees. They also need to listen from them as well. After all, over the last decade they have been unable to reach their inflation targets for reasons that remain poorly understood. Finally, being independent, for good reasons, they must be accountable to the citizens, formally through their elected representatives, but also directly.

This paper argues that much remains to be done, at the European Central Bank (ECB) as well as at many other central banks. The starting point is that communication should not be confused with forecasts. Forecasts are highly unreliable at times of heightened uncertainty, in effect undermining the central banks' credibility. The ECB seems unwilling to share doubts and to reveal possibly divergent analyses among its decision makers as well as within their staff on the ground, because it could hurt credibility. I argue that the opposite is true. Here it may be worthwhile recalling a well-known quote from George Bernard Shaw: "If all economists were laid end to end, they would not reach a conclusion". The economics profession is famous for the diversity of opinions in its ranks. It would be surprising, indeed worrisome, that central banks do not share this diversity. Pretending the opposite is simply not credible. Gone is the time when central banks could be seen as better informed than the professional public. Now, the only existing information asymmetry is that central bankers have their own views, and their views matter because they make decisions. Communication should focus on intentions, and the analyses that lie behind intentions.

Uncertainty is compounded by complexity. The otherwise welcome increase in economic sophistication of central banks' work represents a major stumbling block for communication. It is one reason why central banks easily communicate with the like-minded financial market partipants. At the same time, central banks become isolated from their other constituencies. The paper examines this evolution and offers some suggestions.

2. CENTRAL BANKS AND THE FINANCIAL MARKETS: A HALL OF MIRRORS

2.1 A focus on financial markets

Central banks have been increasingly eager to communicate with financial markets, because these markets are a key channel of transmission of central bank decisions. The financial markets determine the shape of the yield curve, which is pinned down at the short end by the policy interest rate. The yield curve, in turn, affects borrowing costs, which drive investment and saving decisions. The markets also determine asset prices, which further impact business investments and household spending. Over time, the central banks have fine tuned their messaging to move the yield curves and asset prices close to levels congruent with their policy objectives. They are keen to shape market expectations.

The financial markets, on the other hand, are eager to avoid being surprised by central bank decisions, which can be costly if, say, stock prices suddenly fall (but also exploitable to achieve profits in the opposite case). Individual market participants fear being caught by surprise and made personally responsible form losses or missed opportunities. This is why most participants tend to align their expectations, and their financial positions, with each other in order to "be in the crowd". This strategy is handy when they suffer losses, since individual market participants can then claim that everyone else is facing the same misfortune. They may start with divergent opinions but coalesce around what the ECB tells them, not necessarily because they believe that the central bank knows better but because this is where "the crowd can meet" since this is what the central bank said. Central bank communication serves as a coordination device among market participants[1]. Viewed this way, the focus of central bank communication on financial markets can be dangerous for two main reasons.

2.2 The hall-of-mirrors phenomenon

The two-way relationship gives rise to the hall-of-mirrors phenomenon. The information provided by central banks is absorbed by the financial markets which, in turn, provide information to central banks. Each side looks at the mirror presented by the other side. The influence of central bank statements on financial markets is easily observed. The reverse is acknowledged in Grothe and Meyler (2015) as they note that "both market-based and survey-based measures outperform statistical approaches [the economic models] to forecasting inflation. This suggests that these measures should be used as informative variables for assessing possible future inflation developments in the central bank and academic analysis". This may be frequently untrue. As stated by Rungcharoenkitkul and Winkler (2021), "both sides end up misperceiving the macroeconomic effects of their own actions as genuine information: they are staring into a hall of mirrors". Indeed, both central banks and market participants frequently refer to "the consensus" as being the best possible forecast under the circumstances. The risk is that mistaken expectations are not properly challenged.

Figure 2 displays one-year ahead inflation forecasts by the ECB and by professional forecasters – mostly working in the financial markets – polled by the ECB, alongside the actual inflation observed in that

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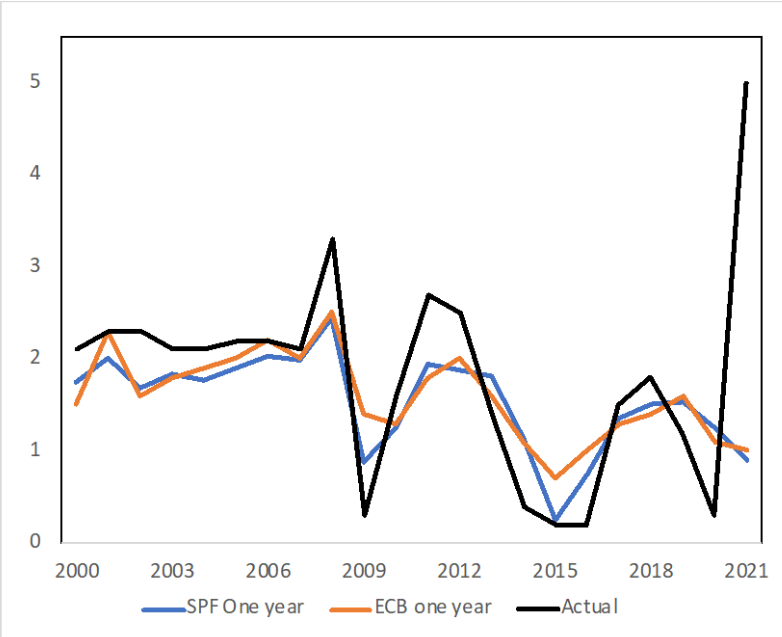
[1] This mechanism has been known since at least 1936, when Keynes developed the theory of beauty contests. He drew a similarity between financial market expectations and voting for beauty queens, which is described as follows; "It is not a case of choosing those [faces] that, to the best of one's judgment, are really the prettiest, nor even those that average opinion genuinely thinks the prettiest. We have reached the third degree where we devote our intelligences to anticipating what average opinion expects the average opinion to be. And there are some, I believe, who practice the fourth, fifth and higher degrees."

year[2]. The forecasts, which concern the euro area as whole, are produced at the end of a year for the following year, therefore they face the least demanding challenge. Both the ECB and the private forecasters often miss the large fluctuation of the actual inflation rate. Strikingly, the sign of forecast errors – whether the forecasts are above or below of the eventual outcome – by the ECB and the private forecasters is always the same, which is suggestive of a hall-of-mirrors effect.

Figure 2: One-year ahead ECB and private inflation forecasts



Source: *Survey of Private Forecasters*, ECB.

2.3 Financial dominance

The other source of concern is that the proximity between central banks and financial markets may also affect policy decisions. As they apparently convince markets, central banks may fear that policy decisions informed by new or previously overlooked information may hurt "the crowd". Delaying action until the markets are adequately prepared can be costly in the end, if not to the markets, at least to the macroeconomy. In such instances, central banks may refer to their responsibility to preserve financial stability, but these risks actually are a consequence of the hall-of-mirrors effect. The ECB's decisions to raise its interest rates in 2008 and 2011, generally seen as policy mistakes, were partly driven by such considerations.

This observation is highly relevant at this juncture. As indicated in a previous paper for the European Parliament (Wyplosz, 2021a), the ECB missed a chance of normalising its policy and escape the interest rate lower bound after the euro area crisis. It currently seems intent on waiting again for the right time at the risk of repeating its earlier mistake. One possible reason is that raising the interest rate will be painful for both highly indebted governments and for bondholders. This is true, of course, but the strategic need for normalising policy before it is too late should be acknowledged. Such an acknowledgement could well trigger a "normalisation tantrum" in the bond markets that the ECB may want to avoid. The fact that its thinking remains unknown reflects a lack of adequate communication, or a fear of market reaction, or both.

[2] An alternative to profession forecasts survey is to extract market expectations from swap rates. For the euro area, the data are available since 2005. They lead to the same conclusions.

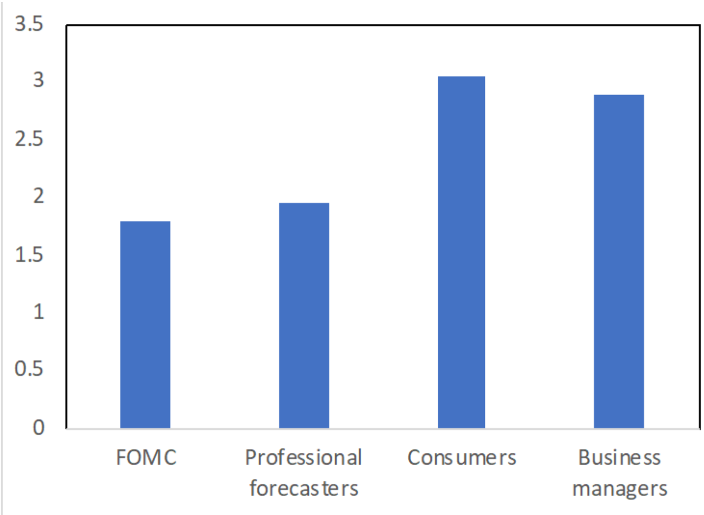
3. CENTRAL BANKS AND PRICE AND WAGE SETTERS

3.1 Which actors directly drive inflation?

Paradoxically perhaps, central bank communications seem more intent to affecting the channels of transmission of monetary policy to inflation than the inflation process itself. The generally-accepted description of the inflation process is the Phillips curve, partly for lack of an alternative. Much has been said about the disappearance of the Phillips curve or about it having become flat so that inflation is not sensitive to the state of the economy (employment, growth) anymore (Del Negro et al., 2020). However, the growing evidence is that the Phillips curve remains relevant. Explanations include the impact of globalisation through competition among labour markets around the world (Forbes, 2019). Other potential explanations look at measures of inflation that ignore its dispersion across good prices (Ball and Mazumder, 2020) and across regions (Hazell et al., 2020). Crucially, Candia et al. (2021) show that business and household inflation expectations profoundly differ from financial market expectations and are quite unanchored.

Thus, central banks are impressed by how effectively they anchor financial market expectations, they fail to recognise that they are failing to drive wage and price-setter expectations, which in turn drive the Phillips curve. Figure 3 displays one-year inflation expectations in the US, as collected in early 2021 from surveys of business managers, households and professional forecasters. It also shows the December 2020 average of one-year forecasts by Federal Reserve Open Market Committee (FOMC) members. Given that end-of-year inflation was 6.8%, consumers and businesses performed better than the FOMC and professional forecasters, which unsurprisingly reached very similar conclusions.

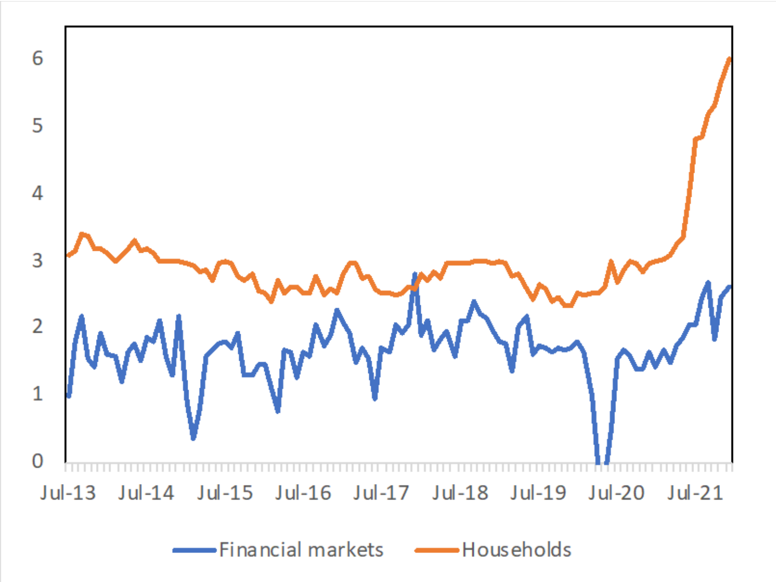
Figure 3: One year ahead inflation forecasts for 2021 in the US



Sources: FOMC;
Survey of Professional Forecasters, Federal Reserve Bank of Philadelphia;
Survey of Consumer Expectations, Federal Reserve Bank of New York;
Survey of Firms' Inflation Expectation (SoFIE), Candia et al. (2021).

Traditionally, the expectations of business managers and of consumers are higher than those of central banks and professional forecasters (Gagnon and Sarsenbayev, 2021; Verbrugge and Zaman, 2021). In a year when the sharp increase in the inflation came as a surprise, the superior performance of business managers and consumers could well be down to luck. Figure 3 compares one-year inflation expectations by households and the financial markets in the case of the US (the latter are measures derived from swap prices) since mid-2013. Household expectations systematically exceed the outcome, but they are more stable than those from financial markets, whose volatility reflects constant revisions. Except for the end 2021, household expectations respond very little to events and, in particular to those central bank announcements which drive financial market expectations. In fact, as noted in Figure 3, the December 2020 expectations of households ignored what the the FOMC was saying, while the financial markets were mirroring the Federal Reserve.

Figure 4: One-year inflation expectations in the US



Sources: *Survey of Consumer Expectations*, Federal Reserve Bank of New York; *Inflation expectations*, Federal Reserve Bank of Cleveland.

3.2 The need to inform price- and wage-setters

Candia et al. (2021) report that business managers and households are generally poorly informed about monetary policy. In contrast with financial market participants, most of them lack the necessary training to be interested in following events, discussions and policy decisions. Communication with this constituency requires a completely different approach. The ECB's answer is that its website contains a lot of plain-language information and education material, but it is likely that a tiny minority of the broad public will ever look at the website. The ECB has also created a Twitter account which broadcasts simple messages – sometimes in several languages – along with many pictures, but Gros and Capolongo (2020) suggest that the broad public is not interested. These well-meaning efforts betray a lack of adequate strategy.

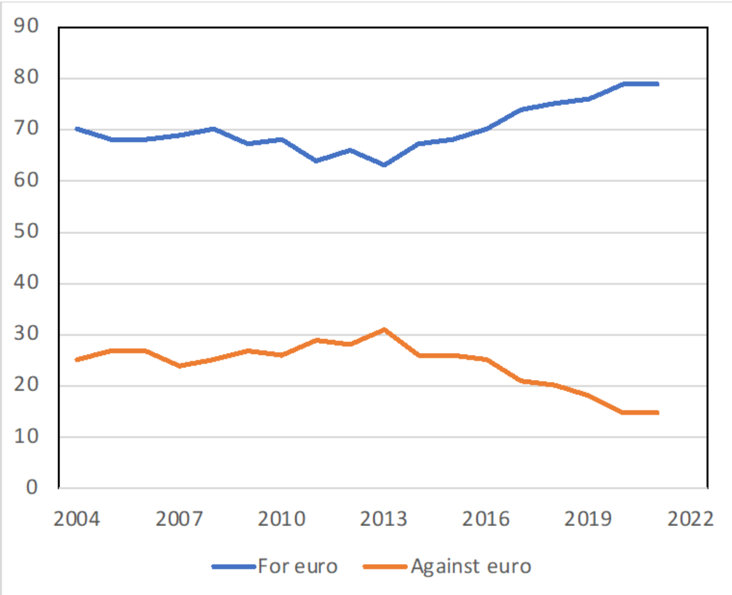
Communicating with the wage- and price-setters is undoubtfully most challenging and should be handled by specialists, so I can only offer a few simple comments. Some central banks, like the Bank of England, have active outreach programmes that require frequent meetings between members of its Monetary Policy Committee (MPC) and the broad public. Given the diversity of languages in the euro area, such a task could be carried out by the national central banks. All members of the Governing Council, who talk to the media and the financial markets, should expand their interventions more widely and meet the broad public. More generally, directly communicating with the broad public should be a major responsibility of the managers of national central banks, involving both speaking and listening.

3.1 Implications for policy making

This sort of communication immediately raises the issue of what representatives of the Eurosystem say and how they say it. The consensus principle, which is the declared objective of Governing Council deliberations, implies a very carefully-crafted communication. The result is invariably quite bland and unattractive beyond few specialists who know how to read in-between the lines. Effective communication therefore challenges the current decision-making process. The literature on MPCs weighs the risks from cacophony (Blinder, 2018) and those from groupthink (Archer and Levin, 2018), without reaching a consensus.

The multinational nature of the Eurosystem greatly complicates the issue and, therefore, the design of a communication strategy. It may be that, indeed, national differences make it impossible to go much farther than what is currently done, but that is not a foregone conclusion. When the euro was created, caution was understandable since the overriding objective was to convince all national public opinions that the euro could work. More than twenty years later, this mission is largely accomplished as indicated by results, shown in Figure 5, from public opinion polls conducted in euro area countries. Opinions differ across countries, ranging from 92% for and 7% against in Belgium, to 70% and 23% in Italy. In Germany, 82% of citizens are for and 12% against.

Figure 5: Are euro area citizens for or against the euro?



Source: Standard *Eurobarometer 95*, Spring 2021, European Commission.

It would be surprising if the ECB were not debating internally whether it should shift toward a more open and less consensual mode of communication. It would be equally surprising if risk aversion were not the dominating sentiment. Yet, the need to address the broad public may be undervalued or possibly dominated by discussions about the form (website, Twitter, etc.) rather than the content. To repeat, the purpose of communication is not to convince but to share analyses, intentions, and risk perception.

4. ACCOUNTABILITY

Perhaps the most important constituency for ECB communication is the European Parliament. In contrast with financial markets and price and wage-setters, in this case the purpose of communication is less about intentions and more about past actions, although the distinction is not waterproof.

The communication has evolved over time and now goes beyond the strict legal requirements. The President of the ECB meets the Parliament's Committee on Economic and Monetary Affairs (ECON) not just once but four times a year and answers written questions submitted by its members. The other members of the Executive Board also meet with the ECON committee. The ECON committee prepares the meetings with the ECB President by commissioning papers from outside experts, of which the present paper is part. On paper, the accountability process is excellent.

In practice, there is room for improvement, as already noted in my latest paper for the ECON Committee (Wyplosz, 2021b). The President comes to the Parliament after the publication of the ECB's Annual Report and after the press conferences that follow monetary policy meetings of the Governing Council. The President's presentations are carefully scripted, precisely following the latest official documents published by the ECB. It implies that the presentation offers little or no new information. New information can only emerge in the following questions and answers (Q&As). However, Collignon and Diessner (2016) describes how the Q&A sessions usually lack precise evaluations of policy decisions. They also report that the ECON Committee members do not think that the dialogue has much influence of ECB decisions. This is not an indictment of the accountability process, which concerns the evaluation of past, not future policy decisions. On the other hand, the accountability process should reveal policy decisions that can be deemed mistaken. Collignon and Diessner (2016) documents two well-known episodes (in 2009 and 2011) when the ECB escaped adequate criticism. One of their conclusions is that the quality of the Monetary Dialogue depends on the willingness of the ECB President to engage the ECON Committee. This should not be an option.

What could improve this process? The ECB could move out of its comfort zone by shortening the presentations of its already known communiqués and by sharing its doubts, possibly even accepting that another course of action could have been followed. Obviously, it has no incentive to do so. The ball, therefore, is squarely in the hands of the Parliament. Its recent resolution (12 February 2021) includes suggestions to that effect, but they remain too general to be effective. The MEPs too need to move out of their comfort zones, with fewer prepared statements and more precise focus on the relevant issues of the day.

5. UNCERTAINTY

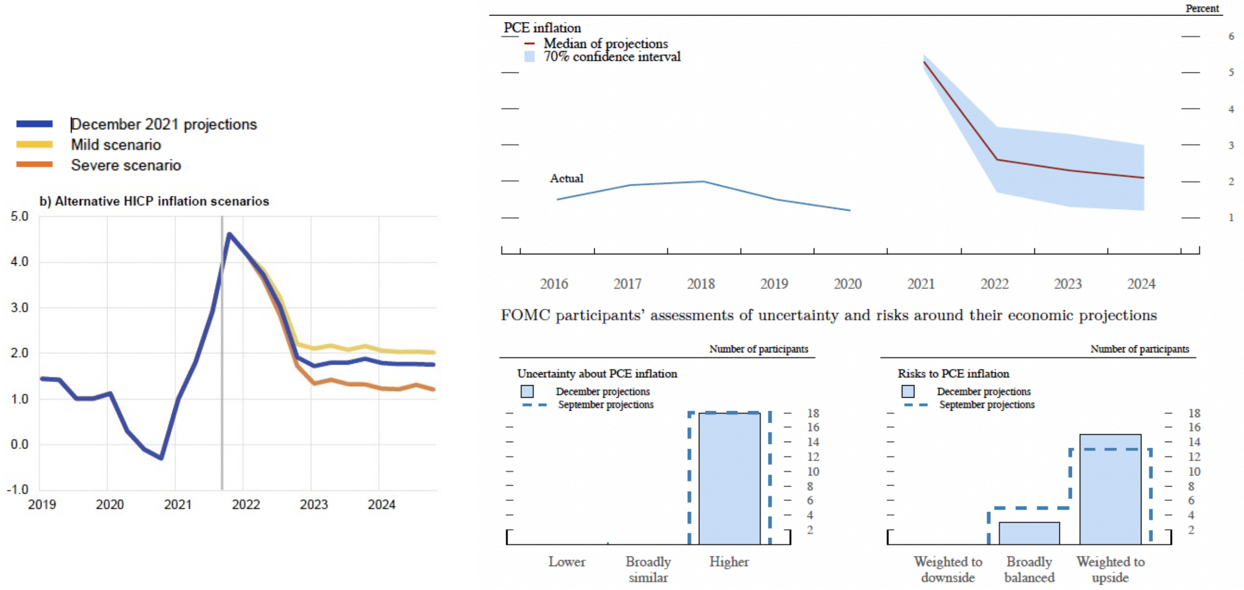
In 2021, the ECB was the last major central bank to admit that its assessment that inflation is purely transitory is subject to doubt. It is too early to know what will happen with inflation in the coming year and beyond. Given that the pandemic is unprecedented in modern times, including the forceful responses by governments, forecasts for 2021-23 were always bound to be subject to exceptional uncertainty. By and large, the ECB has long failed to acknowledge this uncertainty, both in its forecasts and in its forward guidance.

This can be illustrated by comparing the communications of the ECB and the FOMC. Figure 6 presents the inflation forecasts for 2022-24 published in December 2021. The ECB displays its central projection and two alternative scenarios, as prepared by the staff. Inflation is predicted to decline below 2% by end 2022, and to stay there. The margin of error described by the two scenarios is small, ranging in 2022 from1.3% to 2.1%. Scenarios, however, are not stress tests, they are collections of arbitrary possibilities. As described in Section 1, the FOMC publishes the forecasts by members of the FOMC. It synthesises the dot plots (Figure 1) by displaying the median projection as well as a 70% confidence interval. Figure 6 shows that the projected decline of inflation is much more gradual than in the euro area, since the median projection hits the 2% target in 2024, one year later. Obviously, the economic situation in the euro area and the US differ so the projections do not have to be the same. More importantly, however, the FOMC's published margin of error is much wider than in the case of the ECB, ranging in 2022 from 1.7% to 3.5%. It is not clear why the ECB should be more confident of its projections than the FOMC. As important is that the FOMC displays in the same figure a chart that indicates how its members evaluate the risks in their projections (they consider that the risks are tilted toward a higher inflation rate. Clearly, the FOMC is more willing to share its doubts than the ECB.

Figure 6: Inflation forecasts, December 2021

ECB

FOMC



Sources: Eurosystem staff macroeconomic projections for the euro area (Chart B), ECB, December 2021;
Summary of Economic Projections (Figure 4c), FOMC, 15 December 2021.

This matters greatly for communication. As noted by King (2021), "the danger now is that although financial markets may have lost faith in the forward guidance given to them, central banks themselves continue to believe in it and to cling to a narrative about the future path of interest rates that is no longer credible with inevitable problems for the clear communication of policy decisions". It may be that the ECB will be proven right, but its published tight margin of error makes it less likely than in the case of the FOMC, which explicitly acknowledges that it may be underestimating future inflation. It also matters for policymaking. The FOMC is understood to be contemplating raising its interest rate in 2022, while the ECB is believed to not plan any such increase.

6. FINANCIAL STABILITY

As most other major central banks, the ECB has taken responsibility for financial stability. It includes regulatory responsibilities, such as its role in the Single Supervisory Mechanism. It also concerns its contribution to the Single Resolution Board and to national prudential policies, a process of transfer of responsibilities still incomplete. The question is whether normal monetary policy aiming at price stability may be affected by this additional objective.

Under its price stability mandate, the ECB adjusts its interest rates in response to expected deviations of the inflation rate from its target, which is relatively easy to communicate. However, even such a simple rule can become subject to a complicated trade-off because monetary policy operates through its effect on economic growth and employment via the Phillips curve. For instance, inflation may be too high at a time when growth and employment are too low, or conversely. This is a well-known trade-off and all central banks have developed principles on how to respond. The ECB's primary objective of price stability shapes its strategy and can be communicated. Still, errors can be made.

Adding the objective of financial stability creates the possibility of an additional trade-off. For example, when financial markets wobble, the central bank must provide liquidity, possibly in very large amounts, and may also need to lower interest rates, which would round against an on-going restrictive monetary policy stance justified by the price stability objective. It may even be that it is the restrictive monetary policy stance that creates market instability. In fact, this is the situation that is currently feared for the coming period.

A natural solution to trade-offs is to "aim at the middle", another solution is to establish a ranking of priorities. Financial instability, however, often builds up very quickly and can become highly dangerous in little time. In that case, financial stability suddenly becomes an over-riding priority, which happened in 2008. Aiming at the middle is unlikely to work in these circumstances. Designating financial stability generally as a priority over price stability is dangerous because a central bank may become too concerned for too long about this priority and let inflation rise[3]. A reasonable compromise is to establish an escape clause: price stability is the normal objective, but it can be explicitly overridden by financial stability in clearly delimitated circumstances. This is not the announced solution of the ECB, which insists on identifying price stability as it primary objective, always.

The reasoning so far only looks at standard monetary policies, which use the interest rate as the policy instrument. Nonstandard policies, however, rely on liquidity provision and can kick in when the interest rate is at its lower effective bound. As macroeconomic instruments, nonstandard policies are intended to support lending to the private sector. They can be used to prevent financial instability, by reducing the risk of illiquidity and propping up asset prices. To some degree, the interest rate and nonstandard policies are distinct instruments.

It could make sense, therefore, to use the interest rate – when it is not at the lower bound – to aim at price stability and nonstandard policies to be the first port of call in case of financial instability. In 2008, 2012 and 2020, the two objectives fully justified using this instrument, but that may not always be the case.

The current situation provides an example. Inflation is on the rise, maybe not temporarily. Several central banks have already started to raise their interest rates and others are announcing their intention to do so. Currently, many asset prices are historically high. The financial markets are becoming jittery as they fear that rising interest rates will provoke significant falls in asset prices. Central banks face an

[3] Some observers fear that it is currently happening.

uncomfortable choice: it is not a good time to both raise interest rates and undo the financial market stabilisation use of nonstandard policies.

The upshot is that the ECB is right to indicate in its strategy review that it intends to retain both instruments, but it also needs to explain how it plans to deal with possible trade-offs. It makes sense not to make any ex-ante commitment. Constructive ambiguity has important advantages, especially when it prevents the financial markets from taking large risks on the assumption that the central bank will interfere forcefully when the risks materialise in the form of market instability. Beyond recalling the primacy of the price stability objective, however, the ECB has not explained how they plan to deal for a possible trade-off.

For example, in the coming year or two, the ECB might face simultaneously a high inflation rate and financial destabilisation. If price stability is the primary objective, then it will not lower the interest rate nor engage in accommodative nonstandard policies. It may do nothing, relying on financial instability to reduce inflation. It is not credible that it would stay idle when financial markets enter a crisis phase, or even less credible that it would keep rising its interest rate to fight inflation. Both strategies would accelerate and deepen the financial crisis. Hopefully, this situation will not arise, but the ECB should prepare for the worse and delineate a strategy.

7. CONCLUSION

It is customary to recall the time when central banks were not communicating at all. In fact, up until the 1970s, the Federal Reserve was not even announcing its policy interest rate decisions. Since then, progress has been impressive and very interesting. As could have been expected, though, we have realised that central bank communication is much more complicated than just talking.

Central banks will have to refine their communication strategies. They will have to recalibrate the relative importance of their constituencies, focus less on financial markets and more on the broader public. They will have to be more careful in their forecasts and less sanguine in their forward guidance. They will have to be mindful of driving financial markets toward what they wish. The common theme of these evolutions is that they will have to pay more attention to uncertainty and less on shaping expectations. Communication will have to deemphasise forecasting and forward guidance and shift toward explaining analyses, doubts, and the variety of options that they contemplate.

Over the last decade, central banks have also expanded their aims and instruments. In particular, they have taken explicit responsibility for financial stability, which they always exercised but implicitly and sporadically. They have developed new instruments, regrouped under the label of nonstandard policies. They initially presented these instruments as a response to the fact that the classic interest rate instrument had reached its effective lower bound. However, nonstandard policies also, possibly mainly, are the instrument of choice to preserve financial stability. For both policymaking and communication, they will have to clarify how they use these instruments.

The ECB is no exception in this need to make communication evolve, but it is exceptional in that it is a multinational institution. It must talk to different public opinions using different languages. It must accommodate national public opinions that sometimes diverge. So far, the solution has been to claim to focus on the euro area as a whole, not on specific countries. Yet, it cannot ignore, and has not ignored, divergences in opinion and in specific economic situations. This has already affected its decisions – the outright monetary transactions programme and the pandemic emergency purchase programme are two prominent examples – at the risk of becoming contentious. Such an evolution raises deep policy issues but also makes communication all the more challenging.

This desired evolution stands to directly affect the accountability procedure of the ECB, the Monetary Dialogue with the European Parliament. The ECB will have to move away from carefully scripted statements. The ECON Committee too will have to evolve.

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Central bank communication has been developed over the last decades. Much has been learned over time, revealing both the complexity and usefulness of communication. This is an area where there is room for significant improvements. Most of the possible improvements question the way the ECB operates. Only seeking to better talk will not be enough to meet this important challenge.

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