BLOG

Transparency and communication improves the efficiency of monetary policy

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Inflation-targeting central banks adjust their interest rates in response to inflation. If inflation is well below target and monetary policy is credible, consumers and investors should expect interest rates to fall. If, instead, inflation is above target, they should place a high probability on interest rates being hiked in the near future.

Inflation-targeting central banks have chosen different ways to define their price stability objectives – inflation targets in short. In the case of the European Central Bank (ECB), the Governing Council states that *'in the pursuit of price stability it aims to maintain inflation rates below, but close to, 2% over the medium term'*.

The ECB's definition of price stability leaves some room for interpretation. In particular, the definition alone does not unambiguously state what the exact targeted rate of inflation is. Uncertainty over the exact definition of price stability may hinder the private sector's ability to make accurate predictions on the future path of interest rates and jeopardise the effectiveness of monetary policy, unless the ECB succeeds in its communication strategy. This is because interest rates are one of the key determinants of consumption and investment decisions taken by economic agents. If the interest rate is high (low), households and firms are likely to postpone (bring forward) their consumption and investment decisions. As a high interest rate curbs demand (consumption and investment), it is also likely to lead to lower inflation, and vice versa.

Interest rates and inflation matter for the financial markets too. Stock prices, bond prices and exchange rates all depend on the current and expected paths of the interest rate and inflation.

It follows that the general public having a good understanding of the central bank's current and future policy helps households, firms and financial market participants make better consumption and investment plans. This enhances the transmission of monetary policy, as the central bank is able to steer economic behaviour towards the direction the bank wants, essentially by managing private sector expectations.

Together, in a recent research paper co-authored with Maritta Paloviita, Markus Haavio and Pirkka Jalasjoki, we analysed the European Central Bank's reaction function using real-time data. [1]. The analysis provided two alternative interpretations of the ECB's definition of price stability. According to the first one, the ECB is more concerned over inflation rates above 2 % than rates below 2 %, which reflects asymmetry in its policy response to inflation. In the second interpretation, the *de facto* inflation target of the ECB is around 1.6–1.7%, but the policy responses are symmetric around these values of inflation. While both of these reaction functions do reasonably well to explain the behaviour of the ECB during 1999-2014, the reaction function based on the second interpretation of price stability seems to be better aligned with more recent policy decisions.

Most central banks, including the ECB, do not publish their preferred interest rate path, so consumers and investors need to infer it from other macroeconomic information and central bank communications. However, the majority of them may not be able to form consistent expectations concerning the future path of interest rates. Further complications may arise if the price stability objective is not well understood or is subject to ambiguity. Modern central banks, such as the ECB, seek to reduce this uncertainty by communicating their current and future monetary policy stance while also providing information on the central bank's current view on the state of the economy. Open and transparent communication is a win-win situation: it helps the private sector make better economic decisions and allows the central bank to achieve its price stability objective more efficiently.

Key words

ECB, inflation, interest rates, monetary policy