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Central Bank Communication: Managing Expectations through the Monetary Dialogue

Ansgar Belke

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Abstract
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JEL-Classification: E52, E58, G14

Keywords: central bank communication, European Central Bank, forward guidance, monetary dialogue, transparency

Central Bank Communication:

Managing Expectations through the Monetary Dialogue

by

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1. Introduction

Over the last two decades *before the financial crisis*, communication has become an increasingly important aspect of monetary policy. Among others, the advent of inflation targeting in the early 90s worked as the catalyst for enhanced transparency and communication in the conduct of monetary policy. The latter was the focus of mostly empirical research on central bank communication in the decade before the financial crisis broke out. Secrecy and opacity were the keywords in that era of central banking.

The evidence gained by later scholarly papers suggests that *communication can represent an important and powerful part of the central bank's toolkit*. This is because it has the capability to move financial markets, to raise the predictability of monetary policy decisions, and, in the optimal case, also to help achieve central banks' macroeconomic objectives (Blinder, Ehrmann, Fratzscher, de Haan, and Jansen, 2008).

With an eye on the specific cases of the European Central Bank (ECB) and also the US Fed, the huge variation in communication strategies across central banks suggests that (a) *a consensus has yet to emerge* on what makes up for an optimal communication strategy and (b) that the *optimal communication strategy depends on the specific circumstances* which obviously became the favorite explanation for differences in the ECB's and Fed's communication strategies after the crisis set in (Blinder, Ehrmann, Fratzscher, de Haan, and Jansen, 2008).

There are also *differences in) central bank communication before, during and after the crisis*. This is because, in the wake of the crisis, the *trend towards enhanced transparency and communication in the conduct of monetary policy accelerated*. This in turn resulted in further significant advances in monetary policy and financial stability communication. Most importantly, this included the emergence of extraordinary *forward guidance* as a distinct policy tool under unconventional monetary policies.

In this context, this contribution conveys the fact that, starting with attempts to fine-tune monetary policy during the “Great Moderation”, central banks have been increasingly concerned with improving their *communication with financial markets*.

(Allegedly) Better communication has been implemented to facilitate the conduct of monetary policy by *anchoring inflation expectations* and *reducing private sector uncertainty over monetary policy*. But communication has also been supposed to increase the transparency of independent central banks in order to make them *more accountable* to the public.

Just in accordance with these steps toward increased transparency, central banks have put much effort in thoroughly *communicating unconventional monetary policies* which were implemented during the financial crisis. The dominant purpose of these communications is to make sure that, in spite of providing almost unlimited amounts of monetary (and finally also financial) liquidity, financial market participants have no reason to doubt central banks’ credibility and independence.

However, this contribution will underline an important additional aspect: successfully *managing a course back to normality* (“exit”) will depend crucially on the central banks’ ability to *communicate effectively a credible strategy for an orderly exit* from such kind of policies. In this context, *clear, deliberate, coordinated messages that are anchored in the central banks’ mandate* are of essence.

The remainder of this contribution proceeds as follows. In section 2, it gives an overview of the literature dealing with central bank communication and expectations. Section 3 then focuses upon transparency and “forward guidance” as potential tools to stimulate the economy in the Euro Area. Based on a further literature review, it delivers details on whether and how the effectiveness of central bank’s policies can be improved through more transparency and “forward guidance”. We do so by highlighting marked differences in the Fed’s and the ECB’s interpretation of “forward guidance”. Is publishing the Minutes of

Council meetings and publication really a good idea? And, how to assess a publication by name who has voted in what way in the meeting in the minutes? Are central banks such as the ECB plagued by deficiencies in transparency – with an eye on the bank's steadily growing responsibilities? Should central banks such as the ECB stick to the instrument of "forward guidance" even beyond the crisis period? How predictable and assessable can and must monetary policy be? Can central banks such as the ECB be endowed with too much communication duties that guidance itself become a source of volatility on its own? The ECB, for instance, has adopted banking surveillance in the Euro Area: do particular transparency and accountability obligations result from this? And if yes, how can the latter be fulfilled?

In order to highlight the key issues of central bank communication and the management of expectations referring to a practical institutional example, the contribution comments in section 4 on the role the Monetary Dialogue in the context of an evolving monetary policy. For this purpose, this section first discusses the arguments in favour of more ECB transparency. It then compares the effectiveness of publishing the minutes with reference to the new ECB voting model, i.e. the so-called rotation model. This section also describes why the recognition of a lack of ECB transparency may actually improve the design of the Monetary Dialogue. For this end, the current framework for the Monetary Dialogue and its potential changes are discussed in terms of the ECB's new "forward guidance" communication strategy, the transparency of data revisions and the choice of the underlying macroeconomic model. It finally elaborates on how accountable the ECB shall be towards the European Parliament. The need for increasing ECB's transparency and accountability stems from its new supervisory roles. Given their importance, they are emphasised separately. The section finally discusses issues related to the limits to transparency and communication.

In section 5, communication is described as a policy option in terms of minimising risk in the context of exit from unconventional monetary policies and of the signalling channel which refers to what the public learns from announcements of unconventional monetary policy operations such as Quantitative Easing (QE). As a final practical example, this section studies the impact of forward guidance used as an unconventional monetary policy tool at the zero lower bound of the policy rate on real and break-even Treasury yield curves, i.e. on inflation expectations.

2. Central bank communication and expectations – an overview

The significance of a communication strategy for policy effectiveness can be derived from a basic property of the challenge a central bank is typically faced with. “Central banking is not like steering an oil tanker, or even guiding a spacecraft, which follows a trajectory that depends on constantly changing factors, but that does not depend on the vehicle's own *expectations* about where it is heading. Because the key decision makers in an economy are forward-looking, central banks affect the economy as much through their influence on expectations as through any direct, mechanical effects of central bank trading in the market for overnight cash.” (Woodford, 2005). It thus makes much sense for a central bank to follow and to commit itself to a systematic policy approach “that not only provides an explicit framework for decision making within the bank, but that is also used to explain the bank's decisions to the public” (Woodford, 2005).

Since the end of the nineties, a growing emphasis on transparency and enhanced communication in the conduct of monetary policy has manifested itself among central banks worldwide. Indeed, transparency and communication have to an increasing extent been central in the modern conduct of monetary policy, since they have been interpreted as integral parts of “best practices” in monetary policy. This transition to greater openness, from the times when secrecy was the norm rather than the exception to the full-fledged publication of policy meeting minutes, is still continuing (Vayid, 2013). However, significant progress has already been reached by historical standards (Filardo and Guinigundo, 2008).

Indeed, central banking is characterised by a long tradition of secrecy (Geraats, 2007, Goodfriend, 1986, and Vayid, 2013). “Central bankers around the world used to attach a certain “mystique” to their activities. They considered monetary policymaking an arcane and esoteric art that should be left entirely to the initiates; if not, as the consensus view held, public discussions would not only usurp the prerogatives of the insiders but would likewise undermine the effectiveness of monetary policy” (Bernanke, 2004).[i]

During this earlier days, information about policies was routinely employed to *surprise the markets*. Strategic disclosures were frequently limited to policy actions themselves, without really explaining the reasoning which drove the monetary policy decisions (Vayid, 2013).

The trend toward a higher degree of transparency and improved communication was caused by central bankers’ growing recognition that the effectiveness of their policy actions would be higher if markets understood those better (Guinigundo, 2006). As Ehrmann and Fratzscher (2005) state, “Central banks have direct control only over a single interest rate, usually the overnight rate, while their success in achieving their mandate requires that they are able to influence asset prices and interest rates at all maturities.” Effective communication combined with credible policy actions was increasingly seen as fundamentally important for achieving central bank objectives.

The focus on transparency and communication was boosted by the increasing interest in a higher degree of *accountability* of central banks as well, since more and more central banks were granted independence from the government. Responsibility over money and banks by a non-elected central bank (which otherwise could be called a non-democratic institution) could be established if it were institutionally forced to make its targets and monetary policies better known to the general public.

Finally, the increasing preferences worldwide in favour of inflation targeting with its focus upon central bank transparency and accountability has also provided some stimulus to increase both the disclosure and the “openness” of central banks. Inflation targeting as a framework is intended to establish an explicit link among monetary policy decisions and the central bank’s assessment of future inflation (Belke and Polleit, 2010). It thus attaches much importance to the release of *timely information* about the specific view of the central bank on the inflation outlook.[ii]

Let us now turn toward empirical evidence. Ehrmann and Fratzscher (2005) demonstrate empirically hat central bank communication represents a key driver of the markets’ capability to anticipate monetary policy decisions and the future path of interest rates. Based on a comparison of communication policies by the Federal Reserve, the Bank of England and the ECB since 1999, they come up with the result that communicating the *diversity of views* among committee members about monetary policy *decreases* both the markets’ capability to anticipate policy decisions and the future path of interest rates. Accounting for about nearly half of the prediction errors of FOMC policy decisions, the estimated impact is sizeable. On the contrary, *individualistic* communication with respect to the economic outlook turns out to be favorable for the Federal Reserve. This is because it enables the markets to anticipate the future path of interest rates with higher accuracy. Thus, it is exactly the *collegiality of views on monetary policy* but the *diversity of views on the economic outlook* that strengthen the effectiveness of communication by central banks.

Nearly a decade later, empirical evidence systematically underscores the benefits of better central bank communication in the context of the financial crisis. In the following, the results of a few studies are described more closely.

Draeger, Lamla and Pfajfar (2015) investigate whether *central bank communication is able to support the understanding of key economic concepts*. Employing survey data for consumers and professionals, the authors assess how the share of them which has expectations consistent with the Fisher Equation, the Taylor rule and the Phillips curve. What is more, they test, whether central banks are able influence them by accounting for three different channels of communication. The biggest share of participants is characterised by expectations consistent with the Fisher equation, followed by the Taylor rule and the Phillips curve. The authors reveal that having theory-consistent expectations is beneficial, as it improves forecast accuracy. This is also valid for cases in which consistency turns out to be time-varying.

Hayo and Neuenkirch (2014) investigate whether *central bank communication has a positive impact on market participants' perception of central banks' credibility, unorthodox monetary policy measures, and independence.* They conduct a survey of more than 550 financial market participants from all around the world who replied to questions with respect to the Bank of England (BoE), the Bank of Japan (BoJ), the European Central Bank (ECB), and the Federal Reserve (Fed). According to their study, markets believe that the Fed communicates best, followed by the BoE, ECB, and BoJ. With respect to credibility, satisfaction with unconventional monetary policy and a potentially shrinking independence, they empirically identifiy similar rankings. Estimating ordered probit models, Hayo and Neuenkirch (2014) conclude that central bank communication has a positive impact on how central banks are perceived and understood, since communication enhances credibility, enhances satisfaction with unorthodox measures, and strengthens the perceived central bank independence.

More recently, central banks regularly deliver communications about financial stability issues, by publishing Financial Stability Reports (FSRs), speeches and interviews. In this context Born, Ehrmann and Fratzscher (2011) assess how such communications impact on financial markets. They empirical assess the reactions of stock markets to more than 1000 releases of FSRs and speeches by 37 central banks over the 14 years before 2011. Their results suggest that FSRs have a significant and potentially persistent impact on stock market returns, and tend to diminish market volatility too. On the contrary, speeches and interviews induce only small effects on market returns and also do not reduce volatility during tranquil times.

However, they had a substantial effect during the 2007-2010 financial crisis. These findings suggest that central bank communication regarding financial stability are perceived by markets to contain relevant information especially in hard times. What is more, they again underscore the significance of *differentiating between communication tools, their content and the environment in which they are employed* (Born, Ehrmann and Fratzscher, 2011).

Without any doubt the prevailing trend towards more transparency in monetary policy[iii] enhances central banks' accountability vis-à-vis the public. The ECB's idiosyncratic position as a central bank in a monetary union of independent states (i.e., in the absence of political union), however, makes publishing the attributed minutes and voting records an undesirable venture (Gersbach and Hahn, 2013).

3. Transparency and Forward Guidance - tools to stimulate the economy in the Euro Area?

In the following, we assess what other tools/instruments beyond the previously implemented non-standard monetary policy measures the ECB could use in order to stimulate the economy in the Euro Area. This section does so by delivering details on whether the effectiveness of the ECB's policies can be improved through more transparency and "forward guidance", both important elements of central bank communication.

3.1 Minutes of Council meetings and publication by name

In autumn 2012, ECB President Mario Draghi has urged the ECB to publish the minutes of the Council meetings in the future[iv]: is this really a good idea (Schroers, 2013)? And, how to assess a publication by name who has voted in what way in the meeting in the minutes? On February 19, 2015, the ECB has finally started the regular release of the minutes of its policymaking meetings[v], something other major central banks have been practicing since the 1990s (Wyplosz, 2015). But the publications of minutes of the meetings of the Governing Council, officially called an "account", will as things stand, include only an anonymous summary of the discussion.

As indicated in section 2, the debate about a more transparent ECB has been revived by a significant change of its tasks during the crisis. With its Securities Market Program (SMP) and its Outright Monetary Transactions (OMT) the European Central Bank has got very close to the adoption of fiscal policy tasks and hence risks not to conduct pure monetary policy any more. Like finance ministers, it should be thus made accountable in the necessary detail to parliaments. This view appears legitimate because monetary policy has de facto been re-nationalised during the crisis as, for instance, through a resuscitation of national banking systems by the emergency liquidity assistance (ELA, see, for instance, Joerg Kraemer in Handelsblatt, 2013, and Gros, 2012).

The ECB‘s press release as it stood before the regular “accounts” were introduced in 2015 did not allow outsiders to get an appropriate idea of the monetary policy discussion in the Governing Council. This is all the more so since new assignments in the area of financial stability beyond the above mentioned quasi-fiscal tasks accrue to the ECB and conflicts with the price stability goal cannot be excluded any more (Belke, 2013).

It was clear from the beginning with an eye on the arguments presented in section 2, that by publishing Governing Council meeting minutes, following the Fed and BoE blueprints - the ECB may improve the transparency and efficiency of its policies significantly, which would support its stability-oriented orientation from least two angles. On the one hand, the publication of minutes should provide a disciplinary incentive to improve on the quality of internal discussions between Governing Council members and counteracts any effort of Council members to deviate from a euro-wide oriented monetary policy. On the other hand, published minutes may contribute to an improved balance of “influential power” among ECB Board members and the presidents of national central banks (Belke et al., 2005).

This is of interest, for instance, from the German point of view since this country’s representatives took minority positions against the ECB Board, a group of Council member which is much more influential than the national central bank governors (Belke and von Schnurbein, 2012) several times in the past. Up to now, this pattern was identified quite easily with only little guesswork on an informal basis, even without any explicit naming.

The, at that time, foreseeable extension of the Governing Council due to the envisaged further extension of the Euro Area and the reform of the Council's voting modalities enhanced the rationale for publishing minutes (Gersbach and Hahn, 2013). It was clear that further Euro area enlargement would increase the number of members which in turn would make discussions more many-faceted. Moreover, after the Euro Area would have welcomed its 19th member (which in the end turned out to be Lithuania at the start of 2015), a complex reform of the voting modalities would take place which could lead to irritations of the public (Belke and von Schnurbein, 2012).

Certainly, ECB Governing Council meeting minutes shall not necessarily attribute names to individual statement made in Council meetings; they serve to explain the ECB Council's thinking, debate and decision to the outside world. The reason is that the council members, governors of the national central banks could be put under pressure by their governments to vote in the interest of their home countries. Why? The majority of the ECB's council members are the Presidents of the national central banks appointed by national governments, which in turn are accountable to their national electoral constituencies. The national governments' power to reappoint them is speaking against ensuring the ECB's independence. And, as referred to several times in this contribution, there are conflicts of interest among some countries of the euro area (Gersbach and Hahn, 2009). This is endangering the functioning of the monetary union as a whole, as the sensitivity of the central bank's policy to regional shocks and regional demands to alter the common monetary policy increases (Gersbach and Hahn, 2013).

The independence of the Council members would be jeopardised, not to speak of the difficulties due to differences in money and credit growth in the Euro Area and in individual Euro Area countries (Gersbach and Hahn, 2013). And the more explicit the minutes are, the more it has to be feared that controversial topics will be discussed only informally and excluding the public in the future (FAZ, 2013a).

As mentioned already in section 2, any argument for opacity and secrecy has to be taken with caution and should be carefully weighed against the central argument in favor of transparency, i.e., that transparency increases the accountability of a public authority such as a central bank towards the public. The accumulation of power connected with the ECB's new competencies in banking supervision necessitates close and democratically legitimated control. This, in turn, requires stringent transparency and accountability standards. Whereas the publication of voting records and attributed minutes would increase the accountability of individual central bankers vis-à-vis their governments, it would also diminish the ECB's capability to align its policies with the interests of the citizens of the Eurozone as a whole. "Hence, the central argument in favor of transparency has no bite in the context of voting transparency – and may even turn into an argument in favor of secrecy" (Gersbach and Hahn, 2013).

Just reporting the statistical distribution of the arguments and votes thus appears at this stage sufficient in order to put the ECB under pressure to explain to what extent her decisions are in line with its European mandate. Any assignment by name is not necessary for this to happen (Geraats, Giavazzi and Wyplosz, 2008).

From 2015 on, the Eurosystem has been publishing accounts of monetary policy meetings held by the ECB's Governing Council on a regular basis. Four weeks following its first meeting of the year on 22 January 2015 the ECB had issued the first-ever summary report of this kind. The intention of these minutes is not to provide a word-for-word transcript but rather a summary of the ECB's Governing Council members' discussions about monetary policy. Thus, any report on individual vote casts is absent (Deutsche Bundesbank, 2015).[vi]

The Governing Council has met once a fortnight before 2015[vii] and from 2015 onwards a monetary policy meeting takes place every six weeks. The latter can be interpreted as a measure to improve communication since the ECB is driven by the markets to a lesser extent if the frequency of press conferences is diminished. (Bundesbank, 2015).

The ECB Governing Council intends that the accounts will provide the general public and market participants with greater transparency about the deliberations behind its monetary policy decisions. The Bank of England and the US Federal Reserve have already been publishing similar documents for some time now (Bundesbank, 2015).

3.2 European Central Bank: lack of transparency?

Is the ECB still plagued by deficiencies in transparency – as claimed by some observers with an eye on the bank's steadily growing responsibilities? Can we think of other means of enhancing transparency beyond the publication of minutes and to explain ECB policies better?

With respect to monetary policy, section 2 has shown that it is widely accepted that politically independent central banks should choose their policies in a way such that market participants understand them and, if necessary (because monetary policy eventually risks to deviate from its pre-announced target), are able to give voice to their criticism. From this perspective, transparency is a decisive instrument to align monetary policy with the stability preferences of the population (Belke et al., 2005).

The European Central Bank has regularly been placed quite high in a variety of transparency rankings conducted for the pre-crisis period (Dincer and Eichengreen, 2007). But this transparency weakened significantly in the course of the conduct of its Securities Market Programme (SMP). The ECB merely published the weekly total amount of bonds purchased without informing about the country-specific structure, the maturities of the bonds , the criteria and/or the extent of future purchases (for details see Belke, 2012). This clear lack of transparency is striking, especially in comparison to the huge degree of transparency of the Fed and the BoE in the course of their quantitative easing (QE) programmes. Exactly these central banks disclosed detailed information in order to be accountable to their taxpayers (Gros, 2012, p. 12).

In the public, the ECB frequently justified its “secrecy” with its necessity for the functioning of the sovereign bond purchase programmes. *If there would not have been secrecy*, the bank’s representatives say, *the programme would have lost its efficiency*. This is because complete transparency (about the fact that initially Greek and later on preponderantly Italian and Spanish bonds were purchased) would have initiated much resistance in the Northern Euro Area member countries, which itself would have additionally endangered financial stability (Born, Ehrmann and Fratzscher, 2011, Gersbach and Hahn, 2013). However, this argument appears only pleaded because traders could easily identify the bonds purchased by the ECB (for details see Belke, 2012, 2013, Gros, 2012, p. 12).

What is more, another more pertinent reason against the ECB President’s intentions became public: clear *internal clashes in the Governing Council* on the issue of the ECB’s government bond purchases. In case of the SMP they turned out to be even more significant than with respect to the OMTs against which according to Mario Draghi himself only the President of the Bundesbank opposed. Former ECB President Jean-Claude Trichet called these clashes euphemistically “overwhelming majority” instead of the formerly usual “unanimous decision”. “Overwhelming majority” is a classification which became material more than once since Malta and Cyprus entered the Euro Area (Bloomberg, 2010, Draghi, 2012, Gersbach and Hahn, 2009, 2013, and Belke in Ambrose-Pritchard, 2007).

The background is that individual countries' debt purchases incorporate redistributive implications among euro area member countries, since they lower interest rates for some, but increase interest rates for other countries' debt, for instance by re-allocating default risk. What is more, the mere announcement of such purchases in cases such as the OMT program already probably has redistributive effects (Gersbach and Hahn, 2013).

The same caveats can be raised with respect to the ECB's *lack of transparency about its Long-Term Refinancing Operations (LTROs)* at the amount of one billion EUR. Remember that the bond spreads fell nearly synchronously with the LTRO implementation. This raised the suspicion that the additional liquidity was partly used for bond purchases by the commercial banks (the so-called „Sarko trade"). Although this raised serious doubts about a utilization of the financial means conforming with the intended target by the liquidity-pumped commercial banks, the lack of published information did not enable analysts such as those in the Monetary Experts Panel of the EP to consequently analyse the LTRO effects in their Briefing papers launched in spring 2012 (Belke, 2013).

This lack of transparency weighs heavily, especially because the European public represented by the European Parliament, an institution the European Central Bank is accountable to, has been combatting full of verve for more transparency of ECB policy decisions (Belke, 2012). More transparency of the ECB could have really helped to avoid confusion about and negative side effects of its unconventional monetary policies.

Are there *other possibilities* to increase transparency and to explain ECB policies better than in the past? Traditionally, *credible exchange rate pegs* deliver the largest possible transparency of monetary policies. They allow a public monitoring of the monetary policies' compliance with the exchange rate target. The textbook alternative is *direct supervision combined with formal control through the government*. But, clearly, both solutions are not realistic alternatives with an eye on the flexible exchange rate of the Euro and the strongly emphasized ECB independence. This in turn increases the pressure to strengthen *other aspects of transparency* in order to make the central bank accountable to its stakeholders, the markets (Dincer and Eichengreen, 2007). From another perspective, this underlines the importance of putting the ECB's inflation forecasts/projections under more scrutiny because the euro is a floating currency and exchange rate forecasts have implications for the ECB's inflation forecast.

Why then not returning to an *intermediate target* such as the growth rate of the monetary base or of to foster transparency credit (a target strongly rehabilitated since the start of the financial crisis) as a *strict rule*? Before the crisis, the ECB was indeed successful to create a framework which allowed market participants to estimate the ECB's reaction rather precisely on their own - through the monitoring of data which always arrived in time. Basic ingredients for this success story were the two-pillar strategy combined with an adequate definition of price stability (which these days should include different asset price developments) and a consistent communication consequently aligned to the former (Belke et al., 2005, Issing in FAZ, 2006).

3.3 Forward Guidance

In the course of the transparency debate, the ECB has proceeded to deliver an outlook on its future interest rate path ("forward guidance"). In this context, a second question emerges: should the ECB stick to the instrument of "forward guidance" even beyond the crisis period?

"Forward guidance" as practiced right now is, according to ECB and BoE representatives no promise "to keep official interest rates lower than will be necessary in the future" or, expressed differently, to create inflation. It does just not represent an additional stimulus by an ex ante commitment to a time inconsistent policy path. Instead, the main of the interest rate outlook is to elucidate the ECB's assessment against the background of the overall subdued inflation prospects and, more specifically, the bank's policy *reaction function* (Taylor, 2013). From this perspective, the ECB (and, according to Taylor, also the BoE) does not describe anything else than a *policy rule for its future interest rate path*. This seems overall adequate, because in times of higher uncertainty transparency and clarity it helps to give orientation and to stabilise expectations of market participants (see section 2). Hence, “forward guidance” can be interpreted as an *indirect instrument* to loosen credit conditions and thus stimulate credit supply and economic growth without conducting any further interest rate cut (Deutsche Bundesbank, 2013a).

But “forward guidance” at the US Fed appears to follow Michael Woodford‘s proposal for central banks at the zero interest rate bound (Woodford, 2008, 2013): a credible pre-commitment to a zero rate also for that future period for which economic conditions already recommend a rate larger than zero in order to guide expectations and to bring down long-term interest rates as well (Taylor, 2013, and ECB economist Frank Smets (2013) at the 2013 Jackson Hole Conference). An important piece of evidence was Ben Bernanke’s commitment conveyed to the public in 2013 to stick to the zero rate as long as the unemployment rate does not fall below the threshold of 6.5 percentage points, although estimates of the Fed’s reaction function clearly disclosed the necessity of interest rate increases.

However, the ECB and the BoE obviously strived to avoid these inconsistencies when applying their versions of “forward guidance”. It would be very welcomed if the rather recent emphasis of “forward guidance“ at the ECB and at the BoE would represent the entry into the exit of their unconventional monetary policies and the start of a development into the direction of a truly rule-based monetary policy (Belke, 2013). But the European Central Bank will certainly (and will have to) struggle to avoid confusion of different interpretations of “forward guidance“ by ECB representatives like the one which could be observed only recently, in 2013, among Joerg Asmussen who initially bogarted the Woodford version for the ECB, and Mario Draghi.[viii] The ECB President knew only too well that *“forward guidance“ should be formulated only contingent on the bank’s inflation forecast*. If he would have done otherwise, he would have violated the “inflation only“ of the Treaties: the Woodford version of “forward guidance” admits keeping rates close to zero even if inflation has started to increase. In the following, some further risks emanating from the “forward guidance” strategy are discussed.

Fed-style “forward guidance“ tends to further raise the inclination of investors to take over risks. Excess monetary liquidity may spillover to other economies and cause stability risks there (Landau, 2013, p. 9). At the 2013 Jackson Hole Conference even the bon mot „zero rates cheapen risk takeover, whereas “forward guidance“ makes them costless” did the round.

The Woodford variant risks to create massive incentives to enlarge and even overstretch open positions. As the strong movements of the world’s stock markets after Ben Bernanke’s now-famous statements in June 2013 have clearly shown, the Fed has by its efforts to calm down the markets harvested the contrary: higher volatility. This clearly reemphasises the “liquidity spirals” described in the model developed by Brunnermeier and Pedersen (2009).

In this vein, Bernanke (2016) argues that an interest rate peg may principally be a useful communication device. For instance, pegging the two-year interest rate at a low level would strongly signal the Fed’s intention to keep short-term policy rates low for some time as well. Yet, the strongest risk of pegging the interest rate is, according to Bernanke (2016), that the Fed might finally have bought very large amounts of securities, without fully achieving its interest rate target.[ix] Such concerns about “losing control of the balance sheet” were driving the Fed’s preference of quantitative easing over rate targets when Ben Bernanke was Fed chairman.

What is more, the ECB’s announcements may not necessarily be conceived as credible – for instance because there are election dates in between the announcement and the dates for which the outlook is made. In that case, deviations of the markets’ action and the central bank’s ideal projection of market behavior are not excluded any more (Bullard, 2013).

Finally, the central bank risks *to breed even more pessimism* in the markets. By indicating the need to curb official rates also for the next years to come could convey the impression that the bank anticipates a crisis enduring for several years and has surrendered autonomy over its instrument tool box and turned to passivity. But if markets become more pessimistic, consumers' and investors' expenditures decline (Bullard, 2013).

Hence, Mario Draghi has *acted correctly by not chaining the ECB to the unemployment rate*. But he should have anticipated that markets would expect something similar to Fed-style "forward guidance" from himself as soon as he introduced "forward guidance" as a concept. In order to counter these expectations he should persuade the public that introducing "forward guidance" was not just following a popular fashion in central bankers' circles and that it was more than a rotten compromise among those demanding a further rate cut at the Council meeting in July 2013 and the hawks in there. Otherwise, this new concept would only be perceived as a *short-run placebo while capital market rates continue their increase*.

3.4 How accountable can and must monetary policy be?

Through more openness the ECB intends to give the financial markets more orientation with respect to the bank‘s future course: how predictable and assessable can and must monetary policy be? Can central banks endowed with too much and guidance themselves become a source of volatility on their own?

Instinctively, most economists appear to follow the view/reflex that "more information is better“. They tend to assume a model with rational expectations and exogenously provided public and private information. For instance, they do not consider at all that providing public information may *weaken the incentive of market participants to privately collect information on their own* (Belke, 2013).

The more predictably monetary policy behaves, the better market participants are able to align their decisions with those of the central bank. The economy is developing more frictionless with a minimum of unnecessary volatility since actors are better able to forecast the future time path of monetary policy and variables related with it. This view that *more transparency reduces market volatility* is clearly corroborated by the vast majority of academic empirical studies (Kool and Thornton, 2012, Middeldorp, 2011, and section 2).

However, academic theory sees things different in some specific constellations. Under assumptions diverging from those mentioned above, a better public provision of information can interfere with the function of markets. For instance, the "theory of the second best" suggests that the abolishment of a bias does not as a rule improves allocation if further biases exist. As a consequence, economists have examples on hand in which more transparency does not necessarily lead to an improvement of total welfare in an economy. From this point of view, there may be even an optimum degree of "secrecy" which is larger than zero (Kool and Thornton, 2012, Middeldorp, 2011).

However, there is obviously *no way back to less transparency* (Dincer and Eichengreen, 2007). The abolishment of exchange rate commitments can be interpreted as a reaction to the globalization of financial markets and the increasing popularity of central bank independence as a means to isolate banks from short-run political impacts of governments (political business cycles) in democracies. This directly implies that we have to stick closely to transparency if we want to hold on to financial globalisation and central bank independence (see section 3.2).

If the debate in the Council has been run rather controversially, *outsiders should have the opportunity to be informed about such disputes and the underlying arguments*. A policy of limited transparency will hardly be able to solve such kind of internal disputes and hassles. On the contrary, transparency may transport and send out irritating signals which in turn trigger undesirable volatility on financial markets (Belke et al., 2005).

3.5 The ECB and banking surveillance in the Euro Area: transparency and accountability duties

When Banking Union was decided upon, it became clear that the ECB would become the dominant institution in terms of banking surveillance in the Euro Area: do particular transparency and accountability obligations result from this? And if yes, how can the latter be fulfilled?

In fact, the ECB should have become even more transparent, when the bank adopted the task of large banks surveillance in 2014 (*Single Supervisory Mechanism*). This makes sense because in case of a necessary bank restructuring this decisions met within this mandate may imply additional burden for the public budget (see Joerg Asmussen and Benoit Coeure in Handelsblatt, 2013). In addition, the ECB has adopt competencies similar to law-making powers, since it has been empowered to issue regulations concerning oversight. Seen on the whole, thus, accountability has to be enforced even more strongly than in case of ordinary monetary policy.

The ECB representatives should in the ideal case have to justify themselves in the European Parliament. Moreover, it is also in the ECB's original interest to demand and finally also gain the maximum possible obligation to be accountable towards and democratic control through the European Parliament (see Joerg Asmussen on several occasions and Joerg Kraemer in Handelsblatt, 2013). Exactly this was not the case with the SMP and the announced OMTs and led the ECB into an uncomfortable predicament at the German Constitutional Court only recently.

The European Parliament could be given access to the minutes of the surveillance committee within the ECB and of the ECB Governing Council itself, insofar the latter are related to questions regarding financial oversight issues. Information regarding company secrets of single banks or specific group of banks must be exempted of course. In order to ensure the latter, one could make only the minutes of meeting of the newly created surveillance committees ranked below the finally responsible ECB Governing Council available to the public (Belke, 2013).

3.6 Limits to transparency and communication of central banks

The former ECB‘s chief economist, Otmar Issing, cautions against a “crystalline central bank” (FAZ, 2006). What exactly are the *limits of transparency and communication* of central banks with financial markets and the public?

Surely, transparency becomes critical if the incorrect fiction, that the publication of minutes improves the markets’ understanding of monetary policy as strongly as if they would have taken part in the Council meetings themselves, is establishing itself in the minds of the market participants. Hence, publishing minutes does only make sense if it is more than a “carefully texted, corrected and attuned publication” (Issing in FAZ, 2006).

What is more, central banks must *avoid to be driven by financial markets* and their expectations. For this purpose, they should dispense with ex ante publishing the exact dates of planned interest rate movements. It is equally important to counteract market expectations that the ECB will change its official interest rates as a rule only on days at which the bank publishes its new inflation growth projections. This is because other reasons such as, for instance, specific empirical realisations of credit and money growth could decisively drive Council decisions to change interest rates. In this respect, ECB President Mario Draghi has probably been still too ambiguous in the past (Belke, 2013).

Furthermore, limits to transparency are reached if the publication of minutes allows interest groups and national governments to enact significant and targeted impact on specific Council members (Belke, 2013, Gersbach and Hahn, 2013). Transparency is also less useful if an open internal discourse is necessary and efforts at persuasion without humiliation of the persuaded Council member have to be accomplished (“all commensurate majority positions initially started as minority positions“, Joerg Asmussen, cited in Der Spiegel, 2013). Finally, there may be cases in which secrecy and ambiguity are especially important because both may be used as a threat potential against market participants. This is well-known, for instance, in the case of speculative bubbles because markets become more cautious by this mechanism (Hans-Peter Gruener, cited in Handelsblatt, 2013).

However, some claim that limits to transparency arise at a point where the publication of minutes lead to “undue“ attention to the conveyed discrepancies between single members in the media and in the public discussion and thus to ambiguous signals and effects detrimental for the efficacy of the ECB’s OMT policies themselves (Fratzscher et al., 2013).[x]

This argument may appear less plausible, not only because the ECB has grown up in the meantime now and cannot be classified any more as a rather young institution which is in clear need of protection. This may also be valid because the discussion about OMT has already taken place extensively on a European level already a year ago in key institutions like the Monetary Experts Panel of the EP - reflecting and presenting both the “Northern” and “Southern” view in a well-balanced fashion also to the public in the “Northern” Eurozone, also in Germany. Hence, there is no clear need of an additional forum for a call for support of the ECB’s OMT programme to avoid any potential bias of the debate on the OMT Programme (Belke, 2013).

An additional benefit of high transparency would be that potential deviations of the ECB from a stability oriented monetary policy would be brought to the surface. This would protect individual Council members against undue pressure from national governments (Belke et al., 2005). From this perspective, the publication of minutes would *foster rather than damage a stability oriented monetary policy*.

Seen on the whole, thus, the publication of attributed minutes or voting records is most probable harmful, since it will give an incentive to national central bankers to promote their countries' specific national interests. If, in the future, a reform according to which all members of the ECB council are appointed at the European level were adopted, then the publication of attributed voting records and minutes may be reconsidered. This is because research suggests that transparent committees may go along with better-informed members (Gersbach and Hahn 2012, Hahn 2013). The release of non-attributed summary minutes, on the other hand, was adequate "today". Such minutes have the potential to enhance the public's understanding of the ECB's thinking and to increase accountability (Geraats, Giavazzi and Wyplosz, 2008, Gersbach and Hahn, 2013).

4. Transparency and Forward Guidance – A new role for the Monetary Dialogue?

This section deals with a practical example of the relation among communication, accountability and expectations and for this purpose comments on the role the Monetary Dialogue[xi] in the context of an evolving monetary policy. For this purpose, this section first discusses the arguments in favour of more ECB transparency in the light of the Monetary Dialogue. It then compares the effectiveness of publishing the minutes with reference to the new ECB voting model, i.e. the so-called rotation model which has been adopted with the euro area entry of the 19th member country Lithuania on January 1, 2015. This section also describes why the recognition of a lack of ECB transparency may actually improve the design of the Monetary Dialogue. For this end, the current framework for the Monetary Dialogue and its potential changes are discussed in terms of the ECB's new "forward guidance" communication strategy, the transparency of data revisions and the choice of the underlying macroeconomic model.

This section also elaborates on *how accountable the ECB shall be towards the European Parliament*. The need for increasing ECB's transparency and accountability stems from its new supervisory roles. Given their importance, they are emphasised separately.

As a whole, the arguments presented in this section give overwhelming support for the Monetary Dialogue's efforts to enhance ECB transparency. In theory, however, it is not clear how far this process should go as the "optimum degree of the ECB's secrecy" is different from zero. This poses an operational problem for the Monetary Dialogue, yet to be solved (Belke, 2014).

This view is supported also from a policy cycle perspective. Full accountability to and "democratic control" through the EP may conflict with the central bank's policy and instrument independence. Policy independence may be endangered as soon as groups of different political or ideological orientation in the EP pressure for the adoption of specific macroeconomic models or even specific monetary policy measures. Instrument independence may be hampered by the fact that policy tools such as the ECB's sovereign bond purchases may be effective only when they are not anticipated. Because the Monetary Dialogue would lose its social value if the ECB's independence is threatened, Monetary Panel experts shall warn as early as possible about the danger of such negative feedback (Belke, 2014).

While recognising that current times are far from "normal", this section argues that the Monetary Dialogue is even more important "now" than in "normal" times. Still, this section suggests changes regarding both design and focus range of the Monetary Dialogue to make it more effective. In this context, the (new) supervisory role of the ECB should also be carefully scrutinized. Overall, the real challenge is to find out the *optimal degree of transparency and accountability* within the current institutional framework for the Monetary Dialogue.

So what exactly is the Monetary Dialogue? The European Parliament (EP) Resolution on democratic accountability in the third phase of EMU of 4 May 1998[xii] "calls … for the organisation of a dialogue between the EP and the future ECB on monetary and economic affairs, the framework for which dialogue should be confirmed through a mutual agreement". The Treaty on European Union also contains provisions regarding the issues of transparency and accountability of the ECB vis-a-vis the EP. Based on these requirements it was agreed that the President of the ECB would appear four times a year before the ECON Committee (Economic and Monetary Affairs Committee).

With the EP's 7th legislative term having approached its end in 2014, it seems appropriate to reflect on the working of the Monetary Dialogue exercise, to review the past five years of monetary dialogues as well as to look forward for potential improvements. To this end, this section investigates the role the Monetary Dialogue in the context of the ECB's evolving monetary policy. This is done along several dimensions, including: the ECB's adoption of forward guidance on interest rates; the ECB's model choice and data revision policies for inflation forecasts; the ECB role in the Troika and, as a financial supervisor; ECB involvement in bond purchasing programmes; and the Fed's envisaged exit from unconventional monetary policies and its effects on ECB communication policy strategy. This section assesses - on a case-by-case basis - the information exchange between the EP and the ECB and suggests how to improve it via the Monetary Dialogue exercise, taking into account the ECB's communication strategy (Belke, 2014).

In response to the financial crisis, the ECB has been forced to adopt new tools/instruments to support the euro-area economy and preserve the integrity of the single currency. This has challenged the current framework of the Monetary Dialogue exercise (Belke, 2014). This section briefly assesses the implications of enhanced transparency and "forward guidance" for the effectiveness of the ECB's policies. It then checks whether the Monetary Dialogue and if and how the current Monetary Dialogue framework needs to be modified in order to fulfil its goal.

For instance, Transparency International (2012) believes that "the accumulation of the ECB's influence and power especially in the area of banking supervision has not been matched by improvements in transparency and accountability. In this respect, the ECB falls short of the good practices implemented by both its fellow EU institutions and its central banking peers around the globe. Such practices include the publication of meeting minutes and voting records, external independent membership of Boards, robust parliamentary oversight, participation in the EU Transparency Register, clear, detailed policies and procedures for handling conflicts of interest, a “cooling off” period for senior ECB executives returning to the private sector, and a proactive policy on access to ECB documents” (taking care, of course, of confidentiality issues) (see also Gersbach and Hahn, 2009, 2013, on this issue).

The Monetary Dialogue, if improved according to the suggestions the lines sketched out in this section, implies robust parliamentary oversight. This should lead to benefits also for democratic legitimacy and accountability, since a guiding principle is that “democratic control and accountability should occur at the level at which the decisions are taken” (Belke, 2013b).

The remainder of this section is organised as follows. Section 4.1 discusses the pros and cons of enhanced ECB transparency. The effectiveness of publishing minutes and the instrument of the Monetary Dialogue are then compared in Section 4.2 with reference to the new ECB voting model - the so-called rotation model which has been activated as soon as the 19th member entered the EMU. Section 4.3 describes why a lack of ECB transparency may serve as an incentive to improve on the conception of the Dialogue. In Section 4.4 the Monetary Dialogue and potential changes in its conception are discussed in terms of the ECB’s new “forward guidance” instrument and the transparency of data revisions and the choice of the underlying macroeconomic model. Section 4.5 discusses how accountable the ECB should be within the Monetary Dialogue. The ECB’s increasing transparency and accountability duties from taking over banking surveillance in the euro area appear so important in the context of this paper that they are emphasised separately in section 4.6. We finally discuss the limits to transparency and communication within the Monetary Dialogue in Section 4.7. Section 4.8 finally concludes.

4.1 A growing need for ECB transparency? The arguments

Monetary policy and sovereign bond purchases

The discussion about more transparency of the ECB has been rekindled by a distinct change of ECB role during the financial crisis. With the Securities Market Programme (SMP) and its announced Outright Monetary Transaction Programme (OMT), the ECB has blurred the distinction between monetary and fiscal policy (Belke, 2014). This in itself has implications also for the design of the Monetary Dialogue.

The ECB as a member of the Troika

A critical aspect is *the ECB's role within the Troika* in the context of financial assistance to programme countries. This has significantly challenged the previous smooth working of the Monetary Dialogue (Eijffinger and Mujagic, 2004). In part because none of the Troika partners seem to view the Troika arrangement as ideal. Indeed, during the Greek programme significant differences of views emerged among the Troika members, in particular with respect to growth projections and their revisions. This was partly because internal working procedures were uncoordinated. Lastly, documentation of the vast programme is huge, sometimes overlapping, and obeys different degrees of secrecy (IMF, 2013).

In the context of this section, the main problem is the ECB's role within the Troika (Gros et al., 2014, IMF, 2013). *Conflicts of interest* are rendering the ECB's membership in the Troika a doubtful venture. The Treaties limit the ECB's role strictly to monetary policy. But the bank may have overdone things relative to its original mandate by taking an *active role in prescribing the crisis countries "austerity" measures and structural reforms*. Moreover, the ECB's negotiations with the programme countries have clearly been less transparent than necessary – in the same way as its emergency liquidity assistance (ELA) measures which targeted to specific euro area member countries. Most strikingly, an important but hidden feature of, for instance, the Greek programme was that there was "no conditionality on areas within the competency of the currency union's central bank" (IMF, 2013). In addition, the ECB and the national central banks, for instance in case of emergency liquidity assistance, appeared to be *the institutions among the Troika with the largest discretion on setting conditions on their own*. This happened and still happens to go *without democratic accountability and transparency guidelines* as set for instance by the European Court of Auditors (IMF, 2013, p. 30).

In order to avoid conflicts of interest and legal grey areas in the future, the role of the ECB within the Troika may have to be reworked fundamentally. Moreover, it should be accompanied by even more transparency and accountability standards imposed through the Monetary Dialogue.[xiii]

The ECB as a financial market supervisor

In the financial sector of country programmes for Greece, Ireland, Portugal (but less so for Cyprus), the "ECB had an obvious claim to take the lead, but was not expert in bank supervision where the Fund had specialist knowledge" (IMF, 2013, p. 31). It was and will be crucial for the members of the "Monetary Experts Panel" and the EP in the most recent and the coming years to assess whether and to what extent the ECB gets into conflicts of interest as regards its extended competencies in banking supervision and banking union (Gersbach and Hahn, 2013). The Monetary Dialogue is in principle a suitable forum to cope with these new issues. However, it may have to increase its scope to be capable to do this. This is not only due to the high technical complexity of the new ECB tasks, but also to the high level of non-transparency implied (Belke, 2014).

Despite large additional competences conferred to the ECB, the foreseen accountability mechanisms "are limited to the usual hearings at Parliamentary committees, presenting an annual report to Parliament and European Council and providing answers to written questions by MEPs. This is the same level of accountability that the ECB currently has for monetary policy functions. There is no reference to increased transparency as well" (Transparency International, 2012). There is also a clear need of *more transparency on lobbying* by the European financial industry.[xiv] Ideally, joining the EU Transparency Register would be a way forward (Belke, 2014). But also the Monetary Dialogue could have a function here. For instance, the members of the "Monetary Experts Panel" could check empirically whether specific monetary policy decisions closely follow the Taylor reaction function communicated in the ECB's forward guidance framework or whether the empirical fit is much better with some balance sheet events in one larger euro area bank.[xv]

A closer look at the new institutional framework quickly reveals that the ECB's new tasks relate mainly to its *supervisory role and body (Supervisory Board) rather than to the ECB itself*. Therefore, one conceivable and important change in the scrutiny work of the Monetary Dialogue would be to cover activities of the Supervisory Board. However, this will not be an easy undertaking for both political and economic reasons.

The ECB and the exit from unconventional monetary policies

Another issue the conception of the Monetary Dialogue is confronted with is the role of communication in guaranteeing a smooth exit of central banks such as, currently, the US-Fed from current unconventional monetary policies and effects on the euro area (Belke, 2013a). Because the *price effect of asset sales* is *ambiguous* and *complex* in technical terms, international institutions such as the International Monetary Fund recommend central banks to adopt communications strategies focussing on the interest rate path instead of a pre-specified sales volumes (IMF, 2013). This a has direct bearing for the contents of the Monetary Dialogue as regards the assessment of forward guidance (see below). Most important, the ECB usual communication strategy through press conferences and the Monthly Bulletin is not sufficient because the potential impacts of exit strategies on the euro area are not the exact counterpart of the effects of unconventional monetary policies (Belke, 2014).

Implications for the Monetary Dialogue

On the basis of the three arguments discussed above the ECB shall be held accountable in a sufficient detail to the EP like finance ministers are vis-a-vis their national parliaments.[xvi] To an accountability question raised by the EP in a Troika-related questionnaire the ECB responded that: "… (t)he members of the ECB's Executive Board stand ready to share with the EP the ECB's views on the situation in programme countries and to explain the technical advice given as part of the troika, as they have done on several occasions in the past" (ECB, 2013a).

But to the extent that the crisis has blurred the distinction between monetary and fiscal policy, the working of the Monetary Dialogue needs to be changed so as to make the ECB fully accountable towards the EP and, perhaps, even towards the European Court of Auditors. This is not yet the case. One obvious example is the lack of transparency in the context of (realised or announced) ECB programmes of sovereign bond purchases, which, admittedly, affects EU taxpayers' money and European citizens' savings. But the EP through its monetary experts shall *pay attention that national vested interests do not get too strongly involved in the design of community-wide policies.* To the benefit of ensure the ECB's continued credibility, it is key that ECB policies are publicly communicated as providing an European public good and, as such, must be fully accountable through the Monetary Dialogue (Belke, 2014).

And in fact there is no alternative to the Monetary Dialogue. For instance, the Q&A session contained in the ECB's monthly press conferences following Governing Council monetary policy decisions in its form prevailing until 2015 did not provide any information of the discussion on monetary policy within the Governing Council. In contrast, the ECB president Mario Draghi has become increasingly frank about specific issues such as the relation between monetary policy and structural reforms in his quarterly reporting before the EP (Monetary Dialogue, Belke, 2014).

ECB President Draghi's appearance before the ECON committee on December 16, 2013 may serve as a good example for this: "Second, we look closely at the relation between market interest rates and incentives to reform. Do you really think that a country would change its electoral law because interest rates are a couple of hundred basis points higher? Do you think that a country would actually change its educational system or its judiciary because interest rates are higher? It seems implausible. …regarding the real structural reforms, do you think that a country would really change labour market legislation because of interest rates? I think this would probably be unlikely." (Draghi, 2013). Such pieces of evidence are "news", improve the understanding of the ECB's current strategy in "non-normal" times and, hence, represent valuable information for market participants (Belke, 2014).

4.2 Publishing minutes and the Monetary Dialogue – The example of the rotation model

As stated before, ECB President Mario Draghi has recommended already in 2012 that the ECB shall publish the minutes of the Governing Council meetings. By publishing Governing Council meeting minutes, the ECB may improve the transparency and efficiency of its policies significantly, which would support its stability-oriented orientation (Belke, 2013). The extension of the Governing Council due to the extension of the euro area and the reform of the Council's voting modalities going along with it *enhance the rationale for publishing the minutes*. Further euro area enlargement will increase the number of Governing Council members and will have an impact on the effectiveness of the decision process. The upcoming rotation model for voting makes an increase in transparency effort even more necessary (Belke and von Schnurbein, 2012).

Hopefully, the rotation model for voting will not favour the re-surfacing of nationalism. As the rotation model may limit the *representativeness* and the *effectiveness* of monetary policy decisions, the Monetary Dialogue shall gain visibility and importance (Belke and Styczynska, 2006, Belke and von Schnurbein, 2012). In a situation when even big euro area countries such as Germany must drop out from voting every fifth month, accountability and transparency towards the EP must become key to safeguard a common monetary policy. This should include also the ex-post-publishing of minutes (Eijffinger, Mahieu and Raes, 2013).

4.3 Lack of ECB transparency as an incentive to improve on the conception of the Dialogue?

In section 3.2 we asked, whether the ECB became less transparent when taking into account its increasing responsibilities. The answer was “yes”. Can we reach a better explanation of ECB policies within the current framework of the Monetary Dialogue?

The previous paragraphs have shown that enhanced ECB transparency combined with a proper working of the Monetary Dialogue could help in avoiding confusion about and negative side effects of its unconventional monetary policies.

4.4 Monetary Dialogue, “forward guidance” and the transparency of data revisions and model choice

Before we are able to assess the role the Monetary Dialogue could play in the context of the adoption of forward guidance on interest rates, we have to *establish the current and the optimal extent of the ECB’s “forward guidance”*. Reflecting the increasingly vivid transparency debate, the ECB has moved in line with other central banks (Kedan and Stuart, 2014) to deliver an *outlook on its future path of policy rates* (“forward guidance”). In this context, a second question becomes relevant: will the ECB adhere to the “forward guidance” instrument even after the crisis period has ended? This is important in our context because the design of the Monetary Dialogue may be adapted to this systematic change in the ECB’s policy toolbox.

With respect to forward guidance section 3.2 argued that the ECB does not describe anything else than a *policy rule for its future interest rate path*. Forward guidance is thus meant to strengthen the credibility of the ECB’s monetary policy strategy. Most importantly, “forward guidance" cannot correspond with any long-run commitment to a specific interest rate level because this would insinuate an intended change in the medium-term oriented "monetary policy strategy".

If this is true, however, it is clearly *not appropriate* to speak of a *change in the reaction function* of the ECB driven by forward guidance, which makes a change in the design of the Monetary Dialogue necessary. Moreover, most likely, the ECB will not be able to decouple its policies from those of the Fed during and after the process of normalisation (Belke and Gros, 2005, Belke and Cui, 2010). *As soon as the crisis is over and we will have entered more "normal times", the ECB should and probably will not abide by this instrument.* This is so because such kind of "forecasts" are vexed by much uncertainty and entail risks, also for the reputation of central banks. From this point of view, the instrument of "*forward guidance" is almost surely not the most relevant challenge* for appropriate communication and transparency requirements and, thus*, for the design and structure of the Monetary Dialogue*.

However, there are also arguments in favour of a short- to medium run relevance of the forward guidance tool for the Monetary Dialogue. The ECB will have to struggle to avoid confusion of different interpretations of "forward guidance“ by ECB representatives. The ECB President knows too well that "forward guidance“ should be formulated as only dependent on the bank's inflation forecast/projection. What is more, the ECB's announcements may not necessarily be conceived as credible – for instance because there are election dates in between the announcement and the dates for which the inflation outlook is published. In that case, deviations of the markets' action and the central bank's ideal projection of market behaviour cannot be excluded. By indicating the need to curb official rates also for the next years could convey the impression that the bank anticipates the crisis lasting for several years to come. But if markets become more pessimistic, consumers' and investors' spending suffer (Belke, 2013).

On a more general level, it thus seems fair to state that “forward guidance“ and also the discussion about the publication of minutes have indicated that during the crisis the relevance of the classic interest rate instrument has decreased. The future Monetary Dialogue should thus take into account that *expectations* of future monetary policy (as well as with respect to financial regulation) will play a higher role than before, especially in the context of the North-South debate (e.g. financial repression of Northern savers through lower long-term interest rates). Hence, “manipulating” expectations does potentially represent the more effective monetary policy. This is exactly the point where the Monetary Dialogue has to set in in the future to avoid this kind of “manipulation”. The euro area long-term interest rate is the result of the expected patterns for short-term rates which, in turn, are driven by the inflation forecasts. A key task of “Monetary Experts Panel” shall be to assess the current ECB inflation forecasts/projections and the pattern of revisions to detect systematic downward or upward biases.[xvii].

Revisions of, for instance, output gap estimations in Europe which usually enter inflation forecasts may turn out to be especially worrisome since (medium-term) adherence to the ECB’s inflation target is assessed with reference to initial data vintages (De Castro, Perez and Rodriguez-Vives, 2013). It is found that (a) preliminary releases tend to be biased and predictors of subsequent data vintages which are not efficient, (b) such systematic bias in data revisions represents a general feature, (c) Eurostat’s decisions are explaining a significant share of the bias and contribute some evidence of practices of window-dressing, and (d) political cycles, among other factors, contribute to explain the data revision patterns as well.

Ley and Misch (2013) find that output data revisions alone may significantly undermine the reliability of real-time estimates of the overall and structural fiscal balances, and that output data revisions may result in unplanned and substantial debt accumulation. The paper also shows that there are significant differences across country income groups (Ley and Misch, 2013).

Kempkes (2012) analyses real-time output gaps for EU-15 countries over the 1996-2011 period. His results suggest that the ECB's monetary policy (Taylor) rule should incorporate ex-post checks of the un-biasedness of the cyclical components used within the rule. Potential biases would then decrease or increase future limits for the monetary policy stance as measured for instance by the policy rate.

Another issue at stake is the choice of appropriate models and their adequate application to inflation forecasting at the ECB.[xviii] Best academic practice requires that the choice of the adequate model should not be based on ideological priors of the contracting authority ("Keynesian" versus "non-Keynesian", socialist versus conservative, etc.) but, instead, on the much more neutral use of widely accepted empirical model selection criteria (Gros et al., 2014, Pesaran and Pesaran, 1997). The Monetary Dialogue should move significantly more into the direction of focusing on the issue of non-partisan macroeconomic model choice.

To facilitate the dialogue, the ECB in turn should become more detailed in the publication of her inflation forecast. The central bank could do so by drawing more on alternative scenarios, their impact on credit, growth and inflation, and on pricing in systematic biases of its inputs (output gaps, exchange rate trends etc.). As a positive side effect this would help financial markets and – even more important – firms, unions and governments to incorporate risks in their decisions.

4.5 The European Central Bank - How accountable within the Monetary Dialogue?

In section 3.4. this contribution argued in extensor that there may be an *optimal degree of "secrecy"* which is larger than zero. But instrument independence may be hampered by the fact that policy tools such as the ECB's sovereign bond purchases may be effective only when they are not anticipated. Because the Monetary Dialogue would lose its social value if ECB's independence is threatened, Monetary Panel experts shall warn as early as possible about the danger of such negative feedback (Belke, 2014).

4.6 The ECB and banking surveillance in the euro area: increasing transparency and accountability duties

Finally, the new ECB role *as a financial market supervisor* is revisited. Are there particular transparency and accountability obligations resulting from this? If yes, how can these best accomplished?[xix]

In fact, the ECB had to become even more transparent, as soon as the bank was tasked the surveillance of the large majority of the EU banking system. Indeed, a bank restructuring may imply additional burden for the public budget and, in addition, the ECB will have to take up law making powers once it is tasked to issue regulations regarding banking oversight. Principally, the ECB shall therefore become fully accountable to the EP in the context of the Monetary Dialogue exercise, something which did not happen with regards to the SMP and OMT programmes (see section 3.5 and Belke, 2013).

It is true that the ECB has been entrusted with new responsibilities regarding the supervision of banks. However, the conceptual details of the Monetary Dialogue have to take into account that the ensuing decisions, e.g., to restructure or close individual banks, are likely to involve massively conflicting national interests (Gersbach and Hahn, 2009, 2013).

To this end, the “Monetary Experts Panel” shall have sufficient access to the minutes of the ECB Supervisory Board as well as ECB Governing Council, as far as the latter are related to questions regarding financial oversight issues. Information with respect to company secrets of single banks or specific group of banks must be exempted of course.

4.7 Limits to transparency and communication within the Monetary Dialogue?

In section 3.6., it was mentioned that economists have warned against a so-called “crystalline” super-transparent central bank. But a high degree of transparency would, for instance, protect Governing Council members against undue pressure from national governments, since potential deviations of ECB policy from a stability oriented monetary policy would be brought to the surface (Belke, 2013).

From this perspective, only a well-designed, i.e. well-balanced, monetary dialogue would *support rather than hamper a stability-oriented monetary policy*. But what does “well-designed” actually mean? The key aim and purpose of the Monetary Dialogue is to better understand the ECB Council’s decisions (for more details see Belke, 2014).

Hence, the Monetary Dialogue exercise shall not scrutiny each single ECB decision. Rather, it should make sure that the ECB’s strategy is well understood, enable the EP and the market participants to get an idea of the ECB’s policy targets and of how the bank is intending to reach it (Belke, 2014).

4.8 Conclusions

According to Eijffinger and Mujagic (2004), the ECB has been highly accountable to the ECON in the first years of EMU (1999-2003), i.e. in “normal” times. It can, however, be argued that the Monetary Dialogue is currently even more important than in “normal” times. In the previous sub-sections changes of the Dialogue are thus suggested, both procedural as well as regarding its focus, to make it more effective. The (lack of transparency) issue represented by a Supervisory Board “hosted” by the ECB needs to be addressed by the Monetary Dialogue. A crucial challenge is to find out the optimal degree of ECB transparency and accountability towards the European Parliament.

5. Communication as a policy option in the context of unconventional monetary policies

5.1 Minimising risks connected with exit from unconventional monetary policies

As discussed in section 4.1, periods of *exit from unconventional monetary policies* are typically characterized by weakening or even reverting capital flows. Under these severe circumstances it is of utmost importance that central banks in exiting economies as well as in the non-exiting ones demonstrate credibility and excellent communication skills to convince markets that they strictly stick to low target inflation and financial stability (Born, Ehrmann and Fratzscher, 2011). This would be of decisive importance to attenuate the “flight to quality” and the increases in risk premia going along with it (Belke, 2009, IMF, 2013b). What is more, as stated before, emphasis should be attached to letting exchange rates react to changes according to fundamentals.

As things stand, it seems as if the tool of choice to contain instability during the process of exit is communication. Forward guidance, understood as a clarification of the actual Taylor reaction function of a central bank to the public, may be one important component of a successful communications strategy. The latter should also contain guiding principles for asset sales and explicitly discuss the risks to global recovery and stability from a too late exit versus exiting too early.

“Steering deftly a course back to normality will depend crucially on the central banks’ *ability to communicate effectively a credible strategy for an orderly exit* from such policies. In this context, clear, deliberate, coordinated messages that are anchored in their mandate are of the essence” (Vayid, 2013).

As shown in section 2, *too much communication is less of a problem than insufficient communication*, leading to shock-type surprises on the markets (IMF, 2013b). According to the current economic outlook, it seems as if these principles will most probably be applied first to the Fed, but later on also for the ECB.

However, central bank communication is important not only in the exit case, but also more generally in the context of unconventional monetary policies. In the context of quantitative Easing (QE) it has to be noted that the *impact of asset sales on prices* is *ambiguous* and technically *complex*, partly because there are announcement and sale effects. At least, this was one of the important lessons from the Securities Market Programme and the OMTs (Belke, 2010, Belke and Polleit, 2010). This directly leads us to the recommendation that central bank communication should focus on an interest rate path instead of a specified quantity of sales (IMF, 2013, Kedan and Stuart, 2014).

The risks and the innovative nature of the exit from unconventional monetary policies mean that central banks will have to make an extra effort in communications. *Communicating about the exit strategy must be an integral part of the exit strategy*. Monetary policy transparency and intelligibility are fundamental to the credibility of policy objectives. And central bank credibility is of the essence in anchoring expectations (regarding inflation or rates). An exit strategy that is clearly identified and understood strengthens monetary policy effectiveness because it reassures that inflation and the entire yield curve will remain under control once growth resumes (Baudchon 2009 and ECB Observer, various issues). Closely connected with these issues are the concepts of “forward guidance” and “transparency” of central banks which are discussed in detail further above.

5.2 The signalling channel: learning from central banks’ QE announcements

According to the literature on the national (but also international) transmission of QE shocks, authors generally pronounce two main transmission channels: the signalling channel (heavily relying on a specific way of central bank communication) and the portfolio-balance channel. The signalling channel refers to what the public learns from announcements about such operations. Although both channels might explain a certain number of the movements of financial variables in response to QE, Belke, Gros and Osowski (2016) show that the global comparative evidence is also, and probably even more compatible, with the view that QE did not “move” interest rates, but appeared to be important because major central banks undertook purchases when they realised that the recession caused by the financial crisis would be longer and more severe than anticipated. In this regard, it is also possible to explain the decline in interest rates before (the communication and) announcements of QE have been made by central banks.

This observation may indicate that markets were quicker to revise their expectations and rates had thus come down before central banks started to buy assets. Therefore, market participants and central banks with their (communication and) announcements of QE reacted to the same driving force; namely stronger adverse effects of the financial crisis than previously expected. In this regard, the prolonged weakness affected most of the developed world. Interest rates thus fell trend-wise in most advanced economies, independently of whether QE was implemented by the national central bank (Gros, Aldici and de Groen, 2015).

The view of Gros, Alcidi and de Groen (2015) and Belke, Gros and Oswoski (2016) that the central banks’ QE programmes – as well as reductions in interest rates – had a common underlying source is somehow compatible with implications of the signalling channel, if one assumes that QE generated new information about the (future) state of the (global) economy for market participants. Following this argument, QE was a sign that the crisis would be longer and more severe. Market participants reduced their expectation about future growth putting downward pressure on interest rates. However, if one follows this interpretation the fall in interest rates might have occurred anyway – at the latest when market participants would have revised their expectations about the severity of the crisis.[xx]

While Christensen and Rudebusch (2012) find similar cumulative reductions using an event study, their empirical results stress the importance of the signalling channel, however. Bauer and Neely (2015) use dynamic term structure models to uncover whether international yields have declined as a result of signalling or portfolio-balance effects. They find that the relative importance of the signalling channel increases with an economy's sensitivity to signals from conventional US monetary policy. Consistent with the notion that Canada is highly sensitive to US monetary policy, the authors find large signalling effects for Canadian Treasury yields.

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Endnotes

[i] Historically seen, central banking has been always bearing a certain mystique and has been inspiring books such as Greider (1987). These days, however, the Reserve Bank of New York is blogging, the Bank of England is tweeting, the Central Bank of Ireland finds itself on Facebook and the Sveriges Riksbank is holding live webchats (Kedan and Stuart, 2014).

[ii] Detmers and Nautz (2013) assess the dynamic effect of potentially outdated interest rate projections on the expectations management of central banks, referring to the example of New Zealand. Corroborating the stabilizing effect of fresh central bank announcements, they convey empirical evidence that interest rate uncertainty grows with the time elapsing since the most recent rate projection. They also find that stale projections may hamper central bank communication.

[iii] For instance, forward guidance has been assessed by Gersbach and Hahn (2011). For the role of communication in the future of central banking after the crisis, cf. Baldwin and Reichlin (2013). Jansen and de Haan (2013) show that the ECB's communication policy has been quite consistent, at least up to 2013.

[iv] See http://blogs.wsj.com/eurocrisis/2012/09/20/ecb-to-publish-minutes-from-its-monetary-policy-meetings/.

[v] See http://www.ecb.europa.eu/press/accounts/2015/html/mg150219.en.html.

[vi] "The account begins with an overview of the financial market and economic and monetary developments. The ECB Governing Council's discussions are then summarised, and economic and monetary analyses are presented along with the monetary policy viewpoints expressed. Thus, the accounts present a balanced report of the political discussions and document, for example, arguments for and against particular decisions. The account does not report how individual members of the Governing Council voted or put names to comments made by individuals" (Bundesbank, 2015).

[vii] The minutes of these meetings, however, will continue to remain locked away for 30 years.

[viii] See http://www.reuters.com/article/2013/07/09/us-ecb-asmussen-idUSBRE9680MV20130709.

[ix] On the contrary, in a quantitative easing program, the amount to be purchased is usually specified in advance.

[x] In other words: the *diversity of views* among committee members about monetary policy *decreases* both the markets' capability to anticipate policy decisions and the future path of interest rates (see section 2).

[xi] http://www.europarl.europa.eu/committees/en/econ/monetary-dialogue.html.

[xii] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:51998IP0110:EN:HTML.

[xiii] See ECB (2013), Gros et al. (2014) and http://www.europarl.europa.eu/news/en/top-stories/content/20140110TST32314/html/Parliament-investigates-the-decisions-that-have-been-made.

[xiv] See, for instance, Masters (2012): "People familiar with the discussions say the industry has had little success persuading anyone beyond the ECB to accept asset-backed securities, despite extensive lobbying".

[xv] However, the latter pattern could still be covered by the ECB's mandate as a borderline case, motivated by financial stability considerations. This simple example again shows the technical complexity of the issues involved and the strongly increased need for transparency.

[xvi] See section 3.1. However, the ECB is not accountable to national parliaments which, in the past, did not exclude ad hoc consultations between ECB staff members and national parliament representatives s for the sole purpose of sharing views on economic conditions See ECB (2014).

[xvii] Mayer (2014), for instance, argues that the current low-interest rate policy in the euro area affects also the long-term yields of euro area savings negatively (in contrast to Mario Draghi's view), exactly because long-run interest rates are driven by the sequence of the inflation forecasts by the ECB staff.

[xviii] Anyway, since the business cycle and financial cycle are of different length also in the euro area (Borio, Disyatat and Juselius, 2013), the ECB may still fail to use adequate output gaps in its inflation forecasts/projections. This is just another aspect which has become virulent since the start of the financial crisis and should be object of the Monetary Dialogue.

[xix] The following is taken from Belke (2013), Section 4.

[xx] See Glick and Leduc (2011) for a similar interpretation.