

## Monetary Policy and Central Bank Communication

Lars E.O. Svensson  
[www.princeton.edu/~svensson/](http://www.princeton.edu/~svensson/)

ECB and Its Watchers, June 3, 2005

## Best-practice monetary policy

- **Objective:** Stabilize inflation around a low inflation target with some weight on stabilizing the real economy.
- **Decision process:** Set the instrument rate (path) such that forecasts of inflation and the output gap “look good”.
- **Communication:** Announce and motivate forecasts of inflation, the output gap, and the instrument rate.

## Decision process

- **Lags** in transmission process; therefore **forecasts**
- Instrument-rate **path** rather than just current level
- Instrument-rate path matters for CB forecasts, not current level

## Communication

- Private-sector decisions depend on expectations about instrument-rate path, not current level
- These decisions also depend on expectations about future inflation (“credibility”) and output
- Monetary policy is actually the “**management of expectations**”

## Communication, cont.

- Publishing and motivating the CB’s best forecast of inflation, output, and the instrument rate
  - is the most **effective** way to manage expectations
  - provides the best internal CB **incentives** to get it right
  - provides the best info for external evaluation, hence the best **accountability**

## Communication, cont.

- Clearly, the ECB has a long way to go...
- A frequent reaction: “The above is **too ambitious**, it is **not possible**, or it **would be harmful**”
- Really?

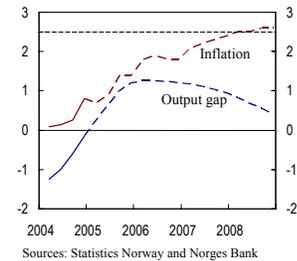
## Monetary Policy in Norway

“**Objective:** The operational target of monetary policy is low and stable inflation, with annual consumer price inflation of approximately 2.5 per cent over time.”

“**Implementation:** Norges Bank operates a flexible inflation targeting regime, so that weight is given to both variability in inflation and variability in output and employment.”

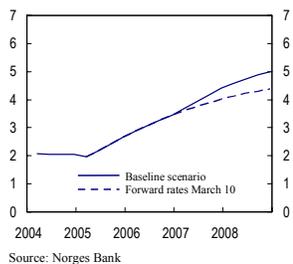
Norges Bank, Inflation Report, March 2005

**Chart 3.4b** Projections for **inflation and the output gap** in the baseline scenario. Quarterly figures. Per cent. 04 Q1 – 08 Q4



Norges Bank, Inflation Report, March 2005, cont.

**Chart 3.3** The **interest rate** in the baseline scenario and forward interest rates in Norway. Quarterly figures. 04 Q1 – 08 Q4



## What can the ECB do?

- **Decision process:** Focus on instrument-rate path and corresponding forecasts
- **Communication:** Publish and discuss graphs similar to those of NB every quarter
- **Whose forecast?** Governing Council's, Executive Board's, or Staff's (then w/ GC/EB comment)
- **Monthly Bulletin:** Make every 3<sup>rd</sup> similar to NB's Inflation Report