Monetary Policy and Central Bank Communication

Lars E.O. Svensson
www.princeton.edu/~svensson/

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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.”

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 3rd similar to NB’s Inflation Report