

Friday, November 2, 2007, 2.00 p.m.

## Press Release

### KOF Monetary Policy Communicator for the Euro Area

#### *A new Indicator for measuring ECB Communication*

The new KOF Monetary Policy Communicator for the Euro Area (KOF MPC) provides a quantitative measure of ECB communication. It translates the ECB president's statements concerning risks to price stability as made during the monthly press conference into an index. By aggregating forward-looking statements concerning price stability, the KOF MPC contains information about the future path of ECB monetary policy. It anticipates changes in the main refinancing rate by two to three months. From **November 8, 2007** onwards, the indicator will be published on the day of the Governing Council meeting at 17.30 CET.

The monthly press conference is – besides the Monthly Bulletin – the most important communication device of the ECB. On the meeting days of the Governing Council it follows shortly after the release of the interest rate decision. The press conference is divided into the introductory statement held by the ECB president and a question and answer session. The introductory statement provides a comprehensive summary of the economic developments most relevant for monetary policy. Its structure reflects the lines of the ECB's monetary policy strategy and its content is agreed upon by all members of the Governing Council. The introductory statement constitutes an effective instrument for a timely description and explanation of the consultations within the governing council and, hence, of their decision making process. Besides the ECB's view of the aggregate economy, the different sections of the introductory statement also provide the ECB's assessment of developments in disaggregate sectors such as the real economy, prices and monetary aggregates. These sectors are assessed by the ECB to evaluate their current and future impact on the ECB's ultimate goal: price stability in the medium run.

The KOF MPC is based on a coding of each introductory statement provided by Media Tenor, a media research institute, which has a long track record in handling press releases and guarantees a high degree of objectivity and reproducibility.<sup>1</sup> Media analysts read the text of the introductory statement of the monthly press conference sentence by sentence. Each sentence contains one or more statements, which are then coded. The coding does

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<sup>1</sup> For more information on Media Tenor see <http://www.mediatenor.de>.

not only capture different topics, but also various other dimensions such as the tense of a statement, ambiguity and the like. The data which underlies the indicator is obtained from all sections of the introductory statement. However, solely statements that refer to risks for future price stability are selected for construction of the KOF MPC. The coding is aggregated into the index by taking balances of the statements that reveal that the ECB sees upside risks to price stability and statements that reveal that the ECB sees downside risks to price stability, relative to all statements about price stability (including neutral). By construction, the values of the KOF MPC are restricted to be in the range of minus one to plus one. The larger a positive (negative) value of the KOF MPC, the stronger the ECB communicated that there are upside (downside) risks for price stability. Since price stability is the ECB's primary objective, movements in the KOF MPC should indicate the path of future interest rates. Figure 1 shows the ECB main refinancing rate and the KOF MPC since 01/1999. As can be seen, the KOF MPC predicts changes of the main refinancing rate quite well. The larger a positive (negative) value of the KOF MPC, the higher is the likelihood that the ECB increases (decreases) its main refinancing rate within the next few months.

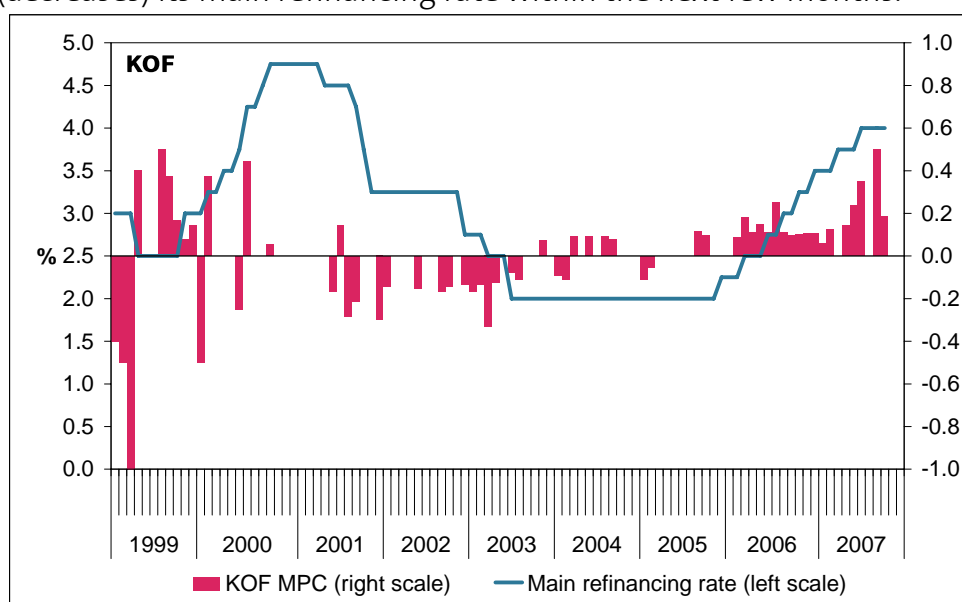
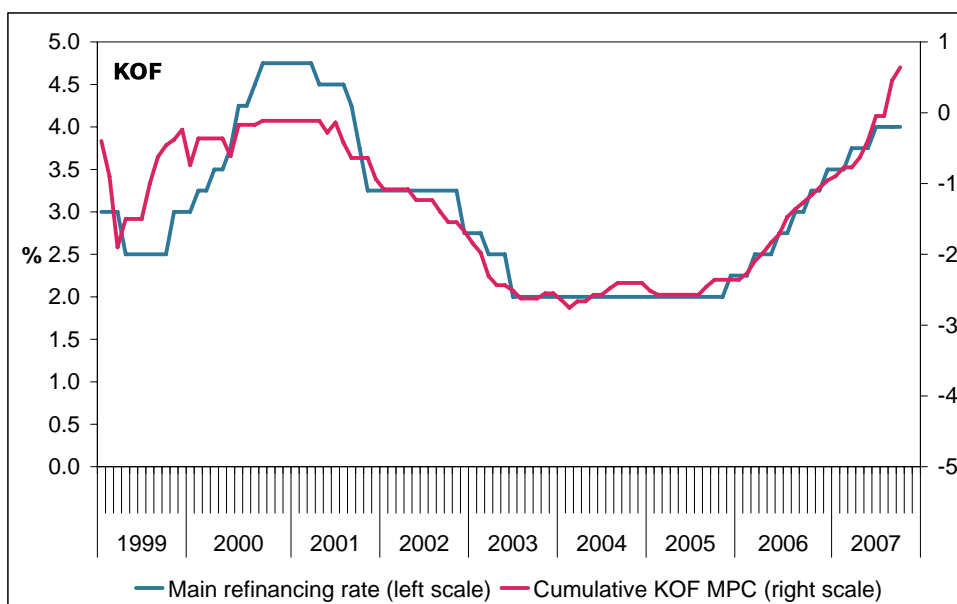


Figure 1 ECB main refinancing rate and KOF MPC.

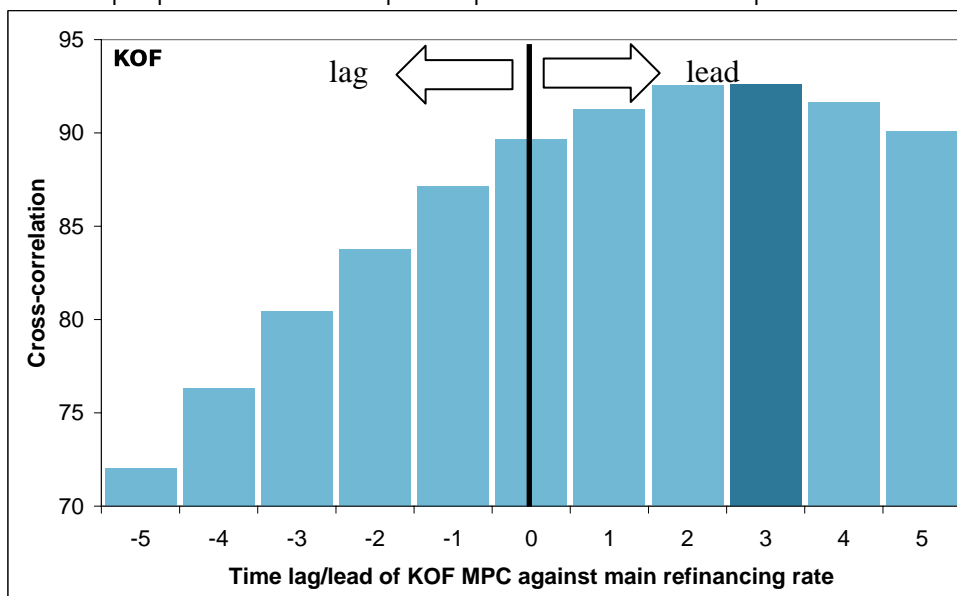
As the KOF MPC indicates changes in the main refinancing rate, summing up these changes over time can give us a better picture of how the KOF MPC correlates with the interest rate. The following cumulative indicator is the sum of all previous values of the KOF MPC and the current value. Figure 2 plots the development of the cumulative indicator and the ECB's main refinancing rate for the period 01/1999-10/2007. Clearly, the time courses of both series are closely related to each other. This visual impression is confirmed by a contemporaneous correlation coefficient between the two series of about 89%. If the sample is divided into the sub-periods 01/1999-04/2003 and 05/2003-10/2007, the correlation between the interest rate and the cumulative indicator is about 69% in the first sub-period, but about 98% in the second sub-period.<sup>2</sup> This development shows that the connection between the ECB's deeds and its communication has become closer over time.

<sup>2</sup> The choice of these sub-periods is motivated by a change in the structure of the introductory statement in May 2003.



**Figure 2** ECB main refinancing rate and cumulative KOF MPC.

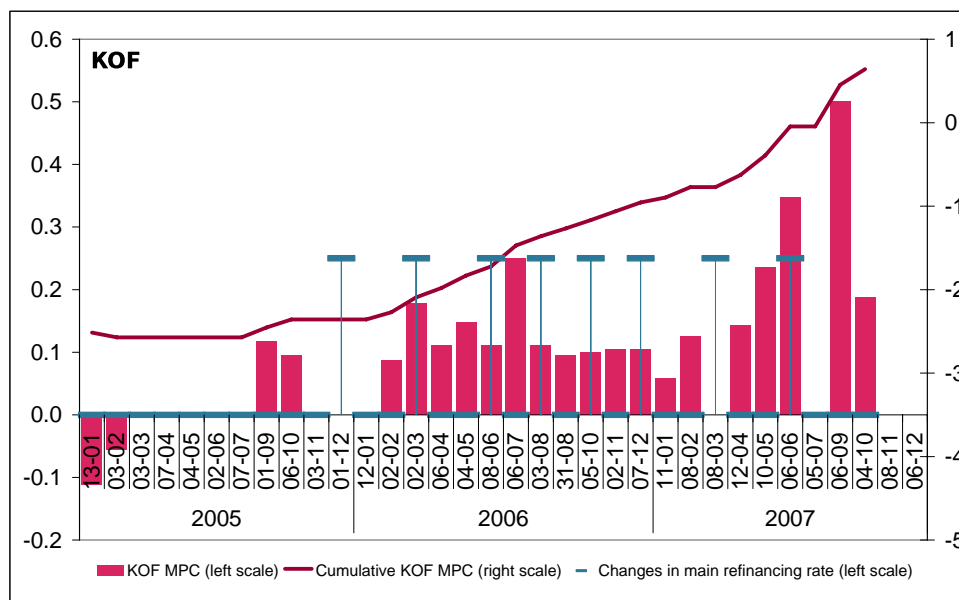
Moreover, it appears that the cumulative indicator leads the main refinancing rate by about two to three months. This is confirmed by Figure 3, which plots the cross-correlation between the cumulative indicator and the ECB main refinancing rate. When the cumulative indicator lags the main refinancing rate the cross-correlation is rapidly decreasing while it is increasing when the cumulative indicator leads the main refinancing rate. The highest cross-correlation is observed when the cumulative KOF MPC precedes the main refinancing rate by three months. This behaviour is reasonable, since the cumulative indicator contains mainly forward-looking information. In this way, the index reflects the intention of the ECB to prepare the market participants for the future path of monetary policy.



**Figure 3** Cross-correlation between KOF MPC and main refinancing rate.

### Recent Developments

Figure 4 shows the development of the KOF MPC as well as of the cumulative KOF MPC in the last three years. Additionally, it plots the changes in the main refinancing rate. Clearly, in most of the cases the changes in the main refinancing rate are preceded by increases in the KOF MPC.



**Figure 4** Recent developments of KOF MPC and interest rate changes and cumulative KOF MPC.

After the October 2007 press conference, the KOF MPC took a value of 0.188. Although this value is lower than the value of 0.5 in September, the two positive values indicate that the ECB sees considerable risks to price stability in the medium term.

Besides the risks to price stability, the ECB highlighted that the financial market volatility and the reappraisal of risk observed in recent weeks, has increased the uncertainty associated with its projections for the fundamentals of the Euro Area. In light of these uncertainties, the ECB awaits additional information and new data before it draws conclusions for monetary policy.

If the financial market turbulences have no lasting impact on the real economy, the course of the KOF MPC suggests that there is a considerable probability for a monetary tightening, i.e. an increase in the main refinancing rate, within the next three months.

### Publication Frequency

From November 8, 2007 onwards, the indicator will be published on the day of the Governing Council meeting at 17.30 CET. The exact dates for 2007 and 2008 are available on the website mentioned below.

The KOF MPC is published via an email distribution list and available at

<http://www.kof.ethz.ch/communicator>

This website contains also additional information on the database and its content.

Contact: [communicator@kof.ethz.ch](mailto:communicator@kof.ethz.ch)