

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

KOF Monetary Policy Communicator for the Euro Area – Supplementary Information

Description and Analysis of the Database

The Role of Communication for Monetary Policy

The importance of central bank communication for the implementation of an effective and credible monetary policy has considerably increased over the last decade. Central banks – as well as researchers – all over the world consider active communication with market participants as an important ingredient of effective monetary policy. First, communication serves as an instrument for explaining and justifying past and present policy decisions. Second, communication enables central banks to guide market participants' inflation and interest rate expectations and, therefore, leads to better predictability of central bank actions and thereby reduces market uncertainty.

The different Sections of the Introductory Statement

The introductory statement generally starts with a brief summary of the decision taken earlier that day and the reasons underlying this decision. Thereafter, a detailed discussion of developments in the real economy, prices and monetary aggregates is provided. Within each of these sections current and past developments are interpreted with regard to their implications for the ECB's main goal: price stability in the medium run. Finally, several issues such as exchange rates, financial market developments, fiscal sector and organisation of the ECB are discussed. While the sections real economy, prices and monetary aggregates appear in every introductory statement, the sections on exchange rates, financial markets or the fiscal sector are discussed infrequently. The KOF MPC focuses solely on the statements which have implications for risks to future price stability.

The Data

The content of each introductory statement from 01/1999 onwards has been coded by Media Tenor, a media research institute. Media Tenor has a long experience in coding articles of media releases and capturing their content. Media Tenor uses professionally trained analysts for the entire process of content analysis. The analysts categorize each introductory statement sentence by sentence according to a set of predefined criteria. The content of each introductory statement is then appropriately coded and entered into a database. Each sentence is analyzed in a variety of ways and partitioned into statements,

i.e., information units. The final data set contains information about several dimensions of each statement. Each statement is treated as an observation and classified as follows:

- topic of the statement (GDP, consumer price index, etc.)
- section to which the statement belongs (real, prices/inflation, monetary)
- tense of the statement (present, future, past)
- tendency of development (no change, increase, decrease)
- judgement of the development (good, neutral, bad)
- ambiguity of the statement (unambiguous, conditional, restricted/conjecture)

The Role of the Sections

By counting the number of statements within each section, we aim at quantifying whether the weight which is attached to real, price and monetary developments has changed over time. As only those three sections are always contained in the statement, we summarize the sections that contain financial markets, exchange rates or the fiscal sector as “other”. Figure 1 shows the number of statements from each section relative to the overall number of statements. Broadly speaking, the shares allocated to the three sections remain more or less constant over time.

In summary, we find that the economic analysis (real plus prices) has a weight of about 45% relative to a weight of about 25% attached to the monetary analysis. These weights have been stable for the last eight years. However, it should be noted that the weights attached to the discussion of the different sections in the press conference, are not necessarily the same weights as those that are applied in the ECB’s internal decision making process. This has been shown in a study by Berger et al. (2006).

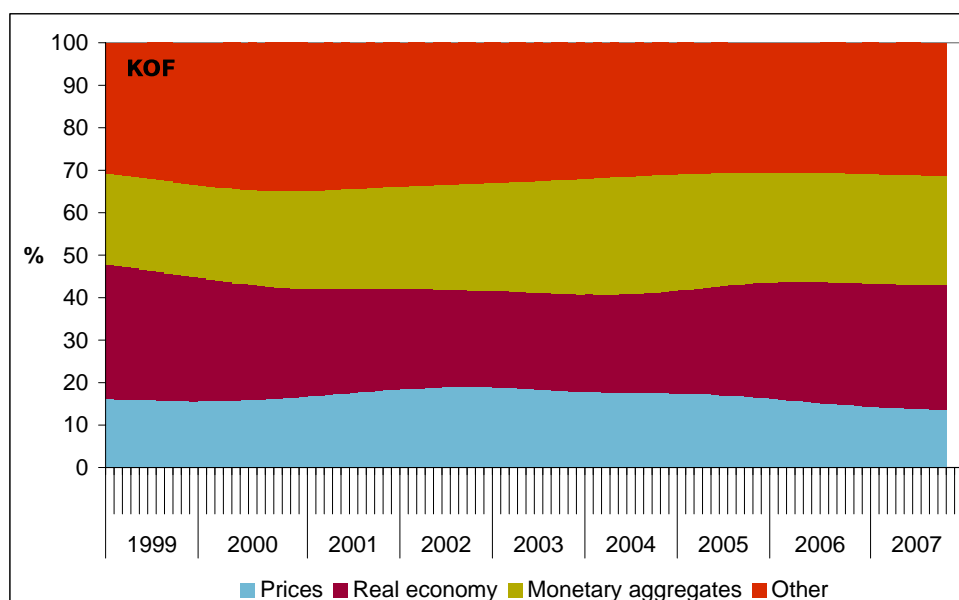


Figure 1 Shares of statements in sections: real, prices, monetary and other.

The Forward-Looking Component of ECB Communication

We are able to categorize the tense of the statements by distinguishing whether they are dealing with the past, present or future. Figure 2 plots the shares of statements allocated to the different tenses. In 1999 about 50% of the statements were related to the past and an additional 25% to the present. Until the beginning of 2004 the share of backward-looking statements decreased while those discussing present developments stayed approximately constant. Clearly, the share of forward-looking statements has increased from 25% in 1999 to about 50% from 2004 onwards. This development suggests that the ECB's communication has become much more forward-looking over time. A potential explanation for this development has been rationalized in a recent study by Conrad and Lamla (2007). They argue that in the first years of the ECB, the introductory statement has been primarily used as an instrument for explaining the Governing Council's actual monetary policy decision to market participants. More recently, the introductory statement has more and more become a tool for preparing future policy decisions.

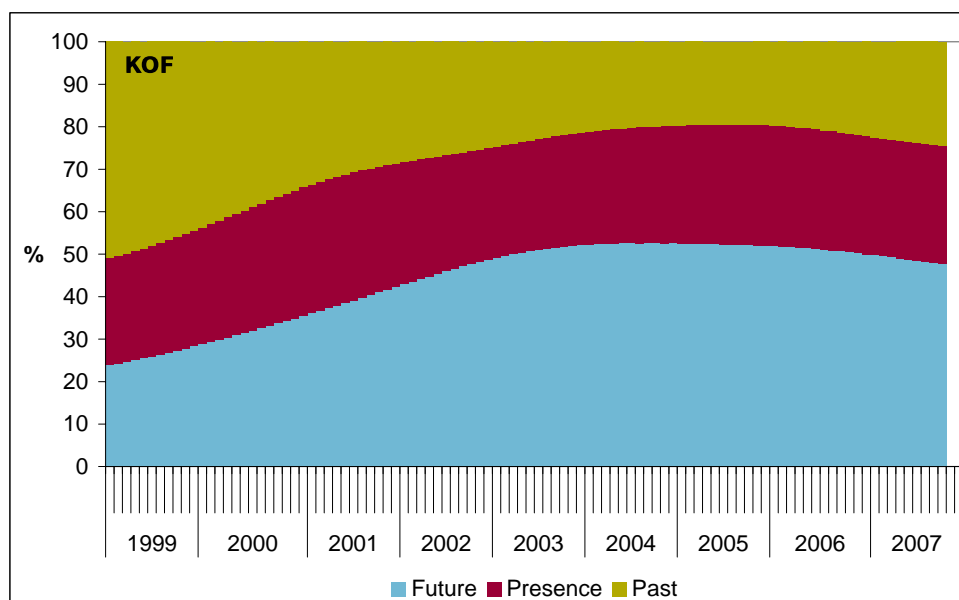


Figure 2 Share of statements with content referring to future, present and past events.

Ambiguity in Communication

Finally, our data set allows us to distinguish between unambiguous statements, statements which are conditional (if ... then) and statements that are restricted (on the one hand ... on the other hand, nevertheless, etc.). Figure 3 shows that unambiguous statements have decreased over the sample period from about 75% to 40%. At the same time, conditional statements have increased from 15% to 45%. The share of restricted statements does not reveal a trend in either direction.

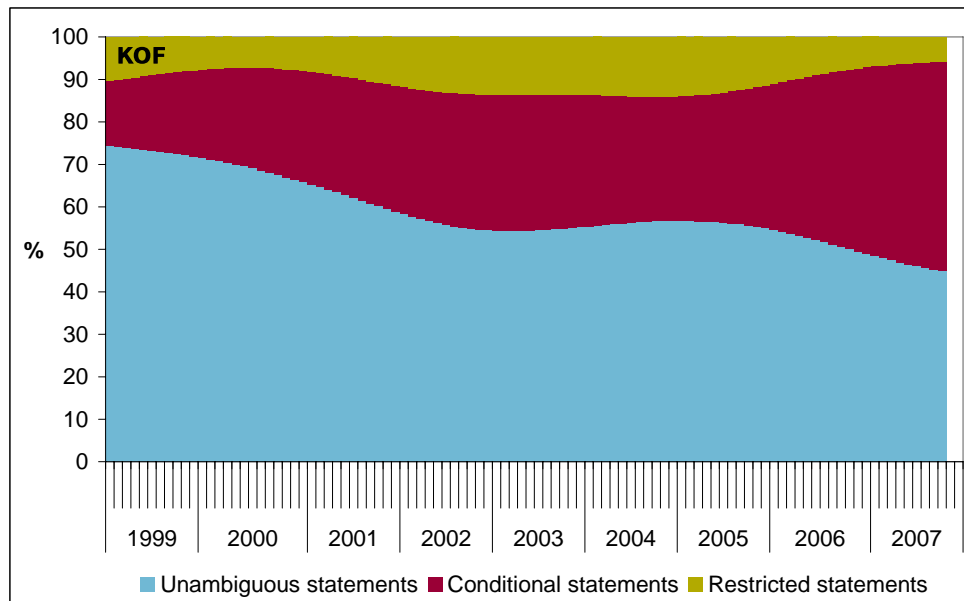


Figure 3 Ambiguity of all statements.

From the above description it appears that the communication of the ECB has become less explicit over time. Figure 4 allows for a more detailed analysis by conditioning also on the tense of the statement. We see that most of the statements referring to the future were conditional. The fact that the ECB's communication has become more forward-looking leads to the observation in Figure 3 that conditional statements have increased relative to unambiguous statements over time. However, it should be also noted that among the statements with forward-looking content those which are conditional have increased. In this sense Figure 4 provides some evidence that the ECB has become more cautious in its communication.

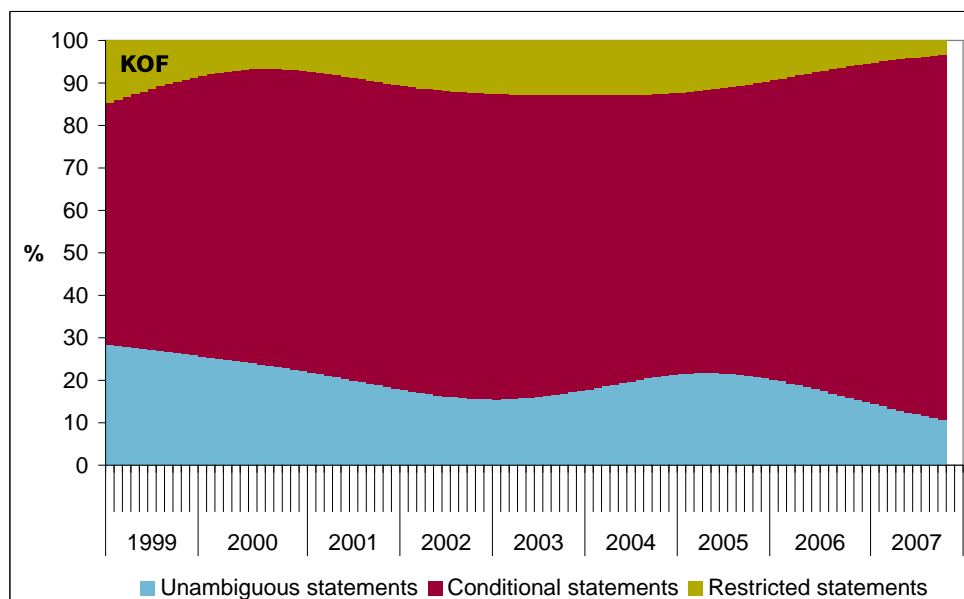


Figure 4 Ambiguity of forward-looking statements.

Design und Construction of KOF MPC

The KOF MPC is based on a quantification of the statements of the ECB President made during the monthly press conference. The coding of the statements is provided by Media Tenor, a media research institute (<http://www.mediatenor.de>). As the ECB raises and cuts interest rates to ensure price stability in the medium run, the indicator is based on statements which reveal the Governing Council's assessment of developments which directly affect "future price stability". The KOF MPC is constructed as follows. First, the balance between statements implying that there are upside risks to price stability and those that refer to downside risks is calculated. Second, this balance is then divided by all statements with regard to "future price stability". Although all the sections of the introductory statement enter into the index, statements from the section on price developments appear to be most relevant. This is in line with research which has shown that forward-looking statements related to price developments are most informative to predict future interest rates (see, Conrad and Lamla, 2007, and Lamla and Rupperecht, 2006).

References

Berger, H., J. de Haan, and J.-E. Sturm (2006). Does money matter in the ECB strategy? New evidence based on ECB communication. KOF Working Papers No. 125.

Conrad, C., and M. J. Lamla (2007). The high-frequency response of the EUR-US Dollar exchange rate to ECB monetary policy announcements. KOF Working Papers No. 174.

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