By influencing market expectations of future interest rates, central bank communications have become a key tool of monetary policymaking. Research by Carlo Rosa finds that announcements by the US Federal Reserve move market interest rates significantly more than comparable announcements from the European Central Bank.

Words that work: comparing the effectiveness of central bank communications
Over the past few years, financial market participants – especially those active in the bond markets – have benefited from increased transparency from central banks about how they set monetary policy. Alongside their interest rate decisions, central banks increasingly publish detailed explanatory documents, such as the Bank of England’s quarterly Inflation Report.

Central banks have tried to become more transparent about their future monetary policy intentions in part because expectations of future interest rate decisions are priced into today's money markets – and so, in theory at least, communication can be a tool to tighten or loosen policy, as much as actually altering the key policy rate.

Of particular note are central banks' 'balance-of-risk' statements – announcements about the likelihood of a future increase or decrease in the target rate. These are used by market participants to predict the future direction of interest rates.

The fundamental question for central bankers is whether (and to what extent) financial markets react to their announcements over and above any change in the interest rate itself. For example, the statement following the Federal Open Market Committee (FOMC) meeting on 28 January 2004 led to one of the largest reactions in the bond market in the past 15 years: no less than a 25 basis point increase (one quarter of one percentage point) in the five-year Treasury bond rate in the half-hour surrounding the announcement.

Contrary to conventional wisdom, this reaction was spurred by the Fed's words rather than its deeds. As market participants expected, the FOMC did not change its target interest rate. Instead, it was the decision to replace the phrase ‘policy accommodation can be maintained for a considerable period’ in its accompanying statement with ‘the Committee believes it can be patient in removing its policy accommodation’ that led market participants to revise upwards their expectations of future interest rates.

Are the words of central bankers always heeded in this way? And are the words of some central banks more effective than others? To answer these questions, my research looks at the communication strategies of the European Central Bank (ECB) and the Fed. I also directly compare the ability of the ECB and the Fed to affect market rates using deeds (changes in the present target rate) or words (balance-of-risk statements).

I find that the Fed is much more effective than the ECB at steering market interest rates on bonds of all maturities. Figure 1 provides a graphical comparison of the average total effects of central bank words and deeds on interest rates for the period 1999-2006. The horizontal axis is maturity of interest rates – from three months to 10 years. The vertical axis is interest rates in basis points.

One possibility is that the Fed's long-term inflation objective is less explicit than the ECB's objective: the Fed's mandate is to pursue stability of both prices and economic activity while the ECB's mandate assigns overriding importance to price stability. Hence, long-term inflation expectations (and hence interest rates) in the United States may be more sensitive to Fed statements than are those in the euro area. In other words, Fed statements may contain information not only about its future policy intentions but also about its opaque inflation target, which may vary over time.

An alternative explanation might be that Fed statements are more informative than ECB statements, and as a result the former move interest rates in the money markets more than the latter.

My analysis suggests that the greater sensitivity of US long-term yields to central bank communication is intimately related.
The size of the dollar-denominated debt market means that Fed words can even affect European interest rates

powerful than others. My research suggests that the Fed’s words are treated as a more accurate guide to future monetary policy than those of the ECB – and so a change in tone by the Fed is more likely to move markets. What’s more, the prevalence of dollar-denominated debt means that Fed words even have the capacity to move European interest rates.

So why does the Fed move the market more than the ECB? The Fed differs from the ECB in at least two respects. The Fed has not only been much more active than the ECB, which could mean that the market understands better what it says and does – a transparency effect. But the Fed also has a different institutional mandate compared to the ECB – the Fed is not ‘inflation targeting’.

Theoretical research has shown that under the Fed’s mandate, it is optimal to communicate more information to the public than under an inflation targeting regime. But I find empirically that the reason why the market responds more to the Fed’s announcements compared with ECB statements is not due to its mandate; rather, it is a pure transparency effect.


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