

Monetary Policy Communication During the Global Financial Crisis

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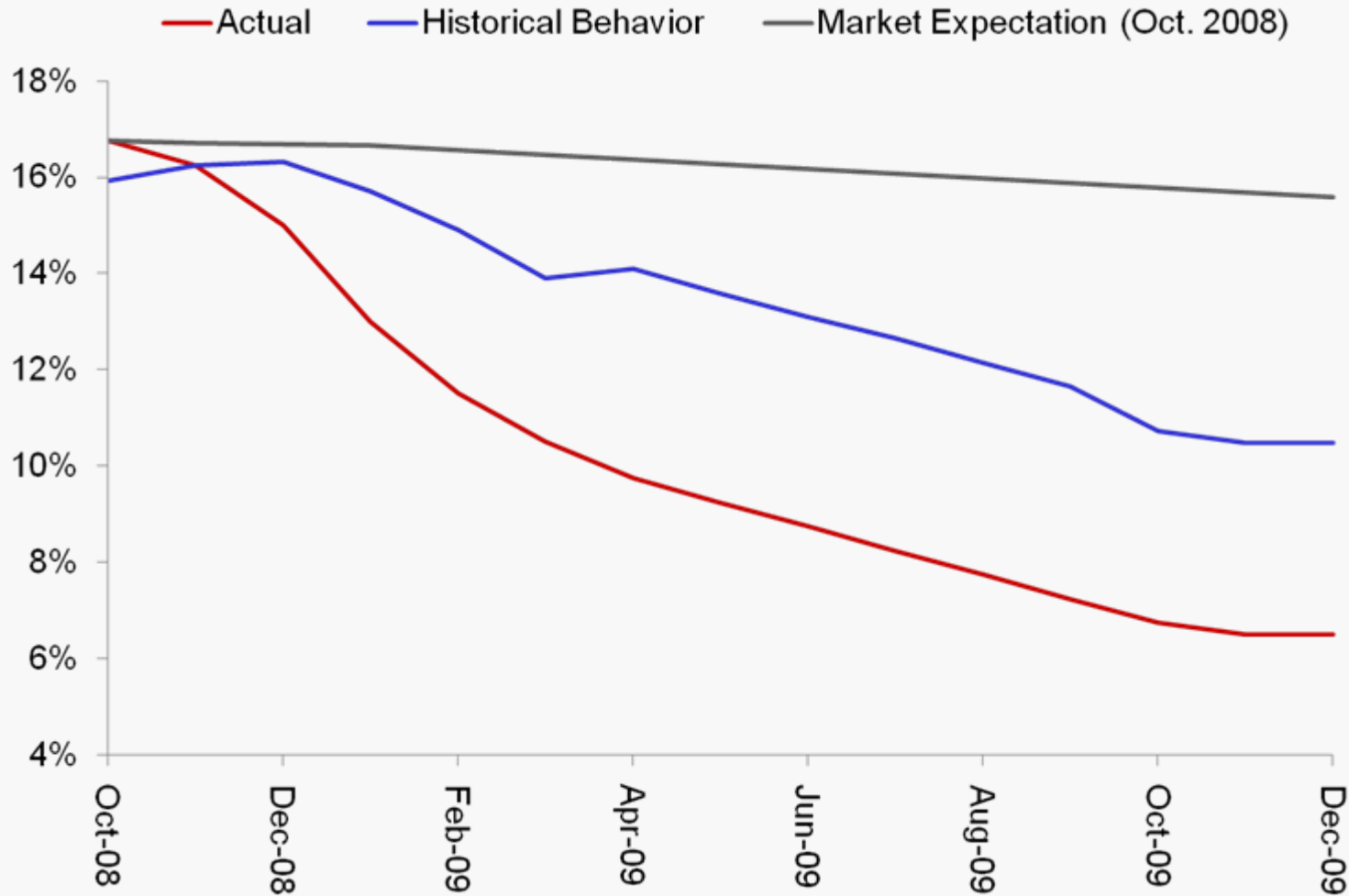
**Seminar on “Inflation Targeting in Open Economies:
Challenges in a Post-Crisis World”
Organized by Czech National Bank September 24, 2010**

Policy Communication During Normal Periods

- Rule based, predictable monetary policy,
 - Forward looking reaction function
 - Market expectations formed through the rule based policy
 - Validation of market expectations by monetary policy
 - Market expectations are largely aligned with Central Bank's views
- Regular communication tools of the CBRT:
 - **Inflation Report:**
 - Qualitative information regarding policy path
 - Inflation forecasts based on endogenous policy rates
 - Risk factors around the forecast and contingent policy responses
 - **Monthly Policy Statement:** Updates on monetary policy and economic outlook

The Crisis, Expectations and the Policy Behavior

Policy Rates in the post-Lehman Period



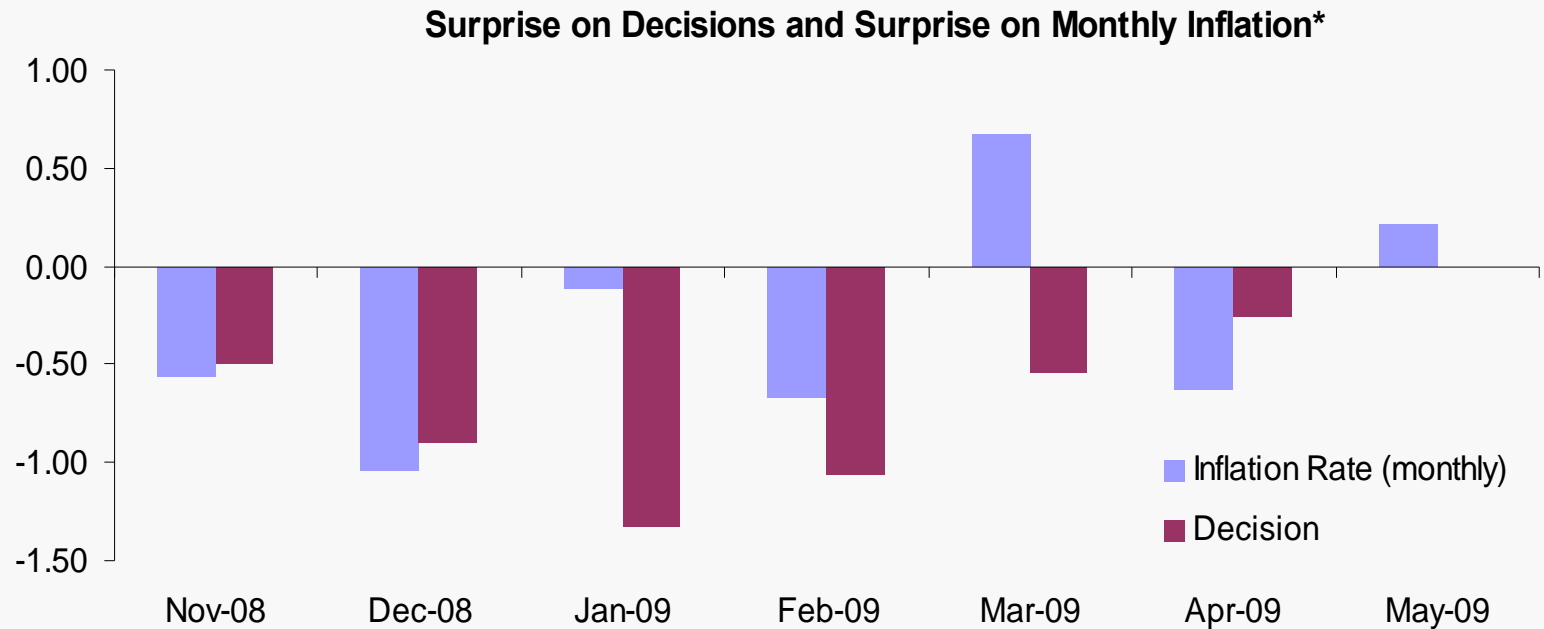
Source: Alp and Elekdağ (2010), CBRT

Policy Communication During the Global Crisis

- Divergence between the Central Bank's and the market's views because of
 - Extreme levels of uncertainty
 - Adaptive expectations, learning about the “new regime”
 - Imperfect credibility
- CB aims to close the expectations gap rapidly, but usual communication tools may not yield effective results under crisis conditions
- How to align market expectations with the CB's view?

Actions Speak Louder than Words

- Speed up the transition of expectations to the new regime
- First, “shock” the market, and then watch the incoming data validate
- Risky! Yet, may be a powerful tool if the CB is confident in its own view



Source: CBRT

* Surprise = Realized-Expected

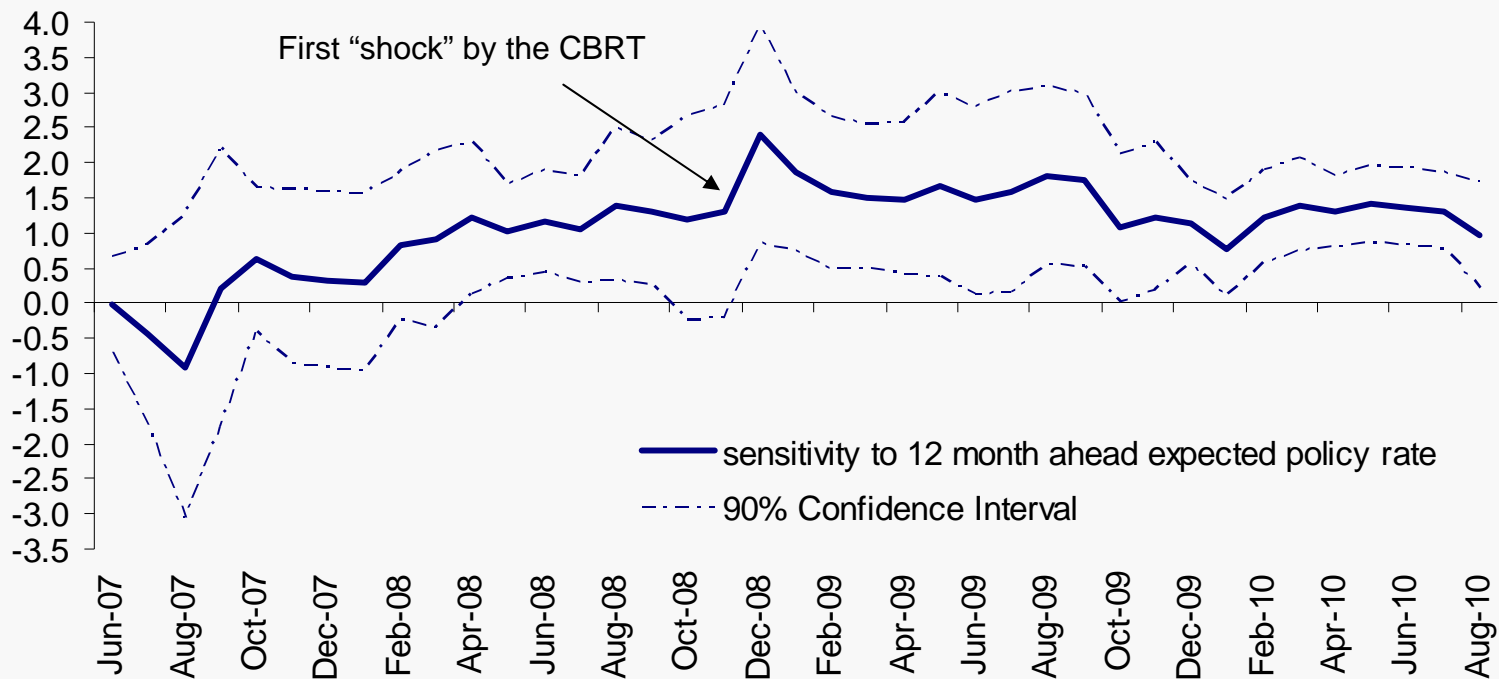
Increased Effectiveness of Monetary Policy

- Rapid credibility build up as the data vindicates aggressive rate cuts:
 - Increasing control of the CBRT over the yield curve
 - Strengthening response of the yield curve to policy communication
 - Improving monetary transmission mechanism

Increased Effectiveness of Monetary Policy

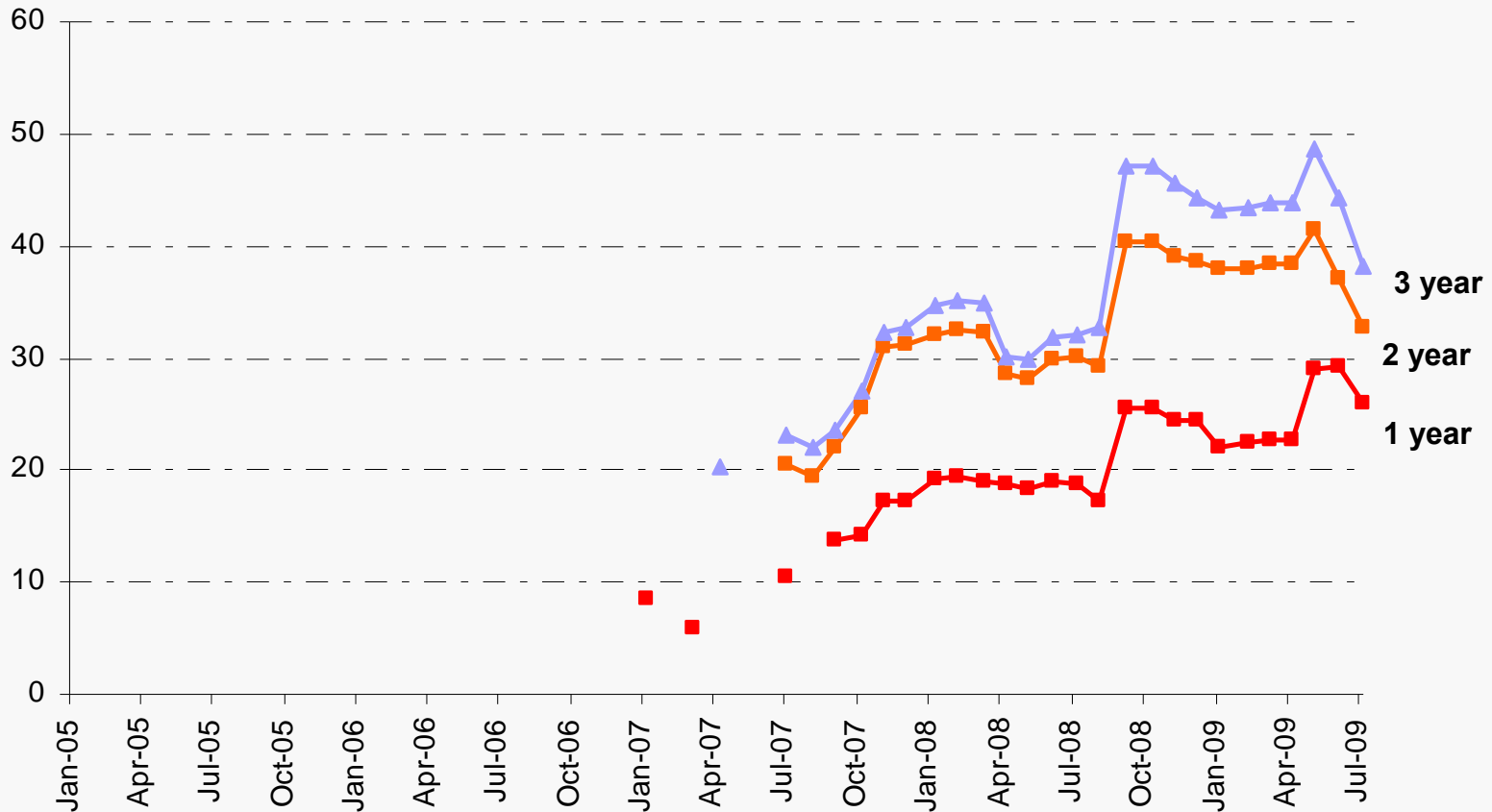
- Increased response of market interest rates to expected policy decisions

Sensitivity of benchmark bond rate to 12 month ahead expected policy rate
(12 month rolling windows)



Increased Effectiveness of Communication

The Response of the Yield Curve to Statement Surprises (15 month moving average)



Source: Demiralp, Kara, and Özlü (2010)

Communication Efforts by the CBRT: An Example

➤ *Summary of the MPC Meeting (Published on July 28th, 2009)*

“The Committee members believe that global interest rates are likely to remain at low levels for an extended period, given the significant slowdown in growth and rising saving rates. **The Committee therefore indicated that this view should be emphasized more forcefully to align market yields closer with future policy intentions.**”

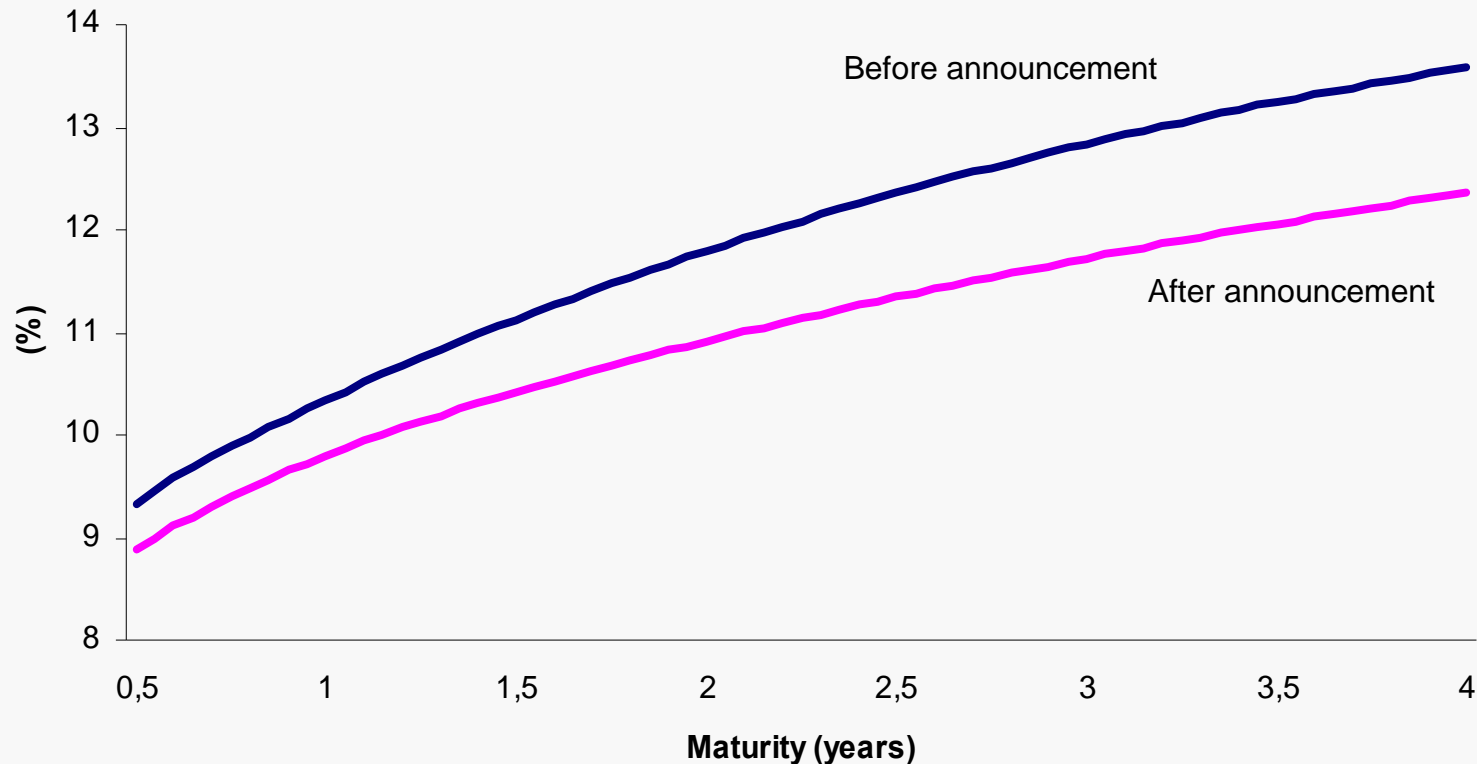
➤ *Inflation Report (Published on July 29th, 2009)*

“**Inflation and output gap forecasts are presented under the assumption of some further easing in the near term followed by constant policy rates until the end of 2010. ...**”

Response of the Yield Curve to CB Announcement

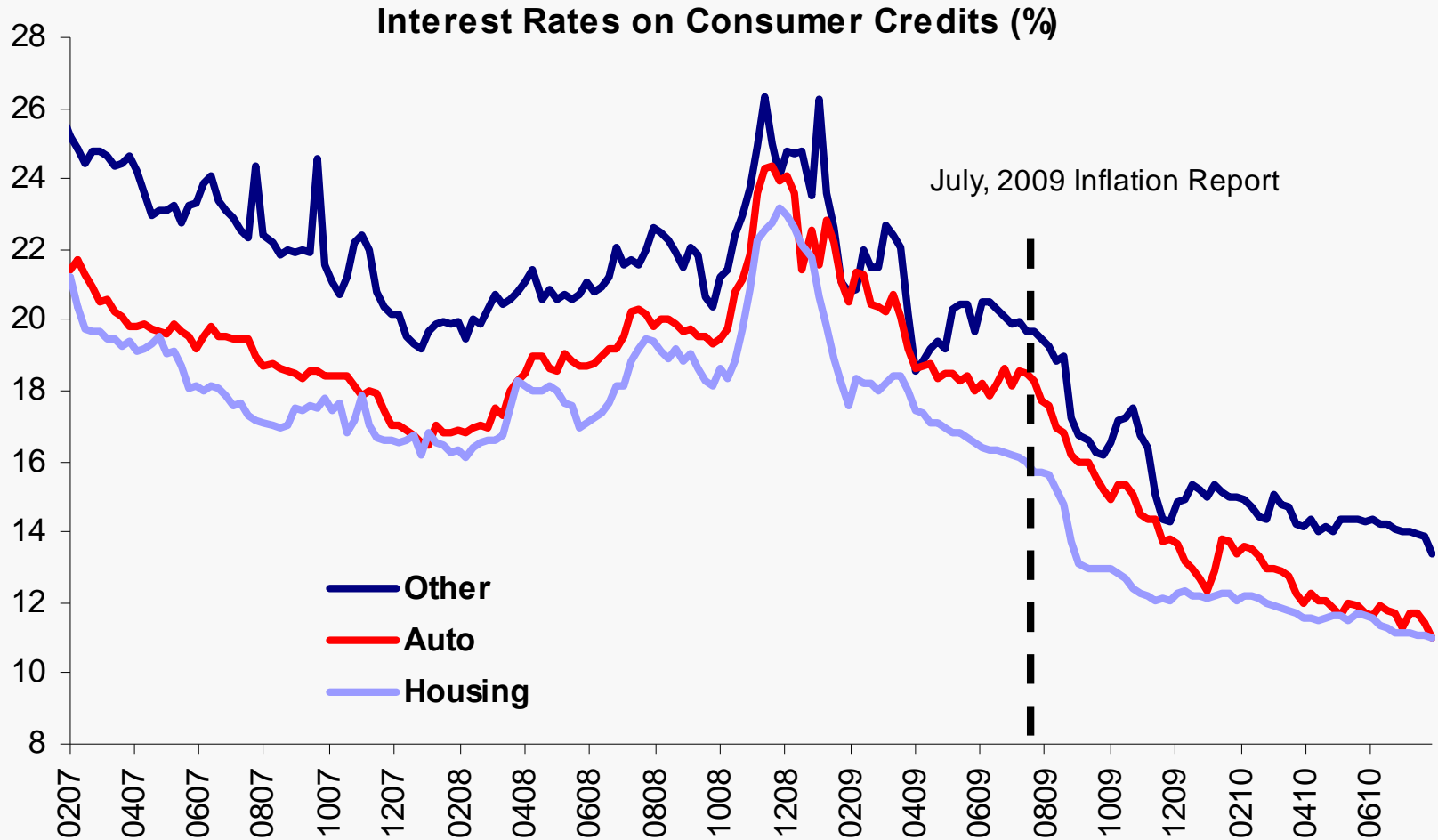
- Following the publication of the July 2009 Inflation Report, market rates fell across all maturities; the decline in long-term yields was more pronounced.

Yield Curve



Enhanced Policy Transmission

- Loan rates also responded significantly for all subcategories.



Summary and Conclusion

DURING CRISES

- The past does not reveal much information about the future: model based analysis becomes less relevant; communication through usual channels may not work properly
- Creating deliberate policy surprises through aggressive reaction may yield more efficient results by speeding up the learning process of financial markets.
 - Orphanides and Williams (2004), Molnár and Santano (2010)
- Once the credibility is established in the new regime, the CB can reap the benefits of communication
- This strategy works only if the quality of economic analysis and judgment within the CB is superior to the financial markets; i.e., economic agents are guided in the right direction

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