

The power of the ECB's words and tone

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The way the European Central Bank modulates its tone with each announcement has recently become an important tool for keeping track of monetary policy. This has come about since central banks have added specific commitments and credible and transparent communication to their toolbox. The ECB uses these tools to anchor the direction of expectations to its main mandate, price stability, and to indicate clearly how it will react if the economy evolves in a particular way. Monetary policy guidance is effective, since it allows monetary conditions to be relaxed when all other instruments have run out of room for manoeuvre, or to be anchored when stimulus measures start to be gradually withdrawn.

Fortunately, today's technology helps us to extract the information from the ECB's words and prepare an indicator showing the issues dealt with and the tone used to convey the message. The indicator published by BBVA Research reveals how the main issues addressed by the central bank have evolved significantly over time to adapt to a changing environment. From the bank's creation until before the international financial crisis, the most influential subjects were those relating to conventional monetary policy or the economy. However, from 2009 on, non-conventional monetary policy and matters relating to the financial crisis and the banking union became more important.

But... is it only the words that matter? Isn't the tone important too? The tone can be interpreted as an indicator of the degree of hawkishness (or dovishness) in the direction of the central bank's monetary policy. In the case of the ECB, until 2007 the tone was positive, indicating that the direction of monetary policy was more contractive, especially during the years 2004-2007 (a period associated with economic prosperity). But from then on the tone was gradually softened, until 2014 when monetary policy reached its most relaxed point. Since then the tone has tended towards neutral, since the ECB is preparing to exit from its non-conventional measures.

In summary, an objective analysis of the ECB's announcements constitutes a key tool for keeping track of changes and forecast expectations of monetary policy decisions. In the next few months the ECB will have to modulate both its tone and its words in order to give the markets correct guidance on their expectations of future monetary policy. To paraphrase Mario Draghi: "In a market economy, transparency and communication are fundamental for the effectiveness of our monetary policy."

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