



CENTRAL BANK OF CYPRUS

**MONETARY POLICY AND
CENTRAL BANK COMMUNICATION:
THE CASE OF CYPRUS**

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Prepared for the MEDITERRANEAN WORKSHOP

CENTRAL BANK GOVERNANCE

ECB & Banque de France

20 September 2004, Frankfurt

The views expressed in this paper are those of the authors and do not necessarily reflect the views of the Central Bank of Cyprus. We wish to thank our colleague, George Georgiou, for comments and editing. We are also grateful for comments received from Nikolaus Siegfried at the ECB and Alain Laurin at the Bank of France. All remaining errors and omissions are ours.

1. Introduction

In the past, the communication practices of central banks could best be described as secretive and ambiguous thus giving rise to a certain mystique surrounding their activities. In contrast, communication today is considered to be an essential and vital part of modern central bank policy making. Over the past fifteen years or so central banks have placed more and more emphasis on the amount of information they release to the public as well as on its timeliness and quality. This new open approach has been welcomed by the public and has improved the efficiency of different monetary policy strategies.

The shift towards greater transparency can be attributed to three factors (Amato *et al*, 2002). First, the greater independence enjoyed by many central banks has been accompanied by the need for increased accountability, which in turn has meant much more extensive efforts by central banks to communicate to the public their views on the economy and the repercussions of monetary policy. Second, the adoption of formal inflation targets has turned the spotlight on the actions and pronouncements of central banks. Third, the growing importance of financial markets entails the need for managing market expectations. This is a task that would be impossible without effective channels of communication with market participants.

All things considered, and despite the slow transformation of central banks into more public oriented and transparent institutions, it is generally agreed that the new levels of openness have helped improve the effectiveness of monetary policy. However, certain questions remain open for discussion and debate, such as the optimum amount of information that should be released.

2. Communication as an integral part of monetary policy: theoretical underpinnings

As already mentioned, the importance of proper communication channels has grown due to the greater independence gained by central banks and the accompanying need for accountability. In particular, when a central bank is independent, the public needs to be able to assess whether or not it has succeeded in using the appropriate instrument to achieve its goal. Accountability is thus the *quid pro quo* of central bank independence and communication facilitates the means to transparency which is important for accountability. Hence communication plays an important role in explaining to the public both the instruments and the goals as well as the reasons behind the decisions made by the authorities (Winkler, 2000). This is especially true in the case where a central bank chooses to follow a strict policy rule, such as inflation targeting.

In an open, free market economy monetary policy can only indirectly affect output and inflation through its influence on a single short-term interest rate. As Blinder (1998) argues the overnight interest rate, which is the rate relevant to monetary policy, is important only to the extent that it moves other economic variables that matter, such as long-term interest rates, stock market prices and exchange rates, which in turn affect both output and inflation. In particular, the interbank market per se is insignificant for the output of the economy. Rather, by setting the overnight rate the central bank is able to affect both the output and inflation of the economy through the different transmission mechanism channels. However, the link between monetary policy's tool and prices relies mostly on market expectations. Assume, for example, that overnight rates remain constant. Any news that leads participants in financial markets to expect a rise in short-term rates will lead to a rise in longer-term rates and thus a decrease in bond prices.

Of course in the case where financial markets are efficient and well informed there is not even a marginal benefit to central bank communication. In theory access to a set of full information will enable markets to reach a rational expectations equilibrium. This assumes a perfect world where systematic policymaking, financial market efficiency and symmetric information conditions hold (Poole, 2003). In practice, however, policy makers have more information than financial markets and allowing the information to channel through these markets moves long-term interest rates closer to the target. This in fact takes place because communication can make monetary policy, *ceteris paribus*, more predictable and thus more effective (Amato *et al*, 2002).

Monetary policy's effectiveness thus depends on open and transparent communication. In contrast, if a central bank keeps misinforming or not informing the public at all, the link between short-term and long-term rates will be lost and the monetary authority will find it increasingly harder to achieve its goals. Expectational bubbles may well be the result of inscrutable behaviour by a central bank which prevents the markets from grounding their perceptions in any underlying reality (Blinder, 1998). It is therefore important to find the right balance for the amount of information the public needs.

If, as we have already discussed, central bank transparency in terms of "information output has the potential to do good, then by the same token it also has the potential to do ill" (Amato *et al*, 2002). For example, a central bank that communicates to the public more information than is needed is likely to include information which is

incorrect, thus creating volatility and noise rather than a clear signal. Moreover, bringing all the information to the public domain may inhibit the decision making process making forecasters more risk averse and monetary policy committee members more restrained in their discussions. In this case the outcome for the economy will not be the desired one, while market participants will lose their trust in the information. In the case where the bank has a monopoly on these issues then the market will often be driven away from equilibrium. At the same time confusion may arise if members of a central bank's monetary policy committee express a range of (or even contradictory) opinions. This is most likely to occur when the committee is large.

3. Different practices: ECB vs. Fed

The ECB has been in existence since 1998 and has carried the responsibility for monetary policy in the euro area. To the surprise of many economists and commentators, it has managed to carry out successfully both the formulation and implementation of monetary policy. The changeover to the euro and the introduction of a new payments system (TARGET) proceeded smoothly and without any significant complications.

As a modern central bank the ECB understands the importance of communication, especially since its goal is that of price stability. The Governing Council has taken on various initiatives to increase the transparency of monetary policy. Indeed, the ECB uses a wide range of channels to communicate its expectations on current and future economic developments¹. Both the President and the Vice-President give monthly press conferences after the Governing Council meeting, while the monthly bulletin provides the general public and the financial markets with a detailed and comprehensive analysis of the economic environment. In addition the President of the ECB appears four times a year before the European Parliament's Committee on Economic and Monetary Affairs, while all the members of the General Council give speeches and interviews as they see fit.

¹ The analysis that follows is based on the book entitled "The Monetary Policy of the ECB", 2004.

Despite all these channels of communication, the ECB has been criticized for allowing a “communication gap” to exist. This is perhaps due to the fact that both the media and the public focus too much on the exchange rate rather than giving appropriate attention to the mandate of price stability (Issing, 2000). Broadly speaking, it seems that the ECB has done well in achieving its policy goals but not so well in explaining itself to the public.

On the other side of the Atlantic, the Fed seems to be doing a much better job in communicating its own policy reasons and thoughts. The Federal Reserve uses the Federal Open Market Committee (FOMC) statements that accompany FOMC actions or meetings (Kohn and Sack, 2003). In increasing its transparency the Fed has changed both the timing and the subject of these statements in recent years and now include the Committee’s assessment of the “balance of risks”. The Chairman also gives a congressional testimony biannually focusing explicitly on the state of the economy and more often to the Joint Economic Committee and the Senate or House Budget Committee. Finally, the Chairman gives public speeches to a variety of audiences just like the governors of the individual Federal Reserve Banks.

The Fed scores higher than the ECB in most surveys that assess the transparency and understanding of central bank policies. Despite its higher approval ratings, the Fed has not been immune from criticism. Specifically, it has been criticized for not publishing forecasts often enough, and for not publishing the minutes of the FOMC meetings on time. It seems, however, that it is easier for “older” central banks to make their case since they are established and have earned the respect of market participants. In contrast, the ECB seems to be facing some difficulties in dealing with market participants. In particular, as a much younger institution the ECB finds it difficult to convince market participants of both its measures and supporting analysis. Moreover, the ECB is faced with additional difficulties in having to communicate to a disparate group of cultures, languages and traditions as well as dealing with a range of national motives. (Hamalainen, 2000). As Professor Issing has argued, communication requires firstly, clarity from the central bank perspective and secondly, the ability and willingness to understand the audience’s point of view (Issing, 2000).

4. Monetary policy at the Central Bank of Cyprus

In preparing for EU accession and participation in ERM II, Cyprus has, since 2001, witnessed a stream of important structural reforms. First, and foremost, on 1

January 2001 the statutory interest rate ceiling was abolished and all restrictions on medium and long-term foreign borrowing by Cypriots were relaxed. At the same time Cyprus liberalised the spot and forward transactions in the foreign exchange market. In July 2002 a new law came into effect which ensures the Central Bank's independence and is compatible with the relevant provisions of the Treaty establishing the European Community and the Statute of the European System of Central Banks and of the European Central Bank. At the same time, the pertinent constitutional provisions were amended so as to ensure central bank independence as prescribed by the *acquis communautaire*.

According to section 5 of the *Central Bank of Cyprus Law*, the primary objective of the Bank is to ensure price stability. Without prejudice to this objective, the Bank supports the general economic policy of the government. Although our monetary policy framework is very similar to that of the ESCB, our price stability objective does not encompass a direct numerical target. Specifically, as opposed to a price stability strategy that is based on the two-pillar analytical perspective followed by the ECB² and the explicit inflation targeting adopted by a number of countries, Cyprus's monetary policy is conducted through an explicit exchange rate target. Historically, price stability in Cyprus has been considered to be best served by pegging the Cyprus pound to the currency of one or more countries pursuing low inflation. In order to achieve its objective the new *Central Bank of Cyprus Law* assigns the responsibility of formulating and implementing monetary policy, as well as of deciding on matters pertaining to the conduct of exchange rate policy,³ to the Monetary Policy Committee (MPC).

The MPC comprises the Governor (Chairman) and five other members, two of whom are appointed by the Governor. The other three members are appointed by the Council of Ministers on the recommendation of the Minister of Finance, following consultations between the Minister and the Governor. The Committee, which convenes about once a month, first convened in December 2000.

A factor often overlooked is the significant role played in transparent communication by the choice of an exchange rate regime (Winkler, 2000). Monetary policy is more transparent in a fixed exchange regime than in a floating regime. The public can observe at all times whether a central bank pursues the promised policy and,

² This refers to the two complementary perspectives as "economic analysis" and "monetary analysis" which provide a comprehensive analysis of the risks to price stability.

³ For a discussion of the CBC's exchange rate policy see Annex 1.

in addition, it is technically less complicated for a central bank to manage an exchange rate target than a future inflation target. Having said that, the wide fluctuation margins allowed for the exchange rate in the case of Cyprus, give some leeway for an independent monetary policy and therefore clouds somewhat the issue of communication. Moreover, due to the newly liberalised environment the CBC needs to explain to market participants, and the public in general, the monetary policy framework and the decision making process.

5. CBC communication channels

In its effort to clarify all aspects of its monetary policy, the CBC has opted to establish various communication channels with the public and market participants.

Immediately after the MPC meeting the Governor holds a press conference in which he gives an introductory speech on the decision made and the rationale behind it. The press conference includes a question and answer session, which is attended by various media representatives, and provides the platform for a timely explanation of the decision just made public. At the press conference the media also has the opportunity to ask questions about broader economic issues that are of importance to the public. Following the press conference a policy decision announcement, both in Greek and English, is posted on our website. On the following working day transcripts of the press conference in Greek become available on the website.

The detailed minutes of the MPC are not published. Although some central banks, such as the Bank of England, release their minutes to the public, the CBC follows the practice of the ECB by not making the minutes available for public consumption. There is a consensus among members of Cyprus's MPC that if the minutes were publicly available it might restrain their discussions thus inhibiting the decision making process. For the same reason, the minutes report the substance and general themes of the deliberations without identifying any particular view associated with a specific individual.

The MPC report, which is released in Greek immediately after the MPC meeting and in English soon after, provides a comprehensive analysis of the domestic and international economy. In particular, the report consists of the following five major sections: (a) international developments and exchange rates, (b) monetary developments, (c) inflation, (d) the domestic economy and (e) external transactions. The December issue of the report also covers the forecasts of the CBC for the coming year.

The CBC is also statutorily obliged to publish an annual report on its activities during the previous year. Moreover, the law requires that the Governor submits once a year a report on past and current year developments both to the President and Parliament. The Governor may also be asked by different parliamentary committees to testify on subjects pertinent to monetary policy and the economy as a whole. Twice a year the Governor meets with local financial journalists during which the Bank's practices and views about a wide range of economic issues are aired and explained.

The Governor and the Bank's senior staff also constitute an important vehicle for explaining the views of the CBC to the public. They are often invited to give speeches or take part in panel discussions which are usually open to the public on subjects that include monetary and exchange rate policy, EU accession, ERM II participation, euro adoption, etc. The CBC also gives presentations to groups of students and experts who are welcome to visit the Bank.

6. The CBC experience and recent examples

a. Financial liberalisation

In recent years the Cyprus economy has undergone significant structural changes. With financial liberalisation falling primarily under the Bank's jurisdiction, and given the complexity of the whole process, it was apparent that for a successful transition to the new environment clear and effective communication channels needed to be established. In fact, the Central Bank had to pursue an enlightenment campaign in order to explain the reasons for the liberalisation, how the new environment would work, and to calm down fears of an imminent rise in interest rates after forty years of a legally binding ceiling.

The CBC quickly realised that, first, there had to be an early start in both informing and educating the public. Two different communication approaches were needed; one directed to the banks and market participants and the other to the general public. In this respect, the Bank introduced the new monetary framework as early as 1996 so that banks would have time to adjust and learn the new market based techniques. Moreover, the Bank organised several seminars at which the staff explained different aspects of the liberalisation of interest rates and exchanged views with market participants. As early as one year before the interest rate liberalisation was due to take place, the Bank stepped up its information campaign. One of the biggest obstacles we had to overcome was the general belief that the lifting of the ceiling would necessarily

mean a hike in interest rates. We organised presentations and lectures, participated in many conferences and gave numerous interviews.

At the same time the Bank had another communication campaign to work on. The liberalisation of the financial system was accompanied by the gradual abolition of capital controls. The lifting of the interest rate ceiling also signalled the abolition of medium and long-term capital controls on borrowing by Cypriots. The capital liberalisation programme envisaged the orderly abolition of controls in three phases, starting from long-term capital controls and eventually leading to the lifting of very short-term flows upon accession to the EU. The Central Bank had to communicate this plan to market participants and the general public, deal with a large number of queries, and inform the public of the exchange rate risks associated with borrowing in foreign currency. The end result of the communication process can be said to have been successful. In this major communication campaign the CBC succeeded in a smooth transition to the new liberalised environment. After forty years of financial dealing in a sheltered and protected environment, the public is now able to make its own informed decisions.

b. Exchange rate pressures

In a more recent example that is of interest here, the Central Bank had to use all possible communication channels in order to calm fears of a possible devaluation of the Cyprus pound. In particular, during the period leading up to accession, i.e. March – April 2004, the CBC was faced with rumours of a devaluation resulting from: the final stage in the abolition of capital controls; the possible immediate entry in ERM II; and the political uncertainty introduced by the referendum on the Annan Plan for the proposed solution of the political problem of the island.

The initial signals of possible pressures on the exchange rate were first received from the banking sector, something that was possible due to the open communication channel that the CBC has with the commercial banks. Following inquiries from the public for the possible transfer of their deposits abroad, the CBC made an announcement reaffirming its confidence in the stability of the Cyprus pound and its commitment to our currency. Despite the Bank's efforts there was no tangible sign of an easing in the public's doubts. As a result, the MPC reaffirmed the strength of the currency, stressing that it was based on sound economic fundamentals. Following its deliberations, the MPC decided to increase the official rates by one percentage point, thus sending a strong signal of support for the Cyprus pound against a background of

unfounded rumours of an imminent devaluation. This decision rendered Cyprus interest rates more attractive with positive repercussions in capital flows and, therefore, for the value of the Cyprus Pound and capital inflows.

The measures taken were fully explained in a press conference the Governor gave after the MPC meeting. Moreover, representatives from the banking system were invited to the Central Bank in order to have a round-table discussion on the issues pertinent to the MPC's decisions.

It is important to note that in both aforementioned examples, and especially in its effort to fight possible exchange rate pressures, the Central Bank used what is often called "oral intervention". It must be stressed that oral intervention as well as any other form of communication is more effective when based on credible policies and a proven past record. Thus the CBC made extensive use of past experiences, such as the war in 1974 and the ERM crisis in 1992, events which, although stressful for the Cyprus economy, did not result in the devaluation of its currency.

c. ESCB Network

Since becoming a full member of the EU, the CBC has had to deal with a vast amount of material and information some of which needs to reach the public. Our efforts have focused on disseminating information on ECB decisions, policies, etc to the public. In this respect, certain documents are summarised and translated in Greek in order to reach a wider audience.

Moreover, the staff of the CBC and other new member state central banks has access to the ESCB network through their participation in different committees and working groups of the ECB and through one-on-one collaborations with the ECB itself. Moreover, drawing on the experiences and practices of other NCBs has also been very constructive.

In its effort to facilitate further our participation and communications in the ESCB and other bodies and activities of the EU, we established the European Affairs Unit. The Unit's functions include assisting the Governor's participation for the ECB General Council meetings and coordinating the Central Bank's participation in ESCB and EU committees. The Unit is also responsible for the coordination of the Central Bank's harmonisation programme with the *acquis communautaire*. The Bank also created the position of Press Officer and Deputy Press Officer in order for the press to have a direct

contact for questions and information. The Officers coordinate questionnaires that arrive from newspapers and magazines, while receiving and processing questions from journalists and the public.

d. Asset price bubbles

Asset price bubbles pose a threat to the stability of the financial system and as such are of great importance for monetary policy makers and central banks in general. The general consensus is that in the presence of such bubbles a central bank should have as its major objective limiting price and/or output volatility. What academics usually disagree on is how to achieve these goals in the presence of such bubbles and to what extent a central bank should intervene. In fact there are two general views on this. One school of thought suggests that a central bank should intervene only if asset price changes signal changes in expected inflation (Bernanke, 2002). The other school supports the view that “central banks can improve macroeconomic performance by reacting systematically to asset price misalignments, over and above their reaction to inflation forecasts and output gap” (Cecchetti *et al*, 2003).

Exactly how monetary policy might respond to large fluctuations in asset prices remains, thus, a difficult and uncertain subject. In addition the use of the term “asset price bubble” raises some thorny communication issues. On the one hand, the use of this term in monetary policy statements may cause short selling. On the other hand, in the case where the central bank knows exactly that it is dealing with a bubble, not communicating this fact would exacerbate the bubble since it would seem as the central bank is endorsing the opposite case⁴.

In the case of Cyprus, the stock market bubble in 1999 and its subsequent burst in 2000 have been a source of criticism of the CBC. The Bank warned in a number of circulars and press releases to the commercial banks and the general public that the rise in stock prices was unsustainable. When it became clear that those warnings were not sufficient to dampen prices, the Bank resorted to strict credit controls. Directives were issued prohibiting the financing of the purchase of stocks while at the same time credit ceilings were imposed. These measures were severely criticized at the time for interfering with the operation of the free market. The truth of the matter was, of course, that speculative profits were in danger of being negatively affected by the Bank’s actions. However, the CBC failed to prevent the rise and subsequent crash in stock

⁴ For a more extensive analysis see Filardo, 2004.

prices and after the bubble burst it was criticized for not acting decisively enough to prevent it.

7. Conclusions and challenges ahead

Central bank independence and financial liberalisation have been the driving force behind a growing need for communication between the CBC, market participants and the public in general. Monetary policy needs to be explained and has to be well understood both for accountability and for gains in its effectiveness.

The CBC has recently been through the liberalisation of its financial system while at the same time a new law has given it full autonomy and independence. Good communication policies in this increasingly liberalised environment played and continue to play a critical role for successful and effective monetary and exchange rate policies in Cyprus. Effective communication, backed by CBC credibility, has been instrumental in overcoming economic recessions, fending off speculative rumours and securing the financial stability and soundness of the banking system.

One of the biggest challenges the CBC and other central banks in the new member countries will face in the future is the changeover to the euro. The project is huge and complex and despite the fact that we have not entered ERM II officially, we have already started the preparatory work for easing the process leading to adoption of the euro. A committee responsible for the changeover has been established with instructions to devise a plan that will include *inter alia*, communication with the public.

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Annex 1: Cyprus's exchange rate policy

As regards exchange rate policy, it has been historically geared towards maintaining macroeconomic stability through the linkage of the Cyprus pound with a currency anchor, be it a single currency or a basket of currencies. Given the smallness and openness of the economy, this was considered to be an appropriate exchange rate policy framework. The currency anchor has changed several times since the country's independence. In 1992, however, the Cyprus pound was pegged to the ecu, and subsequently in 1999, to the euro, at the central parity of CY£1 = €1.7086. Initially, the fluctuation bands were $\pm 2.25\%$, but on 1 January 2001 wider bands of $\pm 15\%$ were introduced in order to allow the Central Bank to absorb any shocks from possibly destabilizing capital movements and to deter speculative capital flows. Later in the same year, economic developments led to the abolition of the narrower bands.