Overtaking the Masters?
Central Bank Policy & Communication in Emerging Markets, US and Eurozone

Special focus: CEE

Tatiana Evdokimova
(JVI)

Piroska Nagy Mohacsi
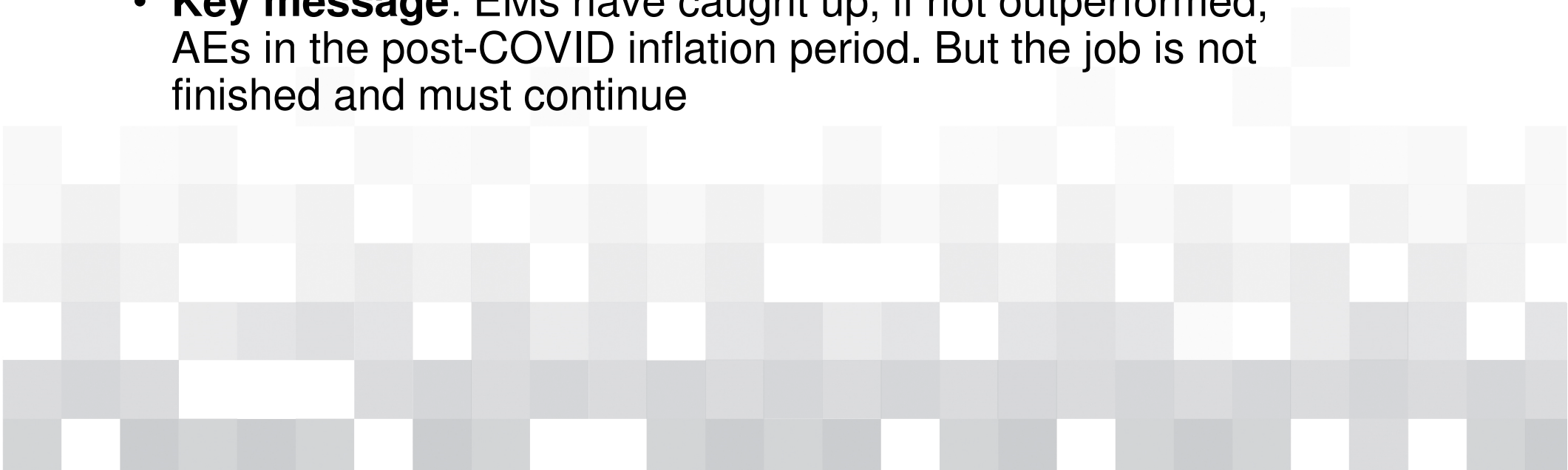(LSE)

Olga Ponomarenko
(Caplight)

Elina Ribakova
(PIIE, Bruegel, KIE)

**THE LONDON SCHOOL OF ECONOMICS AND POLITICAL SCIENCE**

Eger,
September 22. 2023

Outline

- **Topic:** comparing policy actions & communication of 22 emerging market (EM) central banks, the Federal Reserve and ECB, using novel methods to analyse vast amounts of communication data ("Text as Data")

- **Methodology:** sentiment analysis & advanced machine learning techniques

- **Key message**: EMs have caught up, if not outperformed, AEs in the post-COVID inflation period. But the job is not finished and must continue

Context
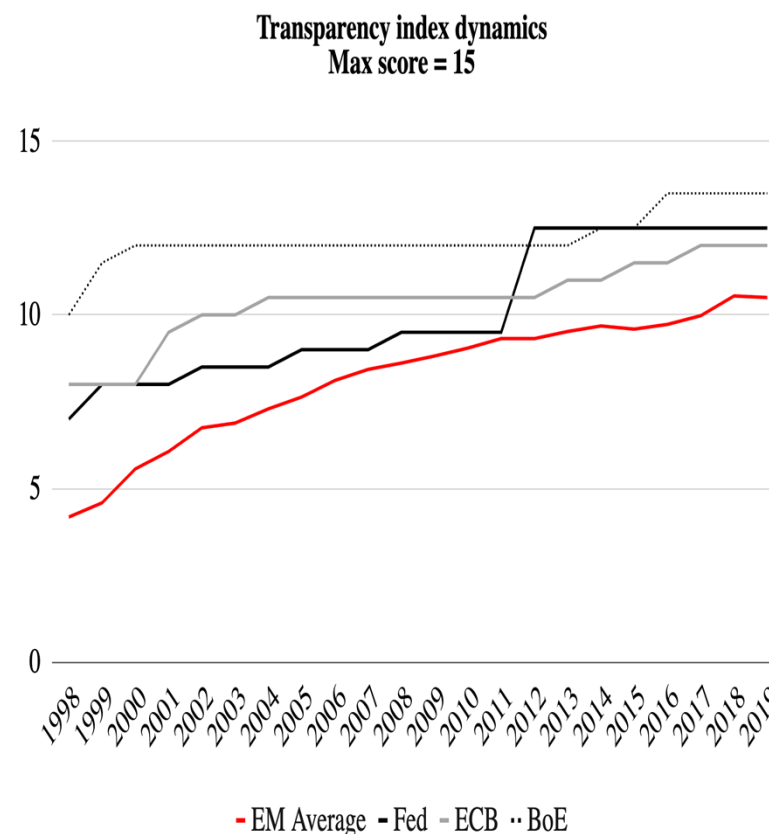
Inflation

Policy rates

Methodology
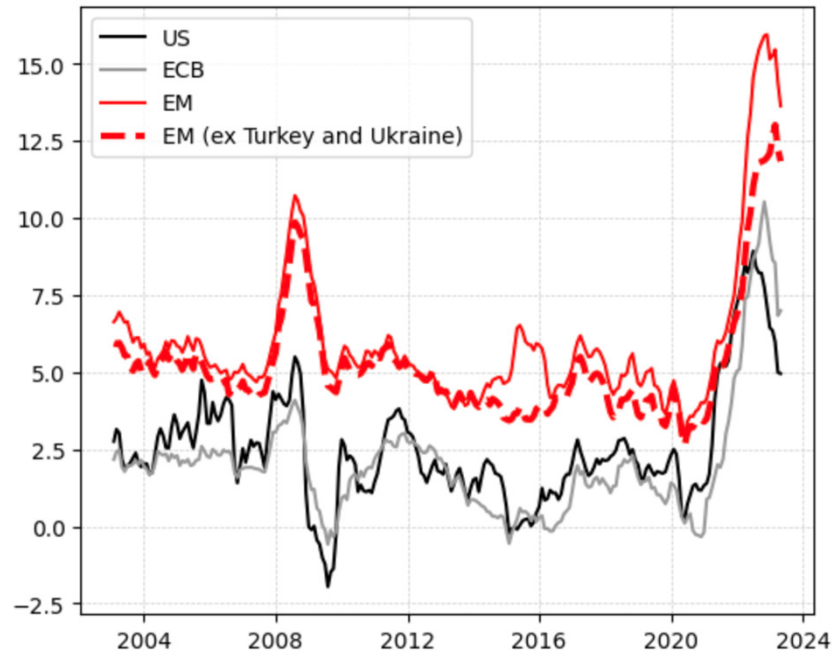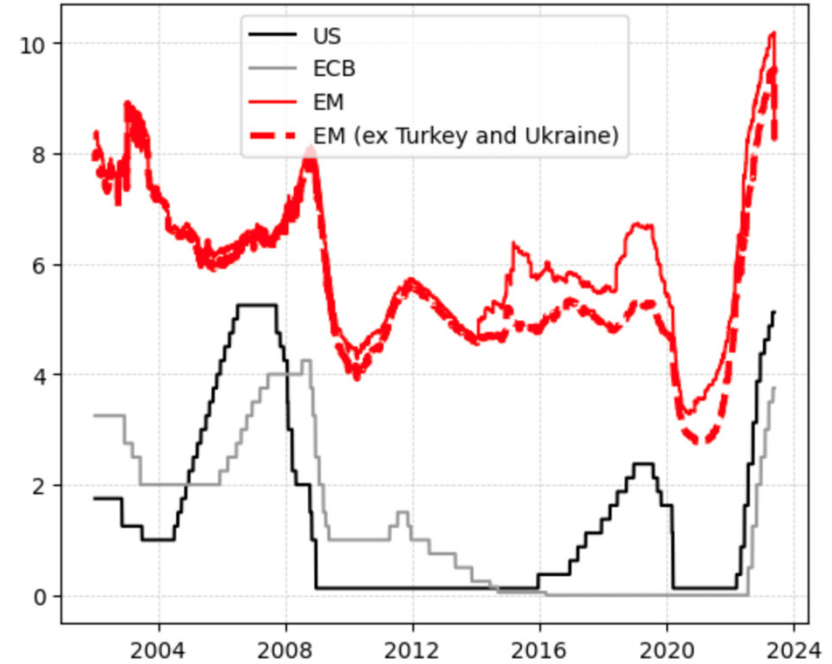
- Central bank transparency & independence

- Statement readability

- Sentiment analysis & topic decomposition

- "See-Say-Act" analysis

- Specific topics:
    - Exchange rate (EM specific)
    - Supply side-factors
    - Macroprudential language by the central banks
    - Forward guidance
    - Reference to fiscal policy & coordination
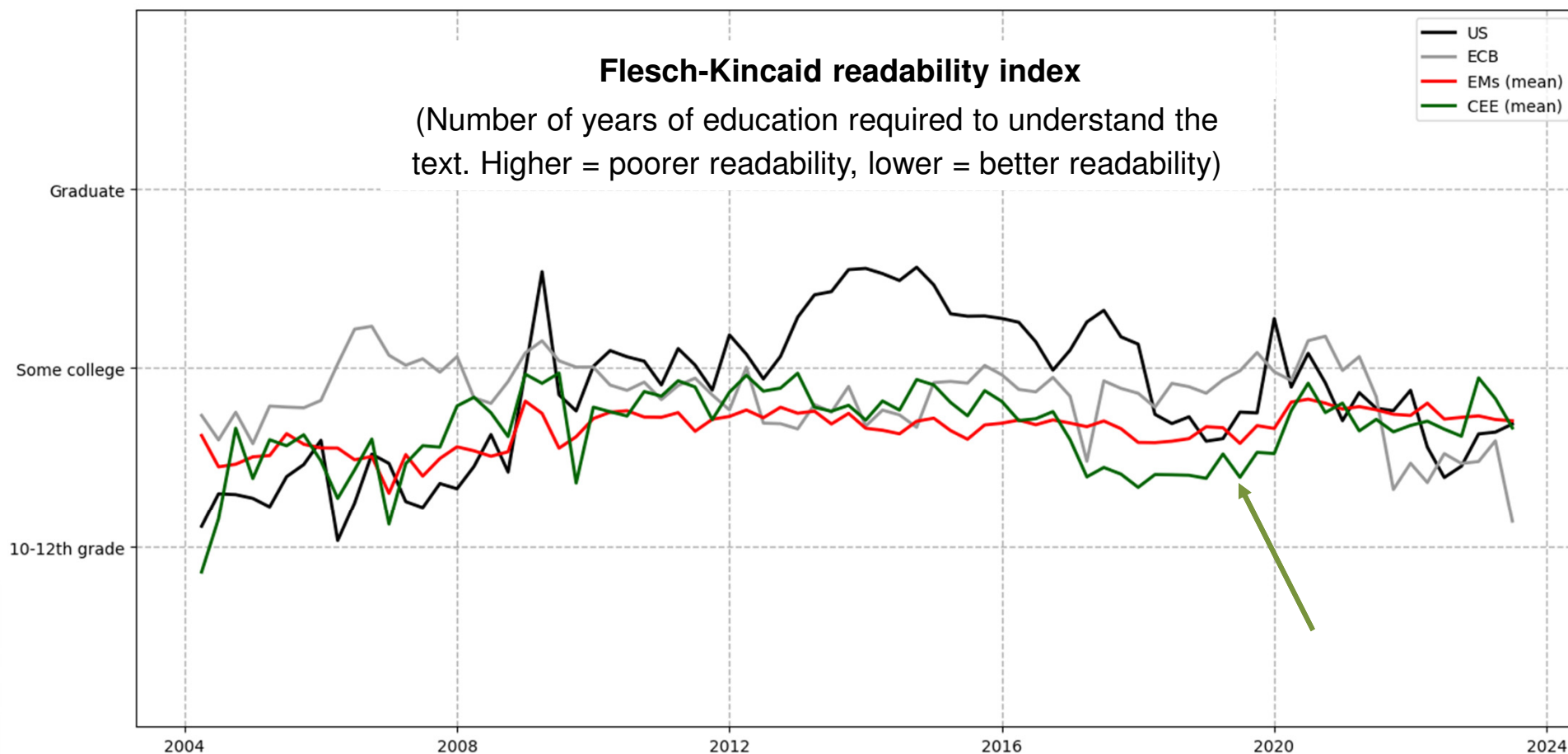
Transparency & independence of central banks

- **EM central banks have made great progress** since 1998

- Some EMs **closed their gap to AE comparators** (Czech Republic, Chile, Hungary, South Korea, South Africa)

- **Progress made across** all five dimensions
  - ➤ Most in *policy transparency* (with introduction of monetary policy targets) & *economic transparency* (better disclosure of macroeconomic models & numerical forecasts)

Transparency index dynamics
Max score = 15

- EM Average - Fed - ECB ·· BoE

Readability:

Until COVID-19 **CEE** statements were more readable than EM and AE on average

Flesch-Kincaid readability index

(Number of years of education required to understand the text. Higher = poorer readability, lower = better readability)

Legend:
- US
- ECB
- EMs (mean)
- CEE (mean)

Y-axis: Graduate, Some college, 10-12th grade

X-axis: 2004, 2008, 2012, 2016, 2020, 2024

Sentiment analysis: our approach

LSE

1. Break the sentence into simpler parts

   When discussing price *stability,*

   the Governing Council recognised that in the short term,

   consumer price *developments are expected to remain subject to* **upward** *pressure*

2. Look for a key word (noun) in each part of the sentence. It can be direct or reverse

3. Look for a modifier (adjective or verb) accompanying the key word, which can be **positive** or **negative**

4. Classify each part of the sentence as dovish (-1) / neutral (0) / hawkish (+1)
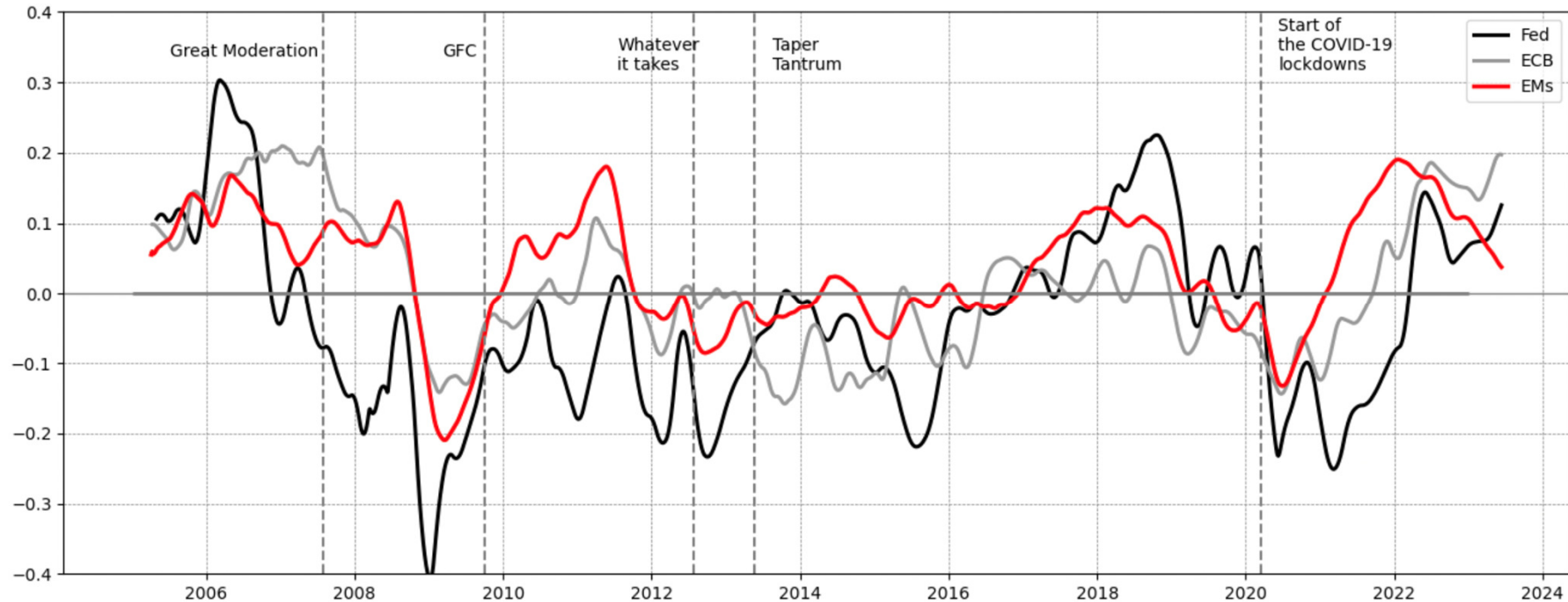
Dictionaries of key words and modifiers

Downward pressure on prices =======> dovish (-1)

Upward pressure on unemployment ===> dovish (-1)

Downward pressure on unemployment => hawkish (+1)

Upward pressure on prices ==========> hawkish (+1)

Sentiment analysis: main results

- **Easing during GFC but then EMs had to tighten (as before)**
- Prolonged dovishness post-GFC with QE
  - ECB tightens early but then confronted with its sovereign debt crisis
- Very hawkish Fed in 2018-19 but not so ECB (deflation)

- **Synchronized dovishness** during Covid (a historic first).
- Fed & ECB **swap lines** helped EMs
- **Post-Covid EM central banks become hawkish** much earlier than AE central banks in the face of surging inflation
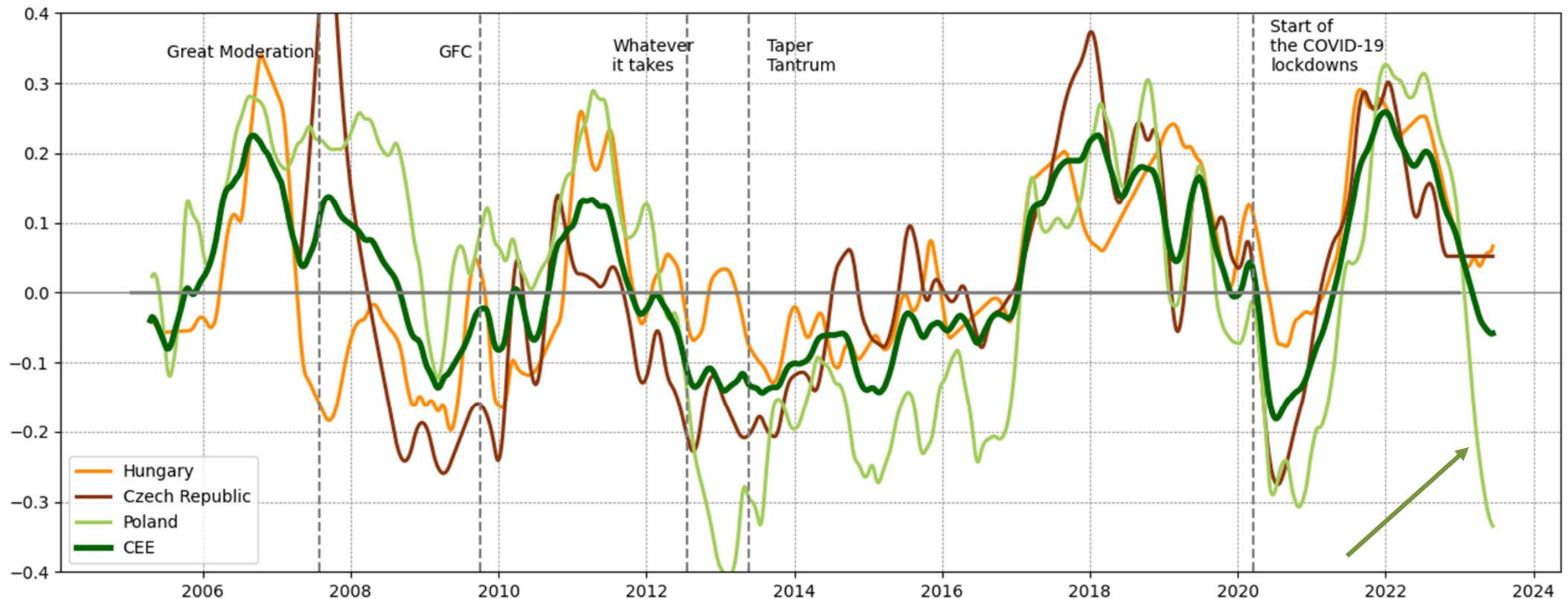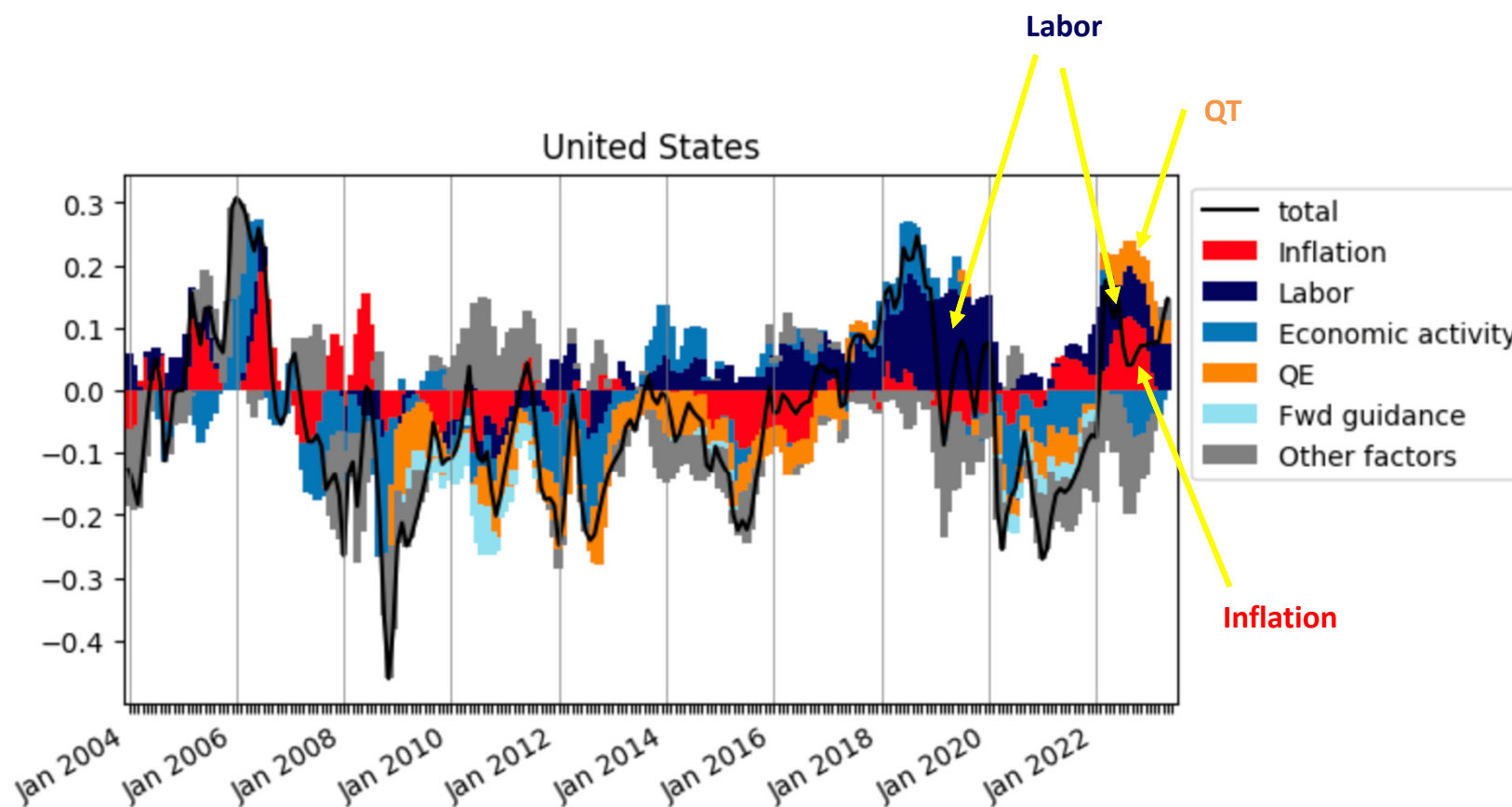
Sentiment with focus on CEE

- CEE initially followed ECB in post-pandemic period but moved swiftly to very hawkish stance in the face of inflation
- CEE moved to dovish faster than other EMs prob prematurely, due to Poland (maybe prematurely)
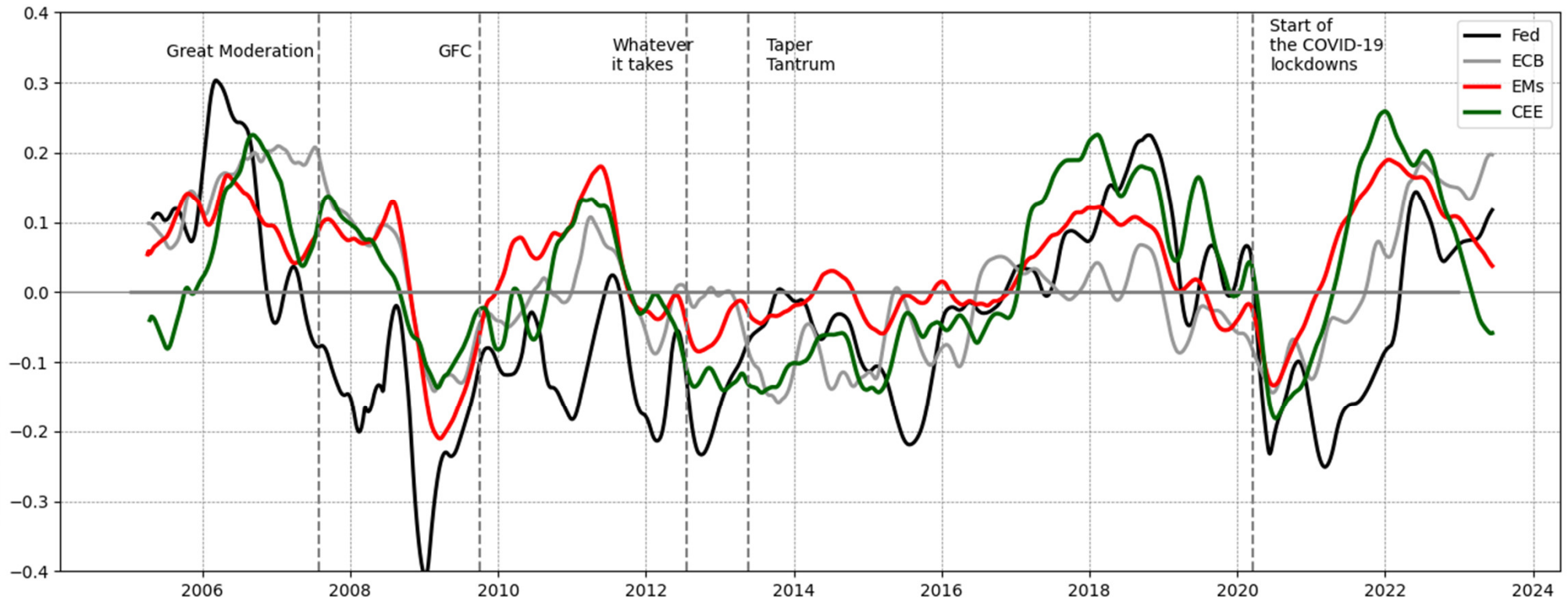
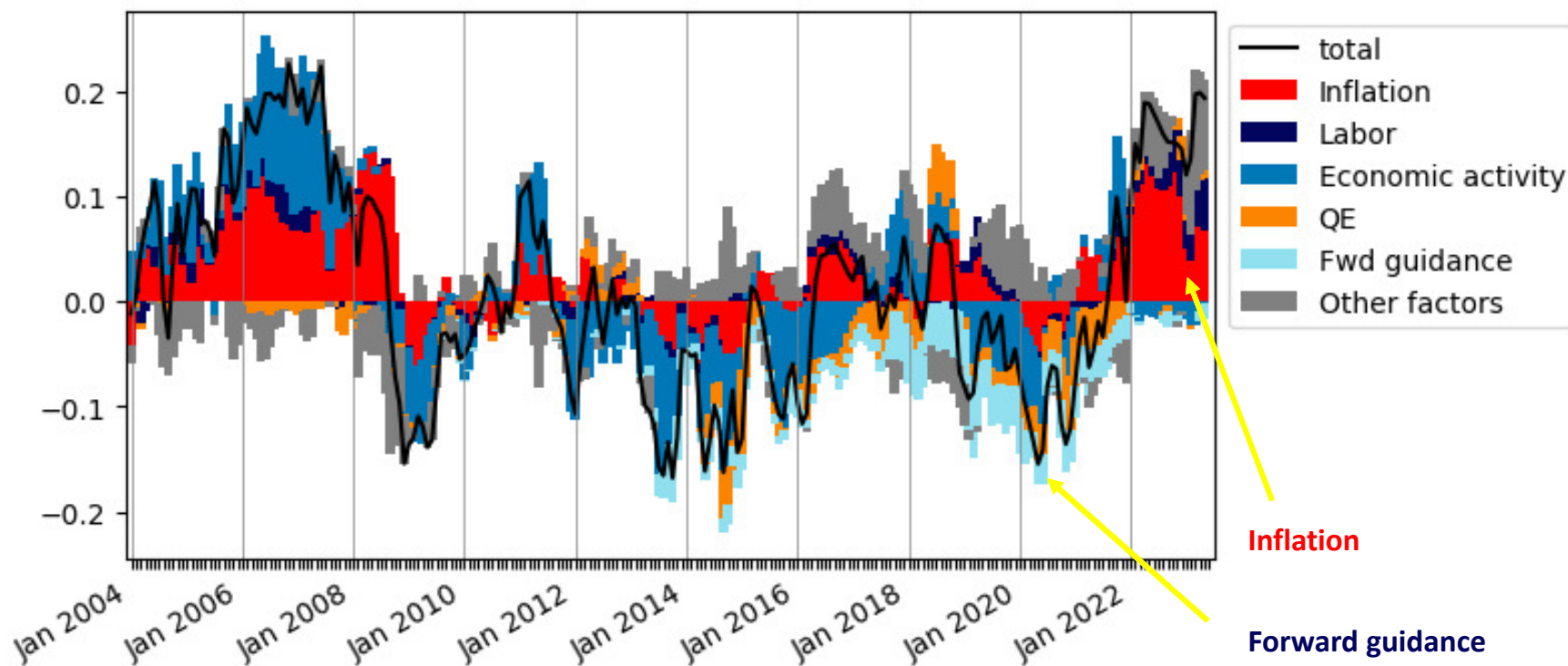# Sentiment:
CEE average & individual countries

# Topic decomposition: Fed

United States

- More ambivalent communication (going both directions)
- Labour in focus
- Delayed focus on inflation
- QT appears recently

Topic decomposition: ECB

- Between GFC and Covid concerns over economy recovery
- Shifting to inflation from autumn 2021
- Extensive reliance on forward guidance until 2022
- Currently 'economic activity' not in focus – dominant concern is inflation

Topic decomposition: CEE
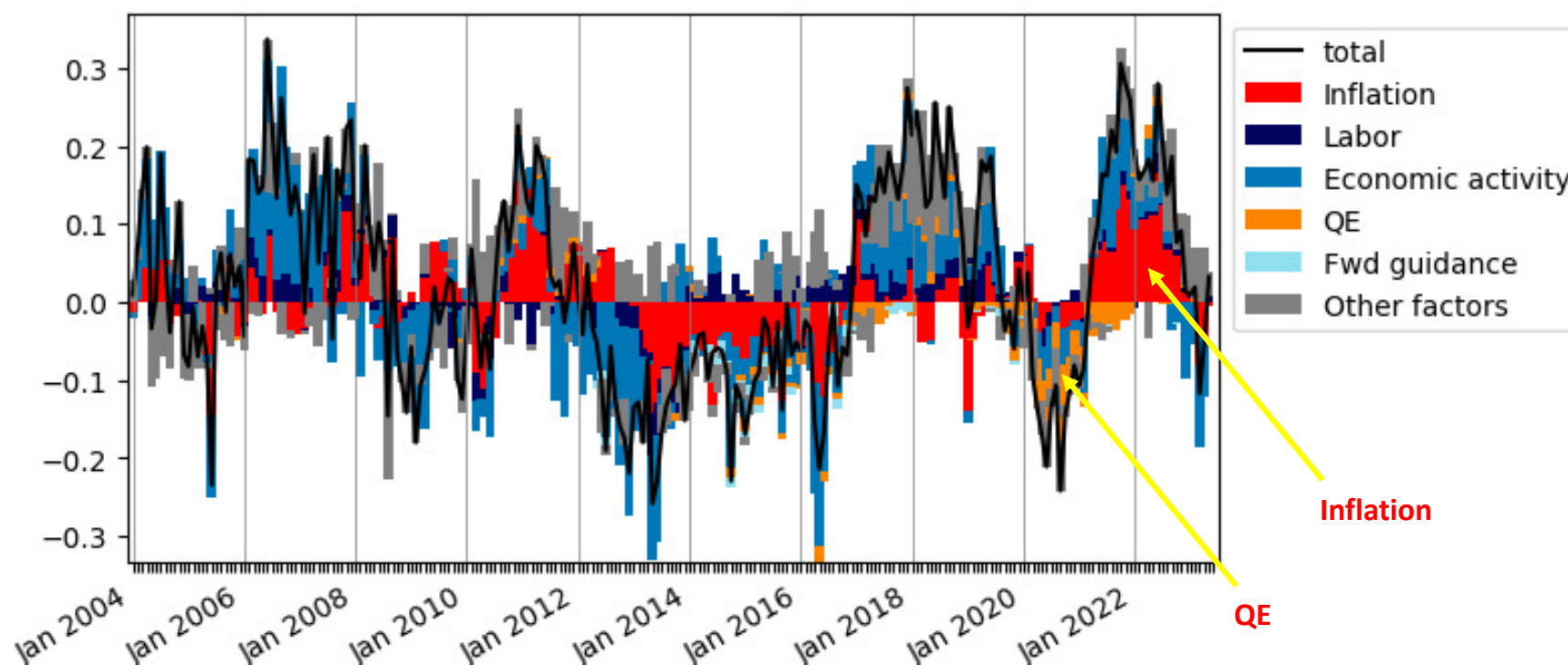
- Communication tone and topics are similar to ECB until post-Covid inflation
- Active use of QE during COVID (a **first**, supported by ECB currency swaps),
- No forward guidance (wisely)
- CEE ahead of ECB on flagging post-Covid inflation concerns

"See–Say–Act" (1)

Do central banks *foresee* inflation?

- We compare the inflation component of the sentiment with CPI (MoM SA)

- Shift the time series until we achieve the highest correlation

- *Answer*: **NO.** Inflation sentiment in communication lags actual inflation for most countries, particularly US; **ECB** too but less so.

- EXCEPTIONS: **Hungary**, **Romania**, **Czech Republic,** South Africa)
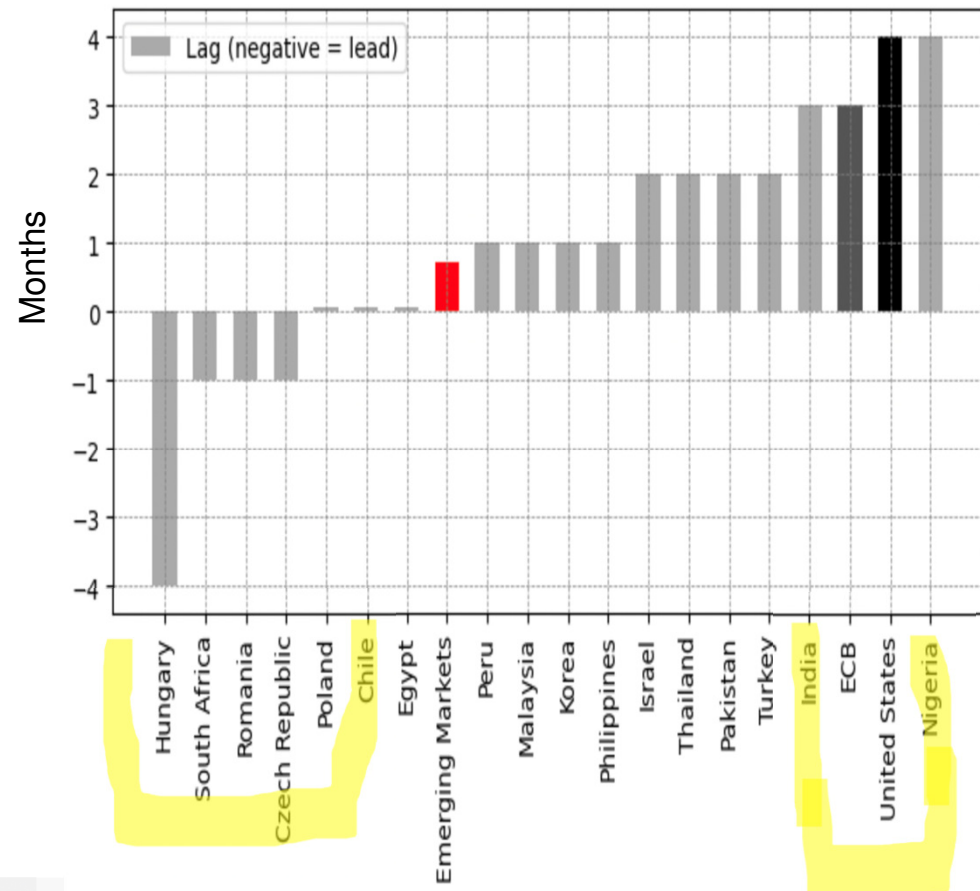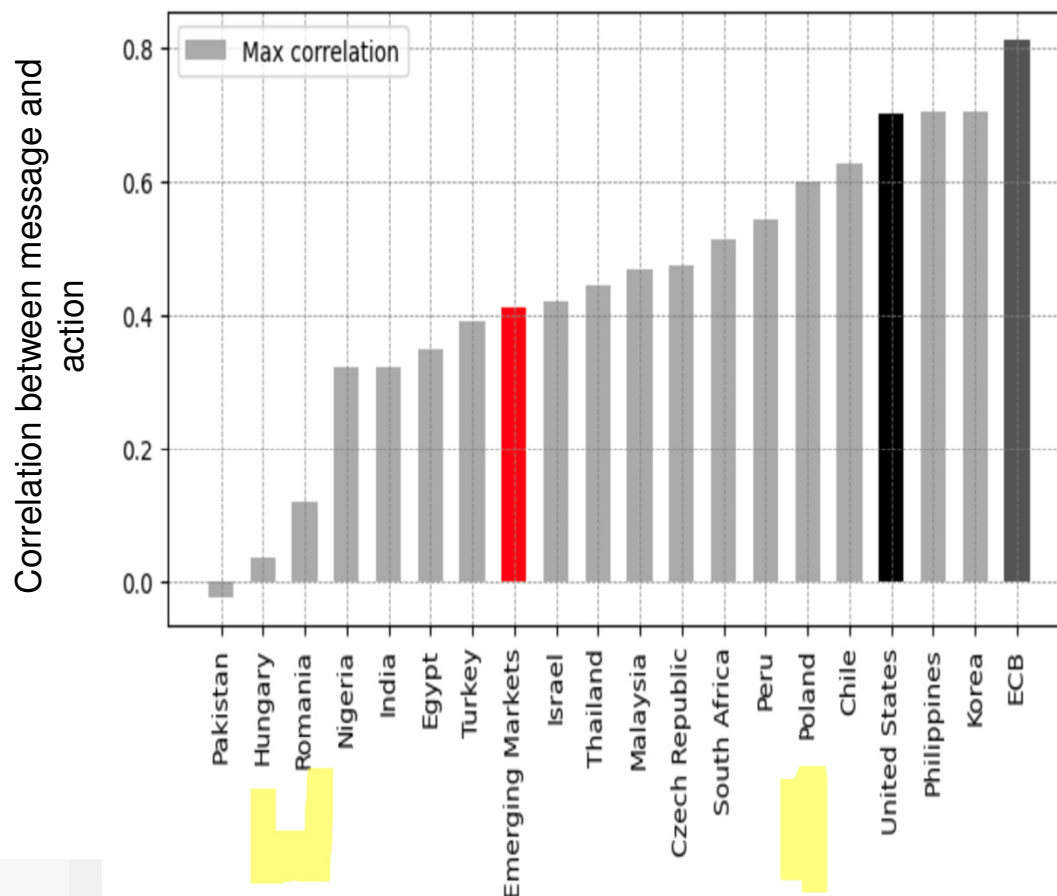
"See–Say–Act" (2)

Do central banks give enough *warning* before their policy rate action?

- Similar approach with policy rates

- *Answer*: **YES**, central banks indicate sentiment change between 6-10 months before they take action

- Fed & ECB are strong in delivering their indicated change

- **EMs are less good on delivery**, including Hungary, Romania. Poland fares better

Specific topics:
Exchange rate: CEE

References to exchange rates in CB communication, % of sentences
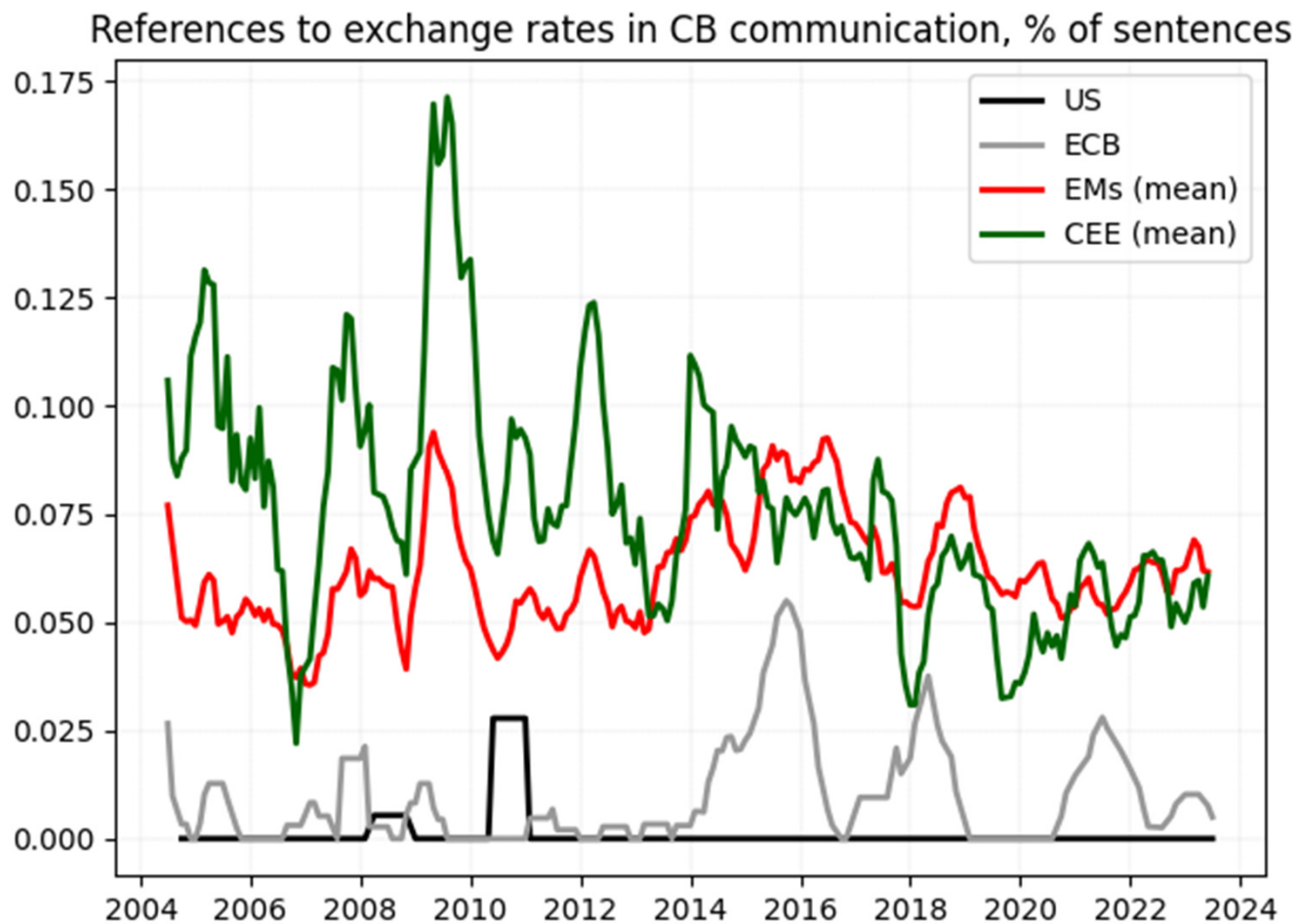
Forward guidance: CEE

- EM central banks started to use some **form of forward guidance but without specifics**
- **Allowed flexibility** in a rapidly changing environment
- EM central banks managed to **avoid over-commitment** to predefined monetary policy path & remain data-dependent

EM average forward guidance component of Dincer&Eichengreen transparecy index (0-1)
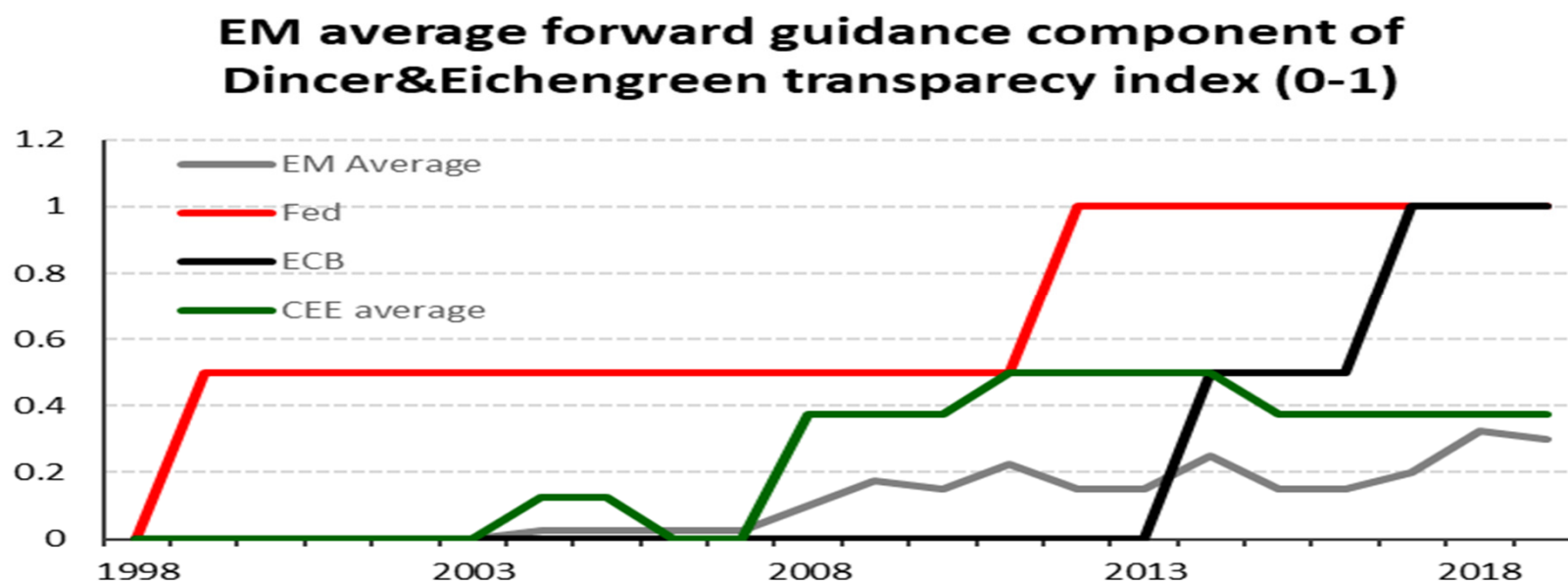
Source: Based on Dincer and Eichengreen (2022)

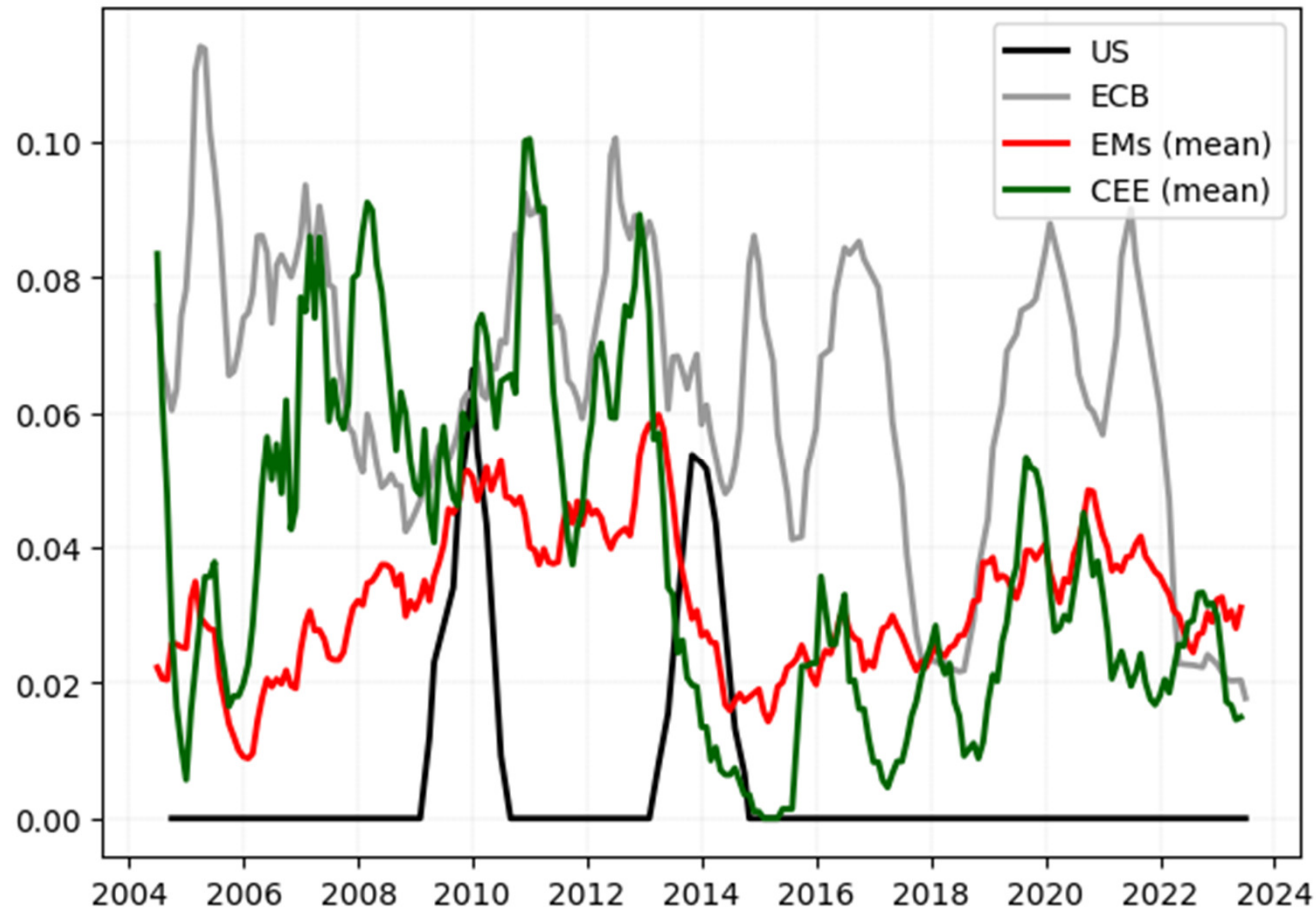**TE0**   This chart is a bit contradicting our chart on slide 15, where we do not see much of forward guidance by CEE immediately after the GFC

Tatiana Evdokimova; 2023-09-13T16:28:35.865

Fiscal policy: CEE

- CEE used to track ECB in reporting on fiscal policy, but since 2013 no longer
- Nothing on central bank and fiscal policy coordination

Summary of findings

LSE

✓ **EM central banks have adopted many principles** of Fed, ECB and BoE in both policy conduct and communication, but with modifications, reflecting their specific circumstances:

  – Concern for exchange rate given vulnerability to capital flows, dollarisation

  – Use forward guidance more vaguely (if at all)

  – Weaker institutional credibility

✓ **EMs have improved** CB transparency & independence

✓ **Readability** of EM CB statements is often better; CEE excels

✓ **EM CBs have outperformed Fed & ECB** in fighting post-Covid inflation and maintaining banking sector stability (so far)

  – In crisis Fed and ECB swap/repo lines & communication were very helpful.

Summary of findings

- **Fed was weak in focussing on Covid-related inflationary pressures** – possible role of dual mandate/wrong indicator & new AIT?

- **CBs in general do not predict inflation in their communication** and instead react to observed inflation with a lag. Exceptions: Hungary, Czech R, Rom, SA

- **EM CBs provide reasonable forewarning of intended policy changes, but link between communicated signal and actual rate change is weak** compared to AEs

- **EM have wisely used forward guidance** less & flexibly

- **Monetary easing/dovish stand** has started in EMs already; in CEE mainly by Poland (possibly prematurely).

Policy lessons

- **Both AE and EM central banks need to improve their inflation projection & communicate it**

- **All CBs signal policy change in advance, but EM central banks need to follow up much more consistently.** EMs need to "walk the talk" better

- **Forward guidance can be detrimental at times of rapid change**. FG reduces CB data dependence, which backfired post-Covid. EM central banks have wisely it used less

- **Central banks with multiple mandates need to have a particularly clear communication strategy** to identify their priority when various policy goals may conflict.

Policy lessons

- **Distinction between first &second round effects of inflation gets blurred when inflation rises rapidly.**

- **Important to monitor supply-side factors behind demand-supply imbalances.** AE central banks seem to focus more on demand side of inflation pressures, whereas EMs follow supply side factors more consistently

- **Central banks should revisit their communication re *coordination* with fiscal authorities.**
    - Fed is largely silent on fiscal policy; CEE has even reduced fiscal monitoring
    - CBs are <u>not</u> transparent about *policy coordination.* Yet the fiscal-monetary *policy mix* is central to macroeconomic policy. Joint review & communication of the policy mix would help transparency, credibility and accountability of both monetary and fiscal authorities.

THANK YOU!