Peter Praet: Forward guidance and the European Central Bank

Column by Mr Peter Praet, Member of the Executive Board of the European Central Bank, published on VoxEU.org, 6 August 2013.

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The Introductory Statement to the Press Conference following the ECB's Governing Council meeting of 4 July contained the following two sentences:

The Governing Council expects the key ECB interest rates to remain at present or lower levels for an extended period of time. This expectation is based on the overall subdued outlook for inflation extending into the medium term, given the broad-based weakness in the real economy and subdued monetary dynamics.

This statement, in particular the formulation "for an extended period of time", marks a change in the ECB's communication of monetary policy. It is a form of *forward guidance*, a communication instrument by which central banks convey their monetary policy orientation going forward, conditional on their assessment of the economic outlook.

The standard view is that monetary policy influences the economy and, ultimately, price setting primarily by affecting interest rates at intermediate and medium-term maturities. Indeed, longer-term interest rates determine the borrowing conditions that are most relevant for a large component of aggregate spending: first and foremost, durable consumption and investment. The expectations theory of the term structure of interest rates suggests that longer-term interest rates reflect the expected path of the very short-term interest rates which the central bank controls. This is because trading in financial markets removes persisting arbitrage opportunities across securities with similar risk characteristics and different maturities. As a consequence, returns are equalised across the term structure, except for premia that remunerate investors holding relatively longer term securities. Therefore, it is not so much by changing their very short-term interest rate instruments that central banks can impact the decisions that matter most for the economy. It is rather by influencing expectations about the evolution of those short-term interest rates in the predictable future.

When a central bank changes its short-term interest rate, interest rates at intermediate to medium-term maturities tend to shift in the same direction, if there is a signal that the new level of the short-term interest rate is likely to persist[1]. In general, this puts a premium on the way central banks communicate about, or at least are perceived to reveal their policy orientation.

Is there evidence supporting the contention that central banks' perceived orientation is as important as their actions? Answering this question is difficult. First, when a central bank communicates a decision, it is difficult to disentangle the impact on market rates which can be associated to its immediate decision to change its policy instrument from the effect that its action may exert via signalling and expectations of future policy. Second, there is of course no obvious counterfactual against which any impact can evaluated. And the term structure of interest rates always also reflects news and expectations that are not related to monetary policy. Subject to all these caveats, evidence indeed supports the view that the way in which a central bank communicates decisions is perhaps as important as the decision itself. For example, using an event study methodology and high-frequency data around official communications, Gürkaynak et al. (2005) show that the impact of Fed monetary policy works through two distinct channels, the signalling one being very effective in influencing

[1] For an exposition of this standard view, see for example Woodford (2003) or, for a focused discussion of central bank communication in this context, see Blinder et al. (2008).

expectations and the yield curve. Brand et al. (2010) tend to reach similar conclusions using euro area data.

But, how do economic actors form their expectations about future policy? The simple answer is: by trying to gain an understanding about the way the central bank *systematically* responds to economic developments. Indeed, monetary policy decisions are not isolated, *ad hoc* reactions to ever new constellations of circumstances. Instead, they tend to display a recognisable pattern. This pattern is a reflection of a *strategy* by which a central bank – faced with ever new shocks – modifies monetary conditions so as to bring the economy back to a steady path of price stability and balanced growth.

In light of this mechanism, the expectations channel by which economic actors anticipate the path of future policy consists of two interlinked parts. The first part is an interpretation by economic actors of the strategy governing central bank actions in response to economic conditions. The second part is related to their perceptions about the central bank's present assessment of current and future economic conditions.[2]

A taxonomy

Not surprisingly, forward guidance – a form of advance communication about future policy orientations – intervenes on both components of the expectations channel. In modern parlance, one could say that forward guidance has both an Odyssean and a Delphic element in it (this evocative taxonomy has been proposed in a recent paper by Campbell et al, 2012).

The *Odyssean* element has to do with the central bank's disclosure or clarification of its monetary policy strategy. In contemporary quantitative economics terms, one could say: through the Odyssean element of forward guidance, the central bank communicates the parameters of its reaction function and its policy goals. It is Odyssean to the extent that a reaction function, or a *strategy*, is a reflection of the central bank's mandate and statutes, and therefore is binding for central bank actions. Not unlike Odysseus who tied himself to the mast of his vessel to resist temptations, by anchoring itself to a strategy a central bank commits to never lose sight of its general purpose as spelled out in its mandate and statutes.

Through its *Delphic* element, forward guidance gives information about the central bank's perceptions of macroeconomic fundamentals. Like the utterings of the Delphic oracle, such communication reveals expectations of future events, given the current state of knowledge. To the extent that the future course of monetary policy is motivated by the underlying path of the economy, and is contingent on the direction that the economy is expected to take, the Delphic component of forward guidance discloses a conditional expected path of policy. In fact, the conditionality of forward guidance statements by central banks is mainly an implication of their Delphic element.

Two examples of forward guidance

In one way or another, various forms of indications – more Delphic in nature – about the conditional direction of policy have implicitly been part of central bank communication for a while, increasingly so since the mid of the 1990s. Around that time, a small number of central banks pioneered the publication of numerical forecasts for the future path of their policy rates. For example, since 1997, the Reserve Bank of New Zealand (RBNZ) has provided a numerical projection of future policy rates. In 2005 the Norges Bank took such explicit forward guidance a step further by communicating not only a forecast of the short-term interest rate path, but also a confidence interval around it. These two – and many other – examples of explicit forward guidance, once more, underscore the importance of

[2] There are some intermediate steps missing in this simple view. A description of the (likely) transmission of monetary policy via the real and, importantly, the financial sector is outside the scope of this text.

conditionality. By stressing that the forward guidance is a forecast based on current information, and consistent with the central bank's broad-based projections about the underlying economic conditions looking forward, there is no commitment to future actions. When new information is available, the forecast is updated. This point is reinforced by publishing the confidence intervals, i.e., the probability distribution over possible future interest rates.

More recently, forms of forward guidance with a distinct (and extreme) Odyssean character have gained some prominence in the academic debate over monetary policy in a very low interest rate environment. Here, the main idea is the following: when the central bank is constrained in its capacity to reduce the short-term interest rate further by the lower bound on nominal rates, it could resort to communication about its intention to keep the short-term interest rate at the current level for some time in the future. This would help steer expectations in the desired direction, and thereby exert downward pressure on longer-term interest rates. It is therefore an indirect channel to engineer an easing of credit conditions, broadly defined, even though the level of the short-term interest rate remains constant. Eggertsson and Woodford (2003), among others, go as far as suggesting that a promise by the central bank to maintain a zero interest rate policy for some time in the future, and even in the face of conditions that would otherwise dictate a firming of the stance, would be a powerful instrument to stimulate the economy already at present. In this line of thinking, forward guidance is a communication campaign by which a central bank advertises its intention to depart from its usual strategy, if only temporarily. It is a promise to suspend its strategy and become "irresponsible", as in Krugman (1998), meaning: unreactive to the cyclical conditions – at some point in the future, when the cycle will turn, inflation will start rising and the usual pattern of central bank reaction would dictate a resolute firming of the stance. Its promise not to follow that usual pattern of reaction will be painful to fulfil, when that time comes, because the central bank will have to watch inflation rising while remaining atypically passive. But that promise has a value today, as it generates optimistic expectations, supports spending and thus facilitates the central bank's job at present.[3]

The ECB's forward guidance

As I wrote at the start, the ECB Governing Council has recently provided forward guidance, and the Federal Reserve and other major central banks have done so before on various occasions. What interpretation should one assign to it in current circumstances?

To be sure, our forward guidance does not promise irresponsibility! Our purpose was *not* to communicate a suspension – even temporarily – of our strategy. Quite the opposite: it was a sharp and definite pronouncement to reassert it. Why did we feel it was necessary to reassert our strategy? Because, starting in May and with increased intensity in the month of June, we perceived that expectations regarding the stance of monetary policy and its evolution had become somehow detached from our assessment of the state of the economy and our monetary policy inclinations, given that assessment. A sustained upward trend in money market interest rates had led to a restriction in money market credit conditions, so that a large portion of the amount of monetary accommodation that we had introduced in early May had been de facto withdrawn.

This called for a clarification of our assessment and a more precise description of our strategy. So, the ECB's formulation of forward guidance includes a Delphic component clarifying the assessment, and an Odyssean element reasserting the strategy.

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[3] One way to signal commitment is to purchase long-term bonds (see Clouse et al., 2000). More recently, Woodford (2012) discusses refinements to his version of forward guidance, by which the central bank would adopt targets for expected inflation over the medium term.

It is Delphic because it is clearly conditional on the Governing Council's current assessment of the outlook for price stability. The Governing Council believes that the ECB interest rates will remain at current or lower levels for "an extended period of time" *because* it anticipates that economic conditions will remain such as to justify an exceptional degree of monetary accommodation over the same horizon (that is, for as long as it is meaningful today for the Governing Council to project future economic developments on the basis of current information). Such economic conditions can be described by an overall subdued outlook for inflation expected to extend into the medium term, and associated with broad-based weakness in the real economy and subdued monetary dynamics. The cross-checking of the inflation outlook through monetary indicators is particularly important. Optimal monetary policy in response to a given inflation outlook depends on the shocks that drive inflation. Monetary developments help identify these underlying shocks explaining inflation in the medium term. In this way, monetary developments support a correct calibration of monetary policy. In current conditions, the underlying weakness in monetary dynamics – slow growth of broad monetary aggregates and very weak credit – suggests that inflation pressures, beyond the ups and downs of short-term price adjustments, will likely remain subdued for an extended period of time.

Some Odyssean elements are evident as well in the ECB's statement. But, again, in the following sense: with forward guidance the Governing Council has meant to re-assert – not to suspend – its strategy. We have clarified how our strategy is going to guide us in the difficult conditions that we expect to prevail going forward. We will be guided by two elements of our strategy, in particular. First, our primary objective. By its objective, the ECB is mandated to the pursuit of a positive inflation rate below 2%. In accordance with our strategy, this means aiming for inflation rates below but close to 2% over the medium term. The 4 July forward guidance is an expression of commitment to this objective and of determination to apply the policy prescriptions which descend from it. The second element of our strategy which will give us a sense of direction is the strategy's binary analytical framework. As I said, inflation and the economy need to be interpreted: falling inflation in conditions of surging productivity and a booming economy is not bad news. Falling inflation when aggregate demand is persistently dragging, and credit and money are consistently unsupportive of households' consumption and firms' investment can be a problem for a central bank that is devoted to price stability. The monetary part of our analysis is there – in our forward guidance formulation – to robustify our assessment of the inflation outlook and convey the appropriate monetary policy implications that derive from that assessment according to our strategy.

Against the conditions that we see prevailing over a meaningful horizon, our guidance includes an easing bias. This conveys the notion that we have not reached the lower bound on our key interest rates. We have not run out of ammunition. Further cuts in policy rates remain an option for the ECB if the outlook on price stability so warrants.

The ECB's forward guidance has contributed to more clarity over our assessment of the outlook and our reaction function. Our forward guidance has contributed to more stable money market conditions and has helped to anchor market expectations more firmly. It also ensures that our monetary policy stance is not excessively vulnerable to shocks that are disconnected from the underlying economic and monetary conditions in the euro area.

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