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## **FORWARD GUIDANCE AS A TOOL OF THE EUROPEAN CENTRAL BANK'S MONETARY POLICY**

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### **Abstract**

The purpose of this article is to take a closer look at one of the most unconventional instruments of monetary policy which is the Forward Guidance. This instrument is increasingly more often adopted by central banks. What is more, it is also used by the European Central Bank which implemented this approach for the first time in 2013.

The first part of the article will be focused on presenting a theoretical approach of forward guidance, while the following part will describe examples of implementation of this instrument by the European Central Bank as the new way of communication with the market. The example of forward guidance use by the European Central Bank covers the way of communication of future monetary policy regarding the interest rates.

The data presented in this paper shows a positive effect of the forward guidance approach. This method of communication has brought a clearer view of monetary policy adopted by the European Central Bank. Moreover it limited some uncertainty showed by the market participants regarding the level of future interest rates. The positive effects of the forward guidance lead not only to the continuous but also widespread use of this approach by the European Central Bank.

**Keywords:** central banking, ECB, monetary policy, interest rates

**JEL classification:** E58.

## Introduction

The outburst of the financial crisis in 2007-2009 and later the debt crisis of PIIGS (Portugal, Ireland, Italy, Greece and Spain) countries have led to no effectiveness of the conventional instrument of monetary policy. The main cause of this ineffectiveness was zero lower bound of interest rates. The ECB decided to implement some new instruments which are currently known as an unconventional because the bank was unable to stimulate the economic growth.

The topic of this article is one of these unconventional instruments of monetary policy - the forward guidance. This method is currently one of the key components of communication between the European Central Bank and its market.

The purpose of this paper is to analyze and evaluate a new instrument adopted in the information policy of the ECB, which is one of the key components of communication between central bank and the market.

### 1. Notion of forward guidance

Communication between the central bank and its market in terms of the type of monetary policy it would like to carry out have intensified because of an aftermath of the financial crisis in 2007-2009 and the debt crisis of PIIGS countries. As a response to the crisis and the following period of low GDP growth, the European Central Bank XYZ its monetary policy by lowering the interest rates to almost zero lower bound. As a result, the ECB exhausted the ability to continue lowering the short-term interest rates which could stimulate the economic activity. By exhausting the conventional instruments of monetary policy, the European Central Bank was forced to search for new methods of stimulating prosperity. One of the new ECB's instruments was a new communication method with the marked in terms of the interest rates policy, as well as a time horizon of the asset purchases programme, which was named *the forward guidance* (Bernanke, 2012; den Haan 2013).

#### 1.1. Definition of forward guidance

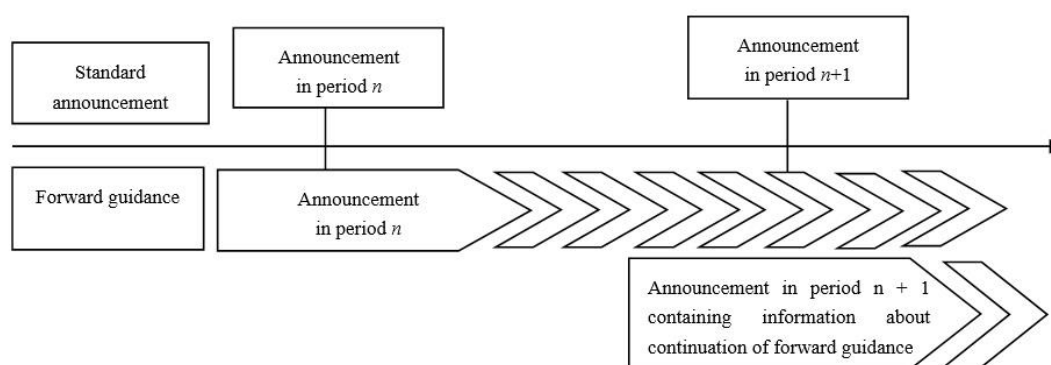
The forward guidance emergence is associated with newly created unconventional instruments of monetary policy. However, this method of communication between monetary authorities and market participants was not introduced during the financial crisis of 2007-2009, but it had been proposed in the second part of the 1990s. The process of central banks transparency improvement at the beginning of 1990s paved the way to the forward guidance. Until then, central banks had not informed the market about their intentions. In that time there was a belief that transparency of monetary policy limited the possibility of making surprises by the Central Bank, and that led to lower effectiveness of the bank's actions (Cukierman and Maltzer, 1986). What is more, the belief of precise future prediction by the market would lead to incoherency of monetary policy at the time (Kydland, Prescott 1977; Calvo, 1978). In addition, communicating the intentions by the monetary authorities in terms of the interest rates was seen by the economists as too big a liability of the Central Bank (Goodfriend, 1986).

At the beginning of 1990s, central banks started to take actions intended to improve their transparency. Central banks started to distribute information in regard to their goals and tasks.

Furthermore, to make their actions clearer, the banks started to publish reports concerning inflation, stability of the financial system, and started to reveal protocols from the monetary authorities' sessions. Mishkin (Mishkin, 2004) believes that clearer functioning of central banks from 1990s revolutionized the communication between central banks and the market. Forward guidance was adopted for the first time in the 1997, and its precursor was the New Zealand's central bank (Contessi, 2013). Forward guidance has a lot of definitions. A very general definition of this method comes from M. Woodford (Woodford, 2012), who defines forward guidance as a clear position of monetary authorities in relation to its future monetary policy, which is an ad-on to statements concerning the current central bank policy. Whereas C. J. M. Kool and D.L. Thornton (Kool and Thornton, 2012) define forward guidance as a tool of monetary policy which is used as a mean of revealing private information by monetary authorities, in a form of an obligation taken by a central bank to conduct a particular monetary policy for a specified time. The main goal of this policy is for the central banks to exert impact on long-term interest rates.

Forward guidance depends on central bank communication with financial markets when it comes to the monetary policy.

Forward guidance is about communication between a central bank and the financial markets, as to what type of form of a monetary policy they wish to carry out in a horizon going beyond the next monetary committee session. This method is adopted for anchoring the market expectations in the scope of maintaining the future interest rates on a specified level, and/or maintaining a particular level of asset purchase for a specified time. Such a solution gives a sense of stability of business entities, which allows them to take a role in stimulating the business cycle by a growth in investment and consumption level (NBP, 2013). The decrease in uncertainty by determining a fixed level of interest rates can also reduce some volatility of interest rates in short- and mid-term, and this could lead to a drop in long term interest rates and a growth of aggregate demand (Fisher, 1930; Woodford, 1999). As the central banks do not have too much room to move in (because of the near zero lower bound interest rates) the transmission channel of financial market expectations management can turn out to be crucial for stimulating the business cycle (Rzońca, 2014). The chart below shows the working principle of the forward guidance works and the difference between the forward guidance and the standard method of communication between the central bank and the market.



**Figure 1:** Comparison of standard way of communication with the forward guidance

Source: (Przybylska-Kapuścińska i Szyszko, 2017)

Figure no. 1 shows a scheme of functioning of a standard way of communication adopted by the monetary authorities in comparison to the forward guidance approach. In stage  $n$  a central bank makes e.g. a decision to decrease the interest rates and declares that they will maintain on this level until a specified moment. This moment can be presented by numerous different means (the means of presenting forward guidance will be shown in later part of this paper). In another stage, the central bank, according to forward guidance prediction from stage  $n$ , makes another decision concerning the interest rates. In that announcement the central bank reprises its declaration regarding the long term policy which was declared in stage  $n$ . Forward guidance declarations can be related not only to interest rates level but also to programmes of assets purchase, credit loosening or currency market interventions.

For example, in order for monetary authorities to declare a decrease of long term interest rates under the forward guidance, they would have to declare that short term interest rates will be maintained for a long time, by usage of bank authorities, which would signalize to what period of time they wish to implement loosen monetary policy. An end-point period of monetary policy by the announcement from the forward guidance does not have to be defined by a specified date, but it could be defined by macroeconomic parameters (for example, reaching a specified level of inflation, economic growth or unemployment level). In order for a central bank to adopt the forward guidance, it needs to be deeply certain about the economic situation not only in a particular moment, but also in the future. Apart from this certainty about the economic situation, monetary authorities also need to fulfil the following three conditions in order to implement the forward guidance (Filard and Hofmann, 2014):

- Forward guidance should be seen by economic entities as a commitment of monetary authorities to take specified actions,
- Forward guidance should be announced in a clear way,
- Efficiency of forward guidance depends on how it is interpreted by the market, namely if it is consistent with assumptions of monetary authorities.

Central bank could lose credibility in the eyes of the market, if it does not follow the above-mentioned criteria while implementing the forward guidance method.

## 1.2. Types of forward guidance

There are several classifications of forward guidance. First, a more general one, is a classification introduced by J.R. Campbell, Ch. L. Evans, J.D.M. Fisher and A. Justiniano (Campbell, Evans, Fisher, Justiniano, 2012). They divide forward guidance into two groups. The first group known as the Delphic forward guidance, predicts the course of real economic proceedings and possible actions taken by the monetary authorities towards those proceedings. The second group is named the Odyssean forward guidance. This group is characterized by rather an interventionist nature because in this case monetary authorities are obliged to take specified actions publicly when particular events occur. However, a

classification that is more often seen in the literature is the one proposed by the European Central Bank, which divides the forward guidance into four groups (ECB, 2014a):

- pure quantitative forward guidance – the monetary authorities introduce their future monetary policy in a frame manner, not mentioning any particular conditions, which must be fulfilled in order to consider its adjustment,
- qualitative forward guidance depending on a narrative – a central bank introduces a direction of monetary policy subject to macroeconomic quantities,
- calendar-based forward guidance – monetary authorities specify an exact date. for fulfillment of monetary policy included in the forward guidance,
- outcome-based forward guidance – a central bank is obliged to conduct specified actions, until a macroeconomic indicator reaches a previously set level (for example reaching inflation goal, or reaching a set rate of unemployment).

There are many other classifications of forward guidance, nonetheless above mentioned examples are the most common classifications found in literature.

## **2. The use of forward guidance by the European Central Bank**

The European Central Bank implemented the forward guidance in its instrumentation recently. It took place on the 4th of July, 2013. At that time, the governing council of the European Central Bank announced that it is expecting that the key interest rates in the euro zone will be maintained in a longer perspective on the same or even lower level. The purpose of the decision of announcing the future level of interest rates was a strong need to establish a link between the market's expectations concerning future changes of interest rates and conditional orientation of monetary authorities policy. That is why the authorities of the European Central Bank decided to precisely communicate information regarding direction of the monetary policy. The ECB's new method of communication contributed to stabilization of the financial market situation, as well as was „anchored” the market's expectations regarding the future interest rates in the euro zone.

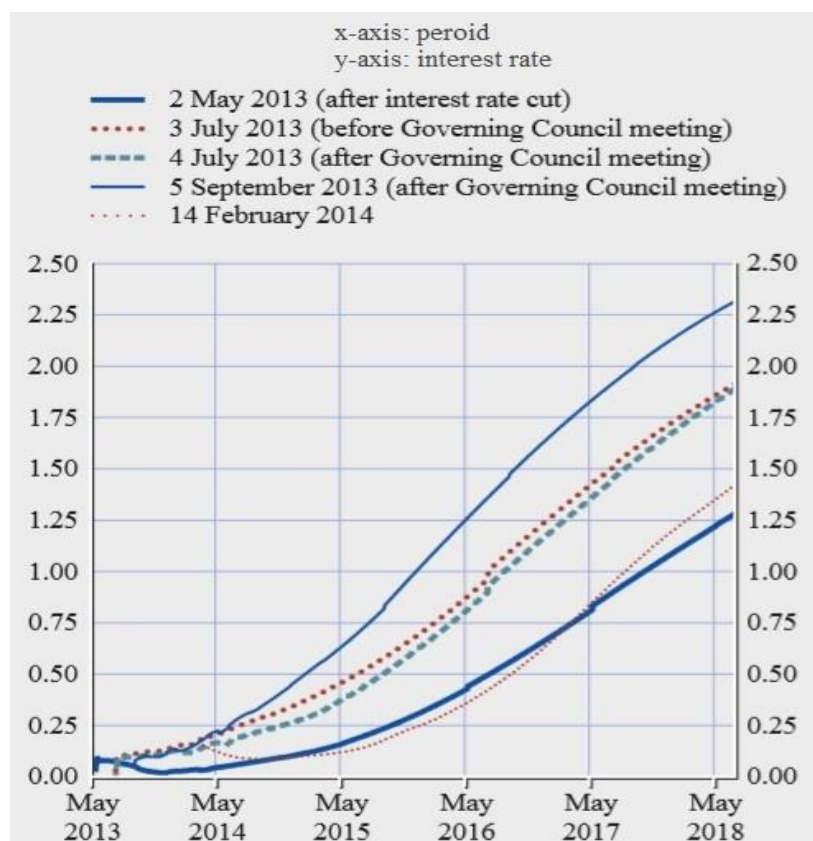
As one can read in the ECB's annual report from 2013, announcements of central bank regarding the level of future interest rates were consistent with the bank's strategy. This strategy included three elements (ECB, 2014b):

- The governing council's expected path of interest rates was based on medium term inflation perspectives, in accordance with the main goal, which was stabilization of prices.
- Longer period given by the monetary authorities ensured a flexible time horizon, without giving a specific end date which depended on European Central Bank's situation judgement of determining the stability of prices.
- Basic conditions, which expectations regarding the level of interest rates were based on, were reflected by central bank's attitude to organizing, evaluating and cross-checking

information, essential for risk assessment for stability of prices. It also took into consideration an economic and monetary analysis, which allowed to have more trustworthy assessment of mid-term perspectives for stability of prices.

It is worth mention in that the European Central Bank authorities announced forward guidance concerning the future interest rates, before running out of possible further drop in interest rates. Therefore, the uncertainty around the expected path of future interest rates decreased. This method of central bank's communication can allow broader control over market's expectations. Implementation of the forward guidance on the 4th of July 2013 led to a possibility of further decrease in interest rates which occurred on the 7th of November 2013. During that time, the governing council decided to decrease the interest rate for the main refinancing operations, lending rate in central banks, as well as to keep the deposit rate on the same level. The decision made by the governing council on the 7th of November 2013 was consistent with forward guidance assumptions from the 4th of July 2013. ECB's authorities believe that the confirmation of the 7th of November 2013 of 4th of July 2013 forward guidance predictions contributed to amplifying accommodative impact of the reduction in the interest rate by facilitating the process of its transmission on longer-term rates of money market (ECB, 2014b).

The announcement of forward guidance on the 4th of July 2013 caused immediate flattening of the curve showing EONIA forward rates, as presented in Figure 2:

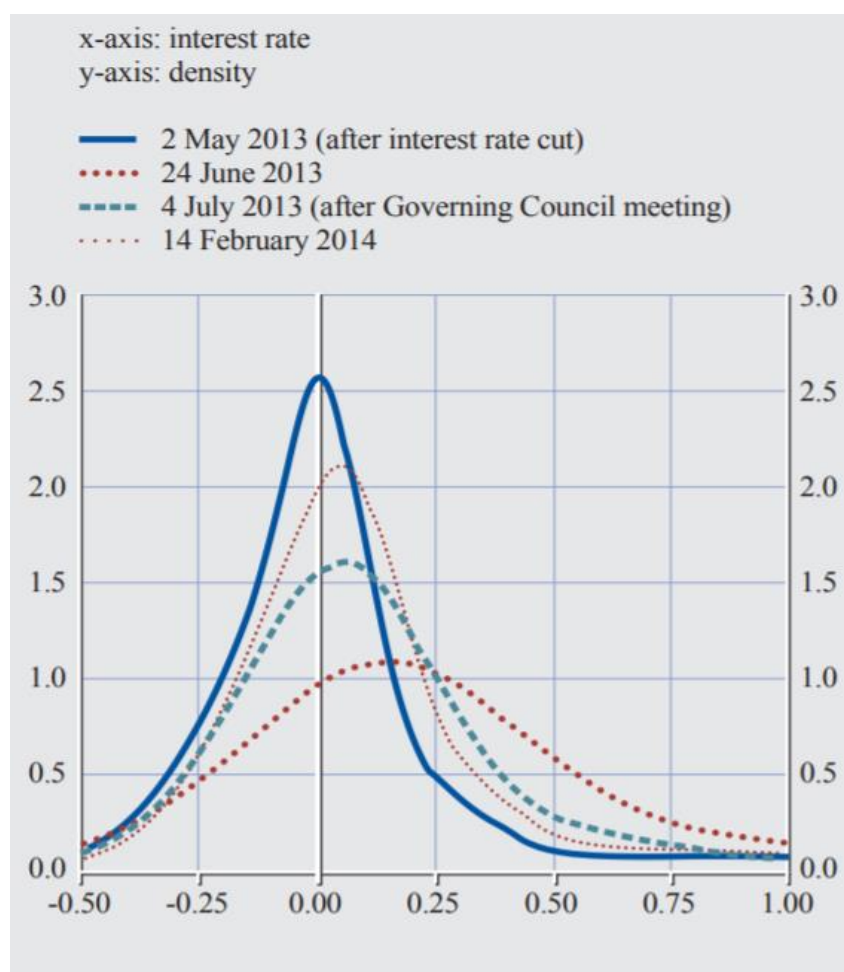


**Figure 2: EONIA forward rates**

Source: European Central Bank, 2014b

As it can be observed in Figure 2, the announcement of the forward guidance led to flattening of the money market curve. However, the forward rate decreased by around 5 basis points, which maturities are longer than 6 months. The curve of forward rates reached a new level in the following months after introduction of the forward guidance, which can be a reflection of good economic information and publications of date from the euro zone. At the end of September 2013, the curve of forward rates reached a new level, whereas as a result of the 7th of November 2013 the curve of forward rates flattened once more.

Nonetheless, introduction of the forward guidance also led to a significant decrease of market uncertainty regarding the path of future interest rates. This is presented in Figure 3:



**Figure 3:** Uncertainty regarding future short-term money market rates

Source: European Central Bank, 2014b

The above chart presents option-implied density of three-month EURIBOR in 12 months' perspective, applied for three-month overnight index swap rate in 12 months' time. This option-implied density function refers to a dispersion of short-term-rate expectations and it decreased significantly. After the lowering of interest rates on the 2nd of May 2013, the expectations of future interest rates in 12 months' perspective were focused on low levels. After that time, the uncertainty regarding future money market rates only increased. However, introduction of the forward guidance led to another narrowing of dispersion of market expectation in the direction of lower levels of interest rates (ECB, 2014b).

After introduction and positive outcomes of the forward guidance, the European Central Bank decided to implement this method to its instrumentation on permanent. What is more, the forward guidance was not only used with announcements related to interest rates, but also with delivering announcements connected to other instruments of unconventional monetary policy, such as the programmes which are a part of the APP (Asset Purchases Programme).

To sum up, the provided data prove that the forward guidance helped to increase better clarity and transparency of monetary policy of the European Central Bank. Moreover, mentioned example of the forward guidance introduction shows, that implementation of this instrument has led to stabilization on the money market and anchoring the market's expectations. Nonetheless, it is also worth to getting familiar with other opinions regarding the forward guidance. The International Monetary Fund (IMF 2013), A. L. Smith and T. Becker (Smith and Becker, 2015) both agree that usage of the forward guidance moderates short-term interest rates and limits the uncertainty of the market with regard to changes of the future interest rates. In addition, this method, in contradiction to other unconventional instruments of monetary policy, does not increase the balance sheet of central bank, which also makes it more attractive.

**Conclusion**

Overall, the above consideration about the forward guidance leads to a presumption that the actions undertaken by the European Central Bank concerning adoption of this method as an unconventional monetary policy instrument can be seen as a positive act. A good example of the usage of the forward guidance is the example of introducing this method of communication for the first time by the ECB, as discussed above. The instrument which was introduced in July of 2013 is still used till this day. Moreover, its use was extended to communicating future actions related to the APP. It is also a sign that the European Central Bank is satisfied with the forward guidance and does not consider its removal from its instrumentation in the nearest future.

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