EUROPEAN CENTRAL BANK
EUROSYSTEM

What is forward guidance?

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If a central bank gives forward guidance, it means it is providing information about its future monetary policy intentions, based on its assessment of the outlook for price stability.

The ECB began using forward guidance in July 2013 when the ECB's Governing Council said that it expected interest rates to remain low for an extended period of time. Since then the formulation of the ECB's forward guidance has been adapted on a number of occasions, and it now clarifies the Governing Council's intentions not only with regard to the expected future path of the ECB's key interest rates, but also with regard to the horizon of its asset purchase programme.

To remain credible, the content of the ECB's forward guidance on its policy intentions must always be consistent with the Governing Council's assessment of the current economic situation and the outlook for the future, in particular for inflation.

How does it work in practice?

Here's one example of how forward guidance can work:

The central bank makes a statement about its future monetary policy intentions, for example that key interest rates are likely to remain low in the future.

As a result, commercial banks are more likely to set the interest rate for long-term loans at a lower level. This is because they know that, when needed, they will be able to borrow money from the central bank at lower rates − so they can be comfortable setting lower rates themselves.

This means businesses can get cheaper loans and individuals are in a better position to make major purchases, such as property. Forward guidance can therefore help to encourage investment and spending, stimulating economic growth, and thus bringing inflation to values consistent with price stability.

When is forward guidance needed?

The ECB's conventional monetary policy tools (the key interest rates) are used to keep inflation in the euro area in line with the ECB's objective (i.e. annual inflation of below, but close to, to 2% over the medium term). If inflation is excessively low, the ECB can decrease its interest rates to bring inflation back up. But if interest rates are already at very low levels, it is difficult for the central bank to reduce them any further and it still be meaningful, so other policy tools are needed. Forward guidance is one of those tools.

In such circumstances, clear communication about future monetary policy intentions helps banks, financial market participants, businesses and consumers have a better understanding of how borrowing costs are likely to develop in the future and helps to give the economy the kick-start it needs.

Forward guidance therefore makes the ECB's monetary policy more effective and helps us to achieve our main objective of serving the people of Europe by keeping prices stable across the euro area.

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