

The chiaroscuro of the ECB's "forward guidance" *

By [Paul Hubert](#) and Fabien Labondance

"The Governing Council expects the key interest rates to remain at present or lower levels for an extended period of time." With this pronouncement on 4 July 2013 at the press conference following the monthly meeting of the European Central Bank Board of Governors, Mario Draghi initiated the adoption by the ECB of a new communication strategy called "forward guidance". Since then these words have always been included in his speech following announcements of the ECB's monetary policy, and he has repeated them again [today \[1\]](#). What should we expect? Forward guidance has recently been adopted by several central banks, but the methods chosen by the ECB differ and indicate that this measure will have only limited effectiveness in the euro zone.

Communication has become an integral part of the conduct of monetary policy since interest rates have been kept at a minimum level. More specifically, forward guidance consists of announcing and making a commitment to the future path of key interest rates. By doing this, the central banks want to increase the transparency of their activities and anchor expectations. The aim is to clarify both their strategy and their predictions about trends in the economy. In the present case, the central banks want to affirm their desire not to raise interest rates in the near future. They also hope to influence private expectations about short-term rates, and thus long-term rates, in order to strengthen the transmission of monetary policy, and thus support the economy.

From the theory...

The promoters of the forward guidance strategy, foremost among

them Eggertsson and Woodford (2003), suggest that monetary policy can be made more effective by adopting a policy of stable interest rates that is well known in advance. This proposal is justified by the fact that demand for credit is highly dependent on expectations of long-term interest rates, which depend on expectations of short-term rates. Hence, by announcing the future levels of interest rates in advance, the central bank declares its intentions and dispels any uncertainty about its future decisions. This strategy is especially relevant in a situation of a liquidity trap, when nominal interest rates are close to zero, as is the case today. The traditional tool of central banks is then constraint, as nominal interest rates cannot be negative. Central banks can thus no longer influence the cost of the loans granted, but they can on the other hand influence volumes through unconventional measures [\[2\]](#). The channel of expectations and the transmission of signals to private agents then become paramount and complement quantitative easing.

It is important to note that the effect of forward guidance on long-term rates and thus on the economy passes through the term structure of the interest rates. Several theories attempt to explain how rates vary in accordance with the term. The term structure of interest rates can be considered from the viewpoint of the theory of expectations, which assumes that long-term rates reflect a combination of expected future short-term rates, and thus that the different maturities are perfect substitutes. For its part, the theory of a liquidity premium implies that long-term interest rates include a premium linked to the existence of one or more long-term risks. Finally, another theory is based on the assumption of market segmentation and stipulates that financial instruments with different maturities cannot easily be substituted and that their prices move independently. If investors wish to hold liquid assets, they will prefer short-term instruments over long-term ones, and their prices will vary in opposite directions. Only in the case of the first two theories will

forward guidance have the desired effect on long-term rates.

...to the practice

This kind of strategy had already been implemented by some central banks even before the 2008 financial crisis, in particular in New Zealand since 1997, in Norway since 2005, and in Sweden since 2007. The United States also implemented this communication strategy several times when rates were very low. The Federal Open Market Committee (FOMC) implicitly introduced forward guidance in its communications in August 2003. At a time when its target rate was at a historic low, the FOMC stated that "...policy accommodation can be maintained for a considerable period". This terminology, specific to forward guidance, remained in FOMC communiqués until the end of 2005. It reappeared in December 2008, and in greater detail in August 2011, when Ben Bernanke, chairman of the US Federal Reserve (or the "Fed"), announced that economic conditions warranted maintaining the federal funds rate at a low level until at least mid-2013. Since then, the announcement on 13 September 2012 that the Fed will not raise its rates before mid-2015 continues this same strategy.

To understand what impact the ECB's forward guidance might have, it is important to distinguish two types of forward guidance: one for which the action of the central bank is subject to a time period, and another which depends on economic variables, including thresholds that trigger an action on the bank's part. In the case of the Fed, the first statements mentioned above refer to a period of time, but since December 2012 it has conditioned its commitment to future rate changes on cyclical thresholds that act as triggers. The Fed has also announced that "this exceptionally low range for the [Fed Funds](#) rate will be appropriate at least as long as the unemployment rate remains above 6-1/2 percent, inflation between one and two years ahead is projected to be no more than a half percentage point above the Committee's 2 percent longer-run goal, and longer-term inflation

expectations continue to be well anchored". The arrival of new FOMC members in January 2014 could, however, change the timing of the next monetary tightening. Likewise, in August 2013 Mark Carney, Governor of the Bank of England (BoE), set out a forward guidance strategy indicating his intention not to raise rates so long as the unemployment rate had not fallen below 7%. This commitment is nevertheless conditional on containing inflation, on stable inflation expectations and on the neutral impact of this commitment on financial stability.

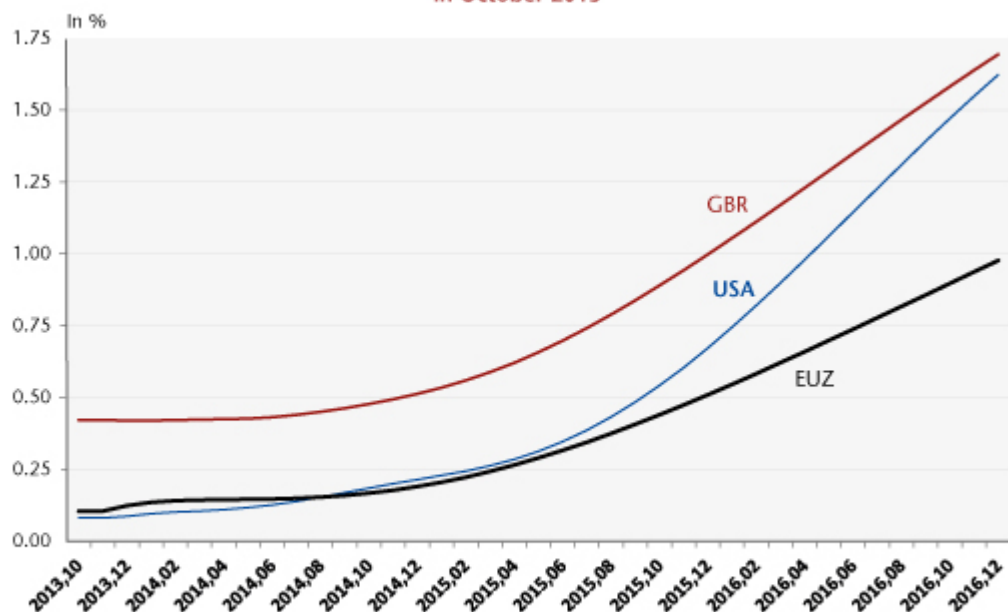
There is a major disadvantage to conditioning forward guidance on a time period, as has been adopted by the ECB (and as will be described later): changes in economic conditions over the time period in question could render the commitment obsolete. The announcement thus has very little credibility. Conditioning forward guidance on thresholds for economic variables does not have this drawback. One criterion for the credibility of commitments conditioned on thresholds is, however, that the underlying variables chosen are observable (GDP rather than output gap) and that they do not suffer from measurement errors (inflation rather than inflation expectations), so that private agents can assess whether the central bank is acting in accordance with its commitments. Then and only then will the agents have confidence in the declarations and will the central bank be in a position to influence expectations of long-term rates. The relative advantages and disadvantages of the two types of forward guidance explain why the Fed switched from one to the other and why the BoE has also made a commitment linked to thresholds.

The establishment of forward guidance conditioned on a threshold for a macroeconomic variable may, however, contribute to muddying the waters on the ranking of the central bank's objectives. If several variables are targeted simultaneously and they begin to diverge, what will the bank decide? The Fed does not prioritize its objectives. As the

economy emerges from crisis it is quite possible that the Fed may decide to ensure the strength of GDP, or to lower unemployment rather than inflation. For its part, the BoE follows a strategy of inflation targeting. It has therefore defined conditions (“knockouts”) on inflation, inflation expectations and financial stability, which, when they are not met, will lead to an end to forward guidance and therefore to any commitment to keep rates unchanged. The hierarchy of objectives would thus be well respected and the BoE’s credibility maintained.

How effective can forward guidance be? Kool and Thornton (2012) express serious doubts as to the results obtained through forward guidance. They assess the predictability of short-term and long-term rates in countries where this strategy has been adopted and show that forward guidance improves the ability of private agents to forecast future short-term rates only for periods of under one year, without improving the predictability of rates in the longer term. The chart below shows the expectations of 3-month rates by the financial markets in October 2013 for the coming months. Since benchmark rates change by a minimum of 0.25%, this figure indicates that no change in rates is expected for the time being, apart perhaps from the United States for the one-year horizon.

Graphique. Current 3-month rates and anticipated 3-month rates at various dates, in October 2013



Note : The short-term rate anticipations that we consider are produced from forward rate agreements (FRAs) or futures contracts on anticipated market rates at a given date for different horizons (1 month, 2 months, etc.).

Source : Datastream.

The timid adoption by the ECB

With regard to the ECB, which for its part sets a hierarchy of goals by giving priority to inflation, the introduction of forward guidance constitutes a conditional commitment to a period of time (“... for an extended period of time”) without any reference to thresholds. From this point of view, it goes against the current of the Fed and the BoE, which adopted conditional commitments to numerical thresholds. For the record, prior to July 4th the ECB gave clues to its decision in the following month in the form of expressions that were easily recognizable to observers. Thus, the insertion of the word “vigilance” in the ECB President’s speech at his press conference announced a probable tightening of monetary policy [3]. By adding forward guidance to its basket of tools, the ECB wants to be less enigmatic. In particular, it seems that it wanted to respond to concerns over a possible rise in interest rates.

However, Benoit Coeuré, a member of the ECB Executive Board,

said that this strategy does not call into question the rule, repeated many times at press conferences, that the ECB will never commit to future policies (“no pre-commitment rule”) and that forward guidance is to be re-evaluated at each meeting of the Board of Governors. Jens Weidmann, a member of the ECB’s monetary policy committee as president of the Bundesbank, confirmed that the ECB’s forward guidance “is not an absolute advanced commitment of the interest rate path”, while Vitor Constancio, ECB Vice-President, added an extra dose of confusion by saying that the ECB’s forward guidance “is in line with our policy framework as it does not refer to any date or period of time but is instead totally conditional on developments in inflation prospects, in the economy and in money and credit aggregates – the pillars of our monetary strategy”.

So how effective can a policy be that is poorly defined, that does not seem to have a consensus within the ECB Governing Council, and whose key to success – the credibility of the commitment – is openly questioned? Not very effective.

Bibliographic references

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* This text draws on a study, “Politique monétaire: est-ce le début de la fin?” [“Monetary policy: Is it the beginning of the end?”], forthcoming in [The OFCE outlook for the global economy in 2013-2014 \[in French\]](#).

[1] Today’s 25-basis point cut in the benchmark rate is consistent with the ECB’s strategy of forward guidance.

[2] Unconventional measures refer to monetary policy practices that are not classified as traditional policy (*i.e.* changes in interest rates). These are measures that result in a change in the content or magnitude of the central bank balance sheet through purchases of government or private securities, which is generally referred to as “quantitative easing”.

[3] Rosa and Verga (2007) offer a description of these expressions.

Austerity in Europe: a change of course?

By Marion Cochard and Danielle Schweisguth

On 29 May, the European Commission sent the members of the European Union its new economic policy recommendations. In these recommendations, the Commission calls for postponing the date for achieving the public deficit goals of four euro zone countries (Spain, France, Netherlands and Portugal), leaving them more time to hit the 3% target. Italy is no longer in the excessive deficit procedure. Only Belgium is called on to intensify its efforts. Should this new roadmap be interpreted

as a shift towards an easing of austerity policy in Europe? Can we expect a return to growth in the Old Continent?

These are not trivial matters. [An OFCE Note \(no. 29, 18 July 2013\)](#) attempts to answer this by simulating three scenarios for fiscal policy using the [iAGS model](#). It appears from this study that postponing the public deficit targets in the four euro zone countries does not reflect a real change of course for Europe's fiscal policy. The worst-case scenario, in which Spain and Portugal would have been subject to the same recipes as Greece, was, it is true, avoided. The Commission is implicitly agreeing to allow the automatic stabilizers to work when conditions deteriorate. However, for many countries, the recommendations with respect to budgetary efforts still go beyond what is required by the Treaties (an annual reduction in the structural deficit of 0.5 percent of GDP), with as a consequence an increase of 0.3 point in the unemployment rate in the euro zone between 2012 and 2017.

We believe, however, that a third way is possible. This would involve adopting a "fiscally serious" position in 2014 that does not call into question the sustainability of the public debt. The strategy would be to maintain a constant tax burden and to allow public spending to keep pace with potential growth. This amounts to maintaining a neutral fiscal stimulus between 2014 and 2017. In this scenario, the public deficit of the euro zone would improve by 2.4 GDP points between 2012 and 2017 and the trajectory in the public debt would be reversed starting in 2014. By 2030, the public deficit would be in surplus (0.7%) and debt would be close to 60% of GDP. Above all, this scenario would lower the unemployment rate significantly by 2017. The European countries could perhaps learn from the wisdom of Jean de La Fontaine's fable of the tortoise and the hare: "*Rien ne sert de courir, il faut partir à point*", i.e. Slow and steady wins the race.

France: why such zeal?

By Marion Cochard and Danielle Schweisguth

On 29 May, the European Commission sent the members of the European Union its new economic policy recommendations. As part of this, the Commission granted France an additional two years to reach the deficit reduction target of 3%. This target is now set for 2015, and to achieve this the European Commission is calling for fiscal impulses of -1.3 GDP points in 2013 and -0.8 point in 2014 (see [“Austerity in Europe: a change of course?”](#)). This would ease the structural effort needed, since the implementation of the previous commitments would have required impulses of -2.1 and -1.3 GDP points for 2013 and 2014, respectively.

Despite this, the French government has chosen not to relax its austerity policy and is keeping in place all the measures announced in the draft Finance Act (PLF) of autumn 2012. The continuing austerity measures go well beyond the Commission's recommendations: a negative fiscal impulse of -1.8 GDP point, including a 1.4 percentage point increase in the tax burden for the year 2013 alone. Worse, the broad guidelines for the 2014 budget presented by the government to Parliament on 2 July 2013 point to a structural effort of 20 billion euros for 2014, *i.e.* one percentage point of GDP, whereas the Commission required only 0.8 point. The government is thus demanding an additional 0.6 GDP point fiscal cut, which it had already set out in the multi-year spending program in the 2013 Finance Act.

The table below helps to provide an overview of the effort and of its impact on the French economy. It shows the trends in growth, in unemployment and in the government deficit in 2013

and 2014, according to three budget strategies:

1. One using the relaxation recommended by the Commission in May 2013;
2. One based on the budget approved by the government for 2013 and, *a priori*, for 2014;
3. One based on an alternative scenario that takes into account the negative 1.8 GDP point fiscal impulse for 2013 and calculates a fiscal impulse for 2014 that would be sufficient to meet the European Commission's public deficit target of -3.6%.

The different scenarios for deficit reduction in France

In %

| | Relaxation (1) | | Approved budget (2) | | Alternative scenario (3) | |
|-------------------|----------------|------|---------------------|------|--------------------------|------|
| | 2013 | 2014 | 2013 | 2014 | 2013 | 2014 |
| Fiscal impulse | -1.3 | -0.8 | -1.8 | -1.0 | -1.8 | -0.2 |
| Unemployment rate | 10.5 | 10.6 | 10.7 | 11.1 | 10.7 | 10.5 |
| Growth | 0.2 | 1.3 | -0.2 | 1.0 | -0.2 | 1.7 |
| Public deficit | -4.3 | -3.6 | -3.9 | -3.1 | -3.9 | -3.6 |

Source : Authors' calculations based on the iAGS model.

According to our estimates using the iAGS model [\[1\]](#), the public deficit would be cut to 3.1% of GDP in 2014 in scenario (2), whereas the Commission requires only 3.6%. As a consequence of this excess of zeal, the cumulative growth for 2013 and 2014 if the approved budget is applied would be 0.7 percentage point lower than growth in the other two scenarios (0.8 point against 1.5 points). The corollary is an increase in unemployment in 2013 and 2014: the unemployment rate, around 9.9% in 2012, would thus rise to 11.1% in 2014, an increase of more than 350,000 unemployed for the period. In contrast, the more relaxed scenario from the European Commission would see a quasi-stabilization of unemployment in 2013, while the alternative scenario would make it possible to reverse the trend in unemployment in 2014.

While the failure of austerity policy in recent years seems to be gradually impinging on the position of the European

Commission, the French government is persisting along its same old path. In the face of the social emergency that the country is facing and the paradigm shift that seems to be taking hold in most international institutions, the French government is choosing to stick to its 3% fetish.

[1] iAGS stands for the Independent Annual Growth Survey. This is a simplified model of the eleven main economies in the euro zone (Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Netherlands, Portugal and Spain). For more detail, see the working document [Model for euro area medium term projections](#).

Tales from EDF

By [Evens Salies^a](#)

The challenge facing policy-making on the reduction of greenhouse gas emissions is not just environmental. It is also necessary to [stimulate innovation, a factor in economic growth](#). Measures to improve energy efficiency [1] demand high levels of investment to transform the electricity network into a [smart grid](#). To this end, EU Member States have until 2020 to replace the meters of at least 80% of their customers in the residential and commercial sectors with “smarter” meters. In France, these two sectors account for 99% of the sites connected to the low-voltage grid (< 36 kVA), or about 43% of electricity consumption and nearly 25% of greenhouse gas emissions (without taking into account emissions from the production of the electrical power that supplies these sites).

These new meters have features which, as has been shown by

research, lead to lower energy consumption. The [remote reading](#) at 10 minute intervals of data on consumption, which is transmitted in real time to a remote display (a computer screen, etc.), immediately shows the savings in electricity, which, with two surveys per year, was previously impossible. High-frequency remote reading also makes it possible to expand the range of vendor contracts to include rates that are better suited to customers' actual consumption profiles. The "pilot" flying the transmission network can better optimize the balance between demand and a supply system that has fragmented due to the growing number of small independent producers. For distributors [\[2\]](#), remote reading solves the problem of gaining access to meters [\[3\]](#).

These features are supposed to create the conditions for the emergence of a market for demand-side management (DSM) that is complementary to the supply market. This market would give non-traditional [suppliers](#) an opportunity to differentiate themselves further by offering services that are tailored to the needs of the DSM customer [\[4\]](#). This could lead to significant gains in innovation if other companies that specialize in information and communication technology also develop software applications that are adapted to the use of the smart meters. However, in France, the policy on the roll-out of smart meters does not seem to be facilitating greater competition. Innovation could stop at the meter due to a [decision](#) by the French Regulatory Commission (CRE) which states that:

"The features of advanced metering systems must strictly meet the missions of the electricity [distributors] ... Thus the additional features requested by some stakeholders [essentially suppliers] which are subject to competition (basically remote displays) are not accepted."

A reading of this paragraph would seem to indicate that the suppliers are not willing to bear the cost of developing these features. However, according to Article 4 of this decision,

which specifies the list of features for distributors, none of them seems to have been left exclusively to the competitive sector. In practice, households with a computer can check their consumption data without going through their provider or a third party.

It is worth considering the costs and benefits of such an approach, which *a priori* would seem to amount to the monopolization of the DSM market by the distributors.

This approach will make it possible to quickly reach the goal of 80%, since the CRE has opted for a public DSM service: the distributors, who have public service obligations, will roll out the smart meters. The “Linky” meter alone, from the dominant electricity distributor, the ERDF, will be installed on 35 million low-voltage sites, covering 95% of the national distribution network [\[5\]](#). There is thus little risk of under-investment in the demand-response capacity that electricity suppliers will soon have. In fact, as the suppliers do not have to bear the costs of the manufacture and deployment of the meters, they can quickly invest in the development of these capabilities. In addition, the equalization of subcontracting costs for the manufacturing of the meters and their installation throughout the French distribution network will make for considerable economies of scale. Finally, the low rate of penetration of meters in countries that have opted for a decentralized approach (the cost of the meter and services are then borne partly by the households concerned) argues in favour of the French model. This model is more practical since it removes most of the barriers to adoption.

Despite this, the degree of concentration in the business of the distribution and supply of electricity to households raises questions: ERDF is affiliated with EDF and has a virtual monopoly on the supply of electricity to households. In terms of innovations in DSM services, it would seem that EDF has little reason to go beyond its subsidiary’s Linky project – first, because of the costs already incurred by the

Group (at least five billion euros), and second, because the quality of the default basic information mechanism in Linky will be sufficient to lead to a cost for migrating to DSM services offered by competitors. [6] Alternative suppliers will of course be able to introduce innovative tariffs. But so will EDF. One way to overcome this problem would be to set up a Linky platform so that other companies' applications could interact with its operating system. With the agreement of the household and possibly a charge for access to the data, the business would of course be regulated, but entry would be free. This would stimulate innovation in DSM services, but would not increase competition since these companies would not be electricity suppliers. Would the consumer have a lot to lose? This would obviously depend on the amount of the reduction in their bills. Given that the price of electricity is likely to rise by 30% by 2017 (including inflation), we are worried that consumers' efforts to optimize their consumption will not be rewarded. The net gain in the medium term could be negative.

Finally, we can ask ourselves whether with Linky the EDF group is not trying to reinforce its position as the dominant company in the supply of electricity, a position that has grown weaker since the introduction of competition. With DSM service installed by default on 95% of the country's low-voltage sites, Linky will become an element in the network infrastructure that all DSM service providers will have to use. From the point of view of the rules on competition, one must then ask whether ERDF and its partners have properly communicated information about the Linky operating system, without any favouritism being shown to the EDF Group and its subsidiaries (Edelia, NetSeenergy). The story tellers would like to tell us a beautiful tale about encouraging innovation in energy and the digital economy in order to deal with the ecological transition. Knowing that the current CEO of the company in charge of the architecture of the Linky information system, Atos, was Minister of the Economy and Finance just

prior to the launch of the Linky project in 2007, there seems to be room for doubt ...

[1] “Energy efficiency improvement” and “energy savings” are used interchangeably in this post. For precise definitions, see Article 2 of Directive [2012/27/EU](#) of the European Parliament and of the Council.

[2] The distributors manage low and medium-voltage lines. [ERDF](#) has the largest network. The networks and meters are licensed equipment, which are the property of the local public authorities.

[3] This would nevertheless involve, for example for ERDF, the elimination of 5000 jobs (compared with 5900 retirements, see Senate Report no. 667, 2012, Vol. II, p. 294).

[4] In accordance with the NOME law of 2010, suppliers and other operators must be able to make ad hoc reductions in the consumption of electricity for certain customers (temporarily cut the supply to an electric boiler, etc.), which is called demand-response load-shedding.

[5] In areas where the ERDF is not a supplier, other experiments exist, such as that of the distributor SRD in Vienna, which has installed its smart meter, i-0uate, on 130,000 sites.

[6] See the document by the DGEC, 2013, the Working group on smart electricity meters (GTCEC) – [Coordination document](#), February [in French].

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