

Box I

**THE GOVERNING COUNCIL'S FORWARD GUIDANCE ON THE KEY ECB INTEREST RATES**

Following its meeting on 4 July 2013 the Governing Council of the ECB communicated that it expects the key ECB interest rates to remain at present or lower levels for an extended period of time. The Governing Council's 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. The monetary policy stance remains geared towards maintaining the degree of monetary policy accommodation that is appropriate given the current outlook for price stability and towards the need to promote stable money market conditions.

This box explains the rationale for the Governing Council's decision to provide forward guidance on the key ECB interest rates and describes the modalities for providing it.

**Rationale for forward guidance**

Throughout the first half of 2013 euro money market interest rates displayed significant volatility. More recently a sustained upward trend in money market rates has led to a restriction in money market credit conditions, so that part of the amount of monetary accommodation that was introduced when the Governing Council last changed the monetary policy stance has been de facto withdrawn. For example, forward rates based on overnight index swaps – an important measure of market expectations about the evolution of overnight interest rates – shifted upwards by some 20 to 30 basis points at intermediate to medium-term horizons between 2 May and 3 July (see the chart). The drift was most pronounced in late June.

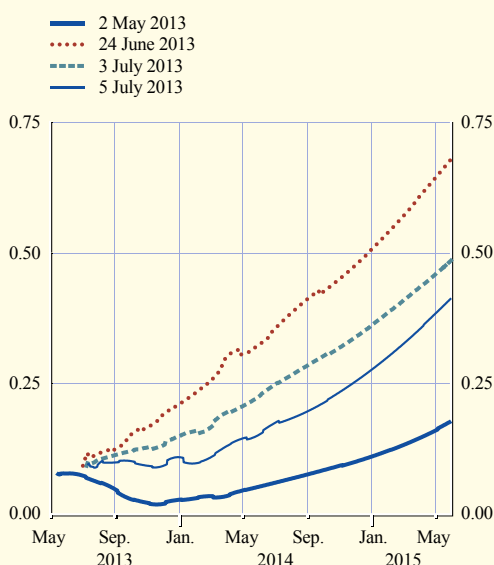
While several factors may have contributed to these developments, the increased volatility in money market rates has made expectations regarding the stance of monetary policy excessively vulnerable to shocks that are disconnected from the underlying economic and monetary conditions on which the intended stance is calibrated.

In these circumstances precise communication about the monetary policy orientation of the Governing Council, conditional on its assessment of the outlook for price stability and how it expects the outlook to evolve as the underlying conditions change, can promote more stable money market conditions and anchor market expectations more firmly.

The assessment that the monetary policy stance should remain accommodative for an extended period of time is consistent with the expectation that price developments should

**Forward rates based on overnight index swaps**

(percentages per annum; daily data)



Sources: Thomson Reuters and ECB calculations.

remain subdued over the medium term. This expectation is based on the regular economic and monetary analyses conducted by the Governing Council within its two-pillar analytical framework.

As regards the economic analysis, price pressures over the medium term are currently assessed to be low owing to the broad-based subdued trend in aggregate demand in an environment of weak labour market conditions and low capacity utilisation. A cross-check with the monetary analysis confirms this picture. Underlying monetary dynamics, as reflected in the slow growth of broad monetary aggregates and very weak credit developments, remain unsupportive. Specifically, the improvement in bank funding conditions which has been observed since the turn of the year has not yet led to increased dynamism in the provision of loans to the non-financial private sector. The ongoing balance sheet adjustments in the public and private sectors, while reflecting necessary corrections, will continue to weigh on economic activity.

Based on this assessment, the Governing Council currently expects the key ECB interest rates to remain at present or lower levels for an extended period of time. The path of the key ECB interest rates remains conditional on the outlook for inflation and will be reviewed over time within the analytical framework provided by the ECB's monetary policy strategy. Within that framework, in the period ahead the Governing Council will monitor all incoming information on economic and monetary developments and assess any impact on the outlook for price stability. The chart shows that after the Governing Council's communication on 4 July the forward rates based on overnight index swaps have declined appreciably.

### **Modalities of forward guidance**

The Governing Council's forward guidance has three main elements.

First, it has been provided before exhausting the scope for further reductions in the key ECB interest rates. The uncertainty surrounding the expected conditional path of monetary policy can be reduced, independently of the level of the very short-term interest rates. In fact, the key ECB interest rates can be reduced further if warranted by the evolving outlook for price stability.

Second, forward guidance is consistent with but not directly linked to the decision taken by the Governing Council on 2 May to extend the horizon for the fixed rate tender procedure with full allotment until July 2014. The latter decision was intended to ensure that banks will continue to have unimpaired access to central bank liquidity – and thus to a stable source of funding – even in conditions of renewed financial turbulence and a drying-up of private funding. This form of forward reassurance can be provided – and has been provided in the past – independently of the level of the key ECB interest rates.

Third, and most importantly, forward guidance is fully consistent with the ECB's mandate and with its monetary policy strategy. In particular:

- the Governing Council has specified that its expected path for the key ECB interest rates is based on the outlook for inflation extending into the medium term. This is in line with the ECB's primary objective of maintaining price stability and with the Governing Council's aim of accomplishing inflation rates that, over the medium term, are below, but close to, 2%.

- The extended period of time over which the Governing Council currently expects the key ECB interest rates to remain at present or lower levels is a flexible horizon which does not pre-specify an end-date but is conditional on the Governing Council's assessment of the economic fundamentals that determine underlying inflation.
- The underlying conditions upon which the expectation regarding the key ECB interest rates is based reflect the ECB's approach to organising, evaluating and cross-checking the information relevant for assessing risks to price stability. A scenario of subdued inflation will continue to warrant keeping the key ECB interest rates at very low levels for as long as broad-based subdued trends in aggregate demand and persistently weak monetary and credit trends prevail.

At the current juncture, forward guidance contributes to the ECB's pursuit of its mandate of maintaining price stability effectively, within the framework and in full respect of its strategy. After the Governing Council's decision on forward guidance, price stability is expected to be maintained in the medium term and to be reflected in medium to long-term inflation expectations.