



When words do the work of interest rates: forward guidance

(Recorded on 4 May 2026)

Introduction

Voice-over: Summer 2012. The euro area was experiencing one of the most critical moments in its history: the sovereign debt crisis. In the markets, investors were betting on the collapse of the single currency, abandoning Spanish, Greek, Italian and Portuguese bonds, and taking financial positions that would pay off if certain countries were to abandon the euro. Faced with this mistrust, borrowing rates for several countries went through the roof.

On 26 July 2012, in London, Mario Draghi, then President of the European Central Bank, made a speech in which he uttered two sentences:

Mario Draghi: *“Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And, believe me, it will be enough.”*

Voice-over: Just a few words were enough to put a stop to the crisis. In the hours that followed, under-pressure government bond rates began to fall.

But how can words have such an impact on the economy? And, if just a few sentences – without costing a single euro – are enough to calm the markets, can central banks turn words into a tool in their own right?

My name is Lucile and I work at the Banque de France. Today I’m going to talk about forward guidance, another tool of unconventional monetary policy. In French, we refer to this as “prospective guidance of expectations”, or how a promise for tomorrow affects the economy today.

Welcome to L’Éco en court.

Part 1: The role of expectations: in economics, what people expect from the future shapes today's reality

Voice-over: In economics, what people expect from the future is just as important as today's reality.

Let's take a simple example:

If you are convinced that the price of a particular product will rise between now and next year, you will try to buy it as soon as possible in order to pay less. If everyone thinks like you, demand for that product will rise... and so will its price. Conversely, if we are all convinced that prices will fall, we will postpone our purchases and the drop in demand will indeed help to drive prices down.

Applied to the economy as a whole, this mechanism is central to inflation – and therefore to monetary policy: if households and businesses expect that prices will rise by 2% a year, then wages, prices and contracts, etc. will adjust accordingly, which will help to keep inflation at close to 2%. This phenomenon was explained by François Villeroy de Galhau, Governor of the Banque de France:

"If people are convinced that we're going to come back towards 2% – in technical terms, what we call inflation expectations – that's a powerful addition to monetary policy."

Voice-over: In other words, if there is a clearer understanding of central bank decisions, monetary policy is more effective. Communication therefore becomes a monetary policy tool in its own right.

Part 2: The shift in the ECB's communication strategy: from "never pre-commit" to "forward guidance"

Voice-over: For example, after each Governing Council monetary policy meeting, the European Central Bank holds a press conference to comment upon its decisions.

This is retrospective communication – this is what the Governing Council has decided and here is why.

But in certain situations, explaining the present is no longer enough. Prospective communication is sometimes necessary – providing guidance on the various paths monetary policy may take in the future.

This is what happened in 2013: key interest rates were already close to zero, but the euro area economy was stagnating, credit was sluggish and inflation was below 2%.

Key interest rates, despite being very low, were no longer sufficient to kick start the economy because the markets anticipated that they would rise rapidly. The ECB needed to find a way to influence these expectations regarding future key interest rates.

Until 2013, the European Central Bank adhered to a clear principle of communication: *“We never precommit.”* It never committed to future decisions, thereby retaining considerable room for manoeuvre.

However, during Mario Draghi’s press conference on monetary policy on 4 July 2013, a turning point was reached.

Mario Draghi: *“The Governing Council expects the key ECB interest rates to remain at present or lower levels for an extended period of time.”*

Voice-over: This was a minor revolution, immediately picked up on by one of the journalists present, to whom Mario Draghi replied with equal doses of mischief and firmness.

- **Journalist:** *“Is it time that you put aside the pre-commit barrier to more detailed and specific forward guidance?”*
- **Mario Draghi:** *“If you are asking this question, you have not really listened to my statement.”*

Voice-over: For the first time, the ECB Governing Council had explicitly committed to the future direction of its key interest rates: they would remain low – for a long time.

This is what forward guidance is all about. A commitment to the future designed to guide current behaviour.

Once this corner had been turned, forward guidance became an integral part of European monetary policy. At its meetings, the Governing Council bases its decisions on its economic and monetary analyses, taking account of previous commitments.

Part 3: A powerful tool, but not without limitations

Forward guidance is a powerful tool, but it does have its limits.

A poorly calibrated message can cause turmoil. In 2013, a simple allusion from the US Federal Reserve to a future reduction in its asset purchases was enough to trigger the taper tantrum: a sharp correction in global bond markets. Words can also have a destabilising effect.

Uncertainty represents another limitation. Commitments made yesterday may prove restrictive if the economic and political situation changes rapidly. Whilst forward guidance is a means of easing the monetary policy stance without lowering already low key interest rates further, the inflationary shock of 2022 caused by the invasion of Ukraine and the emergence from Covid changed the playing field: the aim now was to raise key interest rates to contain inflation. Forward guidance was therefore no longer necessary.

Ultimately, while words can be an instrument of monetary policy, they don't have any magical powers. Just like the other instruments discussed in previous episodes, their effectiveness depends on one essential condition: central bank credibility. They must say what they are doing, do what they say, explain their decisions, and outline how they view the changing economic situation, so that economic agents – that is, you and I – can gain a better understanding of the economic environment and the central bank's future decisions. François Villeroy de Galhau calls this “soft guidance”:

François Villeroy de Galhau: *“Soft guidance is not the kind of almost unconditional and “long horizon” forward guidance we have used at the ELB [effective lower bond]. Nor should soft guidance be interpreted as static. [...] Soft signaling is our everyday life business, in which we influence market expectations of future near-term policy but keep optionality.”*

Voice-over: Central bank credibility is forged over time, through the clarity of its messages and consistency with the actions it takes. Independence is another key factor in credibility. The independence of central banks will be the subject of our next episode – and the last in our series on monetary policy.

Outro

Thank you all for listening. I would also like to thank Guillaume Horny, Head of the Monetary Policy division at the Banque de France, for his invaluable proof-reading. Thanks also to Baptiste, Vincent and Asia for their contributions to this episode. Don't forget to subscribe to L'Éco en court and to leave us your comments and stars on your podcast listening platforms. Till next time!

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[What is forward guidance?](#)

[Evaluating monetary policies in the face of the “forward guidance puzzle”](#)

[Global Investment Conference - Mario Draghi, President of the European Central Bank](#)

[ECB Press Conference - 4 July 2013](#)

[Keynote by François Villeroy de Galhau on Monetary Policy | CEPR](#)