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No Way Back? ECB's Forward Guidance and Policy Normalisation

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Abstract

This article (a) analyses forward guidance by the European Central Bank (ECB) and its role in the "normalisation" of the ECB's monetary policy, and (b) assesses whether communication under the new ECB's "meeting-by-meeting and data-dependent" approach has the potential to increase trust in the ECB and to steer financial markets in the intended direction. By communicating its future policy intentions (forward guidance), a central bank can tighten the gears between the short-term policy rate that it controls and the interest rates that influence economic behaviour. The ECB's forward guidance steered financial markets in the desired direction and, in combination with other unconventional policies, probably helped to raise inflation when it was below target. However, forward guidance constrained the central bank's ability to decide to end asset purchases and raise policy rates once inflation had risen above target. Furthermore, the ECB's forward guidance was formulated in terms of inflation forecasts. As these forecasts seriously underestimated inflation, the ECB reacted too late to the inflation hike, undermining trust in the central bank. Trust is important because the inflation expectations of people who trust the central bank tend to be closer to the central bank's inflation target. Communication under its current "meeting-by-meeting and data-dependent" approach can steer financial markets in the intended direction. It may also be easier for the public to digest than forward guidance. However, recent research questions whether it will increase trust in the ECB. The best way to regain trust is probably to bring inflation back to target.

Keywords

central bank communication; European Central Bank; forward guidance; trust

1. Introduction

By combining insights from several strands of research, this article (a) examines forward guidance by the European Central Bank (ECB) and discusses its role in the "normalisation" of the ECB's monetary policy, and (b) assesses whether communication under the new ECB's "meeting-by-meeting and data-dependent" approach (de Haan & Hoogduin, 2024) can increase trust in the ECB and steer financial markets in the intended direction.

In the two decades leading up to the global financial crisis, central banks in advanced economies typically implemented monetary policy by steering short-term interest rates in the economy. They raised or lowered money market rates through the use of their instruments if inflation and economic developments so required, i.e., raising interest rates when inflation becomes too high and lowering interest rates when inflation is below target. However, central banks cannot lower their policy rates below a certain level (which may be negative), the so-called effective lower bound (ELB). This lower bound reflects the fact that economic agents will prefer to hold funds in the form of cash rather than deposit them in a bank that charges negative deposit rates (i.e., customers have to pay to deposit their money). Thus, when inflation remained stubbornly below the central banks' target (most often 2%), they resorted to unconventional monetary policies, such as asset purchase programmes (APPs; often referred to as quantitative easing, or QE) and forward guidance, i.e., communication about future monetary policy (Blinder et al., 2017).

QE aims to stimulate demand by lowering borrowing costs for households and firms and supporting asset prices. The ECB introduced QE much later than most other central banks in major advanced economies. Initially, its unconventional policies during the financial crisis focused mainly on supporting lending via the banking sector. The main reason is that the banking sector plays a fundamental role in the monetary transmission mechanism in the euro area, because non-financial corporations are highly dependent on bank credit. However, after inflation in the euro area fell below 0% and forecasted inflation remained persistently below target, the ECB launched an APP in January 2015 (de Haan & Pattipeilohy, 2022).

Through forward guidance, monetary policy can be effective even if the central bank cannot lower current policy rates any further (Blinder et al., 2008). This can be explained as follows. Longer-term interest rates reflect, among other things, expected future short-term rates. Thus, a reduction in expected future policy rates would reduce longer-term interest rates in the current period, thereby stimulating contemporaneous consumption and investment. In other words, the central bank can achieve lower longer-term interest rates by promising to keep the policy interest rate "lower for longer." In July 2013, the ECB's Governing Council announced that interest rates would remain low for an extended period of time. Since then, the wording of the ECB's forward guidance has been adjusted several times (see Section 3 for details). However, in July 2022, the ECB announced that it would no longer provide forward guidance on interest rate decisions, but would instead follow a "meeting-by-meeting and data-dependent" approach to policy decisions.

In this article, I first analyse how the ECB's forward guidance interacted with other unconventional policy instruments and how it affected the normalisation of monetary policy, after inflation started to rise. Most of the evidence suggests that the ECB's forward guidance steered financial markets in the desired direction. It probably also helped, in combination with other unconventional instruments, to (slightly) raise inflation when it was below target. However, the ECB's forward guidance constrained the central bank's decision to end asset purchases and raise policy rates once inflation had risen above target. Moreover, the ECB's forward guidance

was formulated in terms of inflation forecasts. As these forecasts seriously underestimated inflation, the ECB reacted too late to the rise of inflation, undermining public trust in the central bank.

Carstens (2023) defines public trust as "society's expectation that public authorities will act predictably in the pursuit of predefined objectives and that they will succeed in their task." As Carstens points out, public trust is important, because if the actions of authorities are trusted, the public "will incorporate them in determining their own behavior." And, as a result:

> It is more likely that the authorities will achieve their objectives. In addition, trust fuels the legitimacy of policies. With trust, the public will be more willing to accept actions that involve short-term costs in exchange for long-term benefits. There is a positive feedback loop in the dynamics of trust. If policies are effective and legitimate, it is easier for the authorities to achieve their objectives, which in turn feeds back into trust, producing a virtuous circle.

Applied to the ECB: If the public trusts the ECB to do what is required to maintain price stability, the central bank's inflation target, rather than current inflation, becomes a key reference for people in making their price and wage decisions, leading to low and stable inflation. Moreover, a high level of public trust in the ECB makes it easier to raise interest rates as part of the normalisation of monetary policy. Ehrmann (2024) points to another reason why trust is important. There is evidence that low public trust in the ECB increases the likelihood that national politicians will put pressure on the central bank to pursue a looser monetary policy, and that they will judge the ECB's policy not from a euro-area perspective, but against the background of their national growth performance.

In the second part of this article, I discuss whether communication under the new "meeting-by-meeting and data-dependent" approach can increase trust in the ECB. Although communication under the new approach may be easier for the public to digest than forward guidance, based on the findings of recent literature I conclude that it is unlikely to increase trust in the ECB. However, just like forward guidance, communication under the ECB's current "meeting-by-meeting and data-dependent" approach could help steering financial markets in the intended direction, although it is not helpful that ECB officials provide (conflicting) hints about future interest rate decisions.

The remainder of the article is organised as follows. Section 2 discusses forward guidance in general and Section 3 analyses the ECB's forward guidance. Section 4 looks at the impact of high inflation on trust in the ECB and discusses whether communication under the ECB's current "meeting-by-meeting and data-dependent" approach might be more successful in increasing trust in the ECB than forward guidance. The section also discusses its potential to steer markets in the desired direction. Section 5 concludes.

2. Forward Guidance

2.1. Rationale of Forward Guidance

Monetary policy works not only through policy instruments but also through expectations about the future course of policy, which influence, among other things, longer-term interest rates. Influencing these expectations can be a particularly powerful tool when the central bank has lowered the policy rate to the

ELB. The central bank can circumvent the ELB constraint by promising to keep policy rates low in the future. This also lowers longer-term interest rates, as they reflect expected future short-term rates (Eggertsson & Woodford, 2003). However, the announced policy of keeping interest rates low in the future, which is optimal under the ELB, is no longer optimal once the ELB is no longer binding. Under these circumstances, the central bank would prefer a higher interest rate, whereas it had promised to keep interest rates low during this period. So, the central bank has an incentive to break its promise. And if financial market participants believe that the central bank will not keep its promise, i.e., that the central bank is not credible, they will not adjust their expectations about future policy rates downwards, so that long-term interest rates do not fall. In other words, forward guidance is most effective if the central bank can convince financial market participants that it will stick to this "low for long" policy and will not change course if circumstances change. However, as will be shown in Section 3.3, if circumstances change quite drastically (as happened during the recent rise in inflation), the cost of sticking to "low for long" can be very high.

For this and other reasons, central banks may therefore be unwilling to commit to a policy stance, like Odysseus who tied himself to the mast to resist the song of the Sirens (Moessner et al., 2017). However, apart from *Odyssean forward guidance*, central banks can also provide *Delphic forward guidance* (Campbell et al., 2012). This means that, similar to the Delphic oracle, central banks provide information, such as expected macroeconomic developments and their likely monetary policy actions, while reserving the right to re-optimize their policies in each future period. As pointed out by Blinder et al. (2008), this type of forward guidance can also affect private sector expectations, since any central bank action that influences interest rate expectations could be a potential monetary policy tool.

There are three types of forward guidance: (a) qualitative (or open-ended) forward guidance, in which the central bank does not provide detailed quantitative information about the intended time frame for its policy intentions; (b) calendar-based (or time-contingent) forward guidance, in which the central bank refers to a clearly specified time horizon for its policy; and (c) threshold-based (or data-based, state-contingent) forward guidance, in which the central bank links future interest rates to specific quantitative economic thresholds. In practice, central banks often use more than one type of forward guidance (Moessner et al., 2017). Note that forward guidance can be applied to different policy instruments. Most commonly, it has been applied to the future path of policy rates, but, as will be discussed in more detail in Section 3.1, the ECB has also provided forward guidance about its asset purchases.

2.2. Criticism of Forward Guidance

The theoretical effects of forward guidance depend crucially on one's assumptions about how expectations about future economic developments are formed. After analysing the effects of forward guidance under different assumptions about expectation formation, Cole (2021, p. 160) concludes that:

> Policymakers should exercise caution when recommending forward guidance policy. If monetary policy is based on a model with the standard rational expectations hypothesis, which assumes agents know the true structure of the model, the results may be misleading relative to a more plausible theory of expectations formation (e.g., adaptive learning). Specifically, during an economic crisis, the predicted effects of forward guidance under the rational expectations assumption are overstated in comparison to adaptive learning.

Moreover, as pointed out by Campbell et al. (2017), announcements that interest rates will remain low for a long time may not only reflect a future accommodative monetary policy but also poor future economic fundamentals. This can lead to different consumption decisions. While optimistic agents will consume more in anticipation of higher future inflation and lower real interest rates, pessimistic agents will consume less in anticipation of lower future inflation and higher real interest rates. These offsetting choices hamper the effectiveness of forward guidance.

Cole et al. (2023) argue that the effect of forward guidance depends on the public's perception of the credibility of policymakers to follow through on their interest rate announcements. Only if a monetary authority is perceived as credible, will its communication of future policy have stimulative effects as the public will incorporate these announcements in their decisions today. Based on their estimates of a small-scale New Keynesian model, the authors find that central bank credibility is similar across many countries (with the notable exception of Japan). However, credibility tends to be lower during the period of low interest rates (2005–2022). This suggests that the effectiveness of forward guidance is time-varying and that forward guidance was less effective when it was most frequently used.

Finally, forward guidance may reduce the quality of information coming from financial markets due to the so-called echo chamber or hall of mirrors effect, i.e., price changes reflect previous central bank communication rather than reflecting the actual views of financial markets (Blinder et al., 2024). As Shin (2017, p. 1) puts it, "the louder the [central bank] talks, the more likely it is to hear its own echo." This leads to the paradoxical situation that central bank forward guidance could drown out valuable market signals. Ehrmann et al. (2019) find that when the central bank provides calendar-based forward guidance over a short time horizon, it increases the sensitivity of government bond prices to surprising economic news. This is paradoxical, because under forward guidance, policy rates are unlikely to change for a significant period of time. In other words, market interest rates should be less sensitive to macroeconomic news.

3. Forward Guidance by the ECB

3.1. Introduction and Development

The ECB has used different types of forward guidance. Initially, the ECB's forward guidance was open-ended, as it did not specify a time frame until which interest rates would remain low or the economic conditions that would trigger an increase in interest rates (Ehrmann et al., 2023). The Governing Council stated that monetary policy would be accommodative "for as long as necessary" (Moessner et al., 2017, p. 693). However, in July 2013 the ECB announced that interest rates would remain at current or lower levels for "an extended period of time" (Draghi, 2013). This statement was used until January 2016 (Coenen et al., 2017). Importantly, the ECB also provided forward guidance on its APPs. For example, in December 2015 it was announced that the principal payments on the securities purchased under the APP would be reinvested as they matured, "for as long as necessary," a case of open-ended forward guidance (Coenen et al., 2017).

Subsequently, the ECB's forward guidance on interest rates became state-dependent (inflation) and time-dependent (horizon). For example, on 10 March 2016, the ECB stated that it "expects the key ECB interest rates to remain at present or lower levels for an extended period of time, and well past the horizon of our net asset purchases" (Draghi, 2016). This statement links the future path of policy rates to the ECB's

APP, which, at that time, was "intended to run until the end of March 2017, or beyond, if necessary, and in any case until the Governing Council sees a sustained adjustment in the path of inflation consistent with its inflation aim" (Draghi, 2016).

When the Governing Council announced the end of QE on 14 June 2018, it also stated that it expected the key ECB policy rates to remain at their then present levels at least until the summer of 2019 and, in any case, for as long as necessary to ensure the sustained convergence of inflation to levels that are below, but close to, 2% (Hartmann & Smets, 2018). A similar statement was issued in September 2019:

> We now expect the key ECB interest rates to remain at their present or lower levels until we have seen the inflation outlook robustly converge to a level sufficiently close to, but below, 2% within our projection horizon, and such convergence has been consistently reflected in underlying inflation dynamics. (Draghi, 2019)

During the Covid-19 pandemic, forward guidance on asset purchases was calendar-based. For example, on 10 December 2020, the ECB announced that it would "increase the envelope of the pandemic emergency purchase programme (PEPP)" and extended the horizon of net purchases to "at least the end of March 2022" (Lagarde, 2020). Irrespective of how the economy develops, the ECB would thus continue to ease policy through this facility for 15 months (Orphanides, 2023).

At its meeting on 16 December 2021, the ECB's Governing Council decided to stop net asset purchases under the PEPP at the end of March 2022, but also announced that APP purchases would continue for much longer:

> The Governing Council decided on a monthly net purchase pace of €40 billion in the second quarter and €30 billion in the third quarter under the APP. From October 2022 onwards, the Governing Council will maintain net asset purchases under the APP at a monthly pace of €20 billion for as long as necessary to reinforce the accommodative impact of its policy rates. (Lagarde, 2021b)

3.2. Has the ECB Forward Guidance Worked?

According to the ECB Task Force on Forward Guidance (ECB, 2022a), the ECB's forward guidance was effective in that it steered markets in the intended direction (see also Goodhead, 2024) and raised inflation (and output). More specifically, the report concludes that an unexpected forward guidance announcement equivalent to a 10-basis-point decline in the one-year overnight indexed swap forward rate is estimated to have a median peak impact on real GDP of 0.17% and a cumulative impact on inflation of 0.1 percentage point, with impacts ranging from 0.1 to 0.2% for GDP and 0.08 to 0.17 percentage points for inflation.

Contrary to the conclusions of the ECB Task Force report (ECB, 2022a), not all empirical research suggests that the ECB's forward guidance has been effective. For example, Sutherland (2023) examines how private forecasters revise the level of their interest rate forecasts following a change in forward guidance. The analysis covers about 32 years of monetary policy statements from eight central banks (including the ECB). The author finds that forward guidance has had the largest influence on interest rate expectations in Canada, New Zealand, Sweden, and the United States, while forward guidance of other central banks, including the ECB and the Bank of England, has had less impact. The author argues that this is because these central banks were late adopters

of forward guidance and all of their guidance was done at or near the ELB, when it is less powerful (Cole et al., 2023).

Using micro data, D'Acunto et al. (2022) report that the ECB's forward guidance had a negligible impact on households' inflation expectations. These authors use data from the European Commission's harmonized consumer survey programme for Germany, France, the UK, and Sweden. As a counterfactual, the authors employ households in the UK and Sweden that were not directly exposed to the ECB's forward guidance announcements, as these countries are not part of the euro area. This muted effect on inflation expectations is consistent with the ambiguous signal of forward guidance discussed above. If the announcement is interpreted as bad news about future macroeconomic outcomes, expected inflation will fall. However, if the announcement is interpreted as a signal that in the future the central bank will deviate from its usual reaction function, expected inflation will rise. These effects may cancel each other out. Andrade and Ferroni (2021) find that the ECB's communication was initially interpreted as a signal about the future economic situation, but since 2012 it has been interpreted as a signal about future monetary policy.

3.3. The ECB Forward Guidance Trap

This section discusses how the ECB's forward guidance hampered its policy normalisation. According to Issing (2014, p. 8), a former member of the ECB's Executive Board, a "central bank should…under no circumstances make any unconditional commitments to its future policy." In other words, forward guidance should not be Odyssean. Yet, this is exactly what the ECB has done, linking forward guidance on lift-off to the end of its APPs (Orphanides, 2023). For instance, after the March 2022 Governing Council meeting, the ECB announced that "any adjustments to the key ECB interest rates will take place some time after the end of the Governing Council's net purchases under the APP and will be gradual" (ECB, 2022b).

And the ECB stuck to this "promise." Perhaps the ECB feared that reneging on the commitment that normalisation would only begin after the end of the APP would undermine its credibility with financial market participants. After all, credibility is defined by Blinder (1998, pp. 64–65) as "that your pronouncements are believed—even though you are bound by no rule and may have an incentive to renege." Nevertheless, with inflation rising rapidly to levels well above target, there were good reasons to change policy.

In June 2022, the ECB announced that:

> On the basis of our updated assessment, we decided to take further steps in normalising our monetary policy.…First, we decided to end net asset purchases under our asset purchase programme (APP) as of 1 July 2022. The Governing Council intends to continue reinvesting, in full, the principal payments from maturing securities purchased under the APP for an extended period of time past the date when it starts raising the key ECB interest rates and, in any case, for as long as necessary to maintain ample liquidity conditions and an appropriate monetary policy stance. Second, we undertook a careful review of the conditions which, according to our forward guidance, should be satisfied before we start raising the key ECB interest rates. As a result of this assessment, the Governing Council concluded that those conditions have been satisfied. Accordingly, and in line with our policy sequencing, we intend to raise the key ECB interest rates by 25 basis points at our July monetary policy meeting. (Lagarde, 2022)

It was not until July 2022, when inflation was already 8%, that the ECB key policy rates were increased by 50 basis points. The ECB also announced that it would no longer provide forward guidance on interest rate decisions, but would move to a meeting-by-meeting approach based on the information available at the time.

The decision not to raise interest rates until July 2022 has been criticized as inflation had already passed the 2% mark in July 2021 and rose sharply to 5% by the end of the year. In addition, the ECB continued to expand its balance sheet, long after the economy had recovered.

According to Orphanides (2023), two aspects of the ECB's forward guidance led to a significant delay in the policy response to the rise in inflation. First, the ECB's calendar-based forward guidance on asset purchase programmes, with a pre-announced schedule of net purchases, implied that asset purchases would continue and maturing bonds would be reinvested even when inflation was above target. Asset purchases under the PEPP continued until March 2022. It was not until July 2023 that the ECB stopped reinvesting assets purchased under the APP. Between March 2023 and July 2023, maturing assets were partially reinvested (the monthly decline of the APP portfolio amounted to 15 billion euros), while in the second half of 2024, the PEPP portfolio was supposed to be reduced by 7.5 billion euros per month. Second, "a commitment to raising policy rates only after net asset purchases ended—a 'sequencing' restriction that was an important component of the ECB's forward guidance" (Orphanides, 2023, p. 10). Indeed, according to a report in the *Financial Times* on 22 July 2022, two members of the ECB Governing Council believe that the ECB would have raised rates at least a month earlier if it had not been bound by its forward guidance that rates would not rise until it stopped buying more bonds in early July (Arnold, 2022). Although the ECB ended the APP earlier than previously announced, it did in fact stick to its sequencing approach.

Moreover, the ECB's forward guidance on normalisation relied on inflation forecasts. (This should not be interpreted as a structural flaw of forward guidance as such, since other types of forward guidance, such as qualitative forward guidance, do not rely on forecasts.) For example:

> The Governing Council expects the key ECB interest rates to remain at their present levels until it sees inflation reaching 2% well ahead of the end of its projection horizon and durably for the rest of the projection horizon, and it judges that realised progress in underlying inflation is sufficiently advanced to be consistent with inflation stabilising at 2% over the medium term. (ECB, 2022b)

This is a crucial part of the forward guidance trap that Orphanides (2023) ignores. As the inflation forecasts turned out to be wrong (see Table 1), lift-off was postponed.

Initially, inflation was expected to rise only temporarily and soon to return to levels below 2%. This explains why the ECB considered it necessary to continue the APP and not to raise policy rates. In her testimony to the European Parliament on 15 November 2021, Lagarde (2021a) stated:

> In our forward guidance we clearly articulated the three conditions that need to be satisfied before rates will start to rise. Despite the current inflation surge, the outlook for inflation over the medium term remains subdued, and thus these three conditions are very unlikely to be satisfied next year.

Although inflation forecasts were subsequently revised upwards, they remained too optimistic for a long time. To put the forecasts reported in Table 1 into perspective: Inflation in 2022 was 8.5% and 5.4% in 2023. To be fair, most private sector inflation forecasts in this period were also off the mark (Buiter & Rahbari, 2024). Several explanations for this poor forecasting have been proposed. Policymakers may have underestimated the impact of massive fiscal policy loosening (such as pandemic-related transfers to firms and households) and pent-up demand after the Covid-19 restrictions were eased. In addition to these demand shocks, the economy was hit by hard-to-predict supply shocks due to the pandemic (bottlenecks in supply chains) and then Russia's invasion of Ukraine. And these shocks were particularly large in 2020–2022. Note, however, that inflation was already well above target when the latter supply shock occurred.

Table 1. ECB inflation assessments and forecasts.

Meeting	Statement	Forecast				
		2021	2022	2023	2024	2025
July 2021	Inflation was 1.9 percent in June. We expect inflation to increase further over the coming months and to decline again next year.					
September 2021	Inflation increased to 3.0 percent in August. We expect inflation to rise further this autumn but to decline next year.	2.2	1.7	1.5		
October 2021	Inflation increased to 3.4 percent in September. We expect it to rise further this year. But while the current phase of higher inflation will last longer than originally expected, we expect inflation to decline in the course of next year.					
December 2021	Inflation increased further to 4.9 percent in November. It will remain above two percent for most of 2022. Inflation is expected to remain elevated in the near term, but we expect it to decline in the course of next year.	2.6	3.2	1.8	1.8	
February 2022	Inflation increased to 5.1 percent in January, from 5.0 percent in December 2021. It is likely to remain high in the near term. Energy prices continue to be the main reason for the elevated rate of inflation.					
March 2022	Inflation has continued to surprise on the upside because of unexpectedly high energy costs. Price rises have also become more broadly based. The Governing Council sees it as increasingly likely that inflation will stabilise at its two percent target over the medium term.		5.1	2.1	1.9	
April 2022	Inflation increased to 7.5 percent in March, from 5.9 percent in February. Energy prices were driven higher after the outbreak of the war and now stand 45 percent above their level one year ago. They continue to be the main reason for the high rate of inflation.					
June 2022	In May inflation again rose significantly, mainly because of surging energy and food prices, including due to the impact of the war. But inflation pressures have broadened and intensified, with prices for many goods and services increasing strongly. Eurosystem staff have revised their baseline inflation projections up significantly.		6.8	3.5	2.1	

Table 1. (Cont.) ECB inflation assessments and forecasts.

Meeting	Statement	Forecast				
		2021	2022	2023	2024	2025
July 2022	Inflation increased further to 8.6 percent in June. Surging energy prices were again the most important component of overall inflation. Market-based indicators suggest that global energy prices will stay high in the near term.					
September 2022	According to Eurostat's flash estimate, inflation reached 9.1 percent in August. Price pressures have continued to strengthen and broaden across the economy and inflation may rise further in the near term.		8.1	5.5	2.3	
December 2022	Inflation remains far too high and is projected to stay above our target for too long. Amid exceptional uncertainty, Eurosystem staff have significantly revised up their inflation projections.		8.4	6.3	3.4	2.3
February 2023	Price pressures remain strong, partly because high energy costs are spreading throughout the economy. Although supply bottlenecks are gradually easing, their delayed effects are still pushing up goods price inflation.					
March 2023	Inflation edged down to 8.5 percent in February. The decline resulted from a renewed sharp drop in energy prices. By contrast, food price inflation increased further, to 15.0 percent.			5.3	2.9	2.1
May 2023	Inflation is still being pushed up by the gradual pass-through of past energy cost increases and supply bottlenecks. In services, especially, it is still being pushed higher also by pent-up demand from the reopening of the economy and by rising wages.					
June 2023	Inflation has been coming down but is projected to remain too high for too long. Wage pressures, while partly reflecting one-off payments, are becoming an increasingly important source of inflation.			5.4	3.0	2.2
July 2023	The drivers of inflation are changing. External sources of inflation are easing. By contrast, domestic price pressures, including from rising wages and still robust profit margins, are becoming an increasingly important driver of inflation. While some measures are moving lower, underlying inflation remains high overall.					
September 2023	Most measures of underlying inflation are starting to fall as demand and supply have become more aligned and the contribution of past energy price increases is fading out. At the same time, domestic price pressures remain strong.			5.6	3.2	2.1
October 2023	Most measures of underlying inflation continue to decline. At the same time, domestic price pressures are still strong, reflecting also the growing importance of rising wages.					
December 2023	While inflation has dropped in recent months, it is likely to pick up again temporarily in the near term. Inflation is expected to decline gradually over the course of next year, before approaching our two percent target in 2025.			5.4	2.7	2.3

Table 1. (Cont.) ECB inflation assessments and forecasts.

Meeting	Statement	Forecast				
		2021	2022	2023	2024	2025
January 2024	Aside from an energy-related upward base effect on headline inflation, the declining trend in underlying inflation has continued.					
March 2024	Most measures of underlying inflation declined further in January. However, domestic price pressures are still elevated, in part owing to robust wage growth and falling labour productivity. At the same time, there are signs that growth in wages is starting to moderate.				2.3	2.0
April 2024	Inflation has continued to fall, led by lower food and goods price inflation. Most measures of underlying inflation are easing, wage growth is gradually moderating.					
June 2024	Since our meeting in September 2023, inflation has fallen by more than 2.5 percentage points and the inflation outlook has improved markedly. Underlying inflation has also eased, reinforcing the signs that price pressures have weakened, and inflation expectations have declined at all horizons.				2.5	2.2

Source: Author based on ECB website presenting press conferences of the ECB president following ECB Governing Council meetings (ECB, n.d.).

4. What Will Happen Now That Forward Guidance Is Gone?

4.1. The Impact of High Inflation on Trust in the ECB

Trust in the ECB has declined during the recent period of high inflation (Dreher, 2024). Lower public trust in the central bank may be problematic as evidence suggests that the inflation expectations of individuals who trust central banks tend to be closer to the central bank's inflation target (Binder, 2021; Brouwer & de Haan, 2022b; Christelis et al., 2020; Dreher, 2024; Rumler & Valderrama, 2020; van der Cruijsen & Samarina, 2021). To illustrate: Using the ECB's Consumer Expectations Survey for 2020–2021, van der Cruijsen and Samarina (2021) examine how trust in the ECB influences consumers' inflation expectations three years ahead to assess the anchoring of expectations around the ECB's inflation target. On average across the countries analysed, the mean expected inflation three years ahead was 3.3% and the median was 2%. Thus, at that time, consumers' median expected inflation was in line with the ECB's definition of price stability (i.e., inflation expectations were anchored). Nevertheless, there is heterogeneity among respondents. A person with complete trust in the ECB is 1.5 percentage points more likely to have inflation expectations between 1.5% and 2% than a person with absolutely no trust in the ECB. Anchored inflation expectations help the central bank to maintain price stability. As ECB Executive Board member Schnabel (2020) argues:

> Stable inflation expectations…ensure that short-term deviations in inflation from the ECB's medium-term target do not take hold in the price and wage decisions of companies and households. This mechanism can be self-reinforcing, as the achievement of our monetary policy mandate may in turn strengthen trust in the ECB.

However, the reverse mechanism also applies. Indeed, as pointed out by Carstens (2023), if society doubts the central bank's commitment to the objective of maintaining price stability, public trust can be lost quickly. That is indeed what has happened. As shown in the previous section, the ECB reacted too late to rapidly rising inflation. High inflation, in turn, has reduced trust in the ECB. The fact that the ECB's inflation projections underpredicted inflation substantially, and persistently so, has also damaged its reputation as an expert and knowledge-based institution (Ehrmann, 2024). Van der Cruijsen et al. (2025) show that the rise in inflation in 2022 had a very negative impact on trust in the ECB. Based on a survey of more than 2,000 individuals in the Netherlands, these authors find that the higher individuals' perceived inflation is and the harder it is for them to make ends meet, the lower their trust in the ECB. However, trust in the government and De Nederlandsche Bank (i.e., the Dutch central bank) also declined as a result of higher inflation (Figure 1). Interestingly, the authors also find that many respondents believe that the government is primarily responsible for maintaining price stability. More specifically: Respondents are more likely to see inflation control as a responsibility of the national government (over 70%), rather than the ECB (over 50%) or the national central bank (just under 40%). Finally, the results suggest that people have less trust in authorities that are seen as responsible for reducing inflation.

Two recent studies confirm the trust-reducing effects of high inflation. First, using Bundesbank survey data for Germany, Eickmeier and Petersen (2024) show that a one-standard-deviation increase in the importance households attach to the ECB's ability to maintain stable prices increases self-reported trust in the ECB by 0.4 units (on a scale from 0 to 10 that respondents could choose). This is consistent with the finding by Bergbauer et al. (2020) that Eurobarometer respondents' assessment of the state of the European economy has a consistently significant effect on trust in the ECB. Eickmeier and Petersen (2024) also report that higher inflation expectations reduce trust in the ECB. Similarly, using individual-level data from the European Commission's Eurobarometer survey, Guillochon and ter Ellen (2024) find that when inflation rises, people become more worried about inflation, which in turn leads to lower trust in the ECB. The authors also show that an important driver of whether people are concerned about inflation is the attention paid to inflation. When there is more media coverage of inflation and therefore households are more likely to pay attention to inflation, they are more concerned about inflation—over and above the effect of inflation itself.

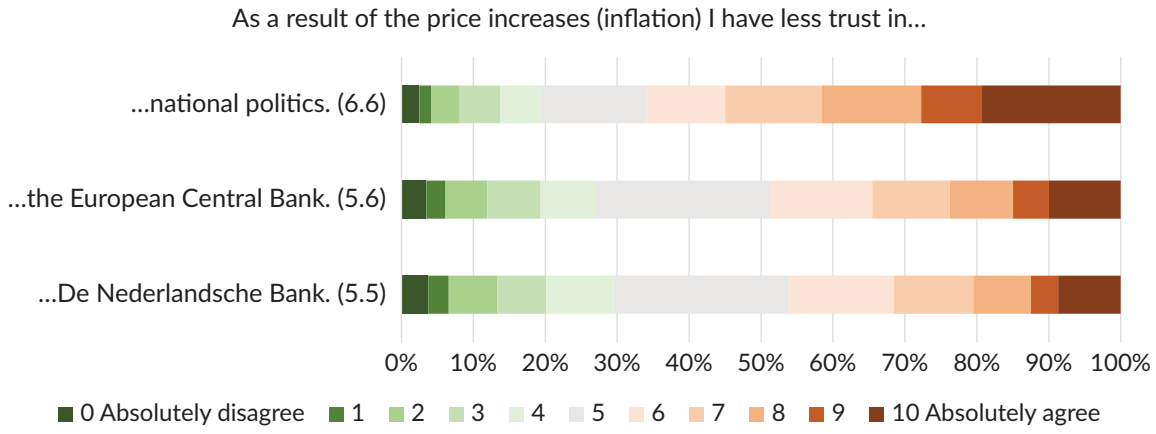

Figure 1. Inflation and trust. Note: Numbers in parentheses show the average scores to the statement. Source: van der Cruijsen et al. (2025).

The next subsections will discuss how communication under the new "meeting-by-meeting and data-dependent" approach works in financial markets and whether it is easier to understand and therefore has the potential to increase public trust.

4.2. Better Predictability Now That Forward Guidance Is Gone?

It seems that the new communication approach has changed the way how financial markets respond to ECB communication. Dragomirescu-Gaina et al. (2024) report evidence for a structural break in financial market reactions to ECB communication on 21 July 2022. Since the introduction of the "meeting-by-meeting and data-dependent" approach, media reports seem to play a more important role in determining financial market reactions to ECB Governing Council decisions.

A key question here is how well financial markets are able to predict central bank actions. Most economists agree with Poole (2001, p. 9) that "the presumption must be that market participants make more efficient decisions…when markets can correctly predict central bank actions."

The decision to cut interest rates by 25 basis points in June 2024 was widely expected, as several members of the ECB Governing Council had hinted at a cut. For example, in an interview with the Japanese financial newspaper *Nikkei*, Schnabel said that depending on the incoming data and Eurosystem staff projections, a rate cut in June might be appropriate. However, she also stressed that:

> The path beyond June is much more uncertain. Based on current data, a rate cut in July does not seem warranted. We should follow a cautious approach. After so many years of very high inflation and with inflation risks still being tilted to the upside, a front-loading of the easing process would come with a risk of easing prematurely. (Teles, 2024)

Thus, while it may not be forward guidance as in the past when the ECB's Governing Council gave statements about its future policies, under the current approach members of the ECB Governing Council give indications about future interest rate decisions. However, they make different public statements about future policy decisions. Whereas Schnabel said in the aforementioned interview that a rate cut in July was not needed, other members of the Governing Council gave different signals. For example, the governor of the Banque de France, Francois Villeroy de Galhau, argued in an interview in favour of maintaining flexibility with regard to ECB rate cuts in both June and July (Azzam, 2024).

This raises the question of whether such dispersed communication is conducive to helping financial markets better understand the ECB's Governing Council discussion and hence the stance of monetary policy, or whether it could be counterproductive. There are different views on this. According to Blinder (2007, p. 114), a "central bank that speaks with a cacophony of voices may, in effect, have no voice at all," while Bernanke (2004) argues that when central bankers express different views this "provides the public with useful information about the diversity of views and the balance of opinion on the Committee."

Most of the empirical evidence supports Blinder's (2007) view. For example, Ehrmann and Fratzscher (2007) find for three central banks (the Federal Reserve, the ECB, and the Bank of England) that a higher degree of dispersion in communication reduces the predictability of their policy decisions (as measured by the

difference between actual and expected decisions). Similarly, de Haan and Jansen (2010) find that dispersed communication by Governing Council members on the inflation outlook reduces the predictability of ECB policy, while inconsistencies in statements on the main refinancing rate and the economic growth outlook are not related to the absolute forecast error.

Another piece of evidence supporting Blinder's view comes from research on dissent in the ECB Governing Council. Although the voting behaviour of Governing Council members is not published, Tillmann (2021) constructs an index of dissent based on the ECB presidents' answers to journalists' questions during the press conference following each meeting. Tillmann finds evidence of dissent in 28% of all meetings, based on the information provided during the press conference. Importantly, the author reports that a monetary policy shock has a smaller effect on long-term interest rates when it comes from a meeting with dissent. Thus, dissent weakens the transmission of monetary policy impulses.

4.3. More Trust in the Absence of Forward Guidance?

There is considerable evidence that better knowledge about the central bank increases public trust (see Brouwer & de Haan, 2022a, for a discussion of the literature). If so, informing the general public about monetary policy may be a promising way to increase trust in the central bank, as long as communicating with the public *increases* their knowledge. However, according to Blinder et al. (2024, p. 452):

> There are severe limits on what communication with the broad public can reasonably be expected to achieve. No country will ever become a nation of monetary policy experts. Ordinary people have neither the time nor the energy for that; levels of financial/economic literacy are low and hard to raise; and the subject matter is complicated enough to strain the cognitive abilities of many. Citizens with so many other things on their minds cannot be expected to understand, for example, the nuances of forward guidance.

Perhaps communication under the current "meeting-by-meeting and data-dependent" approach is easier to digest by the general public than forward guidance. If so, it may increase public trust in the ECB.

Unfortunately, the recent literature on central bank communication and public trust does not provide strong support for this (de Haan & Hoogduin, 2024). Dräger and Nghiem (2023) present experimental evidence for a representative sample of German consumers, showing that providing information about inflation and monetary policy improves respondents' knowledge about monetary policy and inflation and increases their trust in the central bank. However, Brouwer and de Haan (2022a) find that providing information about how the ECB tries to achieve price stability has no effect on trust in the ECB. Hwang et al. (2023) even find that the number of speeches by ECB officials reduces public trust as measured by the Eurobarometer survey. Hayo and Méon (2024) report that showing German respondents a graph representing the ECB's inflation target alongside euro area inflation from 1999 to 2017 does not generally affect trust in the ECB, but providing this information does increase trust among respondents who state no preference for any political party.

In assessing this evidence, it is important to recognize that most of the research discussed above is based on experiments in which respondents are exposed to information about the ECB whereas they are highly unlikely

to receive this information in real life (Blinder et al., 2024). As several studies have shown, the general public is not well-informed about the ECB (Dräger & Nghiem, 2023) and there has been no improvement over time in how well-informed people are about the ECB (Brouwer & de Haan, 2022b). Even worse: They don't care much about being informed (van der Cruijsen et al., 2015).

5. Conclusions

Forward guidance can be very useful when policy rates cannot be lowered any further because the ELB has been reached. However, this way of communicating with financial markets also has some drawbacks. Adherence to forward guidance, combined with inflation forecasts that missed the mark for a long time, led the ECB to raise policy rates far too late and to continue asset purchases far too long. By the time policy rates were finally raised in July 2022, inflation was already well above target. The lesson to be learned, I think, is that in rapidly changing economic circumstances, Odysean forward guidance can be very dangerous, especially if that guidance is based on forecasts that may turn out to be off the mark.

This is not to say that all guidance on future policy should be avoided. In the past, the ECB has often used the phrase "upside" or "downside risks to price stability" to indicate that a change in policy rates was likely in the near future. In the June 2024 press conference, Lagarde used this terminology as well:

> Upside risks to inflation also stem from the heightened geopolitical tensions, which could push energy prices and freight costs higher in the near term and disrupt global trade. Moreover, extreme weather events, and the unfolding climate crisis more broadly, could drive up food prices. By contrast, inflation may surprise on the downside if monetary policy dampens demand more than expected, or if the economic environment in the rest of the world worsens unexpectedly. (Lagarde, 2024)

In my view, this type of communication, just like forward guidance, could help steer financial markets in the desired direction, although it is not helpful that ECB officials provide (contradictory) hints about future interest rate decisions.

Although this form of communication may be easier for the public to digest than forward guidance, it seems unlikely, based on the findings of recent literature, that it will increase trust in the ECB. Restoring trust is important because research has shown that people who trust the ECB have inflation expectations that are close to the ECB's inflation target. Anchored inflation expectations help the ECB to maintain price stability. When the ECB reacted too late to the recent rise in inflation, trust in the ECB fell. The best way to restore trust is probably to bring inflation back to target.

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Conflict of Interests

The author declares no conflict of interests.

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