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Advantages and disadvantages of forward guidance

A central bank uses forward guidance when it provides information about the future stance of its monetary policy, and in particular about the future path of its policy rates. Kevin Warsh, Chairman of the Federal Reserve, expressed his opposition to forward guidance in his speech of 28 August 2026 at the Jackson Hole Economic Policy Symposium. It is therefore useful to review the arguments for and against the use of forward guidance by the central bank, and to analyse the consequences of the Federal Reserve abandoning it.

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Advantages of the central bank's use of forward guidance

The Federal Reserve has used forward guidance since the early 2000s, and the ECB since July 2013. **What are the positive effects of forward guidance**?

1. Improved effectiveness of monetary policy

If a central bank uses forward guidance, it does not control only short-term rates: **it also controls rates out to the horizon of the guidance**. If it announces future interest rate cuts, for example, it brings intermediate-maturity rates down more sharply. The effect is symmetric when it announces rate increases. **Charts 1A and 1B** show **developments in interest rates in the United States since 2002 and in the euro zone since 2013**.

Chart 1A
United States: Federal funds rate and two-year rate (%)

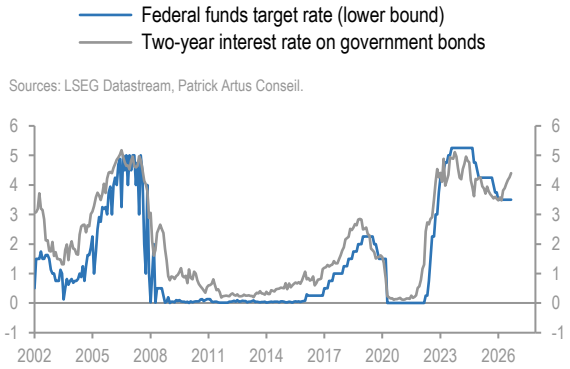
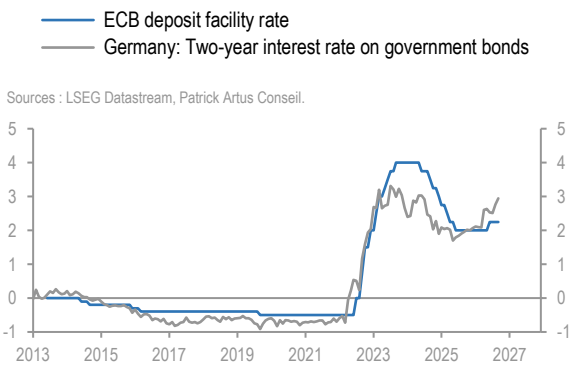


Chart 1B
Euro zone: ECB deposit facility rate and two-year rate (%)



They point to a pass-through of cuts or increases in short-term rates to 2-year rates:

- in the United States, between 2004 and 2006, from 2016 to 2019, from 2022 to 2024;
- in the euro zone, between 2013 and 2017, in 2022, from 2024 to 2025, in 2026. Mario Draghi's "whatever it takes" announcement (July 2012) also constitutes forward guidance, in so far as it led economic agents to expect a structurally more expansionary monetary policy.

2. Stronger response of investment to interest rate movements

Where the central bank uses forward guidance, this greater effectiveness of monetary policy applies in particular to **the response of business and housing investment to interest rate movements**. Since intermediate- and long-maturity rates are more sensitive to movements in short-maturity rates **when forward guidance is in place, monetary policy exerts closer control over business investment**. **Charts 2A, 2B and 2C** show short-term interest rates and investment in the United States since 2002 and in the euro zone since 2013.

Chart 2A
United States: Two-year interest rate and investment in volume terms

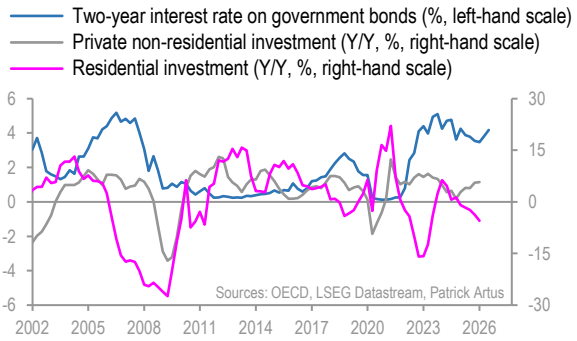


Chart 2B
Germany: Two-year interest rate and investment in volume terms

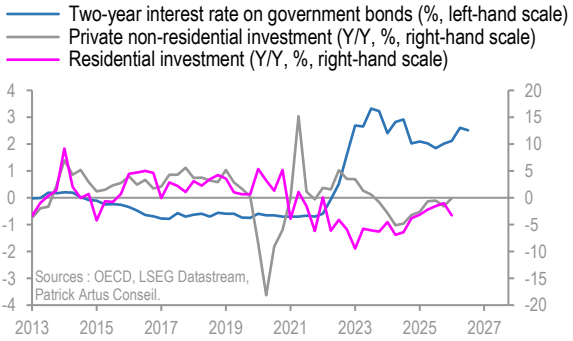
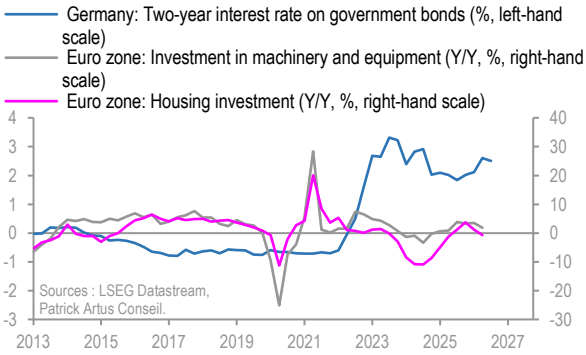


Chart 2C
Euro zone: Two-year interest rate and investment in volume



A marked negative correlation is apparent between short-term interest rates on the one hand, and business investment and housing investment on the other, with housing investment responding more rapidly than business investment.

Disadvantages of the central bank's use of forward guidance

1. Reduced ability of the central bank to respond to unanticipated shocks

Unanticipated shocks have multiplied: geopolitical shocks, commodity price shocks, domestic economic policy shocks, etc. Forward guidance reduces the central bank's ability to respond rapidly to shocks. For example, the use of forward guidance in 2021 and 2022 probably reduced the ability to respond to the inflationary shock caused by the exit from the Covid crisis and the outbreak of the war in Ukraine (**Charts 3A and 3B**). **The Federal Reserve and the ECB were particularly late in responding to the rise in headline and core inflation**.

Chart 3A
United States: Federal funds rate and inflation

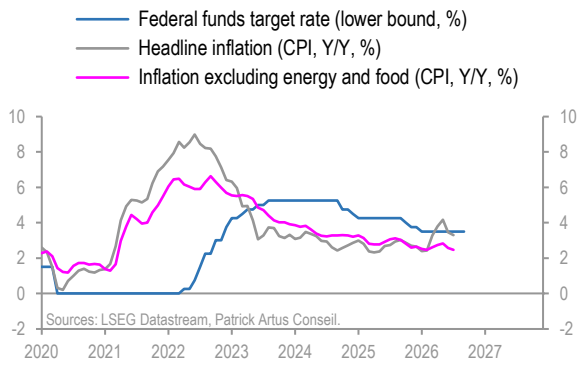
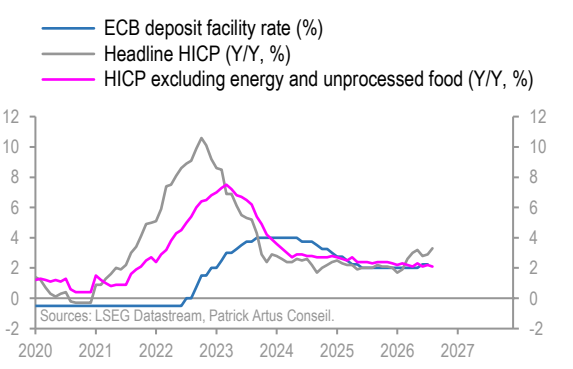


Chart 3B
Euro zone: ECB deposit facility rate and inflation



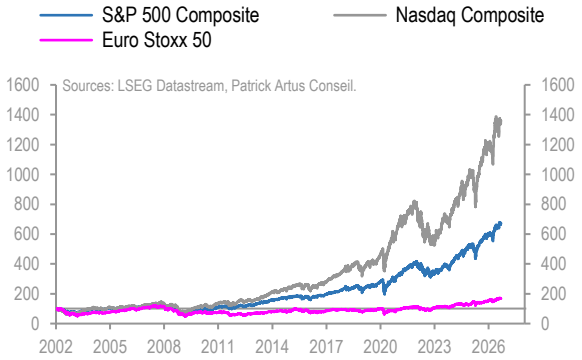
2. Impaired quality of the information conveyed by asset prices

Asset prices convey information: long-term interest rates about inflation expectations, and equity prices about corporate earnings expectations. This information is blurred if asset prices respond primarily to the future stance of monetary policy as it appears in central banks' forward guidance. The result is a mirror effect: the central bank observes asset prices in order to gauge the expected future path of the economy, while private economic agents rely on the information about the central bank's future policy to set asset prices.

3. Reduced uncertainty and asset price bubbles

If, for example, a central bank practising forward guidance announces a future cut in interest rates, the purchase of bonds or equities is perceived as risk-free: this is the mechanism known as the "Greenspan put". **The result is a rise in asset prices disconnected from fundamentals**. The mechanism works in the opposite direction when the central bank announces an increase in its interest rates. Forward guidance therefore fosters the emergence of asset price bubbles and, subsequently, their bursting. Swings in equity indices appear to have been larger since the introduction of forward guidance (**Chart 4**).

Chart 4
Stock market indices (1 January 2002 = 100)



Summary: what would be the effects of the Federal Reserve abandoning forward guidance?

The foregoing suggests that the Federal Reserve's abandonment of forward guidance is likely to lead to:

- **greater inertia in medium- and long-term interest rates in the United States** (the end of the pass-through generated by forward guidance);
- greater uncertainty about the future course of monetary policy, hence **a slowdown in investment and a decline in equity indices**; this decline could be substantial if the starting point today is a bubble sustained by the Federal Reserve;
- **greater variability of the real economy**, given heightened uncertainty about future interest rates and the end of the anchoring provided by forward guidance, and **lower variability of financial markets**, with the end of bubbles and of the risk of their bursting.

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