EXPECTATIONS OF MONETARY ANALYSTS AND FINANCIAL MARKET PARTICIPANTS ON THE ECB'S MONETARY POLICY RESPONSE

In the summer of 2022, amid growing price pressures, the ECB Governing Council started rapidly raising its key interest rates to bring inflation back to the 2 per cent medium-term target.
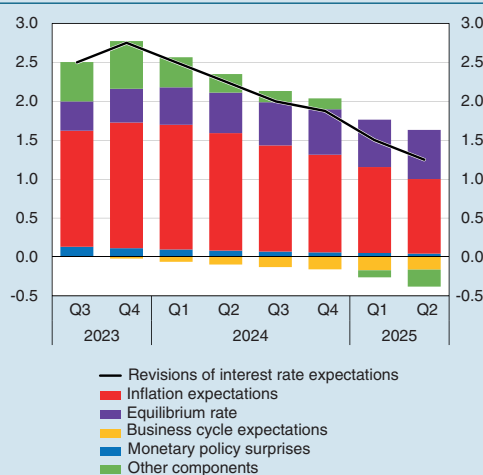
The findings of the ECB Survey of Monetary Analysts (SMA) suggest that expectations for the path of policy rates were revised considerably upwards in the following period, between July 2022 and September 2023. Taylor rule-based analyses for the time horizon between the third quarter of 2023 and the second quarter of 2025 show that these revisions were largely due to higher expectations for both inflation and, to a lesser extent, the equilibrium rate over the same horizon (Figure A).[1]

Policy rate expectations as implied by financial market data have also shifted significantly with the rise in inflation expectations. Evidence based on the changes in 1-year, 1-year ahead (1Y1Y)

Figure A

Analysts' expectations for the deposit facility rate: breakdown of revisions between July 2022 and September 2023 (1)
(percentage points)

Legend:
- Revisions of interest rate expectations
- Inflation expectations
- Equilibrium rate
- Business cycle expectations
- Monetary policy surprises
- Other components

Source: Based on ECB data.
(1) The figure shows the revisions to deposit facility rate (DFR) expectations (black line) for each quarter (x-axis) between the July 2022 and the September 2023 SMAs; the revisions are broken down into their key drivers: revisions of inflation expectations (red bar); revisions of the equilibrium rate (purple bar); revisions of business cycle expectations, as measured by unemployment rate expectations (yellow bar); monetary policy surprises (blue bar), which are defined as the difference between the DFR set by the ECB Governing Council and the DFR expected by the analysts surveyed ahead of the corresponding monetary policy meeting; other components (green bar). The Taylor rule used for the breakdown takes into account the inertial component of expected policy rates, the equilibrium rate, and expected deviations in inflation and in the business cycle from their long-term values (see M. Bernardini and A. Lin, 2024, op. cit.).

overnight indexed swap (OIS) rates and implied yields on inflation-linked swap (ILS) contracts suggests that the responsiveness of interest rate expectations to inflation expectations, as estimated using the Taylor rule, tripled during the initial phase of monetary normalization compared with the pre-pandemic period (Figure B).[2]

The responsiveness of interest rate expectations to inflation expectations was in turn influenced by the ECB's action. Amid high inflation expectations, larger-than-expected policy rate hikes are estimated to have increased the responsiveness of policy rate expectations to expected inflation (see panel (a) of Figure C). Conversely, in periods of low inflation expectations, monetary policy surprises

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[1]   M. Bernardini and A. Lin, 'Out of the ELB: expected ECB policy rates and the Taylor Rule', *Economics Letters*, 235, February 2024, also published in Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), 815, 2023.

[2]   V. Cuciniello, 'Market perceptions, monetary policy, and credibility', Banca d'Italia, Temi di Discussione (Working Papers), 1449, 2024.
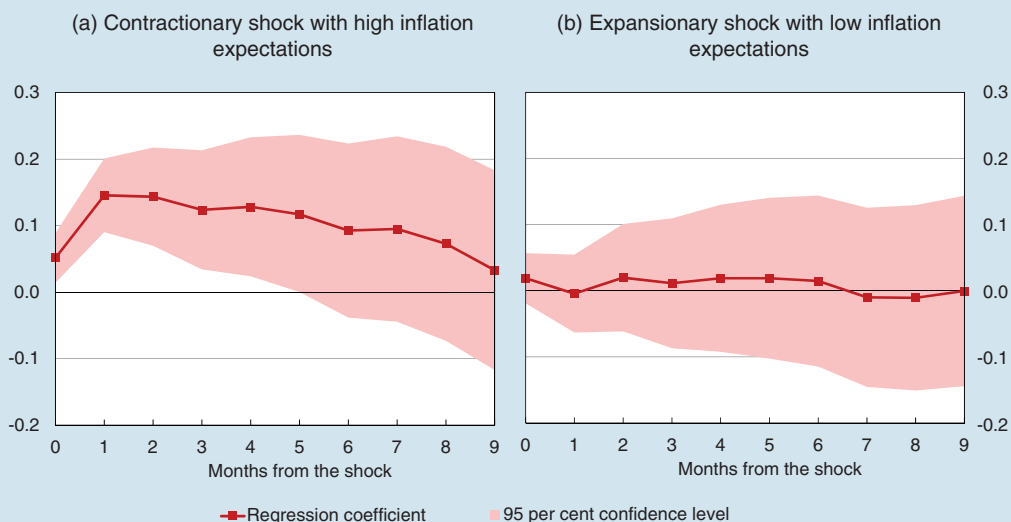
**Responsiveness of financial market participants' policy rate expectations
to inflation expectations for the 1Y1Y horizon** (1)
(monthly data; percentage points)

Regression coefficient — 95 per cent confidence level
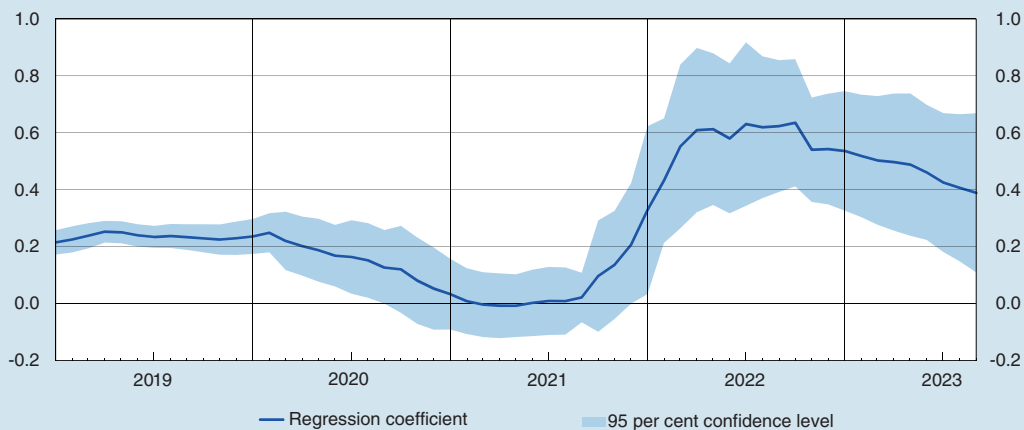
Sources: Based on Bloomberg, LSEG and Consensus Economics data.
(1) Elasticity of expected policy rates (as implied by 1Y1Y OIS contracts) to expected inflation (as measured by 1Y1Y ILS contracts), estimated on the dates of euro-area HICP inflation flash releases using 4-year rolling windows. The forward Taylor rule used to estimate elasticity takes into account the inertial component of expected policy rates (as measured by the 1Y OIS rate), long-term policy rate expectations (as implied by 1Y9Y OIS contracts) and the deviation of the expected annual growth rate of euro-area GDP one year ahead from the corresponding long-term expectation (see V. Cuciniello, 2024, op. cit.).

Figure C

**Effects of a 25-bps monetary policy shock on the responsiveness
of expected policy rates to expected inflation** (1)
(percentage points)

(a) Contractionary shock with high inflation expectations

(b) Expansionary shock with low inflation expectations

Regression coefficient — 95 per cent confidence level

Sources: Based on Bloomberg, LSEG and Consensus Economics data.
(1) The expected inflation response to the monetary policy shock is estimated using 2009-23 data. See V. Cuciniello, 2024, op. cit., for the methodology. The ECB's announcements convey information on its monetary policy stance (pure monetary policy) and are identified through opposite changes in interest rates (2Y OIS rates) and equity indices (Euro STOXX 50) within a narrow window of time, before the publication of the press release on monetary policy decisions and at the end of the press conference that follows the ECB Governing Council's meeting. Periods of high (low) inflation expectations are periods when the yields implied by 1Y1Y ILS contracts are above (below) 2 per cent.

do not appear to have altered market responsiveness (see panel (b) of Figure C), especially when interest rates were close to their effective lower bound.[3]

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[3]   Moreover, the pass-through from short- to long-term inflation expectations is estimated to be lower when expected policy rate responsiveness is higher, suggesting greater central bank credibility.