## DEPOSIT RATE LIFT-OFF, MARKETS AND THE ECB

**Markets have been pricing in an early lift-off of the ECB's deposit rate. The ECB argues that, considering its inflation outlook, this is not warranted. This difference in view could reflect a loss of central bank credibility. More likely is that market participants and the ECB disagree on the inflation outlook. Another explanation is that investors focus on the distribution of possible inflation outcomes and are concerned about the risks of inflation surprising to the upside.**

In the latest press conference following the ECB's governing council meeting, Christine Lagarde had to answer several questions about the rate lift-off, when the central bank would decide to hike its deposit rate. They were triggered by the observation that markets had been pricing in a rate hike towards the end of 2022. This seems quite early, judging by the ECB's inflation projections and its forward guidance. Central banks use policy rate forward guidance to steer market expectations. When growth is strong and inflation is accelerating, such guidance can reduce the risk of a premature rise in market rates that would weigh on the effectiveness of monetary transmission. In addition, by being clear on the conditions that could trigger a policy change, the market reaction should be small when the conditions are finally met. The governing council has recently set clear conditions –in terms of projected inflation and recent inflation developments- for an increase in its deposit rate. They are so strict that meeting them should take considerable time and, as explained by the ECB's president, clearly more so than anticipated by markets: "*our analysis does not support that the conditions of our forward guidance are satisfied, neither at the time expected by markets of lift-off or any time thereafter soon*.[1]" In theory, three factors could explain this difference between the ECB's message and market anticipations. One, a lack of central bank credibility. This explanation seems unlikely considering that survey-based inflation expectations remain well-anchored. Moreover, the ECB would have no interest at all in creating a surprise by suddenly changing its guidance or even dropping it altogether by raising the policy rate early, considering that this would cause a loss in credibility. Such a move would also be contradictory with the outcome of its strategy review, which led to the adoption of a symmetric inflation target of 2%, instead of the previous objective of 'close to but below 2%'. Two, market participants may disagree with the ECB on the inflation outlook.

Interestingly, the ECB Survey of monetary analysts[2] of October shows that half of the participants estimate that HICP inflation will reach at most 1.4% in Q4 2022 and 1.7% in Q4 2023. The distribution is quite narrow as three quarters of them forecast inflation to be below 1.6% in Q4 2022 and 1.8% in Q4 2023. On core inflation, the median estimate is 1.3% and 1.5% respectively, while 75% of the participants anticipate it to be lower than 1.6% and 1.7% respectively.

Given the ECB's forward guidance, this would not warrant an early rate hike, a point confirmed by the survey: the median estimate for the first hike of the deposit rate is June 2024 and only a quarter of the respondents have a lift-off date as early as December 2023. This is quite a bit later than market pricing, which suggests that the survey participants are different from those who take the investment decisions. Three, a more likely explanation of the divergence between the central bank's message and that from financial markets is that the distribution of possible outcomes plays a key role in market pricing whereas it is largely if not completely absent from forward guidance. The latter is about conditions that need to be met to envisage a rate hike whereas markets price the likelihood of moving from one state –the deposit rate stays at its current level- to another state, in which the deposit rate has been hiked. When inflation risks are considered to be biased to the upside, it shouldn't come as a surprise that markets price a lift-off that, at first glance, would come early. It also means that market pricing of lift-off can be interpreted as a measure of upside risks to inflation.

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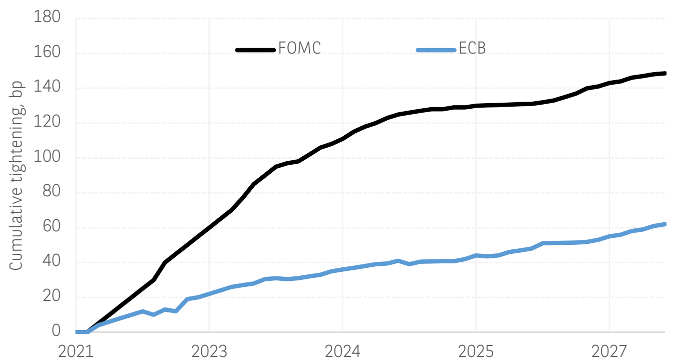
1. Monetary policy statement and press conference, Christine Lagarde, President of the ECB, Luis de Guindos, Vice-President of the ECB, Frankfurt am Main, 28 October 2021.
2. *"Survey respondents are selected from financial institutions participating in the ECB Market Contact Groups (i.e. the Money Market, Bond Market, and Foreign Exchange Contact Groups). Selection of survey respondents is based on the fulfilment of the following criteria: market relevance, geographic diversity, commitment to regular participation in subsequent rounds of the survey, and whether the institution is active in the field that is being surveyed."* Source: ECB, Survey of monetary analysts.

CUMULATIVE MONETARY POLICY TIGHTENING BASED ON FORWARD OIS




SOURCE: BNP PARIBAS

When inflation risks are considered to be biased to the upside, it shouldn't come as a surprise that markets start to price an early lift-off. It also means that market pricing of lift-off can be interpreted as a measure of upside risks to inflation.