On 13 December, the ECB Governing Council announced the end of net asset purchases at the close of 2018 and re-emphasised its reinvestment policy for instruments acquired under its asset purchase programme (APP). Specifically, the Council stated it envisages fully reinvesting the principal payments from maturing securities “for an extended period of time past the date when it starts raising the key ECB interest rates”. At the same meeting, the Council maintained its expectations that these rates would hold at their current levels “at least through the summer of 2019”, lengthening this term to “at least through the end of 2019” at its latest meeting on 7 March.[1]

Against this background it is worth analysing first, how market expectations about the future course of the ECB benchmark interest rate have recently behaved; and further, how the future path of rates currently expected by the markets compares with that observed in past episodes in which the ECB and the US Federal Reserve initiated cycles of interest rate rises.

As Chart 1 shows, market expectations about the future course of the ECB’s benchmark interest rate (the deposit facility rate), proxied by the EONIA[2] instantaneous forward curve, have been revised downwards notably in recent months. In October 2018 the markets were discounting 10 bp increases in interest rates in the following 12 months (see green curve in Chart 1), thereby pencilling in the first rise for October this year. However, they now envisage

1 See: Monetary policy decisions, ECB press releases of 13 December 2018 and of 7 March 2019. At its meeting on 7 March, the Governing Council also agreed on a new series of quarterly targeted longer-term refinancing operations (TLTRO-III).

2 EONIA (Euro Overnight Index Average) is the average overnight interbank interest rate in the euro area. Since 2009, the behaviour of the EONIA index has been very similar to that of the ECB’s deposit facility rate, which is currently the benchmark rate for euro area monetary policy. Also, it should be borne in mind that forward rates, especially for longer-dated horizons, may incorporate risk premia in addition to future expectations about interest rates.

Chart 1
LEVEL OF EXPECTED RATES IN THE EURO AREA WITHIN N MONTHS

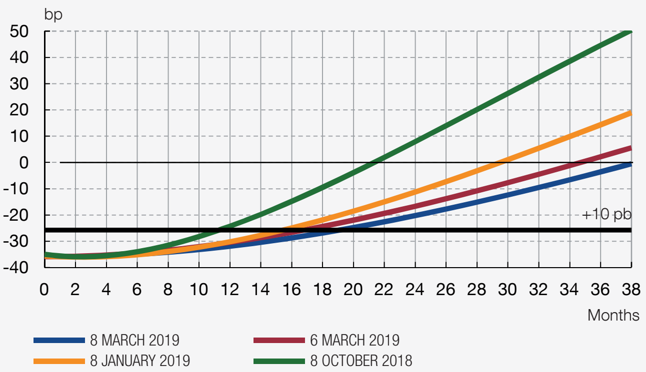


Chart 2
EXPECTED AND ACTUAL INCREASE IN EURO AREA RATES IN N MONTHS AS FROM THE FIRST RISE

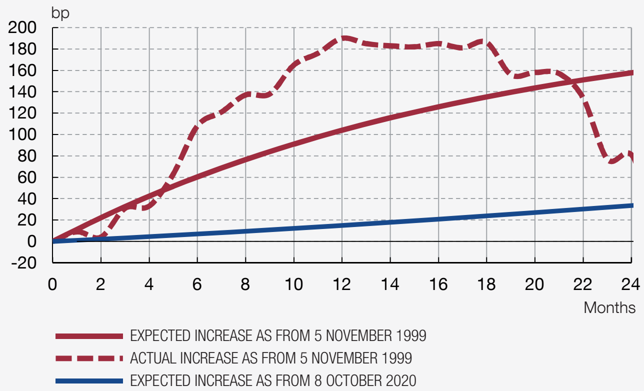


Chart 3
EXPECTED AND ACTUAL INCREASE IN EURO AREA RATES IN N MONTHS AS FROM THE FIRST RISE

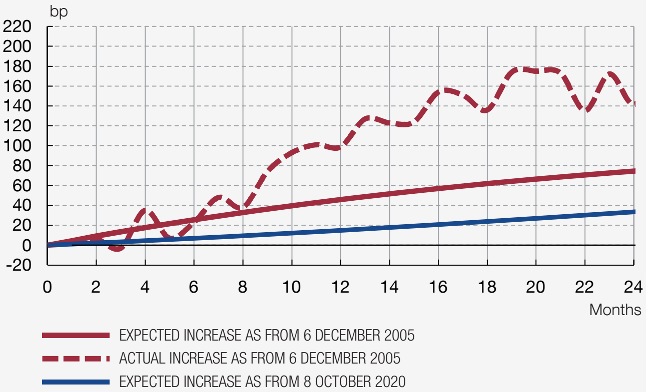
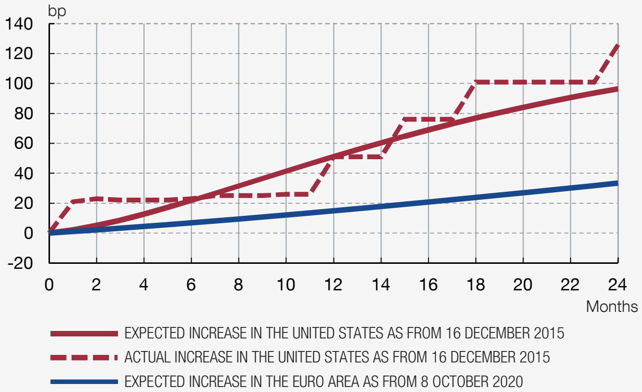


Chart 4
EXPECTED AND ACTUAL INCREASE IN RATES IN N MONTHS AS FROM THE FIRST RISE



SOURCES: ECB, Federal Reserve and Datastream.
NOTE: The data on expected rates are obtained calculating the instantaneous forward curve based on OIS (overnight index swaps). The actual interest rate is the EONIA index for the euro area and the Fed Funds Rate for the United States.

this rise taking place within 19 months (see blue curve in Chart 1), which means a delay until October 2020 (assuming that this first rise were to be one of 10 bp). Essentially behind this change has been the worsening outlook for global growth observed in late 2018, most markedly so for the euro area. But another factor has been the recent change in the minimum time horizon over which the ECB Governing Council expects to maintain its policy interest rates at current levels, announced on 7 March this year along with a downward revision of the growth and inflation projections for the euro area in the coming years. Following these announcements, the date foreseen by the markets for the first rise in rates was set back by three months compared with what the markets had anticipated just before learning of the measures adopted at the last ECB Governing Council (see the red and blue curves in Chart 1).

Beyond the delay in the start of the cycle of euro area policy interest rate rises, Chart 1 shows how market expectations about the intensity of any future process of rises in these interest rates may have been considerably modified in recent months. In particular, if in early October 2018 the EONIA instantaneous forward curve anticipated that the euro area benchmark interest rate would turn positive as from August 2020 (22 months later), the flattening of this curve in the recent period indicates that the market foresees interest rates not moving into positive territory before 2022 (within 38 months).

The high gradualism the markets expect of the future path of euro area interest rate rises is in contrast to the behaviour of these rates in the past two episodes in which the ECB initiated cycles of interest rate rises (1999 and 2005)[3]. It also runs counter to the expectations the markets had about future rises at the time of the first increase in rates in these episodes. Currently, the EONIA instantaneous forward curve is discounting a 34 bp increase in the euro area benchmark rate in the two years following the first rise (October 2020) (see the blue line in Charts 2 and 3). That is below the 158 bp and 75 bp increases the markets were anticipating at the time of the first rise in rates in the 1999 and 2005 tightening episodes, respectively (see the unbroken lines in red in Charts 2 and 3), and less than the respective rises of 85 bp and 141 bp actually observed (see the broken lines in red in Charts 2 and 3[4]).

Current euro area policy interest rate expectations are also in contrast to the intensity of the ongoing normalisation in the United States since the Federal Reserve raised its policy rates for the first time in this cycle in December 2015. Two years after this first rise, US benchmark rates rose by 126 bp, an increase very close to that expected by the markets in December 2015 (96 bp), but far above the current expectations in the euro area (see Chart 4). Yet in recent months the mounting signs of moderation in the US economy's growth rate has prompted the Federal Reserve to revise the path of interest rate normalisation.[5] Indeed, at present, the markets expect US policy rates to stand in the short and medium term below the levels they anticipated only a few months back.

In conclusion, the recent macroeconomic downturn and the announcement of the extension of the minimum time horizon over which the ECB expects to maintain its policy interest rates at current levels has prompted the markets to significantly put back the envisaged date of the start of interest rate rises in the euro area. Moreover, the markets currently anticipate that, following that first rise, the path of subsequent increases will be very gradual, both in historical terms and compared with movements in the United States from 2015 to late 2018. The downward revision in recent months in interest rate expectations shows that the ECB's forward guidance policy has been effective in steering financial market expectations, by making the future path of interest rates conditional upon the economic situation and the inflation outlook. This forward guidance should contribute to mitigating the scale of the slowdown in activity insofar as it promotes, through the adjustment of market expectations, easier financial conditions.

3 Moreover, the ECB increased its benchmark interest rate on two occasions in 2011, in March and in July. That said, this cycle of rises was interrupted in November that same year when the decision was taken to cut the interest rate once more.

4 In the charts, the EONIA instantaneous forward curve is normalised so that it commences with an interest rate equal to zero at three different points in time: the present (showing the curve 19 months ahead) and at the start of the ECB monetary policy tightening periods in 1999 and 2005. Significantly, both in 1999 and in 2005, the euro area benchmark interest rates corresponded to those on the main refinancing operations (MRO), the behaviour of which was in turn very similar to the EONIA.

5 At the press conference following the latest FOMC meeting in late January, at which it was decided to hold policy rates unchanged, the Fed chairman Jerome Powell warned of the need to be patient regarding changes in interest rate policy. This message remains valid, since the Fed chairman suggested in an interview on Sunday, 10 March, that he did not feel any hurry to change the current interest rate policy.