Perceptions about Monetary Policy - 2025

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Remarks based on Bauer, Pflueger, and Sunderam (2024a,b, 2025),

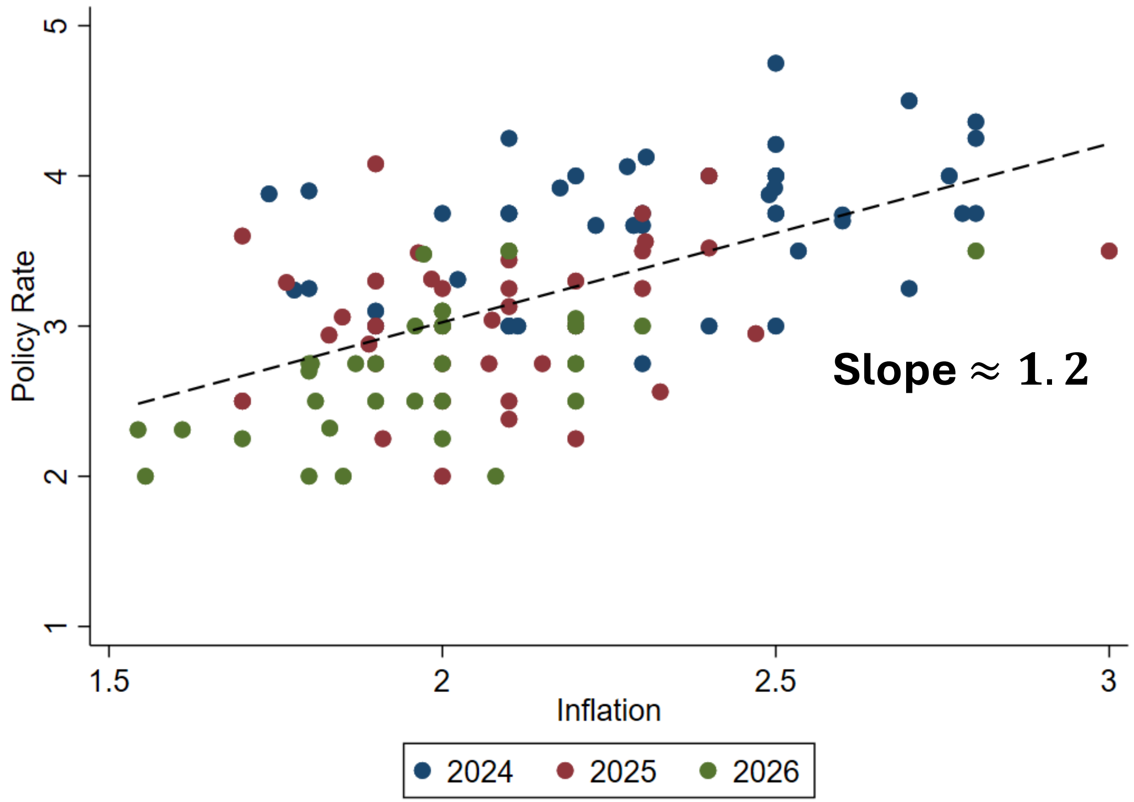
Campbell, Pflueger and Viceira (2020), Pflueger (2025), Pflueger and Yared (2025)

Perceptions and Monetary Policy

- **Well-perceived monetary framework crucial for credibility**
  - Accelerates transmission through financial markets
  - Bring down inflation at smaller economic cost (Clarida, Gali and Gertler (1999))
  - Interlinked with broader economic and policy environment, e.g. geopolitical safety
- **How did perceptions of ECB's inflation reaction change during recent inflationary episode and beyond?**
  1. Perceived inflation reaction in survey data rose substantially, but only *after* liftoff in July 2022
  2. High-frequency market responses to inflation news also rose, remained strong through 2025
  3. Inflation bond-stock betas turned positive with higher perceived monetary inflation reaction
- **Implications for monetary policy communication**
  - Good monetary policy actions are good communication: Markets/forecasters perceive higher inflation response after observing interest rate hike in times of high inflation and vice versa
  - Quantitative data on expectations useful

Perceived inflation reaction from raw survey data

ECB Survey of Professional Forecasters 2024.Q1

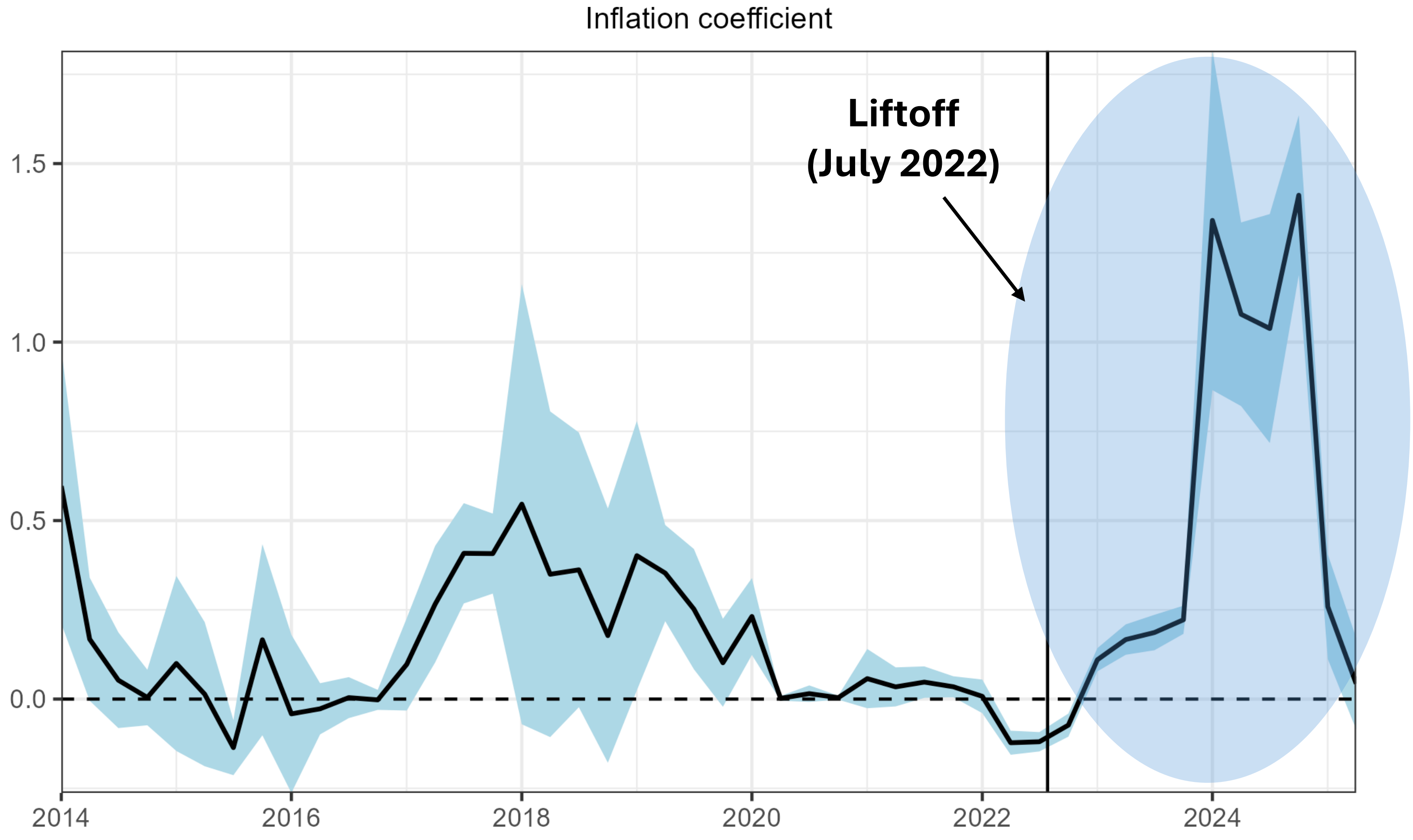


- Each dot = forecaster-horizon combination, 2024.Q1 survey wave
- Example:

Inflation forecast	Rate forecast
1.5%	2.4%
2.5%	3.6%

Based on Bauer, Pflueger, and Sunderam (2024a,b, 2025)

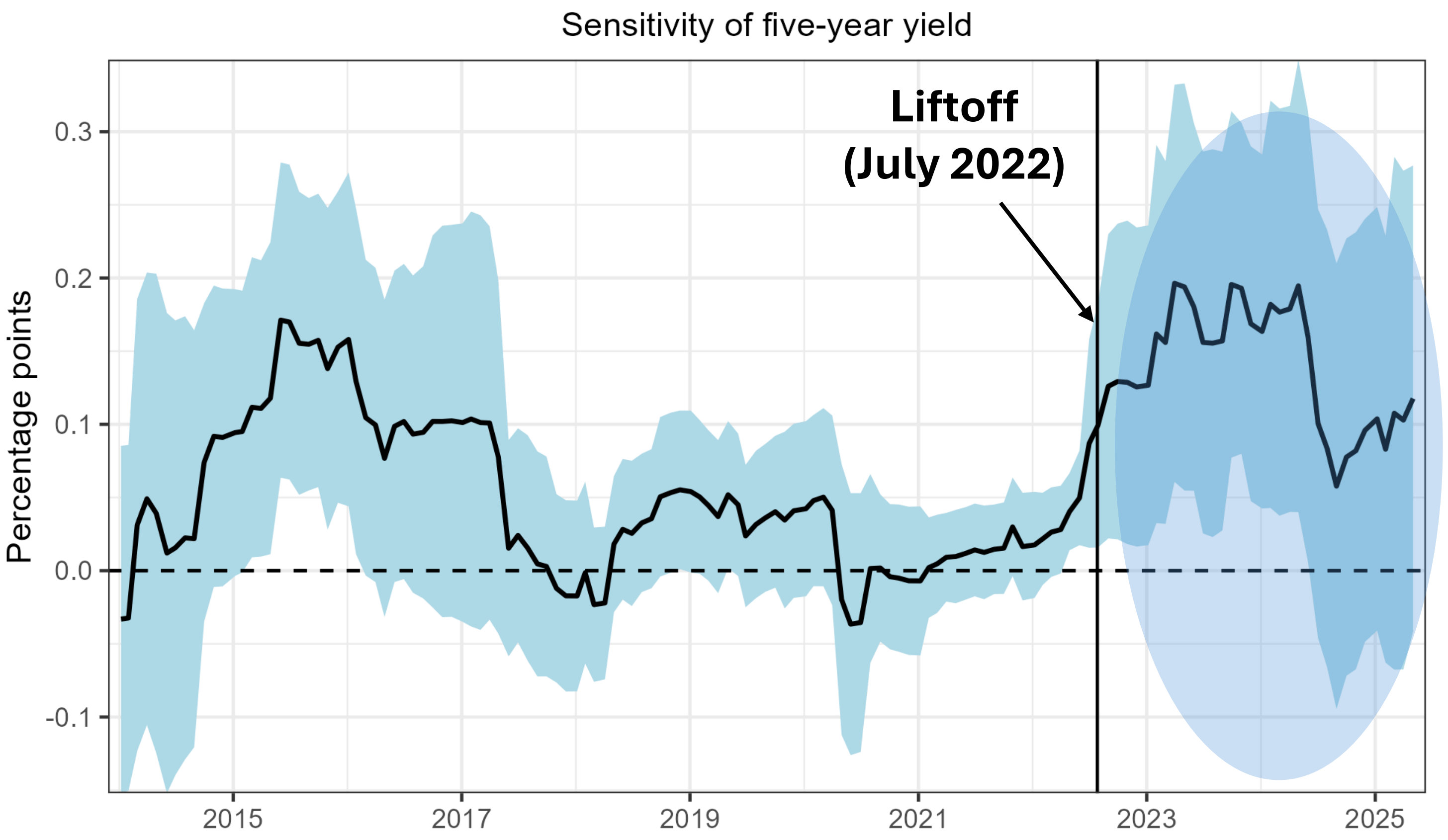
Result 1: Perceived inflation reaction rose after liftoff



$E_t^{(j)} i_{t+h} = \hat{\boldsymbol{\beta}}_t E_t^{(j)} \pi_{t+h} + \hat{\gamma}_t E_t^{(j)} x_{t+h} + e_{th}^{(j)}$ $\quad i_t$ =policy rate, π_t=inflation, x_t =output gap, h =forecast horizon, j =forecaster

Based on Bauer, Pflueger, and Sunderam (2024a,b, 2025)

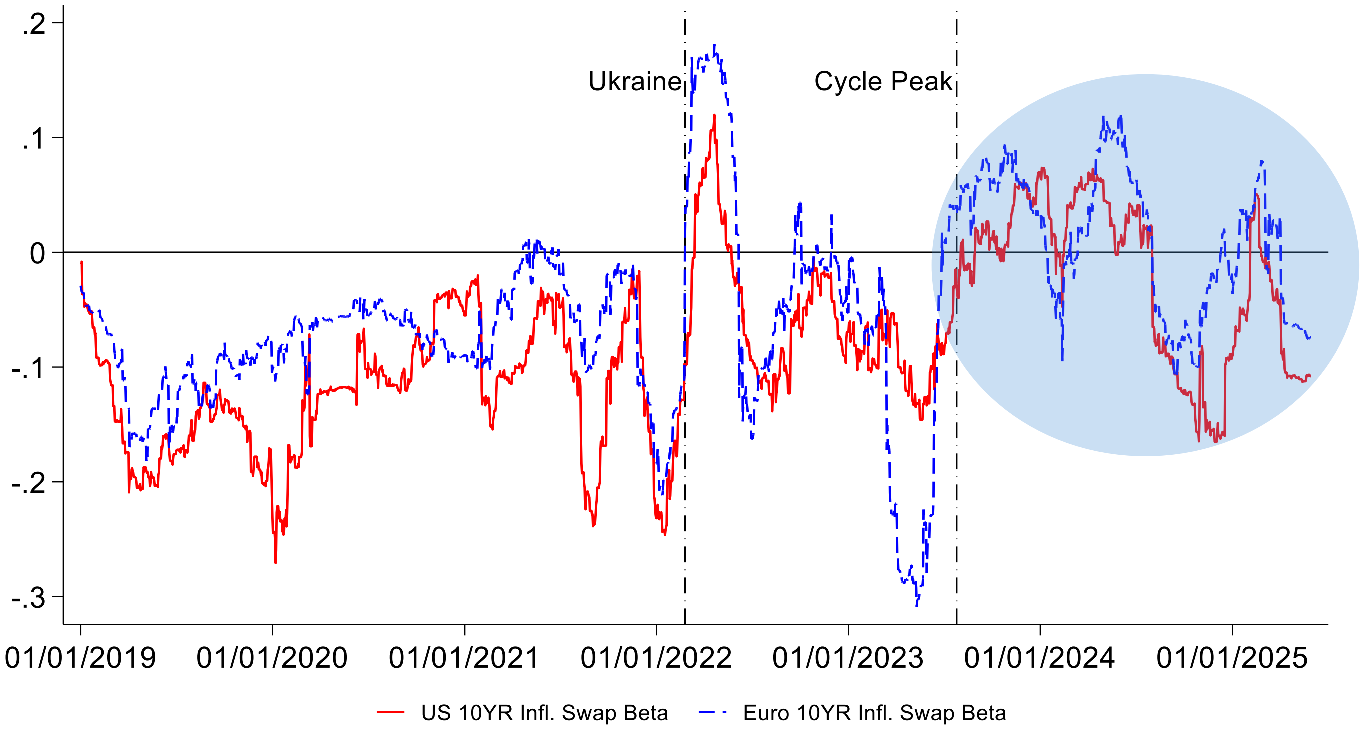
Result 2: High-frequency bond yield response to inflation surprises also increased



- High-frequency 5-year bond yield response to inflation surprises
  $$\Delta y_t = \alpha + \theta s_t + \varepsilon_t$$
- Each observation=core CPI announcement, 24-month rolling regressions
- **Perceived long-term inflation reaction remains strong**

Based on Bauer, Pflueger, and Sunderam (2024a,b, 2025)

Result 3: Bond-stock comovements rose with perceived monetary policy inflation reaction



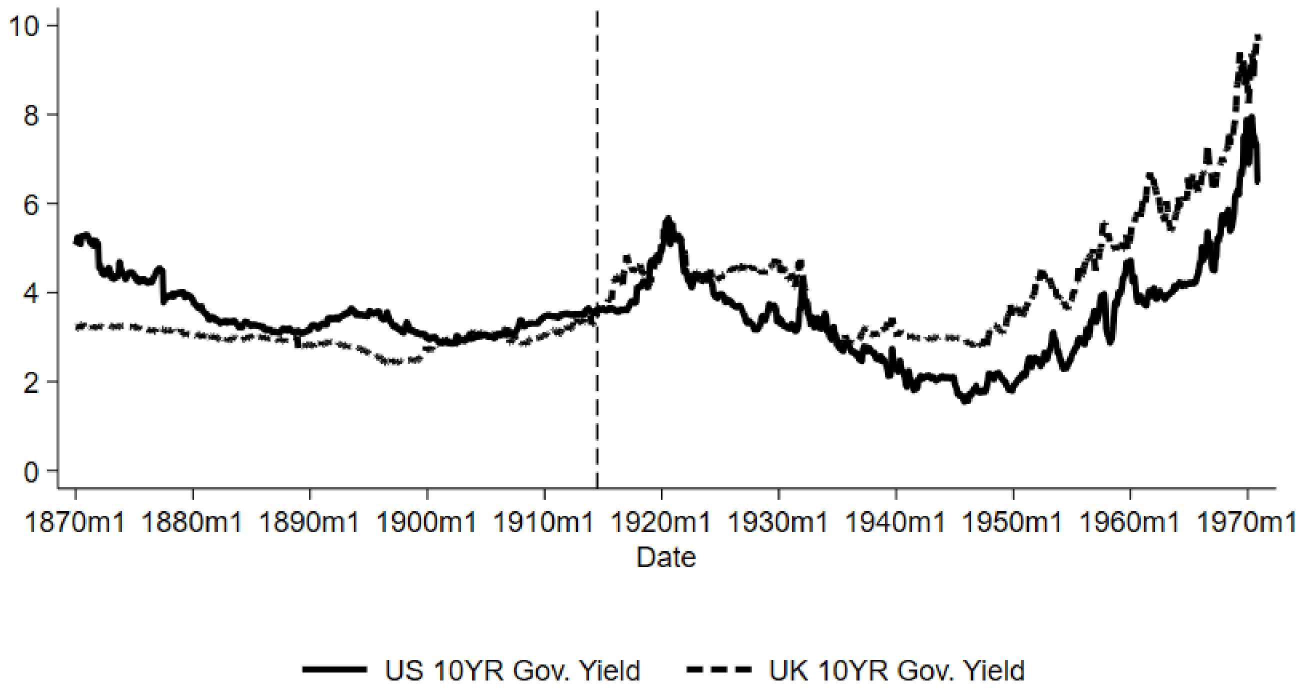
- Inflation swaps to isolate bond inflation component
- $\beta(r^{inflswap}, r^{stocks})$ over 90-day rolling windows
- Daily $r^{inflswap} \propto -\Delta$ 10-year inflation swaps

- Inflation component of bond-stock betas increased in fall 2023 ("Back to the 1980s"?)
- Shorter-term peak around Ukraine invasion
- Monetary policy chooses point on inflation-output tradeoff when supply shocks present
- **Bond-stock comovements support increased inflation reaction**

Based on Campbell, Pflueger and Viceira (2020), Pflueger (2025)

Credibility matters for broader environment: Geopolitics

U.S./U.K. borrowing costs switched around WWI/WWI



- Historically, low borrowing costs have gone along with "hard power"
  - e.g. switch from U.K. "exorbitant privilege" to U.S. around WWI/WWII
- **Two-way virtuous cycle between geopolitical safety, low borrowing rates, and ability to invest in military**

Based Pflueger and Yared (2025)

Conclusion and Outlook

- Perceptions matter for transmission to financial markets, inflation-output tradeoff and broader economy (e.g. geopolitical safety)
- ECB's perceived inflation reaction rose *after* lift-off from ZLB in July 2022
- Longer-term perceived inflation response remains strong
- Good monetary policy actions are good communication (inflation-dependent easings)
- Quantitative information about monetary policy reaction function likely to be useful (connect-the-dots, scenarios…)

References

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