

ECOWEEK

No. 19-25, 21 June 2019

Central banks: synchronised swimming against the tide

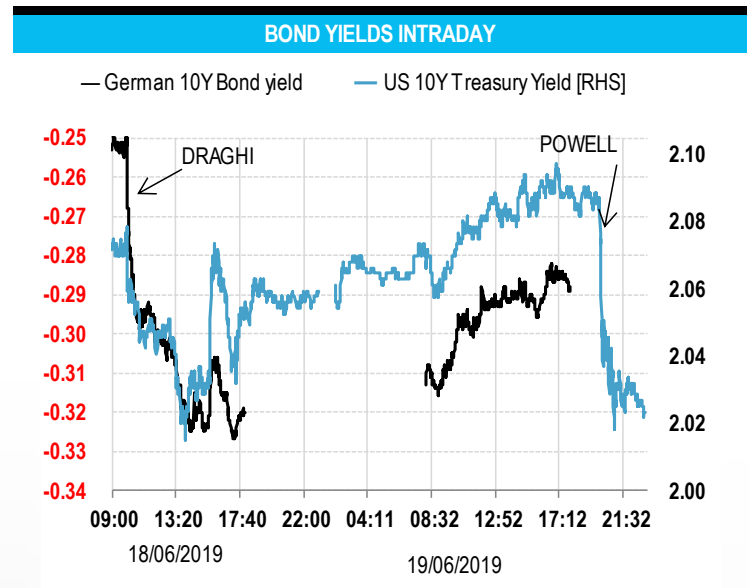
■ ECB President Mario Draghi, speaking at Sintra, has raised expectations of renewed policy easing ■ The message from the FOMC meeting is that rate cuts are coming ■ This policy synchronisation reflects shared issues (inflation too low versus target) and shared concerns, the major being rising uncertainty ■ Should this continue, the effectiveness of monetary accommodation will suffer.

One single striking statement is like a one-off event, two may be the start of a tradition. At the ECB's annual gathering in Sintra (Portugal), Mario Draghi created a surprise in 2017 by stating that as *"the economy continues to recover, a constant policy stance will become more accommodative, and the central bank can accompany the recovery by adjusting the parameters of its policy instruments – not in order to tighten the policy stance, but to keep it broadly unchanged."*

His speech this week was again headline-grabbing by evoking in not to be mistaken words the likelihood of more policy easing. *"The risk outlook remains tilted to the downside, and indicators for the coming quarters point to lingering softness... In the absence of improvement, such that the sustained return of inflation to our aim is threatened, additional stimulus will be required."* The policy implications will be discussed in the Governing Council in the coming weeks, which suggests that more accommodation can come sooner rather than later. In terms of toolkit, he mentioned forward guidance can be adjusted in terms of bias and conditionality. This means that the ECB could state that rates will stay at the current level or lower until a date which stretches further into the future. Additional interest rate cuts are possible with *"mitigating measures to contain any side effects remain part of our tools"* (this hints at a tiering of the deposit rate)ⁱⁱⁱ.

The most important sentence of the speech was that *"the Treaty requires that our actions are both necessary and proportionate to fulfil our mandate and achieve our objective, which implies that the limits we establish on our tools are specific to the contingencies we face."* To put it differently, the limits of the asset purchase programme will be adapted in line with the urgency of the situation. As shown in the charts, Bund yields dropped and pulled along US treasury yields, European equity prices increased, the euro weakened and the 5 year in 5 year inflation swap increased as well, which means slightly higher inflation expectations and/or inflation risk premium. This comes as a relief given its significant decline in recent weeks.

One interpretation why the ECB President went much further than during his press conference two weeks earlier is that the tone at the Fed's meeting the following day was expected to shift. A more dovish message from the ECB could pre-empt an appreciation of the euro if the Fed would hint at policy easing^{iv}.



Source: Bloomberg, BNP Paribas

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ECONOMIC RESEARCH DEPARTMENT



BNP PARIBAS

The bank
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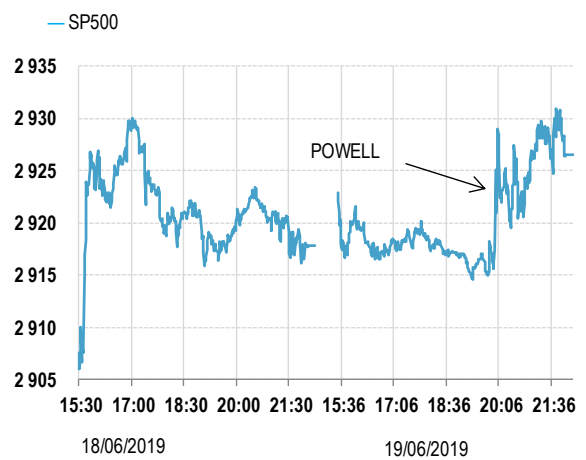
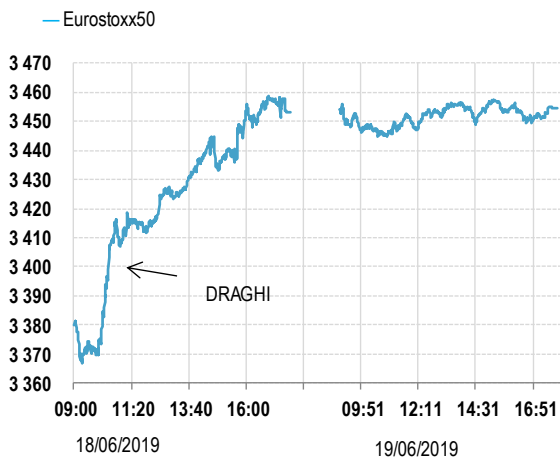
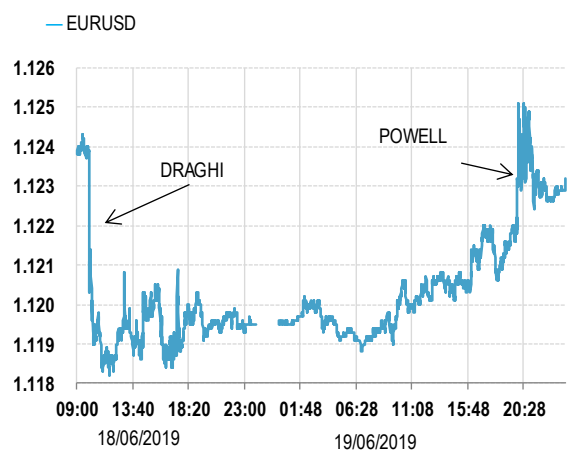
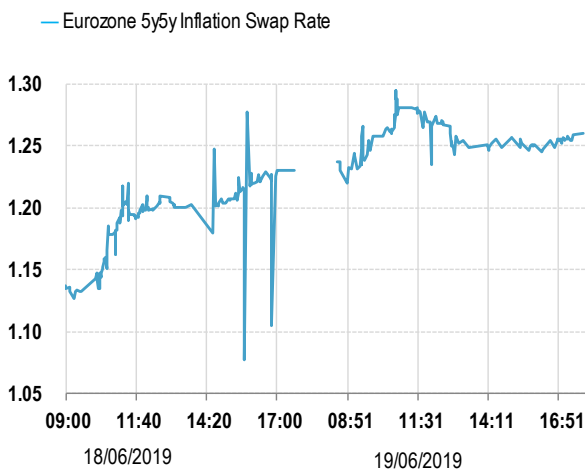
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Whether that reading is right is not clear but there is no doubt that currency markets are very sensitive to the relative monetary policy stance. After all, following the FOMC meeting outcome and Chairman Powell's press conference, the EUR/USD exchange rate even spiked above the level seen before Mario Draghi's speech. The rationale underpinning the Fed's change in tone^v reflects increased downside risk based on cross-currents, weaker business sentiment as well as a softening investment picture. Moreover, the move of inflation to target

is slowing and concern about a more sustained inflation shortfall is increasing. The issues are very much similar to those confronting the eurozone. The synchronised nature of the messages of more monetary accommodation should be welcomed: what's good for the eurozone should be good for the US and vice versa. Yet, there is an impression of swimming against a powerful tide of uncertainty. It is perhaps for this reason that the reaction of the S&P500 to Powell's comments was very much subdued.

William De Vijlder

INTRADAY MARKET EVOLUTION (PARIS TIME)



Source: Bloomberg, BNP Paribas

ⁱ ECB, *Accompanying the economic recovery*, Introductory speech by Mario Draghi at the ECB Forum on Central Banking, Sintra, 27 June 2017

ⁱⁱ ECB, *Twenty Years of the ECB's monetary policy*, Speech by Mario Draghi, President of the ECB, ECB Forum on Central Banking, Sintra, 18 June 2019

ⁱⁱⁱ Under a tiered system, different rates would apply for excess reserves deposited by banks with the central bank. Part of the reserves could even be exempted.

^{iv} Although the euro is not a policy objective, it is a key component of financial and monetary conditions. After all, Mario Draghi did say at Sintra that *"the euro area is a relatively open economy... this means that the impact of negative rates on inflation and financing conditions via the exchange rate is more powerful [than in the US]."* In a slowing eurozone economy, a significantly stronger currency would be most unhelpful.

^v This change is reflected in the downward adjustment of the federal funds rate projection (the "dots") for next year (from 2.6% to 2.1%), which now points towards policy easing, as well as comments from the Chairman during his press conference that many FOMC members consider the case for more accommodative policy has strengthened and that "8 members wrote down rate cuts".

