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Fed and ECB: diverging approaches to monetary policy

■ The Federal Reserve and the ECB are in very different positions: the former has more room to ease policy and it is also closer to its policy targets. The ECB has limited remaining policy leeway but is confronted with an inflation shortfall versus its aim and a risk that this gap would increase, rather than narrow ■ These differences have led to diverging approaches in the conduct of and communication about monetary policy. The Fed is data-dependent and, except for the projections of the FOMC members, offers no guidance. The ECB is agnostic about the data and builds its communication around state-dependent forward guidance: policy tightening will be solely conditioned by meeting its target ■ The ECB stance reduces the sensitivity of financial markets to data surprises whereas the Fed stance increases it. This implies a risk of higher volatility in the US but also, via international spillovers, abroad.

The recent decisions by the ECB and the Federal Reserve have certain points in common. Both central banks decided to ease and in both cases there were dissenters[i]. In assessing the economic outlook, both emphasized the international environment. The downward revision by the ECB staff of the 2020 projection for real GDP growth is to a large degree driven by a more subdued picture for export growth. The FOMC press release mentioned that the decision to ease was taken "*in light of the implications of global developments for the economic outlook as well as muted inflation pressures*". Inflation obviously also appeared in the introductory statement to Mario Draghi's press conference, which mentions "*the continued shortfall of inflation with respect to our aim*" as the trigger for the decision to increase the degree of monetary accommodation. Yet, there are also important differences: the median projections of the FOMC members for 2020 for growth and inflation have remained stable compared to the June release, whereas the new ECB staff projections see slower growth and lower inflation next year. Another obvious difference is the current level of growth, inflation and the policy rate. All three are higher in the US. These differences have led to an important divergence in the conduct of and communication about monetary policy.

As shown on the next page, theoretically different types of policy can be considered: interest rate decisions which are agnostic with respect to economic data in the short run, data-dependent decisions, state-dependent or calendar-based forward guidance[ii]. The choice will to a large degree depend on the available leeway (is there a lot of room to cut if need be?) and the distance to the target (in case of inflation targeting, what is the gap between observed inflation and the objective of the central bank?).

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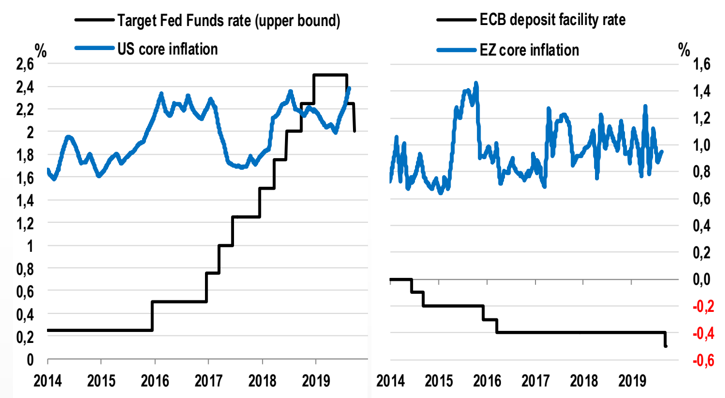
CORE INFLATION AND POLICY RATE



Source: Federal Reserve, ECB, Datastream, BNP Paribas

Consider an economy which is entering a recession with rather high interest rates and inflation dropping below target. In that case, interest rates will be cut swiftly and the central bank will be agnostic to the dataflow, at least until it sees that the policy easing is starting to have its intended effect on growth and inflation.

As growth picks up, markets will start to anticipate a phase of policy normalisation. This may cause a premature tightening of financial conditions (rising bond yields). Calendar-based forward guidance will be used to get a grip on the yield curve. When the target variable is close to the aim, the monetary authority will probably be very data-focused, irrespective of whether policy leeway is considerable or limited: a sequence of strong or weak data can push the target variable beyond the objective or pull it away from it. This is the situation the Federal Reserve is currently in: growth is still satisfactory, although there are downside risks, and inflation is muted, although it is not too low. The ECB on the other hand is confronted with limited leeway (the deposit rate is already very negative and there are market concerns about limits on how much it can buy in the context of QE), whilst inflation is well below target and is very likely to stay there, at least in the short run. State-dependent forward guidance then almost becomes a strategy of last resort. It pushes the timing of the first rate hike far out into the future and it creates an expectation that asset purchases will be conducted for a considerable period of time, considering that the ECB has stated that they will end shortly before it starts raising rates. In doing so, this creates visibility about financing conditions far into the future, which should support credit demand and spending.

Using this framework, it is clear that the Federal Reserve and the ECB are in very different positions and hence adopt very different approaches. The Fed has declared it is data-dependent, so there is basically no guidance (except for the projections of the FOMC members). The ECB on the other hand is data-independent: the policy is entirely built around forward guidance with the gap between observed and target inflation being the key factor. This policy should reduce the sensitivity of eurozone financial markets to data surprises because data will not influence the policy stance as long as inflation is too low versus the central bank's aim. In the US on the other hand, data-dependent policy should increase the sensitivity of market prices to news, leading to higher volatility. It is to be expected that this in turn will have international spillover effects, via currency, bond and equity markets.

William De Vijlder

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[i] In the case of the ECB, there was disagreement about resuming the asset purchase program. In the case of the FOMC, some members opposed the rate cut and another member advocated lowering the policy more aggressively.

[ii] Under state-dependent forward guidance, the central bank commits to stick to the current policy until its inflation target is reached or until key variables (e.g. the unemployment rate) reach a certain level. Under calendar-based forward guidance, it commits to maintain its current policy at least until a certain date.

FED VS ECB: TWO APPROACHES TO MONETARY POLICY