ECOWEEK

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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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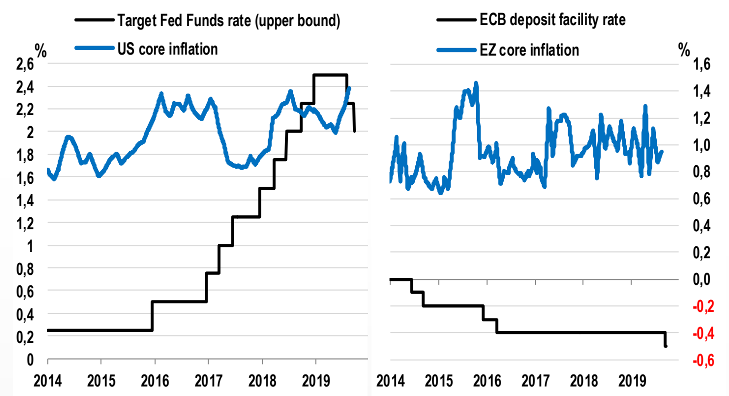
CORE INFLATION AND POLICY RATE



Source: Federal Reserve, ECB, Datastream, BNP Paribas

Eco WEEK

ECONOMIC RESEARCH DEPARTMENT

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.

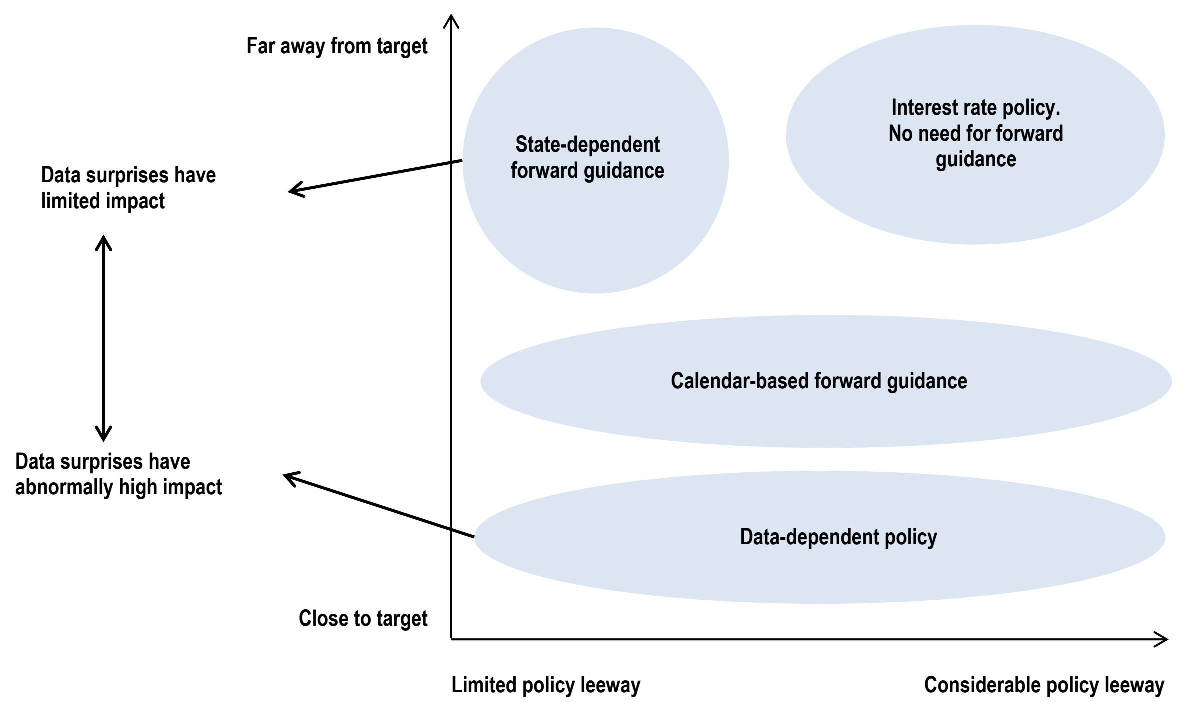
As growth picks up, markets will start to anticipate a phase of policy normalisation. This may cause a premature tightening of financial conditions (rising bond yields). Calendar-based forward guidance will be used to get a grip on the yield curve. When the target variable is close to the aim, the monetary 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

[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



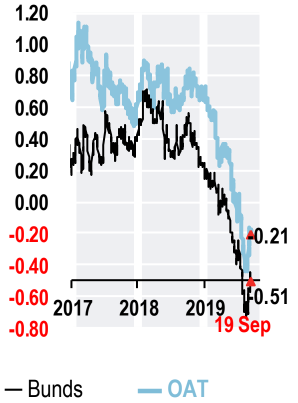
Markets overview

The essentials

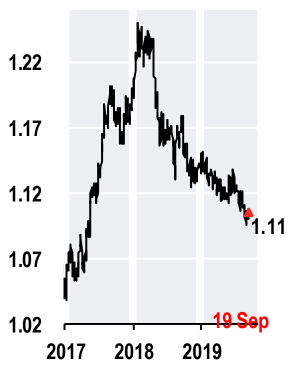
Week 13-9 19 > 19-9-19

↗	**CAC 40**	5 655	▶	**5 659**	**+0.1**	%
↘	**S&P 500**	3 007	▶	**3 007**	**-0.0**	%
↗	Volatility (VIX)	13.7	▶	14.1	+0.3	pb
↗	**Euribor 3M (%)**	-0.40	▶	**-0.40**	**+0.4**	bp
↗	Libor $ 3M (%)	2.14	▶	2.16	+1.6	bp
↘	OAT 10y (%)	-0.17	▶	-0.21	-4.1	bp
↘	Bund 10y (%)	-0.45	▶	-0.51	-5.2	bp
↘	US Tr. 10y (%)	1.90	▶	1.77	-12.6	bp
↘	**Euro vs dollar**	1.11	▶	**1.11**	**-0.2**	%
↗	Gold (ounce, $)	1 493	▶	1 500	+0.5	%
↗	**Oil (Brent, $)**	60.3	▶	**64.5**	**+6.8**	%

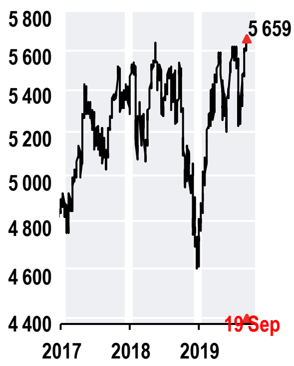
10 y bond yield, OAT vs Bund



Euro-dollar



CAC 40



Money & Bond Markets

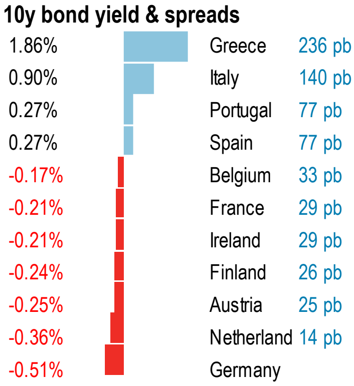
Interest Rates		highest' 19		lowest' 19	
€ ECB	**0.00**	0.00	at 01/01	0.00	at 01/01
Eonia	**-0.46**	-0.25	at 07/06	-0.46	at 18/09
Euribor 3M	**-0.40**	-0.31	at 24/01	-0.45	at 03/09
Euribor 12M	**-0.30**	-0.11	at 06/02	-0.40	at 21/08
$ FED	**2.00**	2.50	at 01/01	2.00	at 19/09
Libor 3M	**2.16**	2.81	at 01/01	2.10	at 05/09
Libor 12M	**2.06**	3.04	at 21/01	1.89	at 05/09
£ BoE	**0.75**	0.75	at 01/01	0.75	at 01/01
Libor 3M	**0.78**	0.93	at 29/01	0.75	at 29/08
Libor 12M	**0.94**	1.19	at 11/01	0.81	at 03/09

At 19-9-19

Yield (%)			highest' 19		lowest' 19	
€	AVG 5-7y	**-0.20**	0.68	at 09/01	-0.36	at 03/09
	Bund 2y	**-0.71**	-0.53	at 05/03	-0.92	at 02/09
	Bund 10y	**-0.51**	0.25	at 01/01	-0.72	at 28/08
	OAT 10y	**-0.21**	0.73	at 08/01	-0.44	at 28/08
	Corp. BBB	**0.83**	2.15	at 08/01	0.64	at 30/08
$	Treas. 2y	**1.74**	2.62	at 18/01	1.44	at 04/09
	Treas. 10y	**1.77**	2.78	at 18/01	1.46	at 04/09
	Corp. BBB	**3.36**	4.65	at 01/01	3.15	at 04/09
£	Treas. 2y	**0.51**	0.83	at 27/02	0.32	at 03/09
	Treas. 10y	**0.56**	1.35	at 18/01	0.33	at 03/09

At 19-9-19

10y bond yield & spreads

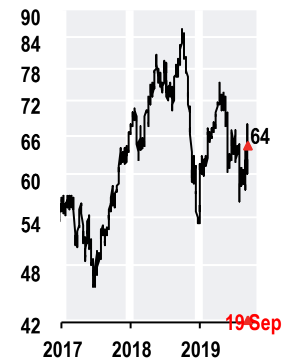


Commodities

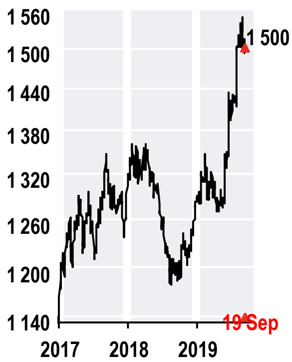
Spot price in dollars		lowest' 19			2019(€)
Oil, Brent	**64.5**	53.1	at	01/01	**+25.4%**
Gold (ounce)	**1 500**	1 268	at	02/05	**+21.1%**
Metals, LMEX	**2 812**	2 718	at	07/08	**+3.8%**
Copper (ton)	**5 762**	5 585	at	03/09	**+0.1%**
CRB Foods	**318**	312	at	11/09	**+1.3%**
wheat (ton)	**180**	166	at	30/08	**-5.5%**
Corn (ton)	**142**	128	at	24/04	**+7.9%**

At 19-9-19 *Variations*

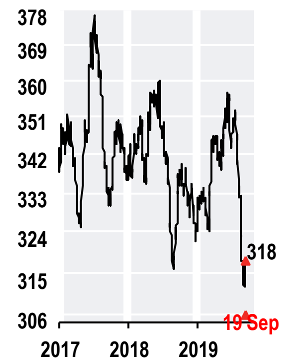
Oil (Brent, $)



Gold (Ounce, $)



CRB Foods



Exchange Rates

1€ =		highest' 19			lowest' 19			2019
USD	**1.11**	1.15	at	10/01	1.10	at	03/09	-3.3%
GBP	**0.89**	0.93	at	12/08	0.85	at	14/03	-1.4%
CHF	**1.10**	1.14	at	23/04	1.08	at	04/09	-2.6%
JPY	**119.46**	127.43	at	01/03	116.08	at	03/09	-4.8%
AUD	**1.63**	1.66	at	07/08	1.57	at	18/04	+0.1%
CNY	**7.85**	7.96	at	27/08	7.51	at	25/04	+0.0%
BRL	**4.58**	4.63	at	27/08	4.18	at	31/01	+3.3%
RUB	**70.62**	79.30	at	01/01	70.26	at	24/07	-11.0%
INR	**78.86**	82.00	at	04/02	76.37	at	01/08	-1.2%

At 19-9-19 *Variations*

Equity indices

	Index	highest' 19			lowest' 19			2019	2019(€)
CAC 40	**5 659**	5 659	at	19/09	4 611	at	03/01	+19.6%	**+19.6%**
S&P500	**3 007**	3 026	at	26/07	2 448	at	03/01	+19.9%	**+24.0%**
DAX	**12 458**	12 630	at	04/07	10 417	at	03/01	+18.0%	**+18.0%**
Nikkei	**22 044**	22 308	at	25/04	19 562	at	04/01	+10.1%	**+15.6%**
China*	**77**	86	at	09/04	68	at	03/01	+9.7%	**+13.2%**
India*	**530**	612	at	03/06	526	at	22/08	-2.9%	**-1.8%**
Brazil*	**2 112**	2 354	at	10/07	1 862	at	17/05	+16.0%	**+12.3%**
Russia*	**725**	747	at	04/07	572	at	01/01	+18.0%	**+31.1%**

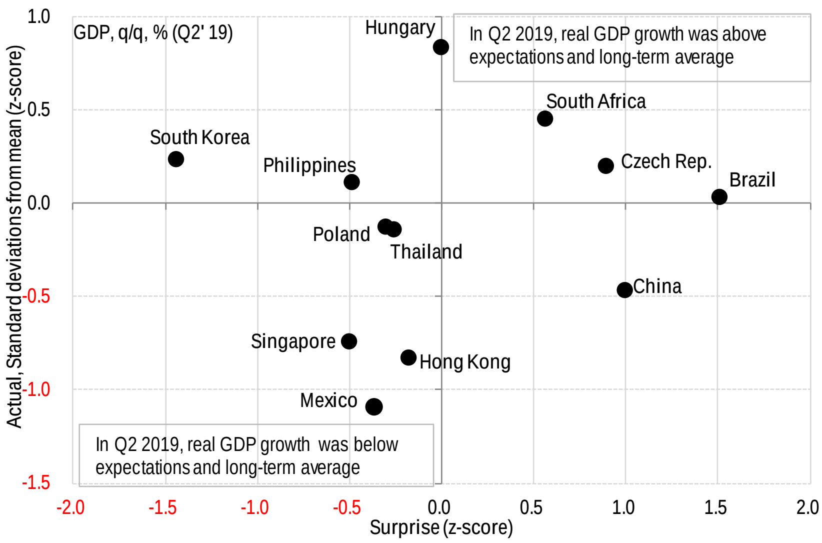
At 19-9-19 *Variations*

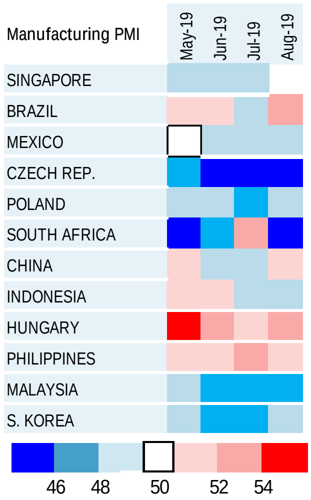
* MSCI index

Pulse

Mexico: slowing down

After recording a 1.2% y/y growth in Q1, real Mexican GDP contracted by 0.7% y/y in Q2. The lack of dynamism of US activity, weighing on the Mexican export sector and the significant slowdown in both public and private investments, due to deteriorating business and investment sentiments, are the two key factors explaining the slowdown. For the same reasons, the risks remain tilted to the downside for the coming quarters.





Note: z-score is a score which indicates how many standard deviations an observation is from the mean: z=(x-μ)/σ where x: observation, μ: mean, σ: standard deviation.
On the X-axis, x corresponds at the last known surprise for each indictor represented on the graph, μ and σ corresponds respectively to the mean and the standard deviation of the last 24 value for monthly data and the last 8 quarters for quarterly data.
On the Y-axis, x corresponds at the last-known value of indicator, μ and σ corresponds respectively to the mean and the standard deviation for this indicator since 2000 (for China since 2011).

Indicators preview

Next week brings an abundance of data which will allow us to assess how the economy is doing in September: flash PMIs in several countries; consumer confidence in Germany, France, the UK; business confidence in France and in Germany. The Richmond Fed and the Kansas City Fed will publish their activity indicators. The European Commission publishes its economic confidence index and its components. We also have University of Michigan sentiment, the CPB world trade outlook and the ECB economic bulletin.

Date	Country/Region	Event	Period	Survey	Prior
09/23/19	Japan	Jibun Bank Japan PMI Composite	Sep	--	51.9
09/23/19	France	Markit France Composite PMI	Sep	52.5	52.9
09/23/19	Germany	Markit/BME Germany Manufacturing PMI	Sep	44.5	43.5
09/23/19	Eurozone	Markit Eurozone Composite PMI	Sep	52.0	51.9
09/23/19	United States	Markit US Composite PMI	Sep	--	50.7
09/24/19	Japan	Leading Index CI	July	--	93.6
09/24/19	France	Business Confidence	Sep	105	105
09/24/19	Germany	IFO Business Climate	Sep	94.1	94.3
09/24/19	United States	Richmond Fed Manufact. Index	Sep	--	71.6535
09/24/19	United States	Conf. Board Consumer Confidence	Sep	133.8	135.1
09/25/19	Germany	GfK Consumer Confidence	Oct	9.6	9.7
09/25/19	France	Consumer Confidence	Sep	--	102
09/25/19	Eurozone	CPB Releases World Trade Monitor			
09/25/19	United States	New Home Sales	Aug	651000	635000
09/26/19	Eurozone	ECB Publishes Economic Bulletin			
09/26/19	United States	GDP Annualized QoQ	2Q T	2.0%	2.0%
09/26/19	United States	Kansas City Fed Manf. Activity	Sep	--	-6
09/27/19	United Kingdom	GfK Consumer Confidence	Sep	--	-14
09/27/19	France	Consumer Spending MoM	Aug	--	0.4%
09/27/19	France	CPI EU Harmonized MoM	Sep	--	0.5%
09/27/19	Eurozone	Economic Confidence	Sep	103.0	103.1
09/27/19	United States	Cap Goods Orders Nondef Ex Air	Aug	0.0%	0.2%
09/27/19	United States	U. of Mich. Sentiment	Sep	92.2	92.0

Source : Bloomberg, BNP Paribas

Economic scenario

UNITED STATES

- Growth is slowing and this trend is expected to continue under the influence of corporate investment (slower profits growth, uncertainty) and housing (declining trend of affordability). Consumer spending should be more resilient. The trade dispute with China acts as an additional drag. Inflation is expected to decline, due to softer growth and weaker oil prices.
- We expect one more Fed Funds target rate cut of 25bp this year and two additional cuts in 2020.

CHINA

- Economic growth continues to slow and our GDP forecasts have been revised down since June. Industrial activity and exports have been hard hit by US tariff hikes. Domestic demand has also decelerated.
- The central bank is easing liquidity and credit conditions, though the reduction in financial-instability risks should remain a priority and banks seem to remain prudent. Fiscal policy is expansionary through increased infrastructure spending and a rising number of household/corporate tax cuts.
- In the short term, exports and private domestic investment should continue to decelerate. Tax measures should have some success in supporting consumer spending.

EUROZONE

- The economic slowdown is continuing in the eurozone, especially in Germany, due to notably international environment uncertainties and a slowdown of the Chinese economy. Activity in the manufacturing sector continues to decline but services still show resilience.
- Inflation is now expected to decrease while core CPI is hardly moving. The activity slowdown also implies that the pick-up in core inflation should be slower than expected until recently.
- Faced with an outlook of subdued inflation, the Governing Council has eased policy at its meeting on 12 September. This very accommodative environment will be maintained as long as inflation hasn't converged sufficiently, in a convincing and lasting way, towards the ECB's objective.

FRANCE

- Growth is slowing although the economy shows resilience. Households' consumption should get a boost from the tax cuts and the jobs recovery but inflation reduces purchasing power gains. Business investment dynamics remain favourable. The global backdrop is less supportive. A slight rise in core inflation is appearing but remains to be confirmed.

INTEREST RATES AND FX RATES

- In the US, we expect the Fed to cut its official rate in December in reaction to a slowing economy, moderate inflation and heightened uncertainty. 2020 should see two more cuts. Treasury yields are to decline further in the coming months. Eventually, in the course of 2020 they should move up again in anticipation of a pick-up in growth.
- In the eurozone, the ECB's state-dependent forward guidance and the sluggishness of the inflation process imply that the very accommodative environment will remain in place for a long time. This will exert downward pressure on bond yields.
- No policy rate change expected in Japan.
- With the Fed in easing mode and given the very accommodative ECB policy, we expect little change in EUR/USD even though euro's fair value is quite higher than current pricing. The yen should strengthen on the back of stable BoJ policy and high market volatility.

	GDP Growth			Inflation		
%	2018	2019 e	2020 e	2018	2019 e	2020 e
Advanced	**2.2**	**1.6**	**1.0**	**2.1**	**1.4**	**1.3**
United-States	2.9	2.2	1.5	2.4	1.8	1.8
Japan	0.8	1.2	0.2	1.0	0.6	0.3
United-Kingdom	1.4	1.1	0.6	2.5	1.9	1.8
Euro Area	**1.9**	**1.1**	**0.7**	**1.8**	**1.1**	**0.8**
Germany	1.4	0.4	0.2	1.9	1.4	1.0
France	1.7	1.2	1.0	2.1	1.2	1.0
Italy	0.7	0.1	0.0	1.2	0.6	0.5
Spain	2.6	2.2	1.6	1.7	0.8	0.7
Emerging	**4.4**	**3.8**	**4.2**	**4.7**	**4.8**	**4.5**
China	6.6	5.9	5.6	2.1	2.4	2.8
India*	6.8	6.5	6.3	2.9	3.0	3.3
Brazil	1.1	0.5	2.0	3.7	3.7	3.5
Russia	2.3	1.2	2.0	2.9	4.8	3.8

Source : BNP Paribas Group Economic Research (e: Estimates & forecasts)
* Fiscal year from April 1st of year n to March 31st of year n+1

Interest rates, %		2019						
End of period		Q1	Q2	Q3e	Q4e	2018	2019e	2020e
US	Fed Funds	2.50	2.50	2.00	1.75	2.50	1.75	1.25
	Libor 3m $	2.60	2.32	1.90	1.70	2.81	1.70	1.25
	T-Notes 10y	2.42	2.00	1.35	1.00	2.69	1.00	1.50
Ezone	Deposit rate (%)	-0.40	-0.40	-0.50	-0.60	-0.40	-0.60	-0.60
	Bund 10y	-0.07	-0.32	-0.50	-0.80	0.25	-0.80	-0.50
	OAT 10y	0.26	-0.01	-0.20	-0.55	0.71	-0.55	-0.30
UK	Base rate	0.75	0.75	0.75	0.75	0.75	0.75	0.75
	Gilts 10y	1.00	0.84	0.75	0.55	1.27	0.55	0.75
Japan	BoJ Rate	-0.06	-0.08	-0.10	-0.10	-0.07	-0.10	-0.10
	JGB 10y	-0.09	-0.16	-0.30	-0.40	0.00	-0.40	-0.25

Source : BNP Paribas GlobalMarkets (e: Forecasts)

Exchange Rates		2019						
End of period		Q1	Q2	Q3e	Q4e	2018	2019e	2020e
USD	EUR / USD	1.12	1.14	1.10	1.11	1.14	1.11	1.14
	USD / JPY	111	108	105	102	110	102	96
	GBP / USD	1.30	1.27	1.20	1.23	1.27	1.23	1.36
	USD / CHF	1.00	0.98	0.99	0.99	0.99	0.99	1.00
EUR	EUR / GBP	0.85	0.89	0.92	0.90	0.90	0.90	0.84
	EUR / CHF	1.12	1.11	1.09	1.10	1.13	1.10	1.14
	EUR / JPY	124	123	116	113	125	113	109

Source : BNP Paribas GlobalMarkets (e: Forecasts)

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