ECOWEEK

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Federal Reserve: monetary policy self-assessment

■ The Federal Reserve will conduct a review of its monetary policy framework and the conclusions will be made public in the first half of 2020 ■ Three questions will be addressed: should the monetary policy stance take into account past misses of the inflation objective? Are the tools adequate? How can communication be improved? ■ The initiative should be welcomed because it shows the Fed's efforts for being ready when the next recession hits ■ Facing similar challenges, the ECB is likely to be interested in the outcome of the Fed research.

It had already been announced last November, but the recent communication has shed light on how the Federal Reserve intends to "*conduct a comprehensive review of the strategies, tools, and communications practices we use to pursue our congressionally assigned goals for monetary policy*"[1].

As explained by Fed Vice-Chairman Clarida in a recent speech[2], three questions will be addressed. The first is whether the Federal Reserve can meet its statutory objectives with its existing monetary policy strategy or whether it should take into account past misses of its inflation objective in setting its policy stance. The second question concerns whether the toolkit is adequate or whether it should be expanded. The third question will analyse how the communication by the central bank can be improved. This question echoes the insistence of Chairman Powell to adopt a "plain English" approach in communication so as to make sure that the Fed's thinking and policy are clear for everybody.

Recent research by Reuters has shown that the level of complexity has continued to decline under Powell, a trend that had already started while Janet Yellen was Fed Chair[3]. Interestingly, as another illustration of an effort to being well tuned-in with American society, the Federal Reserve will conduct several town hall style meetings to underpin its strategy review.

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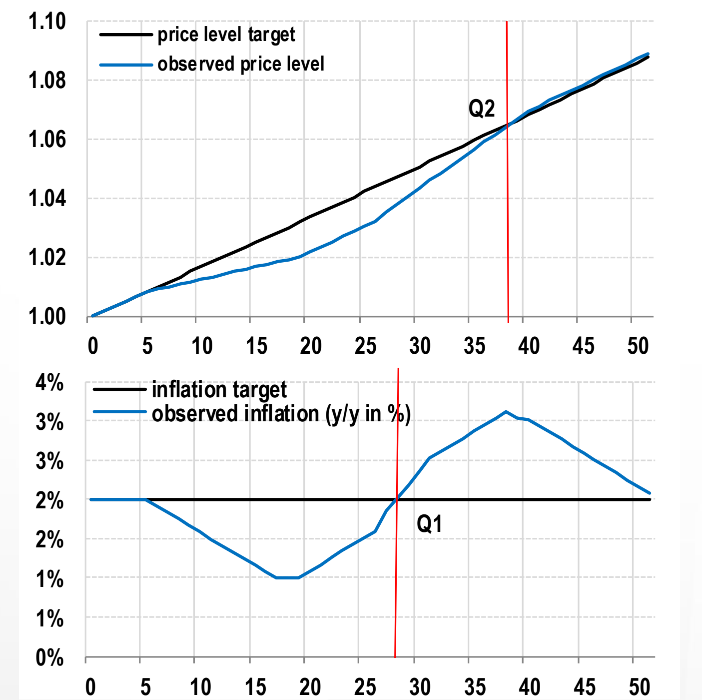
PRICE LEVEL VERSUS INFLATION TARGETING*



*Simulated path, for illustrative purposes only. Source: BNP Paribas

[1] Federal Reserve chairman Powell on the occasion of the presentation of the Semi-annual Monetary Policy Report to the Congress before the Committee on Banking, Housing, and Urban Affairs of the U.S. Senate, 26 February 2019

[2] Richard H. Clarida, *The Federal Reserve's Review of Its Monetary Policy Strategy, Tools, and Communication Practices*, remarks at the 2019 U.S. Monetary Policy Forum, sponsored by the Initiative on Global Markets at the University of Chicago Booth School of Business, 22 February 2019

[3] *You don't need a PhD anymore to read Fed's statements*, Jason Lange, Reuters Business News, 27 February 2019. The author quite rightly observes that reduced complexity may also reflect that the current policy stance is easier to explain

Eco WEEK

ECONOMIC RESEARCH DEPARTMENT

BNP PARIBAS

The bank for a changing world

Communication style is important but, clearly, contents is even more important. So, during the review process, attention of market participants will inevitably focus on the first two questions. The question whether a central bank should take into account inflation misses in setting its policy stance is not new. It boils down to a choice between price level targeting and inflation targeting. Under the latter, prolonged undershooting the inflation target in the past does not per se influence the future stance of monetary policy which, with respect to inflation, only seeks to see it returning to its target. Under price level targeting, the central bank aims for a moving target (the targeted price level increases every year in line with the inflation objective) which implies that an inflation undershoot will need to be made up later by an inflation overshooting: once inflation has been below target for a while, the central bank commits to overshoot its target as long as necessary by keeping a very accomodative policy stance. In the chart, this means that under inflation targeting, the central bank would consider it is “mission accomplished” at T1, whereas under price level targeting, this would only be the case at T2. In a recent blogpost, former Fed chairman Bernanke[4] has, using model-based simulations, demonstrated the merits of such an approach. For it to be effective, it is sufficient that the policy is credible with financial market participants. In that case, the entire yield curve would be “lower for longer” and this would jump start a recovery. As a caveat, if this policy is not credible with households and companies, the inflation overshoot could cause an unanchoring of inflation expectations, making it more difficult to get a grip in inflation.

These issues show the complexity of a price targeting approach. In addition, one wonders what eventually it would entail in terms of risk of financial market bubbles and volatility. “Low rates for longer” means that risky assets (equities, corporate bonds, real estate) would reach higher valuation levels under the belief that monetary policy would remain expansionary as long as the cumulative inflation shortfall hasn’t been corrected. One can imagine how markets would react when the price level gap is about to be closed (around T2 in the chart) considering this would fuel expectations of an accelerated policy normalisation, i.e. tightening. Years of quantitative easing have raised concerns about financial stability risks. Prolonged inflation overshooting to correct for the past inflation shortfall could make things even more challenging.

Considering that, in the case of inflation targeting, a persistent undershoot of the 2% inflation target could cause inflation expectations to drift lower, thereby reducing the ability of monetary policy to stimulate activity because nominal interest rates would structurally be lower, Federal Reserve Bank of New York CEO and President, John Williams, has recently said being pleased that the Fed is undertaking a review of its policy framework[5]. Interestingly, he also showed that the cyclically sensitive components of the price index had behaved normally in the current expansion. These components are less subject to measurement errors and non-cyclical factors such as supply shocks, globalisation and changing market structure. This raises an important question however: if one accepts that cyclically sensitive inflation is behaving normally, this would mean that the inertia in overall inflation, despite the disappearance of slack, essentially reflects the role of supply factors. In this case, should monetary policy strive to compensate for these supply factors? Would it be able? Would this entail an overshooting of cyclically sensitive inflation? These questions illustrate the complexity of conducting a monetary policy based on inflation targeting when changes on the supply side have altered the price dynamics in certain sectors, in particular the goods producing ones.

Notwithstanding the questions raised by inflation versus price level targeting, the comprehensive review of strategies, tools and communications practices should be welcomed, if only because it shows that the Federal Reserve wants to be ready when the next recession hits and to be in a position, if necessary and warranted, to adapt its strategy and toolkit. The discussion is interesting from a eurozone perspective as well. After all, the Fed and the ECB share many challenges (low rates, a large balance sheet, inflation undershooting). As European rates are lower, the challenge facing the ECB looks even bigger. It is interesting that the Fed, which has a symmetric objective (implying that it would accept some inflation overshooting), is about to start a reflection on whether it should commit to prolonged overshooting to make up for past inflation misses. The conclusions should be followed in Frankfurt with great interest, all the more so considering that the ECB has an asymmetric inflation objective and hence is reluctant to accept a temporary overshooting.

William De Vijlder

[4] Ben Bernanke, *Evaluating lower-for-longer policies: Temporary price-level targeting*, Brookings, 21 February 2019

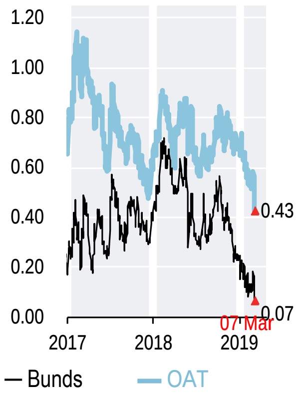
[5] John C. Williams, Discussion of *'Prospects for Inflation in a High Pressure Economy: Is the Phillips Curve Dead or Is It Just Hibernating?'* by Peter Hooper, Frederic S. Mishkin, and Amir Sufi, Remarks at the U.S. Monetary Policy Forum, New York City, 22 February 2019

Markets overview

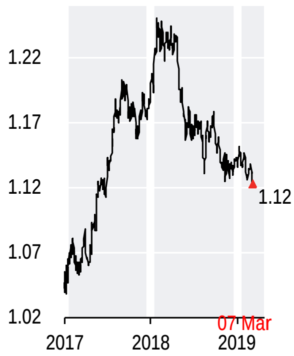
The essentials

Week 1-3 19 > 7-3-19					
↗ CAC 40	5 265	▸	5 268	+0.1	%
↘ S&P 500	2 804	▸	2 749	-2.0	%
↗ Volatility (VIX)	13.6	▸	16.6	+3.0	pb
↗ Euribor 3M (%)	-0.31	▸	-0.31	+0.2	bp
↘ Libor $ 3M (%)	2.60	▸	2.59	-0.4	bp
↘ OAT 10y (%)	0.59	▸	0.43	-15.9	bp
↘ Bund 10y (%)	0.19	▸	0.07	-12.0	bp
↘ US Tr. 10y (%)	2.76	▸	2.64	-11.9	bp
↘ Euro vs dollar	1.14	▸	1.12	-1.4	%
↘ Gold (ounce, $)	1 304	▸	1 286	-1.4	%
↗ Oil (Brent, $)	65.2	▸	66.0	+1.2	%

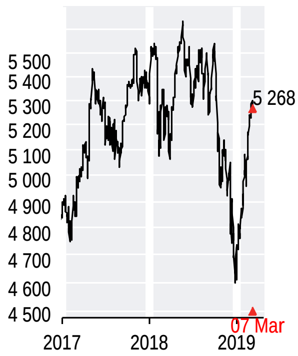
10 y bond yield, OAT vs Bund



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	-0.36	-0.36	at	01/01	-0.37	at	26/02
Euribor 3M	-0.31	-0.31	at	24/01	-0.31	at	02/01
Euribor 12M	-0.11	-0.11	at	06/02	-0.12	at	02/01
$ FED	2.50	2.50	at	01/01	2.50	at	01/01
Libor 3M	2.59	2.81	at	01/01	2.59	at	06/03
Libor 12M	2.89	3.04	at	21/01	2.86	at	28/02
£ BoE	0.75	0.75	at	01/01	0.75	at	01/01
Libor 3M	0.84	0.93	at	29/01	0.84	at	06/03
Libor 12M	1.13	1.19	at	11/01	1.12	at	20/02

At 7-3-19

Yield (%)		highest' 19			lowest' 19		
€ AVG 5-7y	0.54	0.68	at	09/01	0.45	at	26/02
Bund 2y	-0.57	-0.53	at	05/03	-0.62	at	03/01
Bund 10y	0.07	0.25	at	01/01	0.07	at	07/03
OAT 10y	0.43	0.73	at	08/01	0.43	at	07/03
Corp. BBB	1.64	2.15	at	08/01	1.64	at	07/03
$ Treas. 2y	2.46	2.62	at	18/01	2.39	at	03/01
Treas. 10y	2.64	2.78	at	18/01	2.55	at	03/01
Corp. BBB	4.27	4.65	at	01/01	4.27	at	07/03
£ Treas. 2y	0.72	0.83	at	27/02	0.68	at	03/01
Treas. 10y	1.17	1.35	at	18/01	1.14	at	14/02

At 7-3-19

10y bond yield & spreads

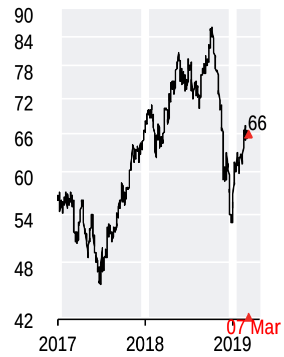
4.29%	Greece	422 pb
2.48%	Italy	241 pb
1.35%	Portugal	128 pb
1.16%	Spain	109 pb
0.56%	Belgium	49 pb
0.43%	France	36 pb
0.40%	Austria	33 pb
0.32%	Finland	25 pb
0.26%	Ireland	19 pb
0.16%	Netherlands	9 pb
0.07%	Germany	

Commodities

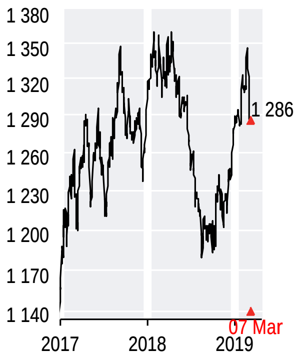
Spot price in dollars		lowest' 19			2019(€)
Oil, Brent	66.0	53.1	at	01/01	+26.4%
Gold (ounce)	1 286	1 281	at	21/01	+2.1%
Metals, LMEX	3 010	2 730	at	03/01	+9.4%
Copper (ton)	6 460	5 714	at	03/01	+10.5%
CRB Foods	324	324	at	07/03	+1.8%
wheat (ton)	171	171	at	07/03	-11.7%
Corn (ton)	132	132	at	28/02	-1.2%

At 7-3-19 *Variations*

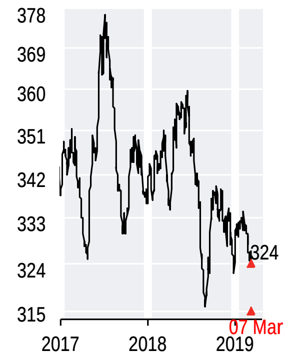
Oil (Brent, $)



Gold (Ounce, $)



CRB Foods



Exchange Rates

1€ =		highest' 19			lowest' 19			2019
USD	1.12	1.15	at	10/01	1.12	at	07/03	-1.7%
GBP	0.86	0.90	at	03/01	0.85	at	27/02	-4.6%
CHF	1.13	1.14	at	05/02	1.12	at	02/01	+0.5%
JPY	125.27	127.43	at	01/03	122.54	at	03/01	-0.1%
AUD	1.60	1.63	at	03/01	1.57	at	31/01	-1.6%
CNY	7.53	7.87	at	09/01	7.53	at	07/03	-4.0%
BRL	4.35	4.43	at	01/01	4.18	at	31/01	-1.9%
RUB	74.40	79.30	at	01/01	74.15	at	12/02	-6.2%
INR	78.67	82.00	at	04/02	78.67	at	07/03	-1.4%

At 7-3-19 *Variations*

Equity indices

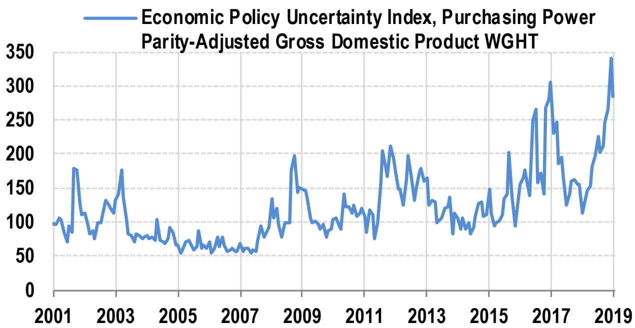
	Index	highest' 19			lowest' 19			2019	2019(€)
CAC 40	5 268	5 298	at	05/03	4 611	at	03/01	+11.4%	+11.4%
S&P500	2 749	2 804	at	01/03	2 448	at	03/01	+9.7%	+11.6%
DAX	11 518	11 621	at	05/03	10 417	at	03/01	+9.1%	+9.1%
Nikkei	21 456	21 822	at	04/03	19 562	at	04/01	+7.2%	+7.3%
China*	82	83	at	06/03	68	at	03/01	+16.3%	+18.2%
India*	566	566	at	07/03	530	at	19/02	+1.9%	+3.4%
Brazil*	2 071	2 304	at	04/02	1 944	at	01/01	+6.4%	+8.4%
Russia*	627	654	at	05/02	572	at	01/01	+5.3%	+11.5%

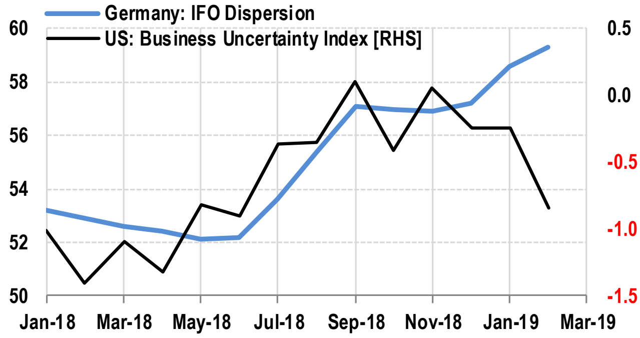
At 7-3-19 *Variations* * MSCI index

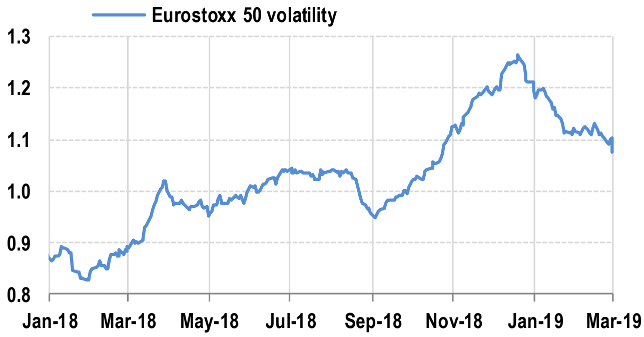
Pulse

Uncertainty: a moderate decline

When households (companies) feel more uncertain, they will spend (invest) less. After a jump last year, the number of media articles mentioning uncertainty, has declined somewhat recently (top left chart). Uncertainty based on company surveys has eased in the US. In Germany it continues to rise (top right). Uncertainty as measured by the dispersion of individual stock returns has declined since the start of the year.







volatility = 60-day moving average of the cross-sectional standard deviation of daily returns of the index constituents

Source: Economic Policy Uncertainty, Bloomberg, IFO, Atlanta Fed, BNP Paribas

Indicators preview

A rather light week ahead of us in terms of data. We will have consumer price numbers in several countries (France, Germany, the eurozone, the US) and producer prices in the US. In France the labour market data for Q4 2018 and the Banque de France industrial sentiment index for February will be published. In the US, small business sentiment and University of Michigan sentiment will be released but particular attention will go to the retail sales, after the disappointment about the most recent numbers. The Bank of Japan will hold its regular policy meeting.

Date	Country/Region	Event	Period	Prior
03/11/2019	France	Bank of France Ind. Sentiment	Feb	--
03/12/2019	France	Total Payrolls	4Q	0.1%
03/12/2019	United Kingdom	Industrial Production MoM	Jan	--
03/12/2019	United States	NFIB Small Business Optimism	Feb	--
03/12/2019	United States	CPI Ex Food and Energy MoM	Feb	--
03/13/2019	Eurozone	Industrial Production SA MoM	Jan	--
03/13/2019	United States	PPI Ex Food and Energy MoM	Feb	--
03/14/2019	Germany	CPI EU Harmonized MoM	Feb	--
03/14/2019	France	CPI EU Harmonized MoM	Feb	--
03/14/2019	United States	Retail Sales Control Group	Feb	--
03/15/2019	Eurozone	CPI MoM	Feb	--
03/15/2019	United States	Industrial Production MoM	Feb	--
03/15/2019	United States	U. of Mich. Sentiment	Mar	--
03/15/2019	Japan	BOJ Policy Balance Rate	March-15	-0.100%

Economic scenario

UNITED STATES

- Growth is expected to slow to 2.1% this year. Trade war uncertainty acts as a drag, the housing market is softening, corporate investment should slow, as well as exports in reaction to the past strengthening of the dollar against a broad range of currencies.
- Core inflation remains well under control and has eased a bit.
- Following the dovish message from the January FOMC meeting, markets are pricing in a policy easing in the course of 2020.

CHINA

- Economic growth is slowing due to both structural and cyclical reasons. The export outlook is significantly darkened by US tariff hikes. Private domestic demand should be affected by the knock-on effect of the worsening performance of the export manufacturing sector, the slowdown of retail sales and the continued moderation in the property market.
- In order to contain the slowdown, the central bank is easing liquidity and credit conditions. At the same time, the reduction in financial instability risks via regulatory tightening should remain a top policy priority. Fiscal policy is also turning expansionary (tax cuts, increased infrastructure spending).

EUROZONE

- The slowdown is becoming increasingly evident, especially in the German economy, which has suffered from one-off factors but also from a slowdown of exports to China. Capacity constraints also play a role. Business expectations continue to decline. Italy has now entered a technical recession with quarterly growth negative in the third and fourth quarter of 2018.
- Inflation is now expected to decelerate following the past drop in the oil price, while core CPI is hardly moving. The growth slowdown also implies that the pick-up in core inflation should be slower than expected until recently. We do not expect the ECB to move rates this year (see below).

FRANCE

- Growth is slowing although the economy should show some 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, the Fed has announced to be patient before deciding on any change in its policy. We expect one rate increase this year, in June. We have changed the forecast for 10 year treasury yields and now expect a yield of 3.00% by mid-year and 2.80% at the end of the year.
- We no longer expect changes in the ECB policy rates this year. We have changed the forecast for 10 year Bund yields and now expect a yield of 0.30% by mid-year and 0.40% at the end of the year.
- No change expected in Japan.
- The prospect of a narrowing bond yield differential between the US and the eurozone should cause a strengthening of the euro, all the more so considering it is still below its long-term fair value (around 1.34).

	GDP Growth			Inflation		
%	2018 e	2019 e	2020 e	2018 e	2019 e	2020 e
Advanced	**2.2**	**1.5**	**1.2**	**2.0**	**1.6**	**1.7**
United-States	2.9	2.1	1.5	2.4	1.8	2.0
Japan	0.7	0.4	0.3	1.0	1.0	1.5
Euro Area	**1.8**	**1.0**	**1.1**	**1.8**	**1.4**	**1.4**
Germany	1.4	0.9	1.1	1.9	1.6	1.6
France	1.5	1.2	1.2	2.1	1.3	1.6
Italy	0.8	0.1	0.5	1.3	1.0	1.0
Spain	2.5	2.1	1.7	1.7	1.0	1.3
Emerging	**5.9**	**5.8**	**5.8**	**2.7**	**2.9**	**3.1**
China	6.6	6.2	6.0	2.1	1.9	2.5
India	7.4	7.6	7.8	3.8	4.0	4.1
Brazil	1.3	3.0	2.5	3.7	3.8	3.6
Russia	1.7	1.5	1.8	2.8	5.1	4.1

Source : BNP Paribas Group Economic Research (e: Estimates & forecasts)

Interest rates, %		2019						
End of period		Q1e	Q2e	Q3e	Q4e	**2018**	**2019e**	**2020e**
US	Fed Funds	2,50	2,75	2,75	2,75	2,25	2,75	2,75
	Libor 3m $	2,80	3,05	3,05	3,00	2,81	3,00	3,00
	T-Notes 10y	2,80	3,00	2,80	2,80	2,69	2,80	2,50
Ezone	ECB Refi	0,00	0,00	0,00	0,00	0,00	0,00	0,00
	Euribor 3m	-0,30	-0,30	-0,30	-0,30	-0,31	-0,30	-0,25
	Bund 10y	0,20	0,30	0,35	0,40	0,25	0,40	0,40
	OAT 10y	0,65	0,65	0,65	0,70	0,71	0,70	0,70
UK	Base rate	0,75	1,00	1,00	1,25	0,75	1,25	1,25
	Gilts 10y	1,70	1,85	2,00	2,10	1,27	2,10	2,10
Japan	BoJ Rate	-0,10	-0,10	-0,10	-0,10	-0,07	-0,10	-0,10
	JGB 10y	0,00	0,00	0,00	-0,05	0,00	-0,05	-0,20

Source : BNP Paribas GlobalMarkets (e: Forecasts)

Exchange Rates		2019						
End of period		Q1e	Q2e	Q3e	Q4e	**2018**	**2019e**	**2020e**
USD	EUR / USD	1,15	1,17	1,21	1,25	1,13	1,25	1,34
	USD / JPY	110	108	105	100	110	100	90
	GBP / USD	1,32	1,36	1,41	1,47	1,26	1,47	1,58
	USD / CHF	1,01	1,00	0,98	0,96	0,99	0,96	0,93
EUR	EUR / GBP	0,87	0,86	0,86	0,85	0,90	0,85	0,85
	EUR / CHF	1,16	1,17	1,18	1,20	1,13	1,20	1,25
	EUR / JPY	127	126	127	125	125	125	121

Source : BNP Paribas GlobalMarkets (e: Forecasts)

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