MONETARY DESYNCHRONISATION: A HEADACHE TO COME?

Monetary desynchronisation between the US and the Eurozone seems unavoidable due to a very different performance in terms of inflation. Whether this will complicate the ECB's task of reaching its inflation target depends, in the short run, on the impact on financial conditions in the euro area. This influence will probably be small. In the medium run, when the US tightening cycle is well underway, US domestic demand growth will be slowing down, which will weigh on imports and hence Eurozone exports to the US. This would complicate matters for the ECB if by then, inflation has not yet reached its target.

The monetary winds are gradually changing direction. They haven't yet turned into a headwind but, at least in some countries, they will end up acting less as a tailwind. The Norwegian central bank has raised its policy rate to 0.25% last week and has indicated that, given the strong recovery in the Norwegian economy, it has become increasingly likely that by the end of 2022, the official interest rate would reach 1.25%[1]. According to the Bank of England's monetary policy committee, recent developments appeared to have strengthened the case for modest tightening of monetary policy over its forecast period, which runs until 2024 Q3[2].

In the US, Jerome Powell has hinted during the press conference following the FOMC meeting that tapering is very likely to start in November. This move has been so well prepared that it will probably become a non-event. Yet bond yields moved higher because investors are now focussing on the FOMC members' interest rate projections –the so-called dots- which showed that more members are now expecting a hike in the federal funds rate next year and even more so in 2023 (chart 1).

Compared to this (gentle) 'sabre-rattling', silence prevails in the euro area, except for the repeated insistence that ending the PEPP does not correspond to tapering. ECB interest rate guidance is very clear and it looks highly likely that the conditions to envisage a rate hike will not be met for several years[3]. Monetary desynchronisation between the US and the Eurozone thus seems unavoidable. It reflects a very different performance in terms of inflation (chart 2). According to an analysis in the latest Economic Bulletin[4] of the ECB, there is still more slack in the Eurozone compared to the US. In the latter, specific factors, such as the jump in the price of used cars, have also played a bigger role. Finally, in the US, the distribution of price increases is also more broadly based.

Does monetary desynchronisation make the ECB's task of reaching its inflation target easier or more difficult? A key factor in the short run is the influence of tighter US monetary policy on financial conditions in the euro area. The prospect of a higher federal funds rate should lead to higher US Treasury yields, which could put Bund yields under upward pressure. In the previous US tightening cycle, Treasury yields rose about 150 basis points. Bund yields moved higher as well, although to a more limited degree, due to different economic conditions as well as

1. Norway raises interest rates, says another hike likely in December, Reuters, 23 September 2021.
2. Source: Bank of England, Monetary Policy Summary and minutes of the Monetary Policy Committee meeting ending on 22 September 2021.
3. See: ECB: accommodation with no end in sight, Ecoweek, BNP Paribas, 13 September 2021.
4. Comparing recent inflation developments in the United States and the euro area, Economic Bulletin 6-2021, ECB.

FOMC PARTICIPANTS' ASSESSMENTS OF APPROPRIATE MONETARY POLICY: MIDPOINT OF TARGET RANGE OR TARGET LEVEL FOR THE FEDERAL FUNDS RATE

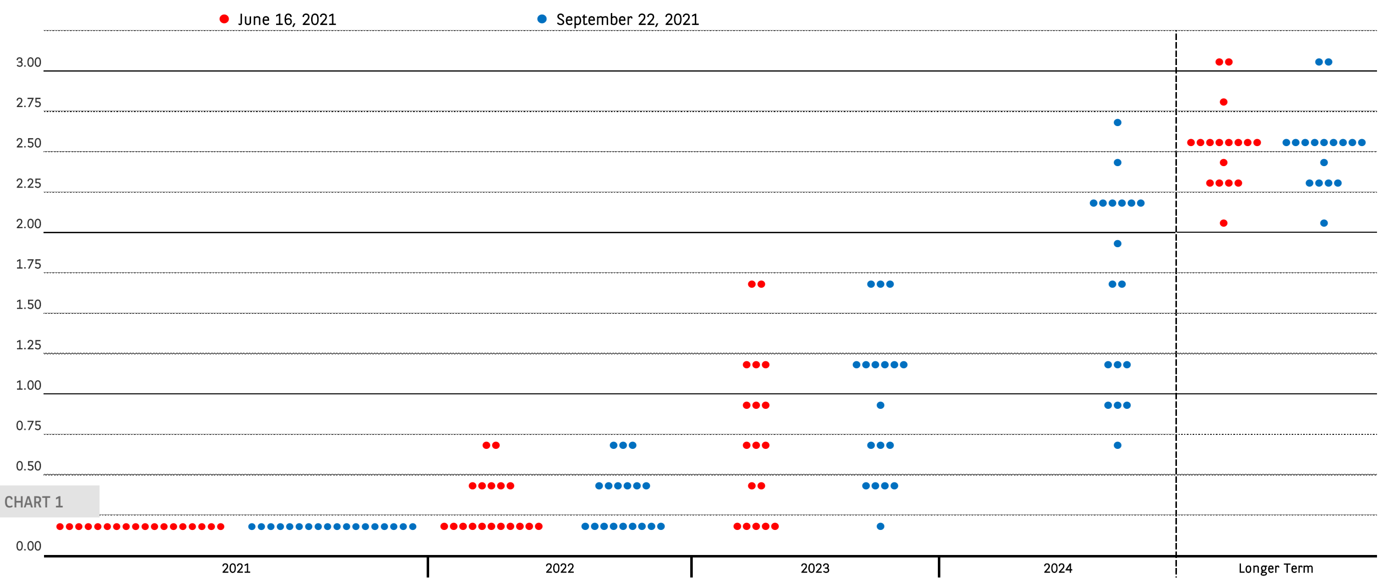

CHART 1

SOURCE: FEDERAL RESERVE, BNP PARIBAS

the ongoing asset purchases by the ECB. If need be, when the Fed starts raising rates, the APP could be used in a flexible way to shield euro area bond markets from US spillovers. Another transmission channel is the exchange rate. Monetary divergence and the ensuing widening of bond yield differentials could weaken the euro versus the dollar, thereby supporting exports[5]. However, it would also make imports more expensive, considering that a considerable percentage is invoiced in dollar[6].

All in all, the net effect should be small. Although we expect a stronger dollar, it is worth reminding that during the previous tightening cycle, the dollar actually weakened versus the euro. Exports should play a bigger role in the medium run, when the US tightening cycle is well underway. By then, US domestic demand growth will be slowing down, which will weigh on imports and hence Eurozone exports to the US. This would complicate matters for the ECB if by then, inflation has not yet reached its target. This shows the key risk of monetary desynchronisation: by the time the objective seems within reach, the euro area could be hit by a negative external demand shock, moving it further away from the inflation target. We have to hope that the rate hike cycle in the US will be slow and very gradual in order to give the Eurozone sufficient time to build enough growth momentum so as to generate more inflation. In parallel, the ECB has no other choice than to keep the foot on the monetary throttle.

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CORE INFLATION IN THE US AND THE EURO AREA (Y/Y%)

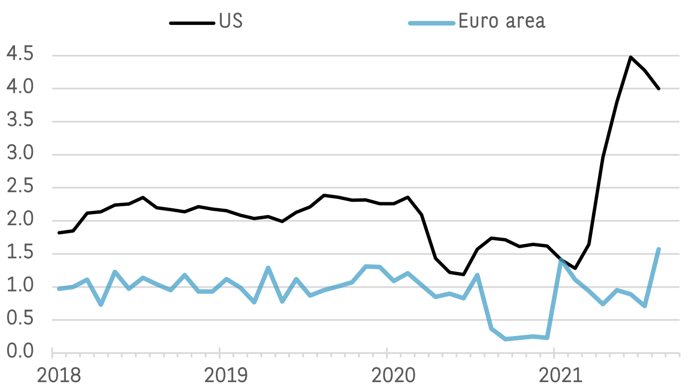

CHART 2 SOURCE: BLS, EUROSTAT, BNP PARIBAS

US MONETARY POLICY AND FINANCIAL MARKETS

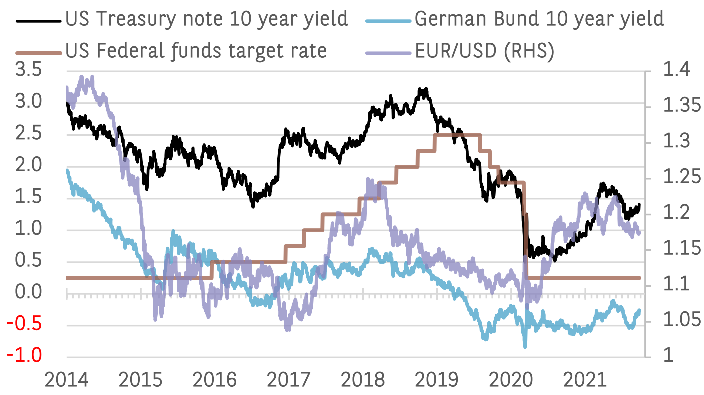

CHART 3 SOURCE: FEDERAL RESERVE, REFINITIV, BNP PARIBAS

5. This is the key factor underpinning our forecast of a strengthening of the dollar versus the euro to 1.12 in 2022 Q4 and 1.10 in 2023 Q4.

6. For most euro area countries, the dollar has a significantly bigger role as an invoicing currency in imports than in exports. See: *A strong euro: inflation matters more than growth, Ecoweek*, BNP Paribas, 2 March 2018.

> We have to hope that the rate hike cycle in the US will be slow and very gradual in order to give the Eurozone sufficient time to build enough growth momentum so as to generate more inflation.