MONETARY DESYNCHRONIZATION BETWEEN THE ECB AND THE FEDERAL RESERVE AND THE EURO

As expected, the ECB has lowered its policy rate, despite the upward revision of the staff inflation forecast. In the US, the very strong labour market report for the month of May will probably make the Fed even more cautious in deciding on a first rate cut. Until we have resynchronisation -with both central banks being in rate cutting mode-, there should be more desynchronisation, reflecting a difference in the disinflation cycle in the US versus the Eurozone. There is concern that this might weaken the euro versus the dollar and possibly weigh on the ECB's policy autonomy. Such fears are unwarranted. Moreover, it would require a significant depreciation of the euro -something which seems very unlikely at the current juncture- for the ECB to be constrained by the euro in setting its policy rate. it is also important to look at the US side of the EUR/USD rate. A 'high US rates for longer' environment means more uncertainty about the growth outlook, which entails a tail risk for US short term interest rates and hence the dollar. When reflecting about exchange rates, the entire distribution of possible outcomes should be considered.

For a central bank, being credible matters more than anything else. In the absence of credibility, inflation expectations become unanchored, and the effectiveness of monetary policy takes a hit. Credibility is all about consistency. Firstly, time consistency, which means acting in line with the guidance that has been provided previously. In recent weeks the guidance from several ECB Governing Council members had become increasingly clear that the June meeting would see its first rate cut in this cycle. Against this background, not acting was out of the question, despite the uptick in the latest inflation data. Secondly, policy consistency, which means acting in line with its mandate and its reaction function. Given the rate cut, despite the upward adjustment of the ECB staff inflation forecast, the post-meeting press conference saw a strong insistence that the decision was only "*removing a degree of restriction*"[1], that policy remained restrictive and that further decisions would be data dependent. Unsurprisingly, 2-year German yields rose about five basis points (bp) on the news. The next day, the release of a very strong labour market report in the US[2] caused a similar increase in German yields on the back of a 10 bp jump in 2-year US Treasury yields. These developments are likely to intensify the debate on policy desynchronisation between the ECB and the Federal Reserve. The latter will probably be even less inclined than before to start cutting the federal funds rate whereas the former is expected to continue reducing the deposit rate, albeit at a gradual pace[3].

This means that until we have resynchronisation -with both central banks being in rate cutting mode-, there should be more desynchronisation. This shouldn't be a surprise because it simply reflects a difference in the disinflation cycle in the US versus the Eurozone. However, there is concern that this might weaken the euro versus the dollar, thereby -through its impact on import price and inflation in general- complicating matters for the ECB and possibly even weighing on its policy autonomy. Such fears are unwarranted. Firstly, there is a very loose relationship between the EUR/USD rate and the difference in policy rates (chart 1).

1 Source: ECB, Press conference, Christine Lagarde, President of the ECB, Luis de Guindos, Vice-President of the ECB, Frankfurt am Main, 6 June 2024.
2 In May 2024, 272000 jobs had been created versus a Bloomberg consensus of 182000. The unemployment rate edged higher to 4.0% (Bloomberg consensus: 3.9%), from 3.9% in April. Against expectations, the growth in average hourly earnings accelerated to 4.1% from 4.0% the month before. Source: Bloomberg.
3 For the remainder of this year, we expect further 25 bp rate cuts by the ECB in September and in December. We expect the first policy easing (25 basis points) by the Federal Reserve in December.

EURO IN DOLLAR AND DIFFERENCE OF OFFICIAL INTEREST RATES

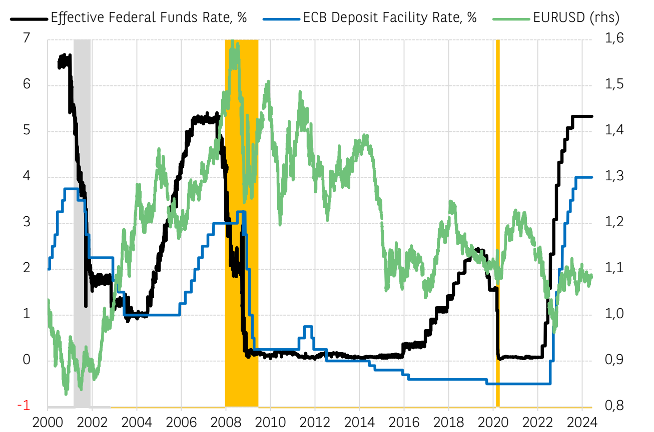

CHART 1 SOURCE: FEDERAL RESERVE BANK OF ST. LOUIS, ECB, BNP PARIBAS

EURO IN DOLLAR AND DIFFERENCE OF 2-YEAR NOMINAL INTEREST RATES

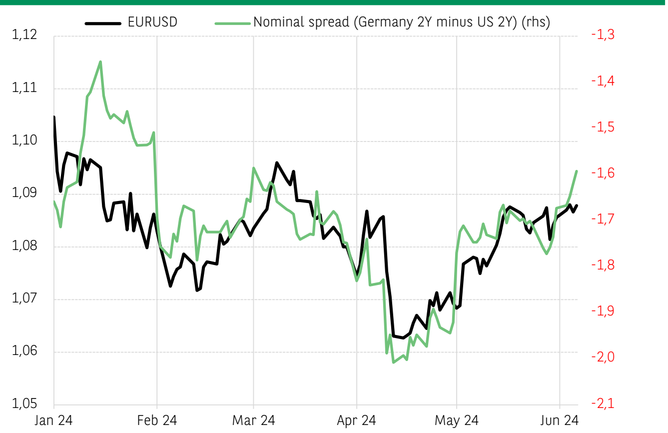

CHART 2 SOURCE: REFINITIV, BNP PARIBAS

Secondly, the expected widening in the policy rate gap is limited.[4] This should imply that the 2-year yield spread between the US and Germany -which highly depends on monetary policy expectations- should not see huge swings either. This matters because since the start of the year, this spread has been highly correlated with the EUR/USD rate (chart 2). In the longer run, the correlation fluctuates and is closer for the interest rate differential in real terms than in nominal terms (charts 3 and 4). Thirdly, the monetary desynchronisation should influence the growth outlook in the Eurozone versus the US. In the former, rate cuts this year should support business sentiment, household confidence as well as spending whereas in the latter, with policy rates staying at their current level during a major part of the year, the growth outlook should soften. Historically, there is a rather close relationship between the difference in business sentiment and the EUR/USD rate: when sentiment in the Eurozone improves compared to the US, the euro tends to strengthen and vice versa (chart 5).[5] Finally, the inflation impact of a euro depreciation is rather small. Calculations by the ECB show that a 1% depreciation of the effective exchange rate of the euro, "*raises total import prices in the euro area and its member countries on average by around 0.3% within a year, and the headline HICP by around 0.04%.*"[6] It follows that it would require a significant depreciation of the euro -something which seems very unlikely at the current juncture- for the ECB to be constrained by the euro in setting its policy rate. In this respect, it is also important to look at the US side of the exchange rate. In a 'high rates for longer' environment in the US and the uncertainty this entails for the growth outlook, one should be mindful of the tail risk for US short term interest rates and hence the dollar. When reflecting about exchange rates, the entire distribution of possible outcomes should be considered.

William De Vijlder

EURO IN DOLLAR AND DIFFERENCE OF 2-YEAR NOMINAL INTEREST RATES

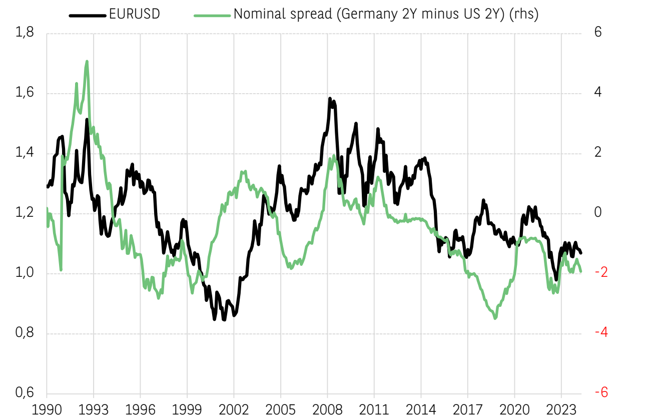

CHART 3 SOURCE: REFINITIV, BNP PARIBAS

EURO IN DOLLAR AND DIFFERENCE OF 2-YEAR REAL INTEREST RATES

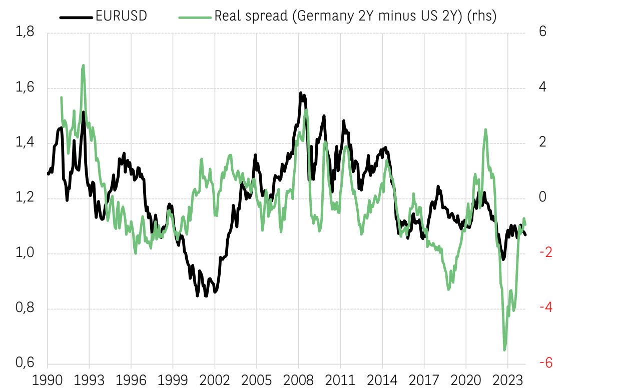

CHART 4 SOURCE: REFINITIV, BNP PARIBAS

EURO IN DOLLAR AND DIFFERENCE OF COMPOSITE PMI

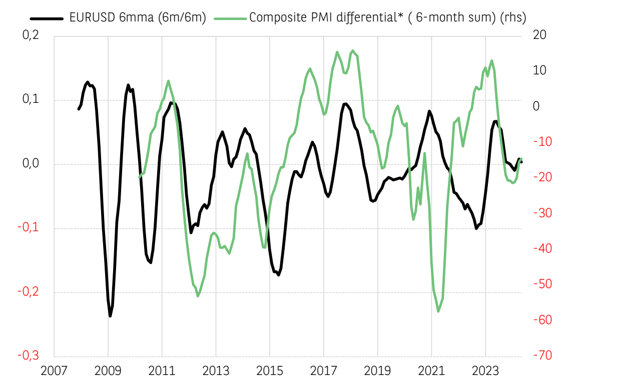

CHART 5 SOURCE: S&P GLOBAL, REFINITIV, BNP PARIBAS

4 Following the latest ECB decision, the difference between the upper limit of the federal funds target range and the ECB deposit rate is 175bp. We expect this to reach 200bp at the September meeting of the ECB before declining again to 175bp towards the end of 2025.

5 Academic research confirms that economic momentum influences the exchange rate. See in this respect Magnus Dahlquist and Henrik Hasseltoft, Economic momentum and currency returns, Journal of Financial Economics, 2020, pp. 152-167.

6 Source: Eva Ortega, Chiara Osbat, Exchange rate pass-through in the euro area and EU countries, ECB Occasional Paper 241, April 2020.