RESILIENCE, UNCERTAINTY AND ROBUST MONETARY POLICY

Recent data in the US show a resilient economy despite the significant and fast tightening of monetary policy. In the Eurozone, the services sector is a source of resilience. Frustratingly for central banks, inflation has also been resilient. This would call for a strong message of further monetary tightening, were it not that uncertainty about the outlook is high. More than ever, central banks need a robust strategy which takes into account a range of possible outcomes. As a consequence, the message from the FOMC has taken a dovish twist. Reading between the lines, the ECB's message is also softening, as witnessed by the strong emphasis on data-dependency and the role of financial conditions.

Despite weakness in certain areas -most notably housing-, overall economic data in the US show a resilient economy despite the significant and fast tightening of monetary policy in this cycle. Based on recent data releases, the Federal Reserve Bank of Atlanta's model-based estimate for real GDP growth (seasonally adjusted annual rate) in the first quarter of 2023 was 3.2 percent on 24 March. Monthly job creations -a key indicator for monetary policy- remain elevated and S&P Global's flash composite PMI for March rebounded strongly on the back of an improvement in manufacturing and services.

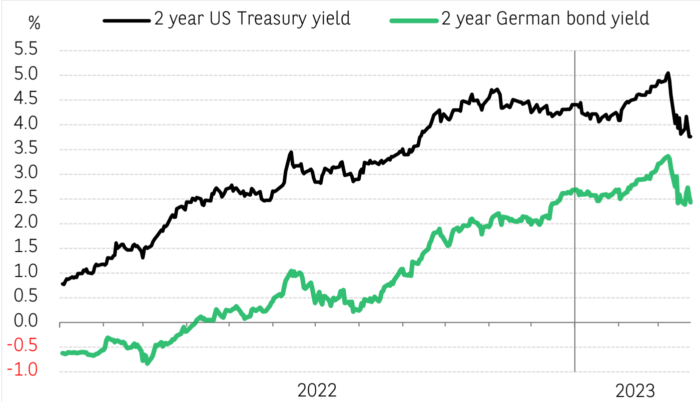
In the Eurozone, resilience has been concentrated in services, as witnessed by the flash PMIs for March that show a mixed picture with a decline in manufacturing but a strong increase in services. On balance, the composite PMI rose for the fifth month in a row, reaching 54.1, which corresponds to a ten-month high[1]. Such a high reading suggests that first quarter growth could surprise to the upside.

Frustratingly for central banks, inflation has also been resilient. Federal Reserve chairman Jerome Powell recently unambiguously stated that *"inflation remains too high"*[2] and ECB president Christine Lagarde has argued that *"inflation is projected to remain too high for too long."*[3]

This would call for a strong message of further monetary tightening, were it not that uncertainty about the outlook is high. In the US, the latest economic projections of Federal Reserve Board members and Federal Reserve Bank presidents show a shift to the left of the range of real GDP growth projections for this year to -0.5%/+1.0%. The range of projections for the unemployment rate has widened, with an upper end at 5.3%[4]. Christine Lagarde has also emphasized that *"the level of uncertainty will most likely remain high."*

A key source of uncertainty is the speed and strength of transmission from monetary policy measures to financial and monetary conditions -the first leg of monetary transmission- and from the latter to demand and inflation -the second leg of monetary transmission[5].

US AND GERMAN 2-YEAR YIELDS



SOURCE: FEDERAL RESERVE, REFINITIV, BNP PARIBAS

The latest ECB Bank Lending Survey and the Federal Reserve's Senior Loan Officers Survey show a clear tightening in credit conditions -the level of interest rates and the conditions that are applied- and an increasing number of banks report weakening loan demand[6]. In the past, similar developments have been followed by a negative impact on growth and this cycle should be no exception.

One can also assume that the full effect of past rate hikes on credit conditions hasn't yet fully materialized. In addition, as stated by Jerome Powell, *"events in the banking system over the past two weeks are likely to result in tighter credit conditions for households and businesses, which would in turn affect economic outcomes."*[7]

1 Source: Fastest uptick in US private sector business activity for almost a year, as new orders return to growth, but selling price inflation accelerates, S&P Global, 24 March 2023. Service sector revival powers eurozone growth higher in March, S&P Global, 24 March 2023.
2 Source: Transcript of Chair Powell's Press Conference, 22 March 2023, Federal Reserve.
3 Source: Press conference, Christine Lagarde, President of the ECB, Luis de Guindos, Vice-President of the ECB, Frankfurt am Main, 16 March 2023.
4 Source: Summary of Economic Projections, 22 March 2023, Federal Reserve.
5 Source: The path ahead, Speech by Christine Lagarde, President of the ECB, at "The ECB and Its Watchers XXIII" conference, Frankfurt am Main, 22 March 2023.
6 For more details on the Eurozone, see Monetary policy's long and variable lags: the case of the Eurozone, Ecoweek, BNP Paribas, 27 February 2023. For the US, see Monetary policy's long and variable
lags: the case of the United States, Ecoweek, BNP Paribas, 13 March 2023.
7 Source: see footnote 2.

The dovish shift in the Federal Reserve's message has been explicit whereas the change in the ECB's message should be read between the lines. In both cases, incoming data credit conditions will play a key role.

EDITORIAL

Christine Lagarde has warned that the latest ECB staff forecasts *"do not incorporate the effects of the recent financial market tensions. Those tensions have added new downside risks and have made the risk assessment blurrier."*[8]

As a consequence, the message from the FOMC has taken a dovish twist. The statement *"we anticipate that ongoing rate increases will be appropriate to quell inflation"* has been replaced with *"some additional policy firming may be appropriate."* The course of action is no longer pre-set and will depend on incoming data and the assessment of "*the actual and expected effects of tighter credit conditions on economic activity, the labor market, and inflation."*[9]

For the ECB, as explained by its president, policy will depend on the incoming economic and financial data, the dynamics of underlying inflation and the strength of monetary transmission. To achieve the goal of price stability *"we need a robust strategy, which takes into account the high levels of uncertainty we are facing today."* Compared to the Federal Reserve, the change in the ECB's message should be read between the lines. It is articulated through an emphasis on data-dependency and the role of financial conditions.

William De Vijlder

8 Source: see footnote 5.
9 Source : see footnote 2.