EDITORIAL

TOWARDS AN UNWELCOME TIGHTENING OF FINANCIAL CONDITIONS IN THE EURO AREA?

The financial cycle, as captured by bond and equity market developments is very much globally synchronised, but, at present, there is a business cycle desynchronization between the US and the euro area. Rising euro area government bond yields, on the back of higher US yields, cannot be considered as a sign of economic strength. Quite to the contrary, they come at a bad moment. One would expect, at a minimum, a very strong statement from the ECB's Governing Council on 11 March on its decisiveness to act should yields continue to rise. Markets would of course prefer immediate action. After all, the tool –the PEPP- is available so one might as well step up its use.

"The dollar is our currency, but it's your problem". The statement was made by Treasury Secretary John Connally at the G-10 meeting late 1971[1]. An updated version would go like *"It's our policy mix, but it's your problem"*. Of course, these words have not been uttered by US officials, but nevertheless, the combination of a strong commitment of sticking to a very accommodative monetary policy as long as necessary and a very expansionary fiscal policy –the upcoming USD 1.9 trillion fiscal stimulus– is having spillover effects in the euro area.

Some are favourable –the prospect of faster growth of exports to the US, confidence effects based on a feeling of "when the US is doing fine, the world economy will be in better shape"– but others are unfavourable. The latter refer to the increase in US Treasury yields which have pulled along euro area government bond yields (chart 1). Whereas the US economy should be able to cope with higher yields, at least up to a certain level, in the euro area it's another story. The financial cycle, as captured by bond and equity market developments is very much globally synchronised, but, at present, there is a business cycle desynchronization between the US and the euro area, witness e.g. the gap between the respective composite PMIs (chart 3).

Considering that the euro area, after a strong but short-lived rebound in the third quarter of 2020, again entered into recession in the fourth quarter, a significant tightening of financial conditions would be most unwelcome. Against this background, the financial conditions index for the euro area that has been developed by the Banque de France provides interesting insights[2]. The index consists of 18 variables grouped in 6 factors: interest rates, credit, equity, uncertainty, inflation and exchange rates. Whereas during the course of January, conditions became less easy, this movement has been reversed in February (chart 3) on the back of developments in exchange rates, uncertainty, equity markets and credit. Inflation moved in the other direction whereas the contribution from the rates factor was stable. It should be emphasized that, based on this measure, financial conditions in general remain easy, so we should not be concerned too much about short term swings. On the other hand, the scores for rates and inflation are already in the 'tight' area and, should higher bond yields end up weighing more significantly on equity markets, the scores for the equity and uncertainty factors would also worsen[3].

The issue of assessing financial conditions came up several times in the press conference of ECB President Lagarde on 21 January and, given recent market developments, we can expect it will again be a key topic during the press conference on 11 March. The message in January was that *"our assessment of favourable financing conditions is not driven by any single indicator. It is a holistic approach, it takes into account multiple indicators"*[4]. The emphasis on 'holistic' reflects that whether tighter conditions warrant policy actions depends on the economic context[5]. At the current juncture, rising euro area government bond yields cannot be considered as a sign of economic strength. Quite to the contrary, they come at a bad moment. Fabio Panetta, member of the Executive Board of the ECB, has been very explicit on this in a recent speech: "*we are already seeing undesirable contagion from rising US yields into the euro area yield curve. If unaddressed, this would lead to a tightening of financing conditions that is inconsistent with our domestic outlook and inimical to our recovery*." [6] Based on this, one would expect, at a minimum, a very strong statement from the ECB's Governing Council on 11 March on its decisiveness to act should yields continue to rise. Markets would of course prefer immediate action. After all, the tool –the Pandemic Emergency Purchase Programme– is available so one might as well step up its use.

William De Vijlder

1. *"The dollar is our currency, but it's your problem"* IPE Magazine, October 2007.
2. A new Banque de France Financial Conditions Index for the euro area, Bulletin de la Banque de France, 223/1 - May-June 2019.
3. In the Banque de France index, the equity factor is represented by the Euro Stoxx broad index and the Euro Stoxx Banks index whereas the uncertainty factor is captured by Euro Stoxx implied volatility and the Citigroup Surprise index for the euro area.
4. ECB, Press conference of Christine Lagarde, President of the ECB, and Luis de Guindos, Vice-President of the ECB, 21 January 2021.
5. For a detailed explanation why a financial conditions index cannot be used in a mechanical way in setting monetary policy, see: Calibrating unconventional monetary policy, Speech by Peter Praet, Member of the Executive Board of the ECB, 6 April 2017.
6. *"Mind the gap(s): monetary policy and the way out of the pandemic"*, Speech by Fabio Panetta, Member of the Executive Board of the ECB, 2 March 2021.

FINANCIAL CYCLE SYNCHRONISATION

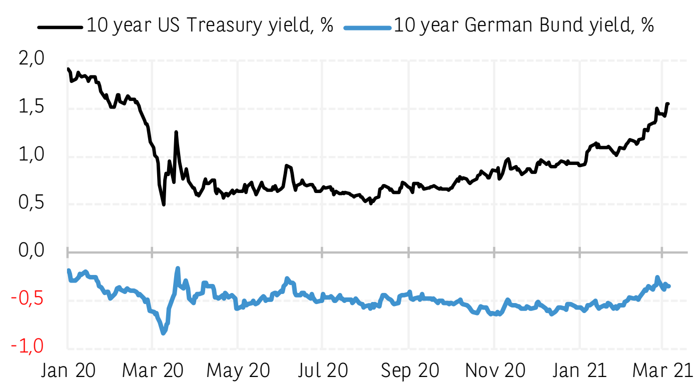

CHART 1

SOURCE: REFINITIV, BNP PARIBAS

DESYNCHRONISATION OF BUSINESS SENTIMENT

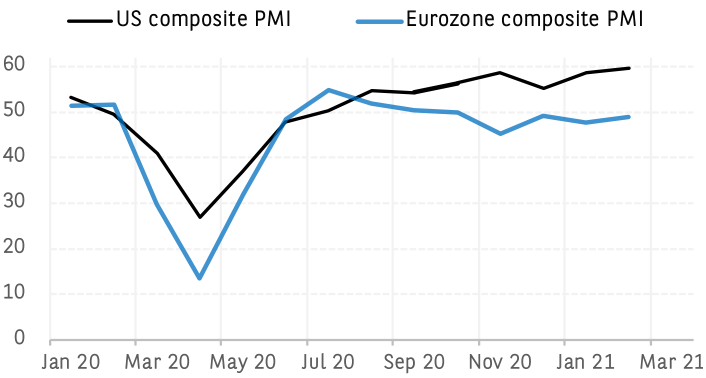

CHART 2

SOURCE: MARKIT ECONOMICS, BNP PARIBAS

EUROZONE: FINANCIAL CONDITIONS INDEX (FCI)

CHART 3

SOURCE: BANQUE DE FRANCE, BNP PARIBAS

EUROZONE FINANCIAL CONDITIONS INDEX – FACTOR DECOMPOSITION

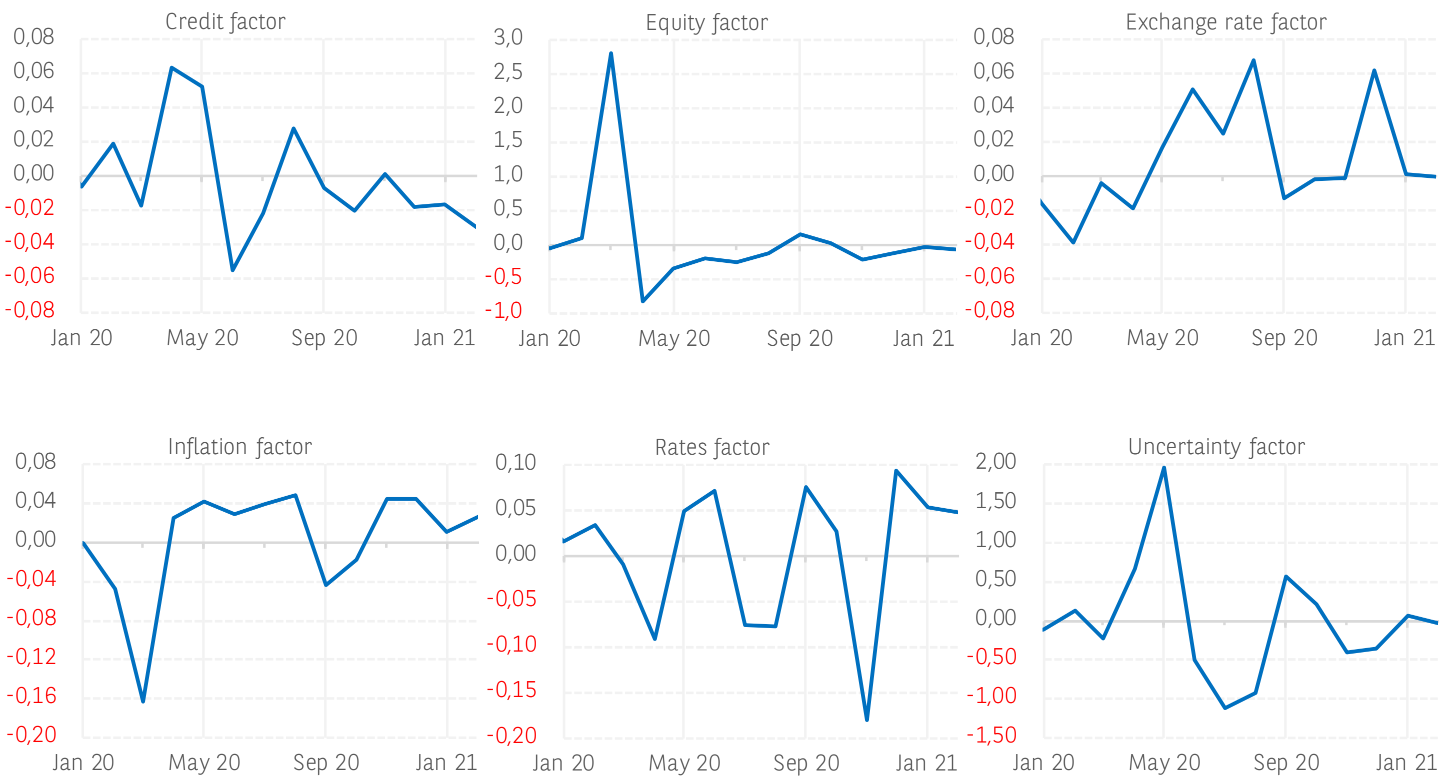

CHART 4

SOURCE: BANQUE DE FRANCE, BNP PARIBAS