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> "THERE IS A CLEAR CASE FOR COORDINATION BETWEEN MONETARY AND FISCAL POLICY IN THE PURSUIT OF THEIR COMMON OBJECTIVE OF PRICE STABILITY. HOWEVER, PUTTING THIS INTO PRACTICE WOULD PROBABLY BE VERY CHALLENGING."

ECONOMIC RESEARCH

BNP PARIBAS

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THE NEXUS BETWEEN PRICE STABILITY, FINANCIAL STABILITY AND FISCAL SUSTAINABILITY (PART 2): THE COORDINATION BETWEEN MONETARY AND FISCAL POLICY

Traditionally, monetary policy focuses on price stability and fiscal policy on other objectives. When inflation is well below (above) target on a sustained basis, this separation of roles implies that monetary policy may need to become extremely accommodative (restrictive). Consequently, interest rates have a large cyclical amplitude, which may have undesirable consequences for the economy and put financial stability at risk. Simulations show that a coordinated approach between monetary and fiscal policy reduces the optimal cumulative amount of rate cuts (hikes). However, putting this into practice would probably be very challenging.

Last week's editorial of EcoWeek concluded that, given the interactions between price stability, financial stability and fiscal sustainability, it is important that each policy -monetary, fiscal, financial stability oriented- is conducted in a way that takes into account its influence on the other policy objectives in order to enhance overall economic stability. This week's editorial applies this line of thinking to assess the potential for coordination between monetary and fiscal policy in the pursuit of a common objective: price stability. Such a coordination would be very different from the traditional approach of monetary policy focusing on inflation and fiscal policy on other objectives.

When inflation is well below target on a sustained basis -such as post the Great Recession of 2008-2009-, this separation of roles implies that monetary policy may need to become extremely accommodative through a combination of official interest rates that reach the zero lower bound, quantitative easing and forward guidance, which signals that this policy will be kept in place for the foreseeable future. Likewise, when inflation is well above target, which corresponds to the recent experience, a very significant monetary tightening may be required by hiking official interest rates, quantitative tightening and dropping forward guidance by moving to a data-dependent approach.

Consequently, over the course of a business cycle, market interest rates may drop significantly but rebound strongly thereafter (charts 1 and 2). Such a large cyclical amplitude of interest rates may have undesirable consequences for the economy and put financial stability at risk. Low policy rates and quantitative easing force financial investors to take more risk and aggressive rate hikes have the opposite effect.

A recent ECB paper[1] studies the effects of low short-term interest rates on the optimal portfolio allocation of investors and introduces the concept of portfolio instability. This corresponds to "*the amount of optimal portfolio shifts needed to respond to exogenous shocks to the expected risk and return of the risky portfolio assets*." Positive (negative) shocks to expected risk (return) trigger a pressure to reduce the exposure to riskier asset classes.

US : POLICY RATE, FED BALANCE SHEET AND 10-YEAR TREASURY YIELD

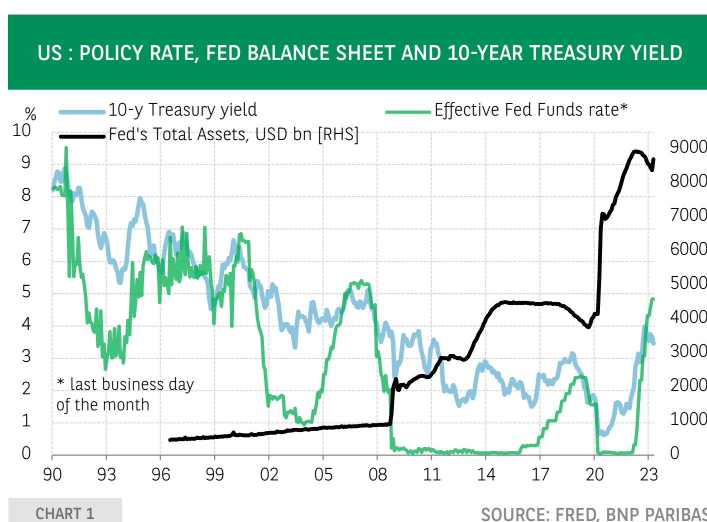


CHART 1 SOURCE: FRED, BNP PARIBAS

This pressure is stronger the lower the risk-free interest rate. Based on counterfactual analysis, the authors demonstrate "*that the sell-off in riskier asset classes during the Covid crisis in March 2020 was more severe than would have been in the presence of higher short-term interest rates*."

This outcome is caused by two channels. First, low rates create an incentive to 'climb the risk ladder' and to increase exposure to assets with a higher expected return, which comes with higher risk. Two, a sustained period of very low official interest reduces the volatility of riskier assets because through forward guidance the central bank signals that rates will remain low for a long time.

1 Lieven Hermans, Thomas Kostka and Danilo Vassallo, Asset allocation and risk taking under different interest rate regimes, ECB working paper 2803, March 2023.

Based on the experience since the Great Recession and model-based simulations, there is a clear case for coordination between monetary and fiscal policy in the pursuit of their common objective of price stability. However, putting this into practice would probably be very challenging.

Moreover, low rates are growth-supportive and reduce concerns about negative shocks to cashflows. Consequently, both channels "*incentivise the build-up of large and leveraged risky asset shares during calm periods which need to be unwound in the event of higher market volatility*." 'Climbing the risk ladder' can also consist of increased duration exposure of fixed income investments. In this respect, the 'dash for cash' in the UK early October[2] last year and the recent problems of a small number of regional banks in the US[3] are concrete examples of the havoc that may be caused when bond yields rise strongly.

As noted by Isabel Schabel of the ECB recently, *"we are coming out of a very long period with very low interest rates. That was a period in which a number of financial fragilities were built up, which are now exposed by the rapid hiking cycle. Rising interest rates affect funding costs and asset prices, and they affect everybody at the same time, banks and non-banks. This poses challenges we need to take very seriously."*[4]

Against this background, it seems commendable to coordinate monetary and fiscal policy. When inflation is too low (high), fiscal stimulus (restraint) could help in boosting (lowering) inflation and reduce the extent of monetary accommodation (tightening). Such an approach has been analysed in a recent ECB working paper[5]. The authors simulate rule-based monetary and fiscal policies that react to a divergence of inflation from its target[6]. When inflation is too low, interest rates are cut and fiscal policy reacts countercyclically by increasing government spending. This coordinated approach lowers the frequency of hitting the zero lower bound of the policy rate, i.e. it reduces the optimal cumulative amount of rate cuts.

Fiscal policy can also be used to cool inflation. This was analysed by the IMF in its latest Fiscal Monitor. Using a model that takes into account inequality in incomes, consumption and asset holdings, the authors conclude that "*a reduction in the fiscal deficit leads to a similar level of disinflation but requires a smaller increase in interest rates than when central banks act alone*." Moreover, "*the analysis also shows that deficit reduction combined with transfers to the poorest yields a smaller drop in total private consumption and a consumption path associated with less inequality across households. These effects are even more important when public debt is high because fiscal restraint limits the rise in the cost of borrowing and reduces debt vulnerabilities*."[7]

Based on the experience since the Great Recession and model-based simulations, there is a clear case for monetary and fiscal policy coordination in the pursuit of their common objective of price stability. However, putting this into practice would probably be very challenging.

Firstly, there is the question of calibration. When inflation is too low (high), the central bank, when deciding on the extent of monetary easing (tightening), will need to make an assumption about the effectiveness of fiscal stimulus (restraint) in generating more (less) inflation[8]. Secondly, joint communication will be important to make sure that economic agents, when forming their inflation expectations, take into account the monetary and the fiscal policy decisions.

EUROZONE : POLICY RATE, ECB BALANCE SHEET AND 10-YEAR BUND YIELD

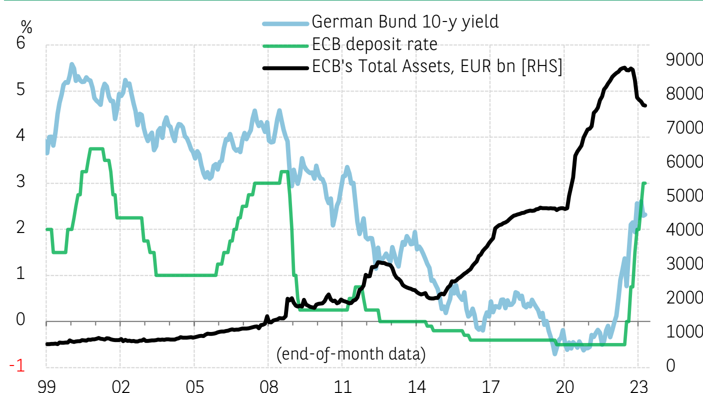


CHART 2 SOURCE: ECB, REFINITIV, BNP PARIBAS

Clear communication must avoid the impression that the central bank is not doing enough to address the inflation issue because this could cause an unanchoring of inflation expectations. Thirdly, there may be concern that fiscal easing when inflation is too low would, for political reasons -upcoming elections, a new government- not be turned back when inflation has reached its target.

A rule-based fiscal policy would allow to address this issue, but what would be the credibility of such a rule? Finally, there may be concern that this would open the door to fiscal dominance and that monetary policy decisions, particularly when inflation is above target, would become influenced by the shape of public finances.

To conclude, in its latest World Economic Outlook, the IMF noted that "*as inflation returns to target, the effective lower bound on interest rates may become binding again[...]. This could limit central banks' ability to respond to negative demand shocks*."[9] According to the IMF, this could trigger the reemergence of a debate about the appropriate level of target inflation. With this in mind, having a debate on the pros, cons and feasibility of a coordination between monetary and fiscal policy would also be useful.

William De Vijlder

2 See United Kingdom: the 'dash for cash', leverage and the need for economic policy coordination? Ecoweek, BNP Paribas, 3 October 2022.
3 In a nutshell, the issue was a combination of an asset side of the balance sheet dominated by elevated interest-rate exposure through securities not priced at market value and a liability side with predominantly uninsured deposits.
4 Source: ECB, Interview with Isabel Schnabel, Member of the Executive Board of the ECB, conducted by Johanna Treeck (Politico) on 20 April 2023, 24 April 2023.
5 Sebastian Hauptmeier, Christophe Kamps, Lucas Radke, Counter-cyclical fiscal rules and the zero lower bound, ECB working paper 2715, August 2022.
6 Fiscal policy also reacts to the increase in public sector debt to avoid an unsustainable development of public finances.
7 Emphasis added. Source: IMF, Fiscal Monitor, April 2023.
8 This depends on whether households associate fiscal stimulus with a future increase in taxes, which would influence their savings decisions today (Ricardian equivalence), on the nature of the fiscal stimulus (tax cuts, subsidies, consumption vouchers, expenditure increases, etc.), on implementation lags, etc.
9 Source: IMF, World Economic Outlook, April 2023.

MARKETS OVERVIEW

OVERVIEW

Week 21-4 23 to 28-4-23				
↘ CAC 40	7 577	▸ 7 492	-1.1	%
↗ S&P 500	4 134	▸ 4 169	+0.9	%
↗ Euribor 3M (%)	3.26	▸ 3.27	+0.4	bp
↗ Libor $ 3M (%)	5.26	▸ 5.30	+4.7	bp
↘ OAT 10y (%)	3.00	▸ 2.84	-15.9	bp
↘ Bund 10y (%)	2.49	▸ 2.32	-16.5	bp
↘ US Tr. 10y (%)	3.57	▸ 3.43	-14.4	bp
↗ Euro vs dollar	1.10	▸ 1.10	+0.6	%
↗ Gold (ounce, $)	1 978	▸ 1 990	+0.6	%
↘ Oil (Brent, $)	81.7	▸ 79.5	-2.7	%

MONEY & BOND MARKETS

	Interest Rates		highest 23			lowest 23		
€	ECB	3.50	3.50	at	22/03	2.50	at	02/01
	Eonia	-0.51	-0.51	at	02/01	-0.51	at	02/01
	Euribor 3M	3.27	3.29	at	24/04	2.16	at	02/01
	Euribor 12M	3.88	3.98	at	09/03	3.30	at	19/01
$	FED	5.00	5.00	at	23/03	4.50	at	02/01
	Libor 3M	5.30	5.30	at	28/04	4.77	at	02/01
	Libor 12M	5.37	5.88	at	08/03	4.70	at	20/03
£	BoE	4.25	4.25	at	23/03	3.50	at	02/01
	Libor 3M	4.62	4.62	at	28/04	3.87	at	02/01
	Libor 12M	0.81	0.81	at	02/01	0.81	at	02/01

At 28-4-23

	Yield (%)		highest 23	lowest 23
€	AVG 5-7y	2.64	2.64 at 02/01	2.64 at 02/01
	Bund 2y	2.79	3.36 at 08/03	2.39 at 20/03
	Bund 10y	2.32	2.75 at 02/03	1.98 at 18/01
	OAT 10y	2.84	3.23 at 03/03	2.42 at 18/01
	Corp. BBB	4.43	4.75 at 03/03	3.95 at 02/02
$	Treas. 2y	4.09	5.12 at 08/03	3.86 at 24/03
	Treas. 10y	3.43	4.06 at 02/03	3.30 at 06/04
	High Yield	8.65	9.16 at 20/03	7.94 at 02/02
£	gilt. 2y	4.17	4.33 at 19/04	3.15 at 02/02
	gilt. 10y	3.72	3.86 at 19/04	3.00 at 02/02

At 28-4-23

EXCHANGE RATES

1€ =		highest 23			lowest 23			2023
USD	1.10	1.10	at	13/04	1.05	at	05/01	+3.4%
GBP	0.88	0.90	at	03/02	0.87	at	19/01	-1.0%
CHF	0.98	1.00	at	24/01	0.97	at	15/03	-0.5%
JPY	150.33	150.33	at	28/04	138.02	at	03/01	+6.8%
AUD	1.67	1.67	at	26/04	1.53	at	27/01	+6.2%
CNY	7.65	7.65	at	28/04	7.23	at	05/01	+3.1%
BRL	5.52	5.79	at	04/01	5.40	at	08/03	-2.0%
RUB	88.54	91.39	at	26/04	73.32	at	12/01	+13.6%
INR	90.35	90.43	at	13/04	86.58	at	08/03	+2.3%

At 28-4-23 *Change*

COMMODITIES

Spot price, $		highest 23			lowest 23			2023	2023(€)
Oil, Brent	79.5	88.2	at	23/01	72.6	at	17/03	-6.4%	-9.5%
Gold (ounce)	1 990	2 037	at	13/04	1 810	at	24/02	+9.6%	+6.0%
Metals, LMEX	3 908	4 404	at	26/01	3 824	at	15/03	-1.9%	-5.2%
Copper (ton)	8 577	9 331	at	23/01	8 236	at	04/01	+2.5%	-0.9%
wheat (ton)	227	2.9	at	13/02	225	at	27/04	-20.5%	-23.1%
Corn (ton)	239	2.7	at	13/02	237	at	27/04	-0.8%	-11.4%

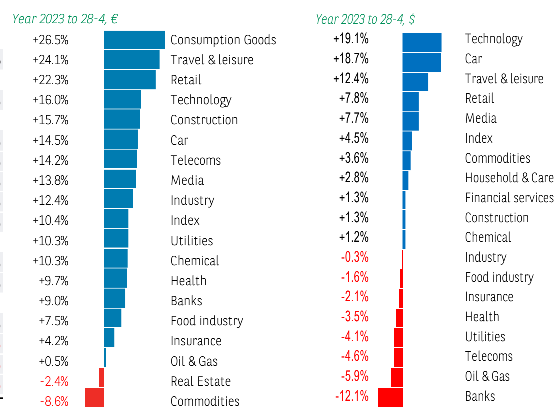
At 28-4-23 *Change*

EQUITY INDICES

	Index	highest 23			lowest 23			2023
World								
MSCI World	2 836	2 848	at	02/02	2 595	at	05/01	+9.0%
North America								
S&P500	4 169	4 180	at	02/02	3 808	at	05/01	+8.6%
Europe								
EuroStoxx50	4 359	4 409	at	21/04	3 856	at	02/01	+14.9%
CAC 40	7 492	7 577	at	21/04	6 595	at	02/01	+1.6%
DAX 30	15 922	15 922	at	28/04	14 069	at	02/01	+14.4%
IBEX 35	9 241	9 511	at	06/03	8 370	at	02/01	+1.2%
FTSE100	7 871	8 014	at	20/02	7 335	at	17/03	+0.6%
Asia								
MSCI, loc.	1 139	1 143	at	09/03	1 065	at	04/01	+0.7%
Nikkei	28 856	28 856	at	28/04	25 717	at	04/01	+10.6%
Emerging								
MSCI Emerging ($)	977	1 052	at	26/01	941	at	16/03	+0.2%
China	63	75	at	27/01	62	at	20/03	-0.3%
India	750	786	at	18/01	703	at	16/03	-3.8%
Brazil	1 422	1 574	at	25/01	1 296	at	23/03	-7.7%

At 28-4-23 *Change*

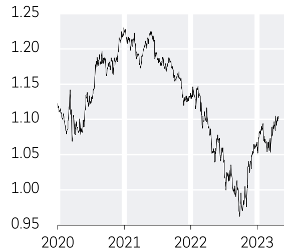
PERFORMANCE BY SECTOR (Eurostoxx50 & S&P500)



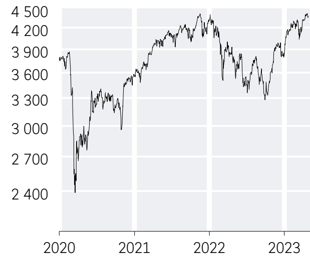
SOURCE: REFINITIV, BNP PARIBAS

MARKETS OVERVIEW

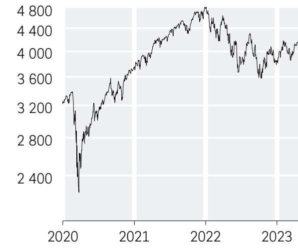
EURO-DOLLAR



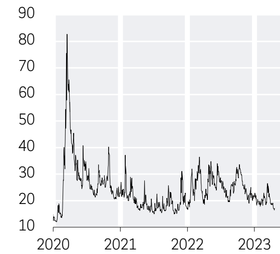
EUROSTOXX50



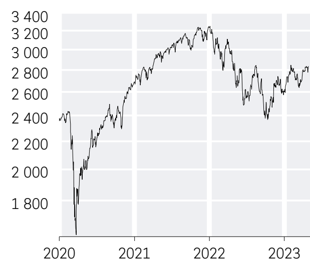
S&P500



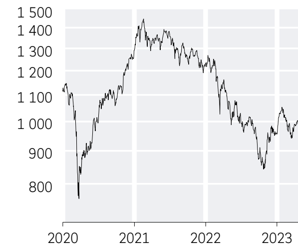
VOLATILITY (VIX, S&P500)



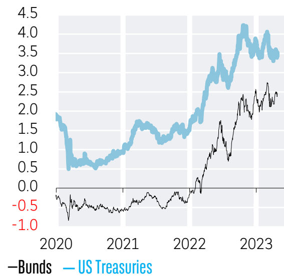
MSCI WORLD (USD)



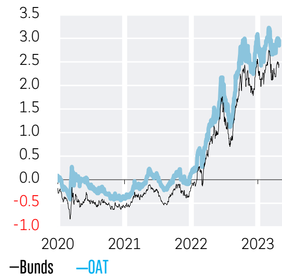
MSCI EMERGING (USD)



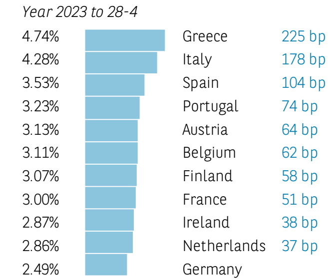
10Y BOND YIELD, TREASURIES VS BUND



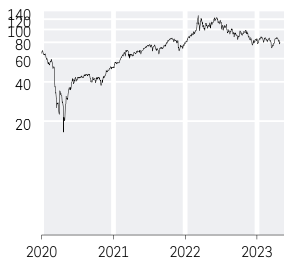
10Y BOND YIELD



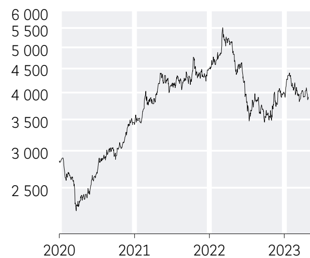
10Y BOND YIELD & SPREADS



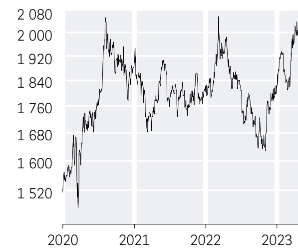
OIL (BRENT, USD)



METALS (LMEX, USD)



GOLD (OUNCE, USD)



SOURCE: REFINITIV, BNP PARIBAS

UNCERTAINTY: BETWEEN REBOUND AND REFLUX, IN APRIL, TRAJECTORIES DIVERGE

Our various uncertainty indicators are complementary in terms of scope and methodology. Starting with the upper left chart, uncertainty over US economic policy, which is based on media coverage, rebounded in March after trending downwards since September 2022. This uptick probably reflects the Minutes of the March FOMC, which showed that several members were concerned about the banking sector.

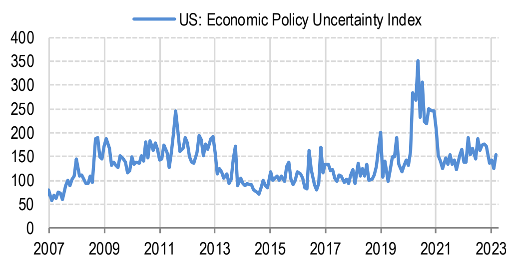
Moving clockwise to the next chart, the uncertainty felt by US companies about their sales revenue growth remains comparatively high compared to before the Covid-19 pandemic. In contrast, uncertainty about employment prospects has fallen back to pre-pandemic levels.

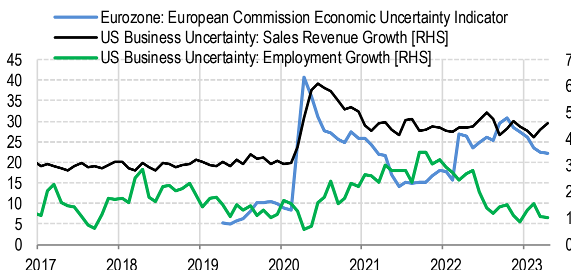
The European Commission's economic uncertainty index declined in April thanks to the easing of uncertainty in the various business sectors, with the exception of services, where uncertainty picked up.

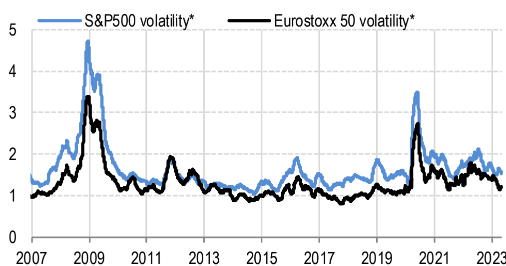
The geopolitical risk index (lower right chart), which is also based on media coverage, increased in April after a sharp decline in March. Lastly, our equity market uncertainty index (dispersion of the daily performances of individual companies) declined in April in the United States, after increasing in March (probably due to the recent turmoil in the banking sector). It remains on a downward trend in the Eurozone.

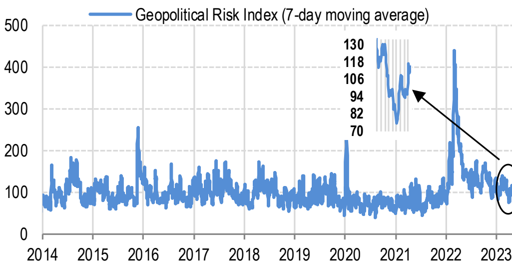
Tarik Rharrab

CHANGES IN UNCERTAINTY









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

SOURCE: REFINITIV, ECONOMIC POLICY UNCERTAINTY, EUROPEAN COMMISSION, ATLANTA FED, GPR INDEX (MATTEOIACOVIELLO.COM), BNP PARIBAS

ECONOMIC SCENARIO

UNITED STATES

The U.S. economy continued to grow in Q4, although it slowed slightly compared to Q3. However, the main drivers of growth, namely household consumption and private inventories, are fragile, suggesting that the economy should continue to slow. This slowdown remains progressive however as evidenced by the slow puncture of the labour market, with job creation remaining high, the unemployment rate low and wage growth buoyant. Inflation seems to have peaked in the middle of 2022, but core disinflation remains gradual in such a way that headline inflation should stay significantly above the target of 2% by the end of 2023. From this point of view, the Fed is probably not quite done with raising its policy rates yet. The ongoing monetary tightening is expected to drive the US economy into recession in the second half of 2023 and limit the expected recovery in 2024.

CHINA

Economic growth, which was sluggish and unbalanced in 2022, will strengthen in 2023. The end of the zero Covid policy has led to a rebound in private demand and activity in the services sector since late January, and household consumption will continue to benefit from large catch-up effects in the short term. However, while export and industrial production prospects are darkened by the weakening in global demand, activity driven by the domestic market remains constrained by important drags. In fact, the recovery in the labour market remains uncertain, the improvement in the property and construction sectors is likely to be limited, and the worrying financial situation of local governments should constrain public investment. Fiscal and monetary support is expected to be prudent. Consumer price inflation, which averaged 2% in 2022, should accelerate only mildly in 2023.

EUROZONE

Economic growth in the eurozone was zero in the fourth quarter of 2022, but better than expected for 2022 as a whole, at 3.5%. It continued to surprise favorably in the early months of 2023 judging by the improvement in survey data (business confidence and, to a lesser extent, consumer confidence). However, the combination of the inflationary shock, the energy crisis and forced monetary tightening and the build-up of their negative effects will weaken activity in 2023. Real GDP growth should be weakly positive in 2023 and 2024, at 0.8% and 0.5% respectively. Although it is expected to decline throughout 2023, inflation would remain elevated and well above the 2% target at the end of this year and still a bit above at the end of 2024, forcing monetary policy to remain in restrictive territory.

FRANCE

Real GDP growth has decreased in H2 2022 (0.2% q/q in Q3 and 0.1% in Q4, after +0.5% in Q2). Corporate investment and inventory rebuilding have remained the main growth drivers, whereas household demand has played on the downside: household consumption has decreased by 1.2% q/q in Q4 and their investment by 0.9%. As inflation is still high (and has reached a new peak of 7.3% y/y in February 2023 according to the harmonized measure) and because of rising interest rates, household demand should remain subdued in 2023, weighing on our GDP growth forecast (0.5% in 2023, compared to 2.6% in 2022).

RATES AND EXCHANGE RATES

In the US, the Federal Reserve should continue its tightening policy, but the terminal rate of the federal funds seems to have moved closer given the ongoing tightening of monetary and financial conditions and lending standards. Our forecasts now see it sooner and 50 basis points lower, at 5.25% (upper end of the target range) in May of this year. Given the expected slow decline in inflation and despite the economy entering recession, this level should be maintained through 2023 and only be followed by rate cuts in 2024. US Treasuries are largely pricing in the upcoming rate hikes. In the near-term, there is still some upward potential, in view of the Fed's bias, albeit somewhat less pronounced, to continue hiking, but subsequently yields should move lower as the inflation outlook improves and the market starts anticipating policy easing in 2024.

The ECB Governing Council is also expected to continue to raise its policy rates. If, for the Fed, we expect the hike in May to be the last one, for the ECB, the expected increase in May would be followed by two more, bringing the deposit rate at 3.75% in Q3. In the near term, government bond yields could resume rising if the ECB continues to tighten but thereafter yields should move lower, driven by a gradual decline in inflation. Lower US yields should also play a role in the decline of Eurozone yields.

The Bank of Japan has increased the upper end of its target range for the 10-year JGB yield to 0.5% and further adjustments to the yield curve control policy cannot be excluded. Nevertheless, we do not expect the BoJ to proceed with a rate hike.

We expect the dollar to weaken somewhat versus the euro. The dollar's valuation is expensive, positioning in the market is very long and the long-term interest rate differential should narrow. We expect the yen to remain around current levels in the near term before strengthening versus the dollar considering that the federal funds rate should have reached its terminal rate.

INFLATION* AND GDP GROWTH**

	GDP Growth**				Inflation*			
%	2021	2022	2023 e	2024 e	2021	2022	2023 e	2024 e
United-States	5,9	2,1	1,4	-0,1	4,7	8,0	4,4	2,6
Japan	2,2	1,0	1,2	0,8	-0,2	2,5	3,3	1,7
United-Kingdom	7,6	4,0	-0,4	1,0	2,6	9,1	6,6	2,0
Euro Area	5,3	3,5	0,8	0,5	2,6	8,4	5,4	2,6
Germany	2,6	1,9	0,3	0,5	3,2	8,7	5,8	2,6
France	6,8	2,6	0,5	0,6	2,1	5,9	6,1	3,0
Italy	7,0	3,8	0,9	0,7	1,9	8,7	6,1	3,0
Spain	5,5	5,5	1,4	0,8	3,0	8,3	3,2	2,2
China	8,4	3,0	5,6	5,3	0,9	2,0	2,7	2,5
India***	8,7	7,0	5,7	6,0	5,5	6,7	5,4	4,5
Brazil	5,0	2,9	1,5	0,5	8,3	9,3	5,5	5,5

* LAST UPDATE 28 APRIL 2023: INFLATION JAPAN; LAST UPDATE 20 APRIL 2023: INFLATION FOR EUROZONE, GERMANY, FRANCE, ITALY, SPAIN AND UK; LAST UPDATE 31 MARCH 2023: GDP AND INFLATION FOR THE US
** LAST UPDATE 21 APRIL 2023: GDP EUROZONE, GERMANY, FRANCE, ITALY AND SPAIN
*** FISCAL YEAR FROM 1ST APRIL OF YEAR N TO MARCH 31ST OF YEAR N+1

SOURCE: BNP PARIBAS (E: ESTIMATES & FORECASTS)

INTEREST AND EXCHANGE RATES

Interest rates, %					
End of period		Q2 2023	Q3 2023	Q4 2023	Q4 2024
US	Fed Funds (upper limit)*	5.25	5.25	5.25	3.50
	T-Note 10y **	3.75	3.50	3.40	3.25
Eurozone	deposit rate*	3.50	3.75	3.75	2.75
	Bund 10y	3.10	2.90	2.50	2.00
	OAT 10y	3.65	3.45	3.02	2.50
	BTP 10y	5.10	5.15	4.75	3.80
	BONO 10y	4.10	4.00	3.60	2.90
UK	Base rate*	4.50	4.50	4.50	3.50
	Gilts 10y **	3.75	3.50	3.35	2.80
Japan	BoJ Rate	-0.10	-0.10	-0.10	0.10
	JGB 10y**	0.45	0.60	0.65	0.80

Exchange Rates					
End of period		Q2 2023	Q3 2023	Q4 2023	Q4 2024
USD	EUR / USD	1.10	1.12	1.14	1.18
	USD / JPY	133	130	127	121
	GBP / USD	1.24	1.26	1.28	1.33
EUR	EUR / GBP	0.89	0.89	0.89	0.89
	EUR / JPY	146	146	145	143

Brent					
End of period		Q2 2023	Q3 2023	Q4 2023	Q4 2024
Brent	USD/bbl	85	90	90	95

* DEPOSIT RATE: LAST UPDATE AT 27 APRIL 2023, FED FUNDS : 31 MARCH 2023, BOE RATE: 20 APRIL 2023
** GILTS 10Y: LAST UPDATE 20 APRIL 2023, JGB 10Y: 28 MARCH, US 10Y: 12 APRIL

SOURCES: BNP PARIBAS (MARKET ECONOMICS, INTEREST RATE STRATEGY, FX STRATEGY, COMMODITIES DESK STRATEGY)

FURTHER READING

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Inflation Tracker April 2023	EcoChart	6 April 2023
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