EDITORIAL

THE GLOBAL REPERCUSSIONS OF THE FEDERAL RESERVE'S INFLATION AVERAGING STRATEGY

The Fed's new inflation averaging strategy should have global real and financial spillover effects. The former refer to international trade whereby a more sustained expansion of US GDP should pull along the economies of its trading partners via increased US imports. The financial spillovers are driven by capital flows, monetary policy and risk appetite. These factors are highly intertwined. The new Fed strategy will also force other central banks to revisit their own strategy. This creates an issue for the ECB.

The revision of the Federal Reserve's longer-run goals which was announced recently[1] should have important repercussions in the US, but also globally. Domestically, the prolongation of the highly accommodative monetary policy is expected to lead to stronger growth, a lower rate of unemployment and, eventually, somewhat higher inflation. It could also lead to a higher cyclical peak in the federal funds rate.

These developments should have global real and financial spillover effects. The former refer to international trade whereby a more sustained expansion of US GDP should pull along the economies of its trading partners via increased US imports. Model-based estimates show that a 1% US growth shock would increase growth in the rest of the world by 0.7 percentage points after one year[2]. The financial spillovers are driven by capital flows, monetary policy and risk appetite. These factors are highly intertwined. Easy monetary policy by the Federal Reserve creates an incentive for US investors to take more risk domestically –e.g. by investing more in corporate bonds, equities, real estate, etc.- and/or to seek attractive opportunities abroad. Capital inflows coming from the US underpin asset prices and force other central banks to adopt a more accommodative policy in order to avoid even bigger inflows and an appreciation of their currencies[3]. This in turn supports domestic credit growth and risk taking and is one of the reasons why financial markets are highly correlated globally. In addition, a very accommodative Fed policy fuels the expansion of global bank credit because of easy access to cheap dollar funding.

A crucial factor for financial markets is risk appetite of international investors. Research shows that fluctuations in the federal funds rate is a key determinant of swings in the required risk premium[4]. When the US policy rate is low, the willingness to take risk is high across the globe, pushing up asset valuations and the reverse happens in a tightening environment. It is important to keep this in mind considering that the Federal Reserve, having accepted inflation above 2% for a while to allow its average over time to reach 2%, will have to tighten at some point. There is genuine concern that 'low for longer' in the short run would be followed by 'quickly higher' in the longer run with the effects on asset prices one can imagine.

In addition to the pure economic spillovers, the new Fed strategy will also force other central banks to revisit their own strategy. This is particularly important for the ECB, which is in the process of conducting its own strategy review. The Fed has taken a dovish turn with the revision of its longer-run goals and there is now a big gap between its *'inflation averaging 2% over time'* and the ECB's *'inflation close to but below 2%'*. Should this continue, it could structurally underpin the euro versus the dollar and make it even more difficult for the ECB to achieve its inflation objective.

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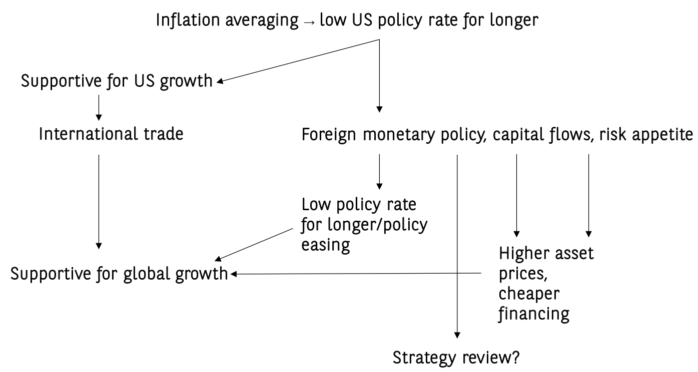
THE FEDERAL RESERVE'S NEW STRATEGY: GLOBAL REPERCUSSIONS



SOURCE: BNP PARIBAS

1. See The *Federal Reserve enters a new era of inflation targeting*, BNP Paribas, Ecoweek, 31 August 2020
2. Source: *The Global Role of the U.S. Economy, Linkages, Policies and Spillovers*, World Bank Policy Research Working Paper 7962, February 2017
3. See *International monetary spillovers*, BIS Quarterly Review, September 2015
4. See *Global Financial Cycles and Risk Premiums*, Òscar Jordà, Moritz Schularick, Alan M. Taylor and Felix Ward, NBER Working Paper No. 24677, June 2018

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