A TOOL FOR EACH TARGET, OR HOW TO RECONCILE PRICE STABILITY AND FINANCIAL STABILITY

The recent difficulties faced by some US regional banks have reignited the debate about a potential conflict between pursuing price stability and financial stability at the same time. Should central banks, and the Fed in particular, stop tightening their monetary policy in order to maintain financial stability, even while inflation remains high? Or should they stay the course, continuing to increase their policy rates until they are sure that inflation is falling towards the 2% target, but risking destabilising the financial sector? The Fed and the ECB decided to stay the course during their March meeting, emphasizing that banking systems were generally sound, that visibility on the possible fallout from the recent turmoil is too limited and that they were still attentive to inflation risks. Thus, unless the economy cools abruptly, the Fed and the ECB have probably not completely finished with their rate hikes just yet.

The current monetary tightening cycle has been atypical in many respects. The pace of the rate increases hasn't been seen for a long time. The reaction of risky assets, such as equities or corporate bonds, which initially was negative (last year saw declining equity markets and widening corporate bond spreads) has been followed by a risk-on mindset, with markets speculating that the terminal value of the federal funds rate was not that far off.

Will the rate hike cycle also end in an atypical way? The recent events, which affected a number of US regional banks in March, raised the question as to whether the Fed will be forced, on financial stability grounds, to end its monetary tightening policy, or even reverse course and cut its rates, despite the still elevated inflation. In a matter of days, the markets have completely repriced the future path of the policy rate[1]. In addition, the two-year Treasury yield, which is very sensitive to changes in the outlook for monetary policy, showed extreme volatility. Its decline on 13 March was bigger than anything seen since the October 1987 stock market crash.

THE DEPENDENCE OF THE FINANCIAL SPHERE ON MONETARY POLICY

Whether there is a potential conflict between the pursuit of price stability (bringing inflation back to the 2% target in a timely way) and maintaining financial stability has been a hotly debated topic for years. The argument for a tradeoff states that a very accommodative monetary policy (with several years of the policy rate at the zero lower bound and quantitative easing) eventually causes financial imbalances (such as excessive borrowing to finance projects, particularly in real estate) and leads to a compression of risk premia and expensive valuation levels in the financial markets, leaving the financial sphere vulnerable to changes in course and tighter monetary policy.

Indeed, when monetary policy becomes restrictive, some projects become unprofitable, risk premia increase, equity valuations become less expensive and corporate bond spreads widen. This does not inevitably lead to a financial crisis (defined by strong instability and a disorderly correction in asset prices and the flow of credit), particularly as, up to a certain degree, the tightening of financial conditions is an integral part of monetary transmission. If anything, the surprise this year had been the resilience of the financial markets despite an ever higher federal funds rate, which sparked debate in early February around monetary policy becoming ineffective due to the easing of monetary and financial conditions[2].

The counter-argument, which claims that no such conflict exists, insists that a tradeoff would risk a central bank losing credibility in its fight against inflation, while inflation is still very high and disinflation is slow. At the same, losing credibility would also likely drive rates up, exacerbating the weaknesses of some banks, rather than easing them.

The difficulties faced by some US regional banks in March 2023 have rekindled fears about financial stability, prompting the government to take containment measures quickly[3]. In view of this turmoil, the question as to whether the Fed should pause its tightening in order to defuse the situation came to the forefront very quickly. Should it opt for financial stability over price stability?

A TOOL FOR EACH OBJECTIVE

The debate was settled in March, with price stability coming out on top. The Fed stayed its course, highlighting the general solidity of the banking system, the overly high levels of inflation and the lack of visibility on the possible fallout from the recent turmoil. The week before, the ECB had already hiked its rates once again, arguing that inflation is well above the target level and that there is a specific tool for achieving each target (separation principle), such as rate hikes for price stability, a range of liquidity mechanisms and the TPI (Transmission Protection Instrument) for financial stability and the smooth transmission of monetary policy. As a result, price stability and financial stability can be maintained at the same time. Finally, in their recent communication, the two central banks explicitly included the macroeconomic and financial conditions used for their assessment of the inflation path in their reaction function.

TOWARDS AN ACCELERATION OF THE TRANSMISSION OF MONETARY POLICY TO THE ECONOMY

However, recent developments are likely to accelerate the transmission of monetary policy as a result of their negative repercussions on financial conditions and lending standards exacerbating the tightening already underway, which, in turn, would be a drag on growth and inflation. The uncertainty stems from the extent of these negative repercussions. Considering that this further tightening will do part of the central banks' job, and that some caution is required in this more unstable and uncertain environment, both the Fed and the ECB would have to raise their policy rates less during this cycle. However, with inflation still very high and core disinflation slow, unless the economy cools abruptly, the central banks have probably not completely finished

1 The market-implied federal funds rate for next December has, at some stage, dropped 150 basis points to about 4.0%, before rebounding.
2 William De Vijlder, Ecoweek editorial of 6 February 2023: Central banks, markets and the economy wrong-footed on three occasions (bnpparibas.com)
3 The Fed decided to make additional liquidity available by setting up a new Bank Term Funding Program (BTFP), with securities pledged as collateral being valued at par. The Treasury Department approved measures to enable the FDIC to execute the Silicon Valley Bank and Signature Bank resolutions in a manner that will ensure full protection for depositors, both insured and uninsured. On 19 March, the

with their rate hikes just yet. Yet, the end of the tightening cycle has suddenly moved closer into view.

Our new forecasts from late March illustrate this and pinpoint the terminal level of policy rates earlier and 50bps lower than expected at the beginning of March: for the ECB, the deposit rate stands at 3.50% in June after two further expected hikes by 25 bps in May and June; for the Fed, the fed funds rate stands at 5.00-5.25% in June, following a final hike by 25 bps in May. We have also slightly revised our growth and inflation forecasts for the United States and the euro area downwards (*see table*). 2023 had started on a more positive note than expected, but since then, uncertainty and downside risks have risen.

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Fed, along with the ECB, the Bank of Canada, the Bank of Japan, the Bank of England and the Swiss Central Bank, announced that its dollar foreign exchange swaps would become more frequent (going from weekly to daily).

GDP GROWTH AND INFLATION

Average annual percentage change	GDP Growth	Inflation	GDP Growth				Inflation			
	2022		New forecast		Early March forecast		New forecast		Early March forecast	
			2023	2024	2023	2024	2023	2024	2023	2024
United States	2.1%	8.0%	1.4%	-0.1%	1.5%	0.0%	4.4%	2.6%	4.4%	2.6%
Eurozone	3.5%	8.4%	0.7%	0.5%	0.7%	0.8%	5.3%	2.5%	5.2%	2.6%

TABLE 1 SOURCE: BNP PARIBAS