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Tough job that of a central banker

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Bruno Cavalier - Chief Economist
bruno.cavalier@oddo-bhf.com
+33 (0)1 44 51 81 35

Fabien Bossy - Economist
fabien.bossy@oddo-bhf.com
+33 (0)1 44 51 85 38

https://www.oddosecurities.com

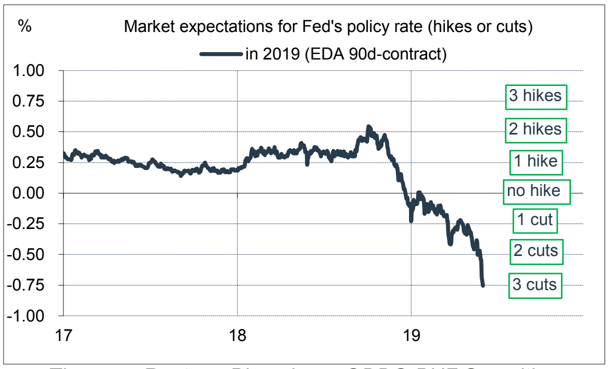
The escalation of trade tensions poses a new problem for central bankers. Making the right choices becomes more difficult in this scenario. The Fed is under constant pressure from Donald Trump to lower its rates. The market thinks that this cut in rates is imminent. The ECB is not subject to this kind of political pressure but the uncertainty surrounding the renewal of the Dream Team that managed the euro crisis in 2012 is complicating the decisions. With inflation expectations pointing downwards, the ECB should logically send signals that there is hope for monetary easing fairly soon. It is far from certain that it will be in a position to do so this week.

Monetary reaction functions, from the Fed to the ECB

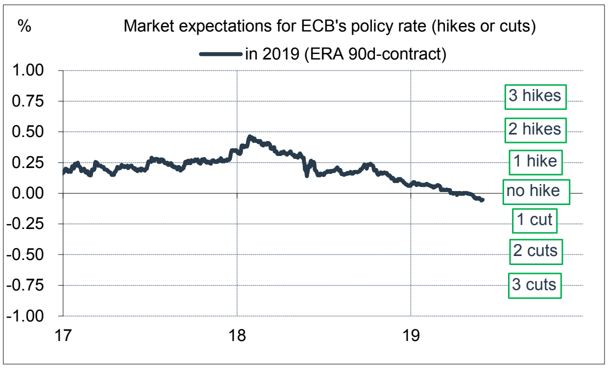
Investors, bankers, economists, financial journalists, politicians, everyone has their own ideas about what monetary policy should be. The central bank cannot satisfy everyone all the time. Normally, its action is dictated by a mandate that more or less explicitly aims to stabilise economic and financial conditions (employment, inflation, markets). Monetary decisions are not always easy to make in ordinary times, but when additional elements of uncertainty are put into the mix, they become infinitely more complex.

Let us give two examples. The first concerns the Fed. At first sight, in a situation of full employment, with inflation slightly below its target and an S&P500 index that is only about 7% below its historical record, there is no justification for lowering key rates, let alone reviving QE. The US president nevertheless is demanding both of these, taking as witnesses his tens of millions of followers as to the merits of his demands. One wonders whether Donald Trump is trying to make the economic environment so chaotic and unpredictable that it forces the Fed's hand. In the face of gloomy prospects, it would be logical for the Fed to ease its policy. A few weeks ago, forward contracts anticipated a decline in Fed rates towards the end of the year. But as of now, two or three decreases are expected out to this horizon, the first one as soon as next month (chart lhs). **The Fed's current position is status quo, but pressure in favour of lower rates is now huge. It will become increasingly difficult for the Fed to resist. This will not be possible if job creation weakens, even modestly, let alone if stock markets really correct.** Given the influence of the Fed's policy in determining long rates and the dollar, its decisions may have a global impact, including on the interest-rate expectations of other central banks. Market expectations about ECB rates are also on a downward trend, even though its key rate is already in negative territory and around 300bp below that of the Fed (chart rhs).

US: market expectations for the Fed's policy rate



Eurozone: market expectations for ECB policy rate



Sources: Thomson Reuters, Bloomberg, ODDO BHF Securities

This brings us to a second example, which we will examine in greater detail, that of the ECB. Here, there is no political pressure to adopt a specific stance. However, it is up to European leaders to appoint the members of the ECB board, which will have an impact on how monetary policy is conducted. This year, this problem is significant in two respects. First, it is a coincidence in terms of the timeframe that the choice of the president of the ECB takes place when the heads of state and government must agree on a candidate to propose for the Commission's presidency. We cannot help but link these two choices, even if one is political and the other should not be at all[1]. Second, the major changes at the ECB this year are not limited to **Mario Draghi's** succession, but also concern the two people who were responsible for framing the monetary debate at the beginning of each Council meeting, **Peter Praet**, whose term of office has just ended, and **Benoît Coeuré**, whose mandate will be over end-2019. **These three formed a Dream Team in the management of the euro crisis in 2012 and in all the decisions that resulted from it. Their successors will, by definition, be less experienced and perhaps less responsive in the event of market turbulence.**

In addition to the uncertainty regarding the composition of the ECB's board, there is also uncertainty about the direction of its monetary policy. **What should the ECB do given that real GDP growth in the eurozone is subject to downside risks and that inflation remains well below its target? If we refer to the ECB's reaction function, the answer is obvious: monetary policy should be eased**. **In 2014, Mario Draghi had even described in detail the procedure to be followed[2]. At the time, he identified three risks, each requiring a different response.**

- **The first risk was unwarranted monetary tightening**, e.g. a rise in the euro or long rates resulting from contagion from the US markets. The ECB then had to respond by lowering its policy rates into negative territory. This is not the type of problem we are seeing today. The euro is currently undervalued. That said, **negative interest rates** are proving controversial. Banks are taking every opportunity to call this a "tax" that is eating into their profits (to the tune of around € 8bn, i.e. 0.4% applied to around € 1,900bn in surplus reserves). This "tax" could be reduced by creating a Swiss- or Japanese-type tiering system which would make some of these reserves "tax"-exempt. But this is a technically complex solution that creates distortion of its own. In addition, banks' low profits are not solely attributable to negative rates. Other causes are at play that the ECB deems more decisive (cost-control and a lack of consolidation). In any case, the governing council does not seem overly keen on creating a tiering system in the immediate term. Some are not in favour because this would allow the negative interest rate policy to be pursued in the longer term. Other probably think that paving the way to a possible reduction in the deposit rate would be premature.

- **The second risk was a freeze on the credit channel due to a shortage of bank liquidity**. The response was an abundant supply of the necessary liquidity by adjusting its cost depending on new loan production. This is what led to TLTRO-II. **TLTRO-III** is now being planned, but we do not know what the terms will be yet. At first glance, the goal is not, as was the case in 2014, to stimulate loans to the economy (their growth is now steady) but to ensure that no bank in the eurozone will encounter refinancing issues over the next two years. This should prompt the ECB to set less generous terms than in the past[3]. Nevertheless, given the negative balance of risks, it would be dangerous for the ECB to increase the cost of liquidity excessively because of the risk of a contraction of its balance sheet. As shown by the US end-2018, market players would be quick to see this as a form of quantitative tightening. This is not the message that Mario Draghi wants to send out.

- **The third risk was a drop in medium-term inflation expectations which, if it persisted, would give rise to expectations of deflation**. The response to this risk was to launch QE on government bonds. At the time, in a noted speech at Jackson Hole, Mario Draghi drew attention to a specific metric for inflation expectations taken from the inflation swaps market[4]. This indicator has declined significantly in recent months. It is much lower than its 2014 level and has recently tested its low points of

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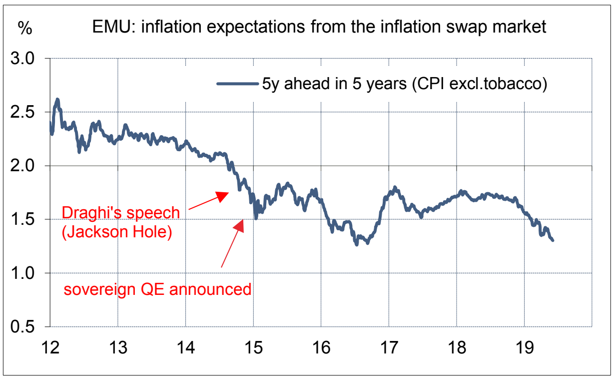
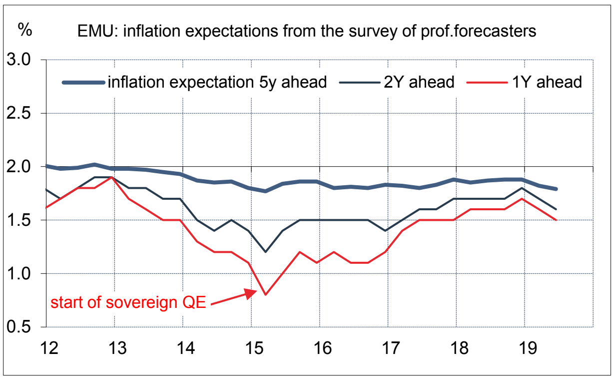
[1] The criteria of competence and experience are the key elements for appointment to the ECB Board. But there are also various unwritten rules on the representation and rotation of different countries. Regarding Draghi's succession candidates, in particular the Weidmann case, see our previous note dated 9 April, 2019: "What legacy will Mario Draghi leave to the ECB?"
[2] See Draghi (2014), "Monetary policy communication in turbulent times", speech of 24 April 2014.
[3] The benchmark rate for the TLTRO-III will be the refi rate (0%) but we do not know yet whether a negative premium will be applied, as in TLTRO-II.
[4] See Draghi (2014), "Unemployment in the euro area", speech of 22 August 2014.

2016 (lhs chart). Rather than being alarmed at this, the ECB has attributed this drop to global factors, which minimises the risk of deflation in the eurozone. Note also that other measurements of inflation expectations, based on surveys conducted with professional forecasts, are less worrying than the levels seen in 2014 (rhs chart). **In any case, there seems to be no question of restarting QE in the eurozone at present. This option would be sure to reignite opposition from the Bundesbank. It would also compel the ECB to review the technical constraints of its asset purchases one way or another** (split by country, 33% criterion).

EMU: inflation expectations – markets' view



EMU: inflation expectations – forecasters' view



Sources: Bloomberg, ECB, ODDO BHF Securities

All in all, we would tend to conclude that the situation in the eurozone is not solid enough to rule out the possibility of monetary easing – especially given the Fed's more accommodative stance now – but not fragile enough for immediate action to be warranted. The growth rates at the start of the year have been a little better than anticipated and the business climate has stabilised, except in the manufacturing sector.

In contrast, inflation in the eurozone is still too weak in light of the target and, more seriously, the ECB seems to be living with the situation, in the absence of a miracle solution to improve the trajectory. In March, the ECB's staff issued a forecast for core inflation of 1.6% in 2021. There is no reason for this figure to be raised in this month's updated projections. On the subject of inflation, the ECB recently endeavoured to show that once the appropriate factors were stripped out (prices of goods set on the global market, price of administered services, impact of taxes), domestic inflation has indeed started to rally in the eurozone. Even if these arguments make sense[5], **the ECB seems resigned to inflation being weak**. Since the start of 2019, core inflation has been around 1%. There was a time that Mario Draghi said that this was the edge of the "danger zone" to be avoided at all costs. We have no memory of this expression being used recently. **Unlike the Fed which has kicked off a review of its monetary strategy this year to re-establish the symmetry of its inflation target, no similar steps are on the horizon at the ECB**.

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[5] *See Cœuré (2019), "The rise of services and the transmission of monetary policy", speech of 16 May 2019, or Ehrmann & al. (2018), "Measures of underlying inflation for the euro area", ECB Economic Bulletin*

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