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Research & Strategy Insights


# And now to the ECB (again)

# 80 – 22 February 2021

## Key points

- Real long-term interest rates rose in the Euro area last week, following the US reaction to the Biden plan. Some overheating in the US is in the ECB's interest, since it could weaken the euro, bringing European inflation closer to target. But without a stronger domestic economy the euro depreciation, alone, will not suffice. The ECB can't be passive.

As we expected the rise in US long-term interest rates continued last week. A new development is that real rates are rising as well. It is no longer only a question of inflation expectations. The situation is still manageable for the Fed though. Real yields are still very negative, maintaining very favourable financial conditions while the US economy is about to receive another substantial fiscal stimulus. The market has brought forward its timing for the first Fed hike by a few months, but it is still not expected before 2023, thus consistent with a very long phase of accommodative monetary policy, considering the fact that with the Biden plan, the US economy may well close its output gap by the end of 2021. At some point the Fed will have to change its mode of intervention on the bond market – possibly with an "operation twist" – if the tightening in market conditions continues, but the "pain threshold" probably has not been met yet.

The rise in real yields in the Euro area is more problematic in our view, as it is at odds with the more compromised macroeconomic situation of the region, and with the ECB's explicit willingness to focus precisely on real interest rates when defining the favourable financing conditions which it has committed to defend. This calls for action, and a decisive acceleration in PEPP purchases could do the trick.

Still, some economic overheating in the US triggering a faster-than-expected rise in market interest rates there could play in the hands of the ECB, as it could lead to a depreciation in the euro exchange rate contributing to bring Euro area inflation in line with the central bank's target. We offer in this note some illustrative quantifications. In case of a "fast tapering" in the US bringing 10-year treasury yields to 3% in 2022, the euro could weaken by 10% against the dollar, in turn lifting inflation to 1.9% in 2023 (against 1.4% in the ECB's baseline). The relationship between exchange rate movements and inflation has been far from perfect though. Since the advent of the single currency in 1999, 3 out of 6 phases of euro depreciation ended up with a deceleration of inflation. Higher imported prices can permeate consumer prices only if domestic cyclical conditions are strong enough. If the European output gap is still far from closed by the time the depreciation occurs, then it is illusory to count on the exchange rate movement to lift inflation. This is another reason why the ECB would need to accelerate PEPP spending, beyond protecting a wide-enough spread with the US. Easy financial conditions in the Euro area are a condition for a quick absorption of capacity underutilization.

## Pesky real interest rates

We focused last week on the odds of Biden's fiscal plan triggering an inflation shock, concluding that irrespective of whether the US inflation regime would move up in reaction to transitory overheating, the market would not take chances and that long-term interest rates would continue to rise. The developments of the last few days have strengthened that view, with 10-year treasury yields reaching 1.30% last Friday, but with a twist. Until then, the rise in nominal yields was almost exclusively driven by a re-appraisal of inflation expectations**. Last week, real rates led the charge**, with a rise of 20 basis points (bps) since a recent low at -1.07% on 10 February (Exhibit 1). This a key change, since it questions the credibility of the Fed's pledge to tolerate inflation overshooting in the future under its Average Inflation Targeting framework.

**The pressure on the US central bank remains bearable though**, in our opinion. Bloomberg computations suggest that investors now expect the Fed's first hike to take place in March 2023, from July 2023 a month ago. Since Biden's plan has the potential to bring the economy back to potential in late 2021 already, such a timeline for the first hike means that the market continues to expect a very unusually accommodative Federal Reserve (Fed) long into an overheating phase. Absolute levels also matter. Real rates remain deeply negative, allowing for a significant natural erosion in public debt, especially in a country where real potential growth is probably around 1.7/1.8%. Assuming debt sustainability matters to the Fed's reaction function – it's not as explicit as in the European Central Bank (ECB)'s case – Jay Powell and his colleagues in the Federal Open Market Committee (FOMC) can still feel relatively comfortable on that front. If market pressure continues, there is of course a level at which the Fed would be forced into action (probably in the form of an "operation twistst"). Symbolically, hitting zero on real rates in the coming months – i.e., another 80bps to climb– would probably get alarm bells ringing, but the central bank would likely want to warn the market some time before reaching that point.

Exhibit 1 – US real rates are affected…

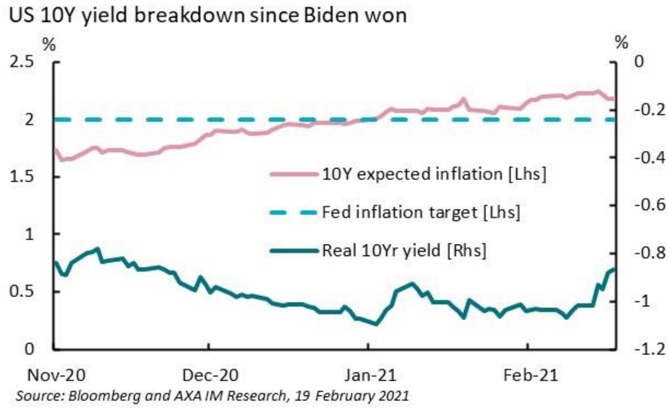
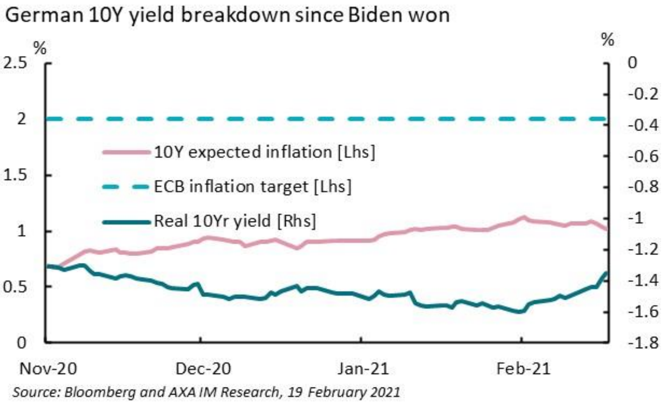



Exhibit 2 – …and this is happening in Europe as well




**The recent rebound in European real yields is more surprising and more problematic for the central bank.** There, market based-inflation expectations have stopped rising over the last week and remain low, barely exceeding 1% for Germany over a 10-year horizon. In other words, investors still believe that the ECB will be very far from delivering on its target for the decade to come. However, real yields have also rebounded by almost 20 basis points there. The absolute level is still nearly 50 basis points below that of the US, but this is smaller gap than the differential in potential GDP growth, closer to 70/80bps in most estimates. Of course, just like in the US, **at such low level, market interests are still very favourable, but this remains an issue for the ECB given its explicit message on keeping "financing conditions" in check.**

At her press conference in January, Lagarde affirmed the ECB's commitment to keeping financing conditions stable but making it plain that the central bank would take a "multi-faceted" and "holistic" view on how these conditions would be defined. The minutes of the January meeting gave the Governing Council an occasion to start being clearer on how they see this. The crucial part of the minutes is the following: *"it was noted that nominal yields were not an appropriate benchmark for assessing whether financing conditions remained favourable, as they could rise because of a better economic outlook and higher inflation expectations. What mattered from a monetary policy perspective* *was the evolution of real rates, which had declined to record low levels in recent weeks".* Such focus on real interest rates will unavoidably get investors asking some sort of policy action from the ECB if the recent rise continues.

**Flows under the Pandemic Emergency Purchase Programme (PEPP) are likely to come under scrutiny.** In January net purchases fell to EUR53bn, down from 57bn in December 2020, hitting the lowest full monthly level since the start of the programme. The data relative to the first two weeks of February (EUR30.6bn cumulatively) suggests some acceleration but failing to stop the rise in yields. A more decisive pace of buying is warranted. The flip side of the recent slow buying is that the central bank has accumulated some dry powder within its expanded envelope and has ample capacity now to "send a signal" to the market by upping its purchases drastically to nip the rebound in market yields in the bud. PEPP is primarily seen as an "anti-spread widening" instrument, which is justified by its flexibility relative to the rules governing the ECB's "old" quantitative easing programmes. The positive political developments in Italy makes this side of the ECB action less of a burning issue. Focusing for a while on the reference "risk-free yield", i.e., Bunds, could be warranted.

## The three channels of inflation contagion

In the section above we focused on "financial contagion", but the intensity of the US news flow should make us explore other types of spillovers which should ultimately be the driving force behind a transatlantic "re-coupling" on markets. **We covered in last week's Macrocast the "great US inflation fear". We want to explore here the ramifications for Europe**.

The region is at little risk of a domestically led inflation burst given how far it is from absorbing its own overcapacity. As we discussed last week, estimating the output gap precisely can be difficult, but there are many reasons to believe it is more negative in the Euro area than in the US: GDP fell by much more in 2020, and it is likelier to decline again in Q1 2021. Fiscal support is decent, but even when taking on board automatic stabilisers, it can't beat Biden's emergency stimulus. Still, the current US configuration can affect the European inflation trajectory through three different channels.

**The first one is the direct trade link, through a rise in the price of imports sourced from the US. This is likely to be negligible**. According to the organization for Economic Co-operation and Development (OECD) integrated trade statistics, US products accounted for only 2.5% of imported consumer goods in France for instance, five times less than those imported from China. True, when taking a broader look and including services, the US continues to matter. Their share in foreign value added embedded in the total domestic demand of the Euro area still stood at 15% in 2015 (last available observation), above that of China (11.3%), but the details suggest that this primarily reflects their dominance in services such as information, communication and entertainment, which ordinarily display very specific price behaviour. To take a concrete example, it is not obvious generic inflation in the US would necessarily trigger a rise in the price of Microsoft products sold in Europe.

**The second channel works through the global output gap**. Inflation in a Phillips curve framework may no longer be solely explained by the pressure of local demand on local supply since businesses and consumers can offset local bottlenecks by resorting to foreign suppliers where pressure on supply is lighter. Then local inflation trajectories would be also dependent on the level of capacity utilisation at the global level. If the world economy is overheating, the overall capacity to dampen local price pressure with imported products will diminish. BIS economist Claudio Borio made his name on developing this framework and providing estimates of the respective impact of domestic and global macro conditions on inflation. He tried different version of the "global output gap" but with remarkably similar results: a change of 1% in the global output gap would lift inflation by 0.2/0.3% after one year.

We can apply these estimates to the current discussion on the international ramifications of the Biden plan. The US share in world GDP stands at 15%. Before the Biden package, the Congressional Budget Office (CB0) expected the US output gap to stand at -1.7% at the end of this year. Assuming the additional stimulus brings it to zero, this would lift the global output gap by some 25bs (0.15*1.7), resulting in a shock to global inflation comprised between 0.05 and 0.075% after one year. This would barely move the dial.

True, some second-round effects would probably magnify this impact to some extent (a quicker output gap closure in the US would boost growth elsewhere in the world beyond the mechanical share of the US in the global economy) but the calculation above illustrates a simple point: **on its own, even the first economy of the world cannot dramatically affect global inflation via the output gap channel.**

We note finally that Borio's analysis is not uncontroversial. Recent research suggests that the model works much better when looking at headline inflation and loses a lot of its predictive power when focusing on core inflation. This reflects the fact that global conditions have a very strong impact on commodity prices (e.g., oil). If one strips the consumer price basket from energy and food items, the weight of services in the index mechanically rises, and the price trajectory of these sectors tends to be driven essentially by domestic developments. Of course, persistent changes in the price of the volatile components of headline inflation can lift core inflation down the road – for instance through wage bargaining, since employees are likely to take into account fuel and food prices in their claims – but most of these shocks are transitory.

**The third contagion channel is through the exchange rate, and it can be quite powerful.** Until December 2019, the ECB systematically added to the baseline scenario in its macro forecasts two "sensitivity tests": one assuming a different trajectory for oil prices, and another one changing the path for the exchange rate. The latter allows us to derive the elasticity of inflation to changes in the euro/dollar parity in the ECB model, which is quite significant. A 10% depreciation (resp. appreciation) in the euro versus the dollar lifts (resp. cuts) inflation by c.0.5% after one year. This helps understand the Governing Council's sensitivity to the issue, to the point that the recent strength of the euro prompted some members to toy with the idea of taking the deposit rate further down to avoid another drift lower of European inflation.

Our macro team developed an econometric model explaining the euro/dollar by the 10-year spread between the US and the Euro area, the relative change in the two central banks' balance sheet, as well as the inflation and GDP growth differentials between the two regions. We can use this model to run illustrative simulations. **The euro would be lower by 10% relative to baseline** (1.06 versus 1.18, our baseline is the same as the ECB's) **at the end of 2022 if the Fed opted for a faster taper than what we have in mind, so that US 10-year yields would reach 3.0% by then instead of 2.0%.**

**So, in a situation of persistent overheating where US inflation would show signs of lasting acceleration beyond the end of 2021,** triggering a "change of heart" at the Fed and a quick roll-back of quantitative easing, with expectations of rate hikes being brought forward, **Euro area inflation could hit 1.9% in 2023 (adding 0.5% to the ECB's baseline in which inflation would be at only 1.4% at the end of its forecasting horizon).**

Of course, our use of "chained models" – plugging the result of our own model for the exchange rate into the ECB's model linking the exchange rate to inflation – means our result should be taken with some precaution. But it helps us make one important point: **US overheating is in the ECB's interest, in helping them bring the Euro area economy back to its inflation target, on the condition that it "stands in the way" of interest rate contagion.** Indeed, in our model, the euro declines by 10% because US long term rates rise much faster than in Europe (we kept the German 10-year yield at -0.2% in 2022). Mechanically, if the interest rate spread were to be tighter than in our simulation, the euro would of course be stronger, dampening the "imported inflation" effect. The ECB could count on some reflation effect from the exchange rate only if it can make sure that market interest rates continue to decouple relative to the US. This is why we think the Governing Council should not take too much time before addressing publicly the recent rise in real yields and act on it – preferably by transitorily upping its purchases.

Beyond avoiding a spread tightening vis-à-vis the US, there is another reason why the ECB would still need to keep domestic financial conditions favourable. Historically, the inflationary impact of a depreciation in the euro has often been offset by a deterioration in the European cycle. **Since the advent of the euro in 1999 we have observed six episodes of two-digit depreciation in the euro exchange rate vis-à-vis the dollar. Maybe counter-intuitively, inflation has decelerated as often as it accelerated a year after the end of these phases** (we take into account the lag between FX movements and the impact on consumer prices). This is illustrated in the second column of Exhibit 3.

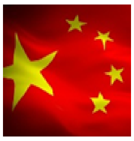
And in all three inflation acceleration cases, the year-on-year change in consumer prices has been smaller what the ECB would have predicted (last column of Exhibit 3).

Exhibit 3 - Inflation does not necessarily follows phases of euro depreciation

| | EURUSD % change | EA Core inflation actual change to yoy growth in t+1 (ppt) | ECB implied change to EA core inflation %yoy growth in t+1 (ppt) |
|---|---|---|---|
| Jan 99-Oct 00 | -26.3 | 1.1 | 1.5 |
| Dec 04-Nov 05 | -12.1 | 0.1 | 0.7 |
| Jul 08-Nov 08 | -19.3 | -0.9 | 1.1 |
| Nov 09-Jun 10 | -18.1 | 0.5 | 1.0 |
| Apr 11-Jul 12 | -14.9 | -0.6 | 0.8 |
| Mar 14-Apr 15 | -22.0 | -0.2 | 1.2 |
| Feb 18-Apr 20 | -12.0 | na | 0.7 |

*Source: ECB, datastream and AXA IM Research, 19 february 2021*

This poor relationship between the changes in the exchange rate and inflation mostly stems from the fact that **several of the depreciation episodes occurred against the backdrop of deteriorated cyclical conditions in the Euro area**. The euro went through two phases of depreciation during the Great Financial Crisis, at a time when domestic economic conditions stopped imported inflation from exerting contagion over much of the consumer price basket. The same occurred during the “double dip” recession triggered by the sovereign crisis, in 2011-2012. In concrete terms, if unemployment is still significantly above its structural level, then the imported inflation shock will merely be absorbed via a decline in real wages. It is only if the economy at the receiving end of the imported inflation shock is strong enough itself that producers and retailers will transmit the rise in the cost of their imports to their customers. The ECB cannot be passive if it really counts on some FX movements to help bring inflation back to target. Reacting to any further significant rise in Euro area real interest rates, for instance by transitorily boosting the pace of PEPP purchases, is not only a way to make sure the transatlantic spread continues to favour a stronger dollar. It is also a way to protect favourable financing conditions which will help close the Euro area’s output gap.

| Country/Region | What we focused on last week | What we will focus on in next weeks |
|---|---|---|
|  | • Retail sales surged to record 5.3% growth on the month – sharpest rise since June as stimulus cheques boost incomes.<br>• US 10-yr yields surged to trade over 1.30% for the first time since Feb 20, considering stimulus.<br>• PPI inflation rose to 1.7%yoy in January from 0.8%, suggests steep rise in PCE inflation<br>• FOMC minutes continued to suggest balance sheet policy changes were some way off.<br>• Virus cases continued to fall. | • Personal income for Jan, expect a leap as next stimulus cheques arrive<br>• PCE inflation for Jan, following sharp PPI reports, 'core' measure could reach 1.7%<br>• Revisions to Q4 GDP<br>• Latest batch of housing stats including new and pending home sales<br>• Jobless claims for latest week.<br>• Continued pace of virus decline and vaccine rollout. |
|  | • February Flash PMIs show solid manufacturing<br>• Draghi won the backing of 262 senators (out of 319) and 535 MPs (out of 630). Priorities of the new government include speeding up of the vaccination campaign, justice, public administration and tax system reforms<br>• Euro area Q4 GDP revised slightly up to -0.6%qoq | • German IFO and European Commission surveys worth watching to gauge manufacturing momentum<br>• Eurostat to reveal new 2021 HICP weights<br>• Expenditure breakdown of German and France Q4 GDP: look for resilience of private consumption and investment |
|  | • Virus cases record one day <10k first time since Oct, vaccines 16mn+, rate >2.7mn/week to 16/2<br>• Retail sales fell back sharply by -5.9%yoy reflecting impact of Lockdown 3.0.<br>• Feb Flash PMIs rise to 54.9 (+0.8p) in manufacturing and 49.7 (+10.2p) in services<br>• BoE's Ramsden sees "headroom" for more QE | • PM Johnson to present initial plans to ease lockdown, starting with schools from 8 Mar<br>• Continued -24%wow pace of virus fall; further increase in pace of vaccine rollout<br>• Labour market unemployment and earnings for December |
|  | • Q4 GDP growth was robust at +3%qoq with a strong rebound in capex (+4.5%), an acceleration in exports (+11%) and robust consumption +2.2%<br>• January CPI increased to -0.6%yoy from -1%, reflecting the suspension of the "Go to" campaign<br>• Feb Manuf PMI flash is now in expansion (50.6) | • February Tokyo CPI should be flat around -0.5%yoy<br>• Industrial production has probably accelerated in January<br>• Retail sales in January are likely to be impacted by the restrictions |
|  | • COVID-related restrictions have uneven impacts, pressuring tourism and transportation but boosting urban consumption, while industrial production remains strong | • Gradual removal of restrictions – as local infection cases fall to zero – should return the laggards to normalcy. PBoC's liquidity operation remains in focus |
|  | • Preliminary Q4 GDP in Colombia (-3.6%yoy), Thailand (-4.2%yoy), Hungary (-3.7%yoy) and Singapore (-2.4%yoy).<br>• Central banks were hawkish on hold in Turkey and Russia; 50bp unexpected rate hike in Zambia while Indonesia cut O/N rate by 25bps in line with expectations. | • CB meetings: Korea, Colombia, Hungary (all expected on hold)<br>• Jan CPI for Malaysia and Singapore; half-month Feb CPI in Brazil and Mexico<br>• Korea first 20 days exports for Feb<br>• Q4 2020 GDP for Mexico, Peru and India<br>• South Africa budget expected |

| | | |
|---|---|---|
| Upcoming events | US: | Mon: Chicago Fed National Activity (Jan), Leading Index (Jan); Tue: House price index (Dec), CB Cons Confi (Feb); Wed: New home sales (Jan); Thu: PCE prices (Q4), GDP (Q4); Fri: Federal Budget |
| | Euro Area: | Tue: HICP (Jan), Ge GDP (Q4), EA Busi and Cons Survey (Feb), EA CC (Feb); Fri: Fr GDP (Q4), PPI (Feb) |
| | UK: | Ave earnings (Dec), Unemployment rate (Dec), Labour productivity |
| | Japan: | Thu: Retail sales (Jan) |
| | China: | Housing prices (Jan) |

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