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Research & Strategy Insights

What won't be in the strategy review

59 – 11 September 2020

Key points

- The divergence between a decisive Fed and a more hesitant ECB is an interesting debate but it hides the fact that on both sides of the Atlantic monetary policy through its traditional transmission channels is facing diminishing returns. Allowing financial space for fiscally accommodative government is probably the most efficient channel at the moment – not something likely to be made explicit in a "strategy review".

The ECB was in focus this week. Although no "hard announcement" was expected, Christine Lagarde's press conference triggered a wave of comments on a divergence between the Fed's decisiveness and the ECB's more hesitant approach, which may be fuelling another bout of euro appreciation. It is true that while Jay Powell at Jackson Hole has communicated a significant change in approach – the shift to average inflation targeting – the ECB is not in a hurry to unveil its own strategy review.

Still, while we find the Fed's decision intellectually alluring, we are not convinced it can "move the dial" that much. Central banks on the two sides of the pond are faced with the same diminishing returns on their stimulus. We find it interesting that the ECB is increasingly explicit about the contribution from fiscal policy to achieving their inflation target. In turn, allowing financial space to fiscally accommodative governments may well be at the moment the most efficient transmission channel for monetary policy. This suggests that more fiscal stimulus does not exonerate the central banks from acting more themselves. In truth, this is why we expect the European central bank to announce a time and quantum extension of its Pandemic Emergency Purchase Programme at the end of the year. Government issuance will grow next year and sticking to the current soft deadline for PEPP (June 2021) would collide with the likely emergence of the EU's Recovery and Resilience debt issuance. The ECB can hardly warmly praise the initiative as Christine Lagarde did this week, without making sure that financial conditions will be favourable when it becomes a material issuer.

This might well be an extreme form of "fiscal dominance", and one which central banks may be reluctant to make too explicit in any strategy review, especially the ECB given the nominal fiscal orthodoxy of the European Treaty. This is of course a slippery slope. Knowing where to stop will be key and finding the right balance between making public debt sustainable and condoning reckless fiscal behaviour is hard to find and will require a very high level of coordination between the central bank and the governments. The alternative though – allowing the economy to fall in a deflationary trap – is not more palatable.

European Central Bank (ECB): markets are insatiable

Market focus on this week's ECB meeting was squarely on the exchange rate issue. There were two realistic options for Christine Lagarde to deal with questions on the recent euro appreciation: either echoing Philip Lane's statement two weeks ago and acknowledge that the strength of the currency has an impact on the Euro area economic outlook and hence implicitly on the ECB's policy; or siding with the more hawkish Isabel Schnabel's line, who dismissed the euro appreciation as merely reflecting heightened confidence in the Euro area as an institutional construct. Lagarde unambiguously chose the Lane's camp, and importantly did so in the prepared statement, which implies the support of a majority of Council members, and not in the Q&A in which the President of the central bank can send a more personal message. The wording ("*the Governing Council will carefully assess incoming information, including developments in the exchange rate, with regard to its implications for the medium-term inflation outlook* ") was similar to the line taken by Mario Draghi in January 2018, the last time the ECB had mentioned this issue in the statement (*"the recent volatility in the exchange rate represents a source of uncertainty which requires monitoring with regard to its possible implications for the medium-term outlook for price stability"*).

This is textbook verbal intervention. The ECB does not have an exchange rate target, nor should it. The history of the European Exchange Rate Mechanism in the 1990s should remind anyone of the dangers of providing the market with a quantitative target to test. If currency movements matter, it is essentially because they affect the inflation and growth trajectory. It is one input among many others in the central bank's reaction function. No less. No more.

This was clearly not enough for the market, which pushed the euro further up. We find this surprising since expecting more than this – e.g. actual policy action – was unrealistic in our view. Moreover, when asked specifically about the possibility to cut the deposit rate further – seen by the market as the nuclear exchange rate appreciation killer – Lagarde did not elude. So far in the Q&A when discussing the ECB's arsenal, she had exclusively talked about quantitative easing and targeted longer-term refinancing operations (TLTROs). She chose to make the point that "*no instrument is excluded*". While we think that the probability of another depo cut is low, it was still important that Lagarde did not dismiss the option – again against the background of Isabel Schnabel coming out quite forcefully against it recently.

Maybe the latter talking point came too late in the conversation and by then the market had "made up its mind" but in truth it may be possible to find in the ECB's communication more reasons to doubt the ECB's resolve to "do whatever it takes" in the current circumstances, even if we don't think it is intentional.

The market was possibly spooked by the upward revision in the ECB's growth forecasts. There might be a communication issue there. The previous batch in June was significantly below consensus. The central bank had provisioned a lot of bad news at the time. True, the ongoing rebound in the pandemic is a clear setback, but the staff had to acknowledge a first half of 2020 which has been less catastrophic than feared. In June the ECB had Q2 GDP falling by 13% when it is now estimated at -11.8%. The upward revision in the trajectory is entirely driven by the change in the starting point. The average quarterly GDP growth is exactly the same in the two successive forecasts (1.8%). The central bank's economists haven't changed their mind on the outlook, even if Lagarde's mention of a "strong rebound" may have sent a different signal.

But it's more the inflation side of the outlook which came with a stronger level of confidence which may have been interpreted as hawkish signals by the market. Core inflation was revised up for 2022 – which is a plausible "policy horizon" for the ECB, from 0.9% to 1.1%. This in itself may not be such a strong signal – this would still be nearly one percentage point below the central bank's target – but it came with comments on the latest inflation data which could suggest the ECB is happy with its current stance: after dismissing the negative print for inflation in August as mainly reflecting one-offs (which technically makes sense) she went on to argue that deflation risks have abated since June, which is not supported by market-based indicators.

Fiscal policy contributing to lifting inflation comes with a price

We don't think this is necessarily intentional. The ECB is on the defensive, with the latest inflation data suggesting its stance is still not supportive enough, while their policy environment has actually improved since June. **Lagarde praised several times the advent of the Recovery and Resilience Fund – this was far from a done deal in June – and**

the ECB is clearly welcoming help from fiscal policy (a point we highlighted last week in Macrocast in our analysis of Philip Lane's Jackson Hole speech). The prepared statement – in a quite exceptional move – acknowledges the contribution of fiscal policy to propping up inflation, attributing the upward revision of core inflation in 2022 to *"the positive impact of the monetary and fiscal policy measures".* So, in a nutshell our interpretation is that while inflation expectations may not have perked up, the ECB is more comfortable with the overall policy push now than three months ago.

We do not conclude from this Council meeting that the ECB is "done". We continue to think that the central bank will do more, and we expect this for December, with a time and quantum extension of the PEPP. A key reason – which the ECB may not want to make too explicit – in our view is **that faced with higher public debt issuance next year, the ECB will have to provide more accommodation in the form of more quantitative easing**. This is the price to pay for fiscal policy helping to bring inflation back to the central bank's target. In other words, more fiscal action does not exonerate monetary policy from providing more stimulus itself.

If monetary policy is facing diminishing returns as the economy is falling into a liquidity trap, it remains useful and should not actually opt for immobilism, because it can still reach its target and reflate the economy by removing financial constraints for governments engaged in their own stimulus. Given the Euro area's legal framework and its focus on prohibiting monetary funding to public administration it is difficult to make this strategy explicit but, in our view, this has been implicit for a long while in the Euro area. Fighting "fragmentation" – read "sovereign spread widening" – has been the explicit aim of the ECB when it finally accepted to intervene on the government bond market during the sovereign crisis. This was fully justifiable in the light of the central bank's mandate of fostering price stability, since without this relief governments would have been forced into pro-cyclical crash fiscal tightening which would have triggered deflation risks. With the pandemic crisis, this de facto cooperation between monetary and fiscal policy goes one notch further: quantitative easing is no longer there to merely avoid a potential ill-timed fiscal consolidation, but to actively support an actual, much needed fiscal push. It is one step further into fiscal dominance, but it proceeds from the same logic.

Next year, the Recovery and Resilience Fund (RRF)will start issuing bonds. It is not exactly additive to national governments' own needs – it will allow some of the most fragile governments to issue significantly less than without the RRF – but the overall quantum of public sector paper on the European market is going to grow. The Pandemic Emergency Purchase Programme is for now scheduled to end in June 2021. This is precisely when the RRF is likely to start issuing significantly. Next year, the ECB will have to choose between on the one hand expanding its pandemic emergency purchase programme (PEPP) or boost its "run of the mill" Public Sector Purchase Programme, or on the other hand accept a tightening in financial conditions. **We don't doubt they will carry on with quantitative easing (QE), allowing for a swift absorption of extra issuance** (this point was neatly made by Bank of America Merrill Lynch (BAML)'s Ruben Segura-Cayuela at the end of July).

If this is the true approach of the ECB, then the "strategy review" – which conclusions have been pushed to next year – becomes less relevant. We noted two weeks ago that the Federal Reserve (Fed)'s conversion to average inflation targeting raised the pressure on its European counterpart to refine its approach. Removing the asymmetric nature of the current definition of the target ("below but close to 2%", thus reflecting more discomfort with inflation slightly above 2%) would make sense for the ECB, although this would still leave it one step behind the Fed, which is now asymmetric on the "inflationary side". But the Governing Council does not seem to be in a hurry, since the first discussion will focus on "inflation measurement" as per Lagarde's comments at the press conference, pushing the debate on the bank's objective to next year. We cannot help but think that given the current state of monetary policy's capacity to effectively move the dial on its own, indeed the discussion can wait. **Central banking is embarking on extremely subtle models which may tickle your humble servant's curiosity, but which effectiveness is more and more elusive.**

Subtle to the point of evanescence

While we find it intellectually alluring, we expressed some caution at the effectiveness of the Fed's new average inflation targeting model in Macrocast two weeks ago ("Pushing with a longer string"). We want to explore this in some detail in this issue.

The new strategy plays on the asymmetry of monetary policy: it is easier to let inflation accelerate in good times – which only entails **not** acting (keeping rates unchanged) - than propping it up in bad times, because at some point the latter would require ever more action which would collide with the zero bound limit to policy rates. In theory then, a central bank is more credible when pledging to allow higher actual inflation *in the future* than in pledging to do "whatever it takes" to lift it *now*. The risk if the current constrained stimulus repeatedly fails is that expected inflation gradually declines (Exhibit 1). Conversely, if the central bank's pledge to allow inflation to temporarily exceed its target in the future, economic agents may revise their long-term inflation expectations up, thus lowering real interest rates today, providing additional support to the economy today and gradually helping push actual inflation up (Exhibit 2). Abracadabra!

Exhibit 1 – What could happen if nothing is done

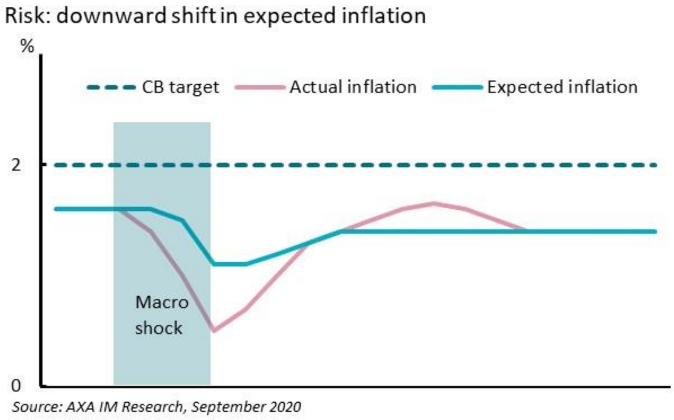
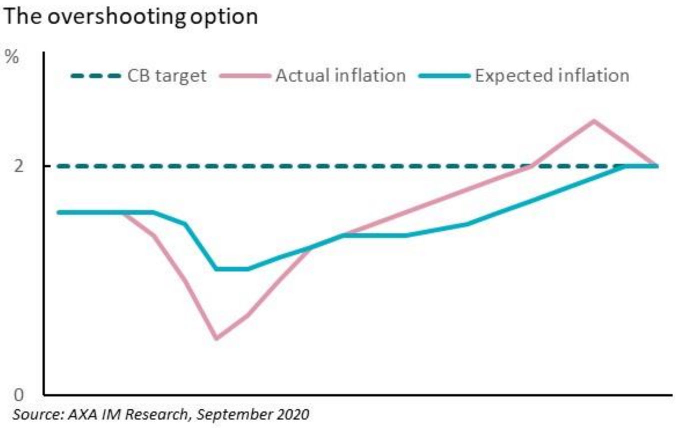


Exhibit 2 – How "average inflation targeting" should work



A key assumption is that inflation expectations are driven by a combination of the recent actual inflation trajectory (what has actually happened) and the expected future path of monetary policy (what will likely happen given what I know of the central bank's strategy). For this to be true, **the central bank needs to be credible, both in terms of commitment (the willingness to do in the future what is promised today) and in terms of capacity – i.e. having the technical means to actually engineer inflation overshooting.**

Let's start with the willingness issue. The Fed has complemented its average inflation targeting with an asymmetric approach to its full employment mandate: instead of focusing on deviations from structural employment (i.e. being equally concerned by employment being above or below its structural level) they now focus on any shortfall from structural employment (i.e. being more concerned about unemployment being too high than being too low). The unemployment rate is a good proxy for slack, or the output gap. This means that **as the output gap gets absorbed, the Fed would hike later than usual, which in turn will allow the output gap to improve even further, ultimately pushing inflation above targ**et (Exhibit 3).

Now let's try a little thought experiment. We are in 2023 and the economy has repaired much faster than we currently expect. US unemployment is back at 3%, credit is growing at 10% year-on-year, equity prices are up another 25%, inflation is at 2.2%. Is it realistic to expect the Fed to remain on hold and allow further overheating to make good on something it said in 2020? It is plausible that some members of the Federal Open Market Committee (FOMC) will be concerned that if they do not act quickly, expected inflation will start exceeding its target and that the Fed would ultimately have to tighten harder, and for longer, its policy to get inflation expectations back in control (Exhibit 4). The welfare maximizing solution of 2023 may be in contradiction with the welfare maximizing solution of 2020. The only way for the central bank to anchor its credibility would be to pledge a set timeline in 2020 – i.e. pledging to maintain inflation above 2% for x months before tightening policy – but this is a radical approach that at least so far, the Fed is not considering.

Exhibit 3 – Hiking later for any given level of the output gap

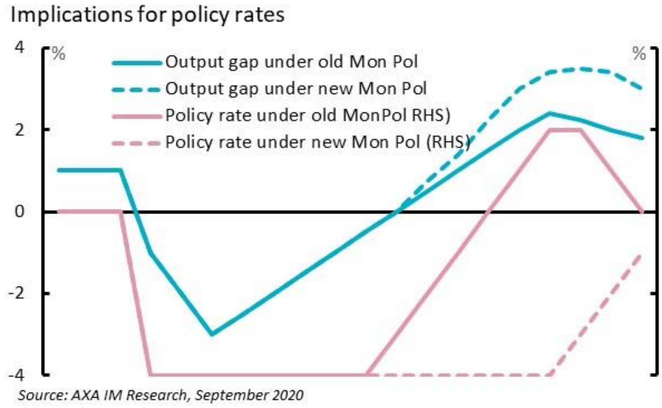
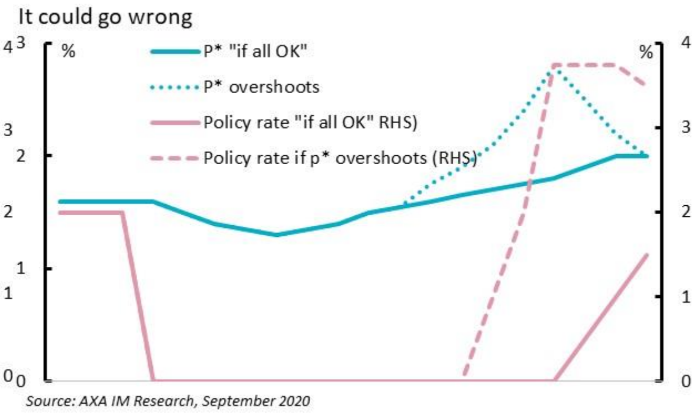


Exhibit 4 – What if expected inflation starts "exploding"



Let's turn to "capacity" now. While we are agnostic on this matter, that inflation is now structurally lower – rather than reflecting rampant capacity under-utilisation – is a plausible hypothesis. There are already strong suggestions from before the pandemic that inflation in the US is lower than before for any given level of the output gap. This means that the level of overheating which would be required to bring inflation back above 2.0% is unrealistic, or to be more precise that it would be so detrimental to financial stability – because of excess leveraging – that the central bank would be stopped in its track before ever being able to reach its target. That inflation is structurally lower, due to technological change, or globalization, is a widely held belief today. Since average inflation targeting belongs as much to the realm of psychology as economics, who knows **which one will be stronger than the other: the belief in lower inflation forever or the belief that the central bank will deliver on its pledge?**

There is another limit to average inflation targeting: it may convey a sense of powerlessness from the central bank which in turn could lower inflation expectations further. We accept the premise of the model – it's easier to prop up inflation than avoid deflation – but we think it is still legitimate to ask from the central bank that at least it tries *everything* to deal with the situation at hand, before focusing on what it may choose **not** to do in an unspecified future. This may be seen as a harsh judgment on the Fed given the magnitude of the support it has offered in this crisis. But what we find striking is that the Fed is entirely focused on one weapon of its arsenal, bond buying, which it has taken to extremes (e.g. pledging to buy "fallen angels" debt). The debate on negative rates was closed before it really opened, and we would argue that the ECB has been more imaginative or adventurous (the TLTRO is a loss-making scheme for the central bank which is now directly subsidizing banks to lend to the corporate sector).

There are perfectly technical reasons why the Fed cannot easily emulate the ECB in some aspects of its framework, and we are no fans of negative rates which entail many adverse side-effects, but we wonder if this sole focus on QE does not get us back to our earlier point: the most powerful monetary policy channel is through allowing ample room for manoeuvre to fiscal policy. The rest is noise. One can observe than market-based inflation expectations have not improved since J. Powell's speech, although they rebounded from their lockdown trough (Exhibit 5).

Exhibit 5 – Post Jackson Hole relapse in inflation expectations

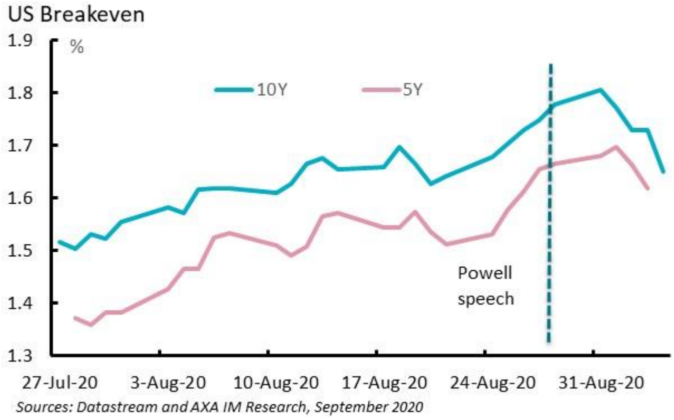
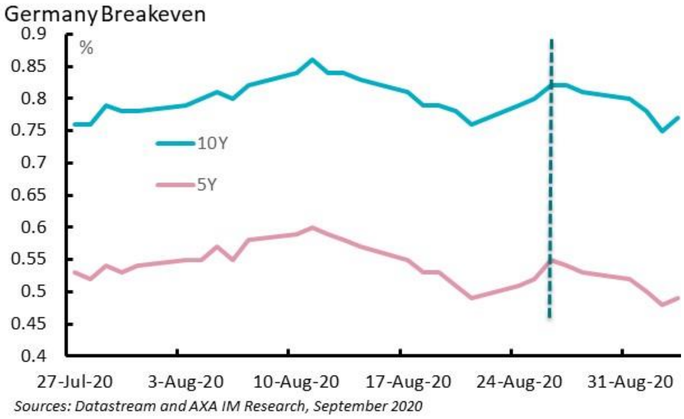


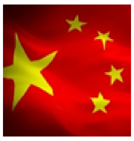
Exhibit 6 – Inflation expectations stuck at a very low level in Europe



When to stop

The hawks at the Governing Council are clearly aware of the shift towards implicit fiscal/monetary policy coordination and it is in this context that we read Jens Weidmann's fiscally hawkish speech last week, in which he made his rejection of fiscal dominance very plain. While we don't think his positions will have a significant impact on actual policy making in the short run, he has a point. This new approach is of course a slippery slope. Finding the right balance between making public debt sustainable and condoning reckless fiscal behaviour is hard to find and will require a very high level of trust between the central bank and the governments

We already explored this before the summer. In our view, **the fiscal stance should be made explicitly and ex ante conditional on the level of slack in the economy.** In other words, once unemployment is back to its structural level, it would make sense for fiscal policy to shift from accommodation to careful consolidation. This policy change would delay the normalization in inflation and allow the central bank to take time before removing some of its stimulus. If everything works well, investors would be reassured about the trajectory of public finance by the time the central bank hikes, which would keep the risk premium in check. Still, detecting when unemployment is back to its structural level is more an art than a science, and electoral calendars may get in the way.

Country/Region	What we focused on last week	What we will focus on this week
	• Stimulus talks still deadlocked: Senate failed to pass 'skinny' stimulus, Pelosi and Mnuchin suggest clean CR to avoid shutdown. • PPI inflation for August rose to -0.2%yoy from -0.4% • Jobless claims disappointed with continuing claims rising to 13.4m in latest week. • MBA mortgage approvals rose 2.9% on the week, first rise in 4 weeks	• FOMC announcement expected to deliver change to forward guidance rules, we expect labour market-based guidance. • US retail sales for August, further slowdown expected, but will guide Q3 GDP. • Empire State manufacturing survey Sept • Further developments on the US stimulus package. • Election polling
	• Industrial production data disappointed in Germany (1.2%mom) and France (3.8%mom), while it surprised to the upside in Italy (7.4%mom). German IP is still 10% below pre-Covid levels, France and Italy 7% below. • The ECB left all of its policies unchanged, the overall message was dovish (FX monitoring in the statement) but with hawkish undertones.	• Euro area IP to increase 3% mom in July • Banque de France business sentiment to edge up and echo INSEE which expects activity to remain 5% below pre-shock levels in Q3, with the pace of improvement losing strength (activity to still be 4% below pre-Covid levels in Q4) • German ZEW expectations to moderate a bit
	• GDP rose by 6.6% on the month in July, a little below our forecast. RICS and BRC releases suggest buoyant consumers in Aug. • Government suggests reneging on aspects of Withdrawal Agreement to broad backlash • Virus cases rise to around 3k, government reimposes some restrictions	• Bank of England policy decision. No change expected, point to recovery with risks. • August CPI inflation (lower on VAT cuts) and retail sales (expect 1%mom), Jul labour market (stable prestart of furlough unwind) • EU trade deal negotiation continue, Internal Markets Bill before Parliament.
	• Bank lending is still dynamic (+6.7%yoy) • Q2 GDP has been revised down by 0.1pp to -7.9%, due to weakest investment • August Economy Watchers poll is improving • July machinery orders surprised to the upside (6.3%mom)-yoy level remains weak (-16.2%) • Q3 Business survey rebounded strongly	• The BoJ is holding its meeting on Sep 16-17 but any changes seem unlikely. Comment on inflation must be watched as CPI should be close to 0% • Reuters Tankan DI should improve • August trade figures are likely to point to a slight improvement
	• Manufacturing PMI moderates a touch in August, while services gauge points to continued solid growth	• August trade may show slower growth in exports of medical and electronic products but offset by shipment of normal goods.
	• Policy rates unchanged in Malaysia (1.75%) and Peru (0.25%) last week, stimulus ongoing • Mexico 2021 budget proposal maintains fiscal tightness growth expectations appear overly optimistic. Aug CPI printed 4.50%yoy • Russia revised up Q2 GDP growth to -8.0%yoy (from -8.5%yoy preliminary).	• Central Bank meetings: Indonesia, Brazil • India, Poland August CPI inflation; India, Malaysia, Turkey July Industrial Production

Upcoming events	US:	Tue: Empire State index, IP; Wed: retail sales, NAHB index, FOMC announcement; Thu: housing starts, building permits, Phily Fed index; Fri:current account, Michigan cons. sentiment
	Euro Area:	Mon: EZ IP; Tue: GE ZEW survey, Fr, IT Final HICP, EZ reserve assets; Thur: EZ Final CPIH, It Trade Balance; Fri: Ger PPI, It Industrial Orders, EZ Current Account
	UK:	Mon: Internal Market bill second reading, 8^{th} round UK/EU negotiations; Tue: Unemployment, earnings; Wed: CPI, RPI; Thur: Car registration, MPC meeting; Fri: Retail sales
	Japan:	Mon: IP, LDP election, Reuters Tankan DI, Capacity Utilizatoin; Wed: Trade Balance; Thur: BoJ announcement, Foreign Bond Investment; Fri: CPI
	China:	Mon: House prices; Tue: Fixed asset investment, IP, Retail sales

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AXA Investment Managers SA
Tour Majunga – La Défense 9 – 6 place de la Pyramide 92800 Puteaux – France
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