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Policy Oxymorons Best Avoided

ECB to cut by 25bp but leave options open for July

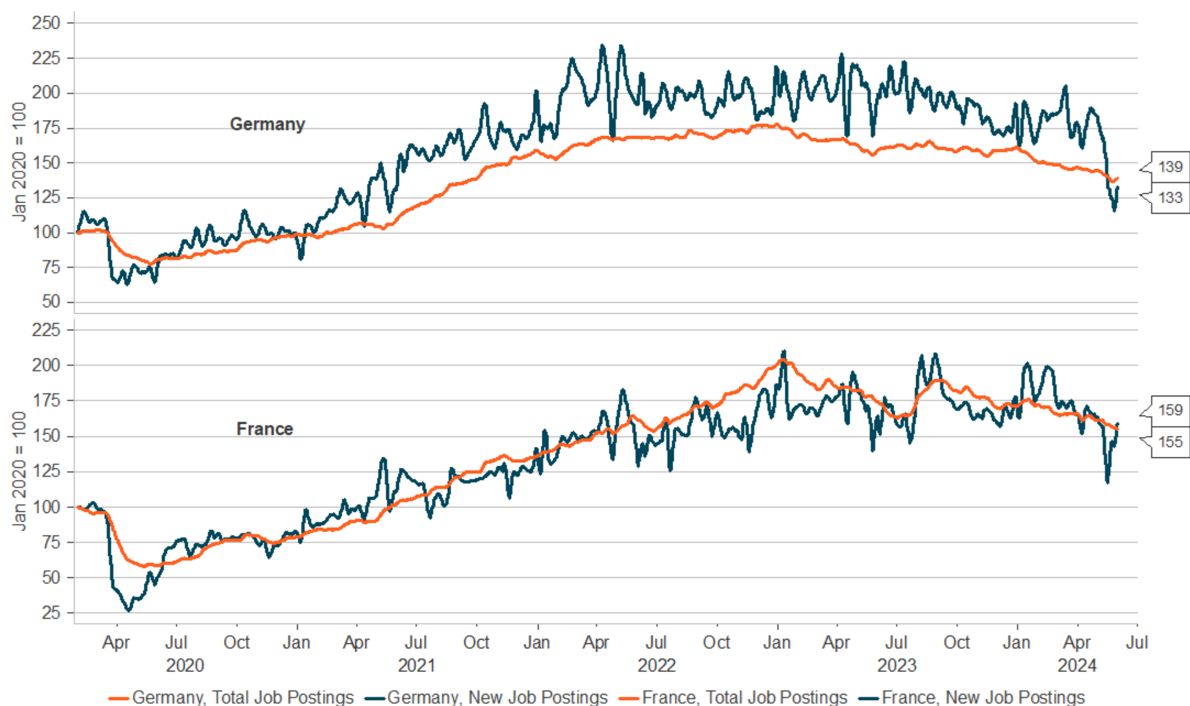
- Labour market rebound narrows policy space for Governing Council
- Quantitative tightening needs revisiting as peers step back
- ECB and/or BoC dovishness may increase dollar valuation concerns

A 'hawkish cut' is meaningless – if in doubt, don't cut

One of the phrases that has arisen in previews of the European Central Bank's policy decision on Thursday is the notion of a ‘hawkish cut’. Monetary policy of any given central bank is no stranger to characterisations by way of oxymorons; we have probably been guilty of using similar phraseology ourselves. Likewise, instances of ‘dovish hikes’ were not uncommon as central banks approached the latter stages of their tightening cycles.

Policy cycles in general are asymmetric. Given ongoing central bank concerns around inflation persistence and the associated socio-political implications, we appreciate that policymakers are wary of committing so-called policy error. In other words, over-tightening is far less a concern compared to premature easing. As we highlighted earlier this week, the Swiss National Bank is already in the latter camp. The ECB will likely attempt to be as non-committal as possible due to the latest Eurozone inflation numbers.

Exhibit #1: Germany & France Labour Market Openings



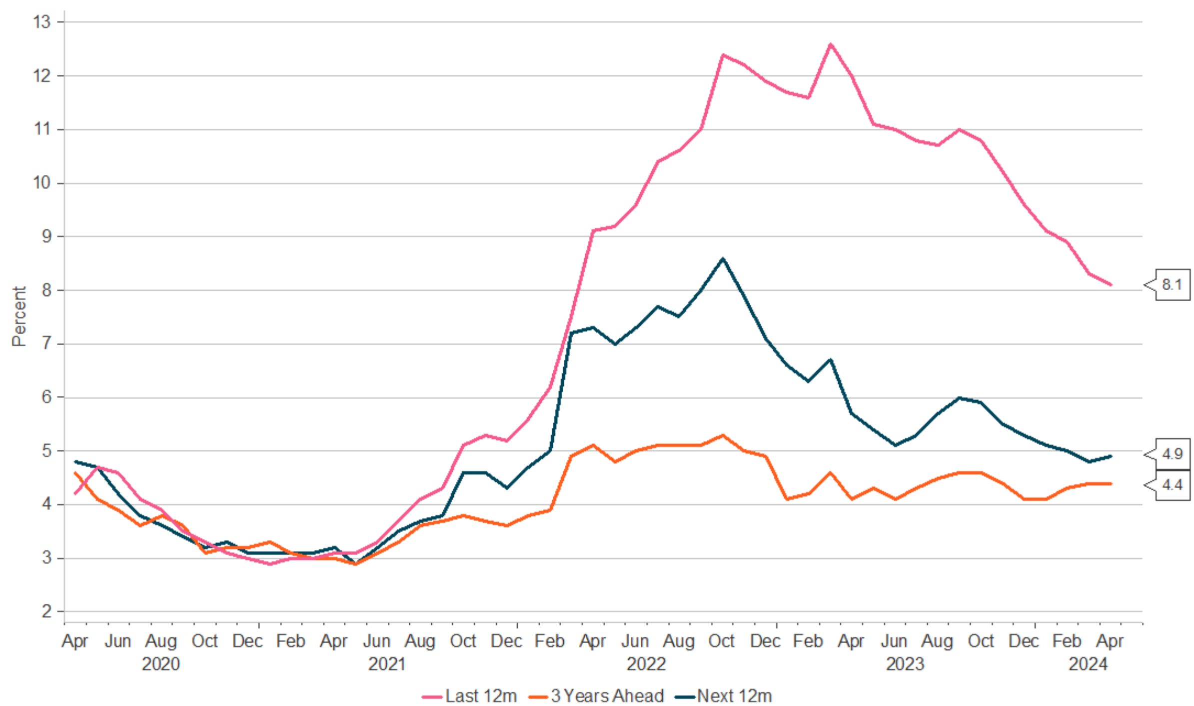
Source: Macrobond, BNY Mellon

High-frequency labour market data for Germany and France (exhibit #1) point to not only stabilisation in openings but also signs of a recovery. The services sector would face seasonal expansion into summer in any case, but there are signs that on an all-economy basis, the boost in hiring intentions may start to offset ongoing losses in other sectors. This means that much further deterioration in the manufacturing sector across Europe will be needed in the short term to generate a cumulative drag. However, the latest PMI data in the region, while weak, appear to have stabilised, so the marginal downside is limited.

Meanwhile, medium-term inflation expectations are starting to look relatively entrenched: there has been precious little progress in forward inflation on 12m and 3y bases (exhibit #2), according to the latest ECB inflation expectations survey. Expectations breaching 5% for the next 12m would be particularly problematic. If the ECB retains a narrow mandate in practice, then by definition inflation expectations are not well-anchored and the Governing Council will need to be hawkish outright, and it's better not to cut at all rather than execute a policy step with deep reluctance and lacking conviction. The staff projections will provide better guidance on the ECB’s trajectory, but upward revisions cannot be ruled out.

Yet, we remain firmly of the view that the ECB’s focus on services inflation and wage persistence in that sector, while befitting current policy targets, is far too tactical and narrow. France President Macron recently called for ‘bolder monetary policy’ beyond an inflation focus. The risk of having a growth mandate enforced upon the ECB is evident. At least ECB President Lagarde and the Governing Council will need to acknowledge the structural issues in place which may require policy support, though not necessarily through interest rates.

Exhibit #2: Eurozone Inflation Expectations



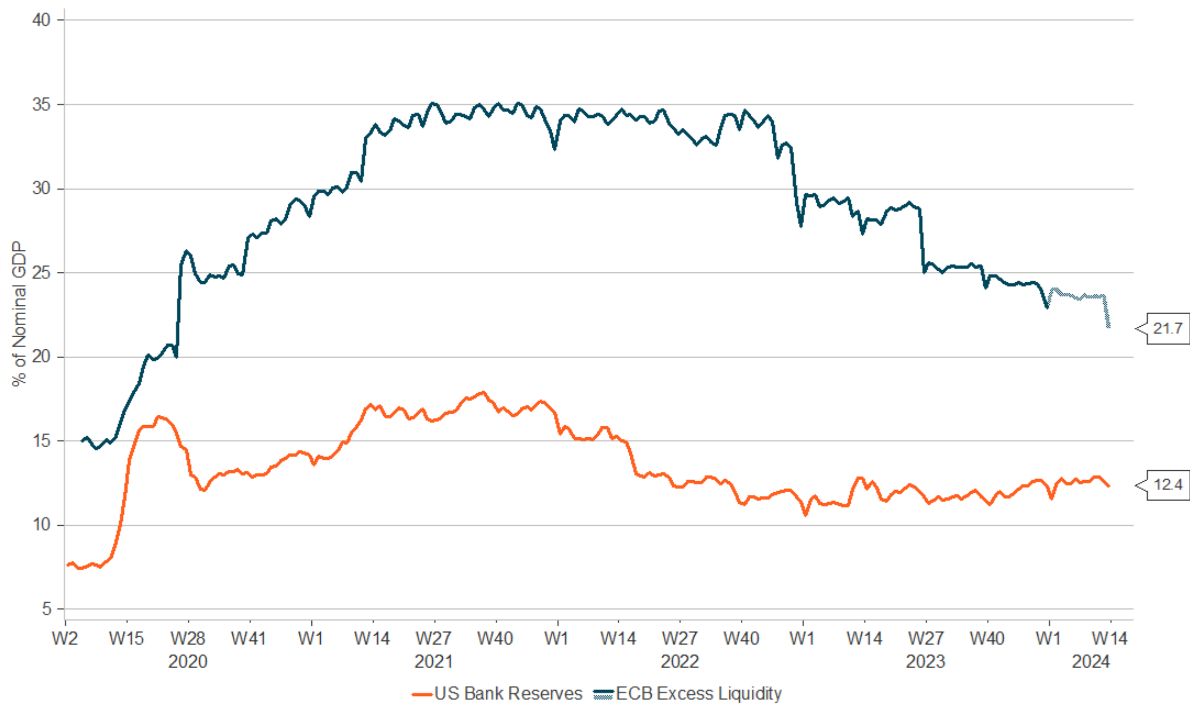
Source: Macrobond, BNY Mellon

One area where the ECB may indeed remain hawkish on an outright basis is in balance-sheet contraction. The ECB is expected to confirm that reinvestment of Pandemic Emergency Purchase Programme (PEPP) will be reduced by EUR 7.5bn per month on average before ending related purchases altogether at the end of 2024.

Based on absolute and relative sizes of the balance sheet, the ECB can continue quantitative tightening – this is one area where some degree of hawkish transmission can take place. Peers have shown that it is viable to cut rates while engaging in quantitative tightening. However, we also note that the Federal Reserve is now moderating balance-sheet reduction, while the Bank of England is also stepping up its short-term liquidity operations to increase reserves, but concurrently selling assets. All these central banks face issues with calibrating what the Fed calls the 'lowest comfortable level' of reserves, but the problem is that such levels are only breached after the fact, when volatility begins to rise.

Considering the experience of peers, this is one area where the ECB may need to step back and apply 'maximum flexibility', rather than commit to hard targets. There will likely be downside risk to the euro accordingly if quantitative differentials start to exert some impact on money-market rate gaps, but more pronounced euro weakness will likely require strong indications of additional cuts in July. While, for now, we think those are not forthcoming, every remaining policy meeting this year should be considered live.

Exhibit #3: ECB vs. Fed Balance QT



Source: Macrobond, BNY Mellon

When the ECB was first asked about policy divergence with the Fed, many Governing Council members retorted that the central bank was not the “thirteenth district of the Federal Reserve” and would act according to its own needs. The Fed historically has not needed to follow international monetary policy conditions too closely, either (financial stability is a different issue). Unlike the ECB, the Bank of Japan and particularly the SNB, the dollar’s exorbitant privilege and limited economic value-added from international trade to US growth meant that FX pass-through was never a major factor in domestic financial conditions.

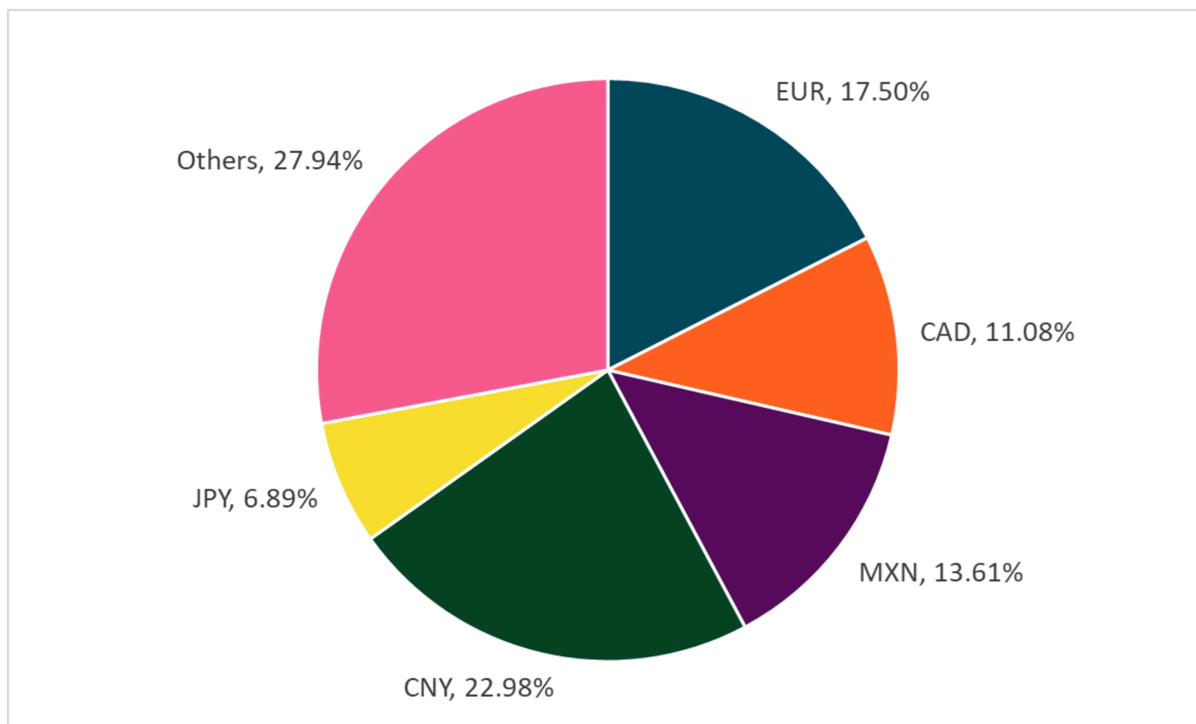
This week could prove exceptional, however, and warrants much closer monitoring by the Fed ahead of its policy decision next week, depending on decisions by the Bank of Canada today and the ECB tomorrow. EUR and CAD account for almost 30% of the US dollar’s broad nominal effective exchange rate (NEER) based on Bank for International Settlements (BIS) weights, and nearly 70% of the US Dollar Index (DXY) weights. In addition, MXN has reacted adversely to the results of Sunday’s presidential election. Across the Pacific, the BoJ and People’s Bank of China have policy stances conducive to continue owning dollar carry, and there is a body of opinion in markets which expects material USDCNY upside this year.

EUR, CAD, MXN, JPY and CNY combined account for nearly 75% of the USD NEER (exhibit #4). After tomorrow’s ECB decision, we see risk of a further repricing of policy differentials in the Fed’s favour vs. the ECB, BoC and most likely all APAC central banks. USDMXN may also be bid as carry-based MXN longs unwind until the political dust settles.

The USD remains more than 5% below the extremes seen in 2022, but this time the drivers are external, rather than Fed-based. This means that on the margins, the dollar is tightening financial conditions in the US (or preventing loosening) beyond the Fed’s original

expectations and likely requires a commensurate response. After all, ‘benign neglect’ – the traditional US attitude towards the dollar – is also a policy oxymoron whose repute may become increasingly dubious amid global economic regime shifts.

Exhibit #4: USD NEER (Broad) Composition



Source: BIS, BNY Mellon

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Please direct questions or comments to: iFlow@BNYMellon.com

Geoff Yu

EMEA MACRO STRATEGIST

CONTACT GEOFF

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