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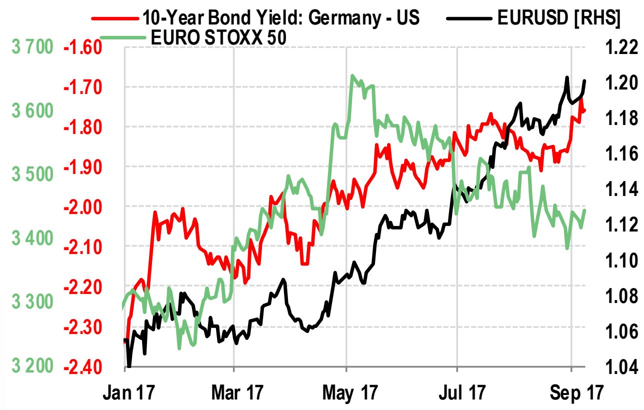
Financial markets as self-appointed subcontractors

■ Financial markets are very much influenced by expectations about monetary policy ■ The recent euro strength reflects anticipations of a scaling back of the ECB's asset purchase programme ■ Market anticipations complicate the ECB's task

Financial markets are the self-appointed subcontractors of central banks. Their monetary policy anticipations influence growth and inflation via exchange rates, wealth effects, confidence channels, the cost of funding, etc. When in easing mode, central banks very much welcome this: it reinforces a given monetary impulse like an interest rate cut or the launch of an asset purchase program. Things get complicated when they're in a tightening mode and market action can pre-empt policy change. International capital flows play a key role in this respect. Think of the taper tantrum in the US in 2013, how it impacted emerging markets, the concerns it raised about US exports and growth.

Today, the ECB is facing a similar challenge. Investors anticipate a scaling back or possibly even an end of the asset purchase programme. Ten-year bond yields have risen and the differential with the US has narrowed, also because investors relatively speaking have become more upbeat about the eurozone compared to the US. The ensuing euro strength has weighed on the equity market and has contributed to modestly tighter financial and monetary conditions. This does not warrant a less confident outlook for growth yet but it does create a challenge for the ECB in terms of communication. Mario Draghi yesterday didn't want to comment about levels of the euro, as the exchange rate is not an explicit objective for the bank. However, it leaves markets guessing at what point the ECB considers the strong euro becomes a genuine headwind for growth. The new ECB staff projections on the other hand show that an exogenous shock which would move the EURUSD to 1.31 in 2019 would, compared to the base scenario of an unchanged exchange rate, have a negative growth impact of 0.3% next year and the year after and lower inflation with respectively 0.4 and 0.5%. Market anticipation also creates a challenge for the ECB in terms of action all the more so because simply maintaining QE for longer would confront it with a shortage of bonds to buy in certain markets.

INTEREST RATES, THE EURO AND THE STOCK MARKET



Source : Thomson Reuters, BNP Paribas

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