Flash Economics

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The Federal Reserve and the ECB will have different monetary policy objectives

Economic literature[1] shows that:

- Discretionary monetary policies (where the central bank chooses its monetary policy by reacting as flexibly as possible to the economic situation) are carried out at times of economic slowdown and high uncertainty;

- On the contrary, central banks follow a monetary policy rule (a reaction that is always the same to changes in the economy) at times when monetary policy must be restrictive.

In the United States, the Federal Reserve's main problem is inflation; the Federal Reserve should therefore follow the usual monetary policy rule which links the level of interest rates to inflation.

In the euro zone, the main problem is weak growth; the ECB will therefore abandon its usual monetary policy rule of linking interest rates to inflation and pursue a discretionary policy by adjusting the level of interest rates according to short-term growth trends. It remains to be seen whether, as has been the case in the past, the weakness of activity in the euro zone will actually push inflation below 2%.

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(1) Bordo, M. D., Istrefi, K., & Martínez, H. (2024). *Rules vs. Discretion: Decoding FOMC Policy Deliberations* (No. w33262). National Bureau of Economic Research.

A behaviour in line with central bank expectations

It is expected, and some research confirms this view, that central banks will behave in one of two ways depending on what they consider to be the greatest risk.

- **If they judge that the greatest risk is the risk of inflation,** they will hold on to their normal rule of behaviour, which is to link **monetary policy, the level of key interest rates, to inflation.**
- **If they consider that the greatest risk is the risk of a slowdown in growth,** they depart from this rule and adopt a discretionary policy of short-term reaction of the monetary policy to the trend in growth. Discretionary policy is when the central bank adapts its short-term behaviour according to its objectives, disregarding the normal rules of setting interest rates and putting its credibility at stake.

Today, the Federal Reserve's problem is persistent inflation; the ECB's problem is weak growth.

1. **US growth is strong today** (**Chart 1**), driven mainly by household consumption, while inflation is resilient (**Chart 2** shows underlying inflation and the rise in services prices), especially in services, due in particular to the rise in profit margins (**Chart 3**).

Chart 1
United States : Real GDP and household consumption (Y/Y as %)

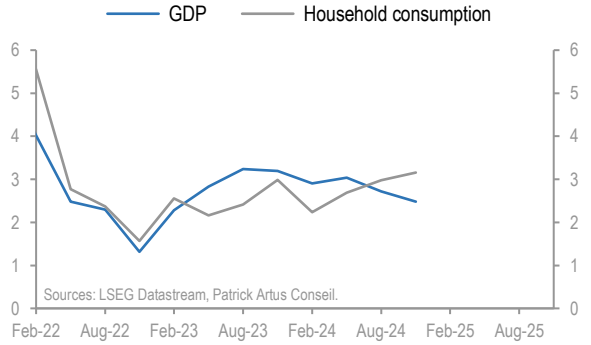


Chart 2
United States: Core inflation and services inflation (as %)

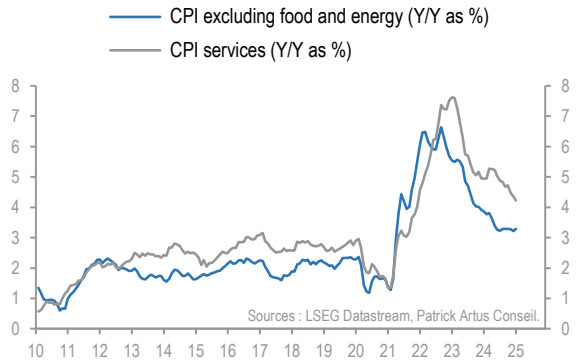
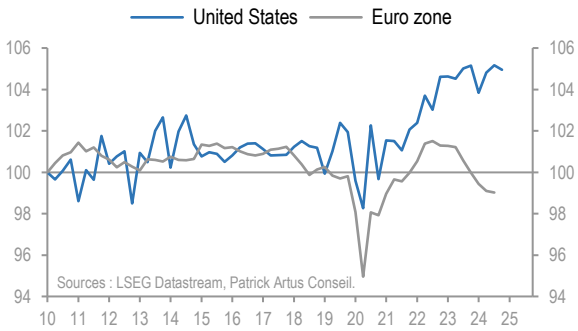
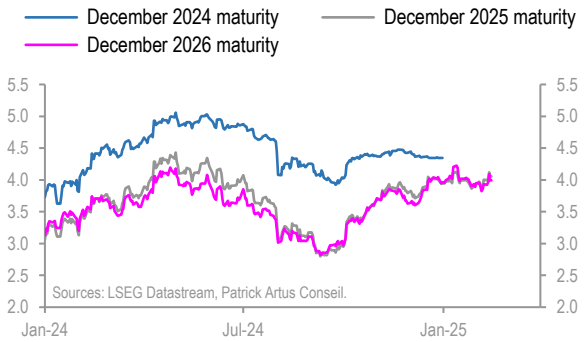


Chart 3
Ratio between GDP deflator and unit labour cost (2010.Q1 = 100)



The Federal Reserve will therefore use **a rule for adjusting key interest rates to inflation**, which means that the Fed Funds rate is likely to remain fairly high (at least 4%), **Chart 4**.

Chart 4
United States: Eurodollar contracts (3-month)



2. **In the euro zone, growth is very weak (Chart 5), and inflation is resilient** (**Chart 6** shows inflation excluding energy and unprocessed food and the rise in services prices), due to **the absence of productivity gains** (**Chart 7**), which is bolstering the rise in unit labour costs and maintaining **strong tension on the labour market** (**Chart 8**) since, even with weak growth, employment continues to rise (Chart 5).

Chart 5
Euro zone: Real GDP and employment (Y/Y as %)

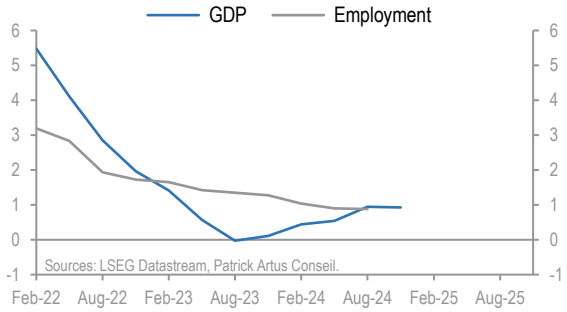


Chart 6
Euro zone: Core inflation and services inflation (as %)

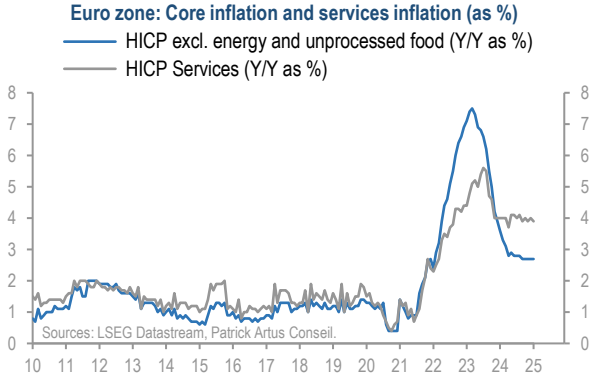


Chart 7
Productivity per head (2010.Q1 = 100)

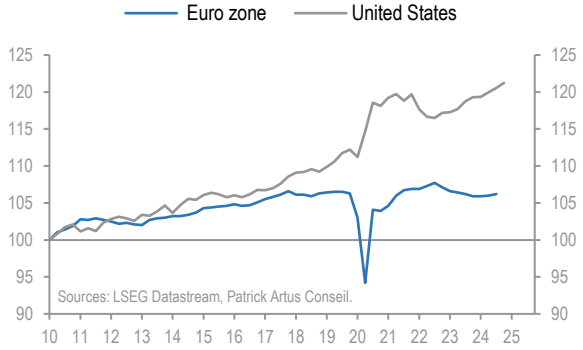
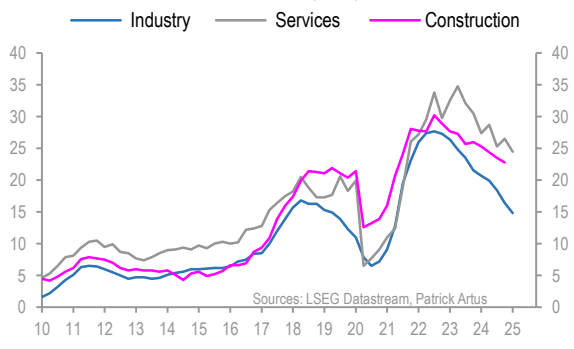


Chart 8
Euro zone: Companies experiencing recruitment difficulties (as %)



Weak growth is likely to lead the ECB **to abandon the monetary rule which, in principle, links key interest rates to inflation** and to switch to a discretionary policy, i.e. to react in the short term to weak growth without worrying about a possible loss of credibility.

Financial market expectations point to a continued sharp fall in ECB interest rates (Chart 9).

Chart 9
Euro zone: Euribor contracts (3-month)



Summary: A key point: will weak growth in the euro zone cause inflation to fall?

We can see that the Federal Reserve, faced with fairly high inflation, uses a monetary rule that links interest rates to inflation, while the ECB, faced with weak growth, abandons this monetary rule and pursues a policy of supporting activity.
The key question involves European inflation. Will weak growth in the euro zone push inflation back below 2%?

If so, the ECB will have been right to cut interest rates aggressively; if not, it is taking a serious risk with its credibility.
It is to be feared that underlying inflation in the euro zone will remain fairly high, due to:

- The absence of productivity gains;
- A continued positive growth (at least 1%);
- And as a result of continued job creation and elevated tension in the labour market.

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