Normalisation of monetary policies under duress

Rising inflation in the western economies is forcing the central banks to normalise their monetary policies, implementing rate increases and balance sheet reductions. The consequences of this tightening can already be seen on the bond markets and financial markets of these economies, as well as in the emerging economies through the exchange rate channel. The Russian central bank is using this monetary tool to reduce the impact of western sanctions.

The western central banks have started the normalisation of their monetary policies, though at varying paces

The health crisis prompted intervention by the central banks on an unprecedented scale to support the financing of governments and businesses (► **Focus** *Economic Outlook* of 1st July 2021[1]). Two years later, faced with the rise in inflation seen in western countries, the central banks have begun to tighten their monetary policies, in order to comply with the objective of price stability included in their mandate. The Bank of England (BoE) thus began to raise its base interest rate from December 2021, while the United States Federal Reserve (Fed) raised theirs first of all in March 2022 (+25 base points, probably less than it would have done had the war in Ukraine not happened[2]), then by 50 base points at the beginning of May, and by 75 base points on 15 June (► **Figure 1**). These two central banks also put an end to their asset purchases, which had reached unprecedented levels following the measures decided in 2020, and they decided on a gradual reduction of their balance sheet.

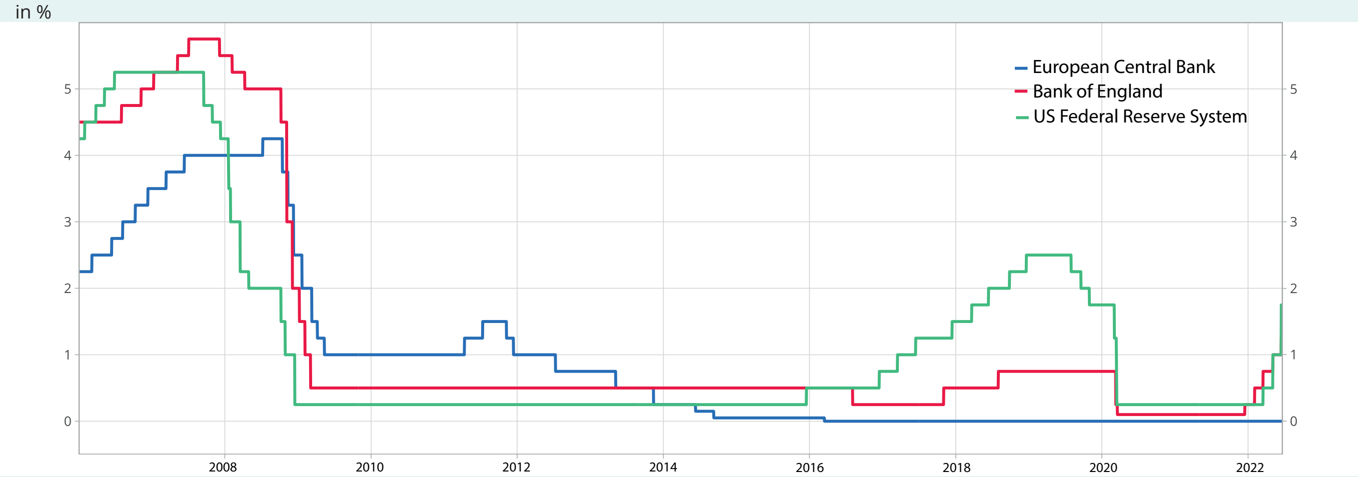
At the same time, the European Central Bank (ECB) has not yet started raising its interest rates. Faced with the diversity of economic situations among the Eurozone Member States, it hoped to maintain a certain flexibility in its decisions regarding the war in Ukraine and its economic consequences. In addition, the rise in inflation in the Eurozone remained essentially imported, linked more to the rise in energy prices and disruptions in value chains than to the dynamism of domestic demand. Nevertheless, since mid-May, the monetary normalisation of the ECB seems to be accelerating:[3] the ECB's asset purchase programme, which has been in place for several years,[4] will come to an end on 1st July 2022, paving the way for an increase in interest rates from July, faster than had previsously been expected.

After more than a decade of unconventional measures, monetary policy is expected to be a little less accommodative. This monetary tightening is already affecting financial asset prices, just as the sharp decline in the United States stock market has done for several months. Bond markets are also reacting to this monetary tightening: the rate of 10-year US government bonds rose sharply, from 1.5% at the end of 2021 to almost 3.5% in mid-June 2022. On the European bond market, sovereign rates have also risen since the start of the year (► **Figure 2** left), as have differentials between rates, especially between Germany and Italy.

1 "Central banks facing an unprecedented crisis", by Hadrien Leclerc, Focus of the *Economic outlook* 1st July 2021, INSEE.
2 Minutes of the Federal Open Market Committee, 16 March 2022.
3 Monetary policy decisions, Press release of 9 June 2022, European Central Bank.
4 *Asset Purchase Programme*, set up in 2014 and of which the ECB adjusts the pace as needed. At the beginning of the health crisis, an additional asset purchase programme was introduced (PEPP, Pandemic emergency purchase programme). It was ended in March 2022.

► 1. Base interest rates of the main western central banks

in %



How to read it: Since 15 June, the Fed wants the US interbank rate to be between 1.5% and 1.75%. On 22 June, the main refinance rate of the ECB was 0%, while the marginal lending rate of the Bank of England was 1.25%.
Source: BCE, Fed, BoE

In addition, we have observed a flattening of the yield curve in the United States for several months (►Figure 2 right): the rate of 2-year government bonds, which are more sensitive to anticipated increases in base interest rates, rose from 0.6% to 3.3% between the end of 2021 and June 2022, thus clearly approaching the 10-year rate, and even exceeding it occasionally in April and June. The narrowing of the gap between these two rates (short-term and long-term) –usually called yield curve flattening, or inversion when the rate of the 2-year bonds becomes higher than that of the 10-year bonds– is often considered as a recession indicator. In Europe, the yield curve shows no sign of flattening: on the contrary, the differential between the 10-year rate and the 2-year rate has increased since the end of 2021.

The tightening of the Fed's monetary policy affects the economies of other countries, and especially the emerging economies

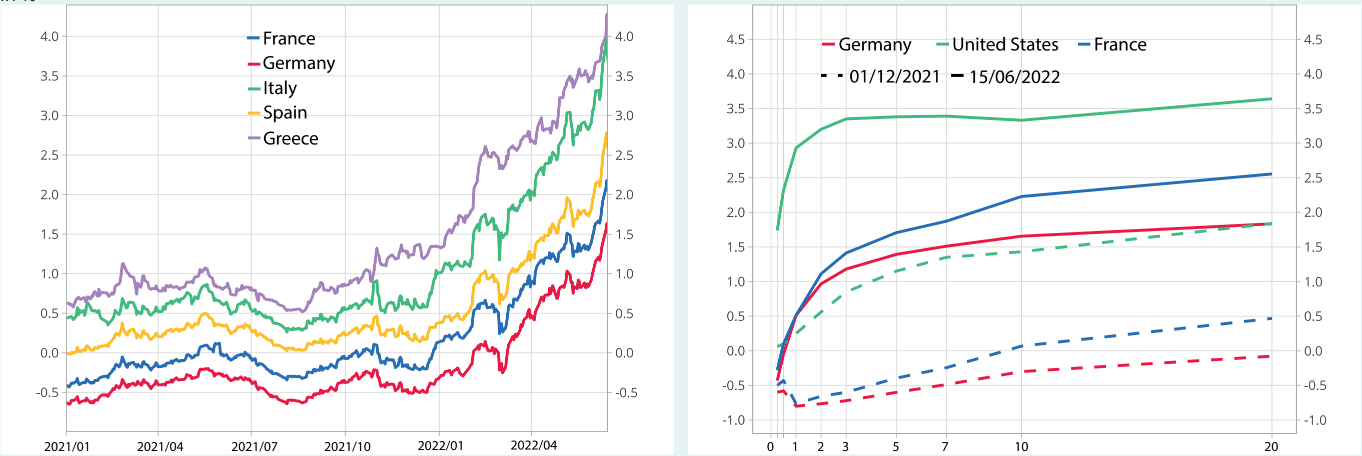
The Fed's monetary policy depends essentially on the economic situation in the United States, but it has consequences for all of the world's economies, in particular via the exchange rate channel. Hence the greater speed of monetary tightening in the United States than in the Eurozone has pushed the dollar up compared to the euro (►Figure 3), with the exchange rate falling from more than 1.2 dollars per euro in June 2021 to 1.05 in May 2022. The yen also depreciated, but more vigorously as the policy of the Japanese central bank is still very accommodative, dropping to its lowest level in twenty years. There are other factors to account for the appreciation of the dollar in 2022 against the majority of other currencies. In fact, the dollar serves as a safe haven currency in periods of crisis or high uncertainty, which partly explains its appreciation against the yuan, in the context of China's economic difficulties, or against the pound, in connection with a possible deterioration in activity in the United Kingdom (►Sheets). One of the economic consequences of the depreciation of these currencies is that it makes the economies concerned more vulnerable to a rise in the price of a barrel of oil, the price of which is determined in dollars. However, by mid-May, the markets' expectation of a slowdown in monetary tightening by the Fed reversed this trend, before the unexpected rise in inflation in May in the United States and the ensuing increase in the Fed's base interest rate shored up the dollar once again. The assumption used in this *Economic Outlook* is that of a constant euro-dollar exchange rate, fixed at 1.08 dollars for 1 euro, i.e. the level measured in late May.

The appreciation of the dollar could affect the emerging economies even more: foreign investment in emerging countries is expected to be limited, resulting in a reduction in capital flows to these countries, while the cost of government debt looks set to increase. The exchange rates of emerging countries appear to have been volatile since the beginning of the year and closely linked to the decisions of the central banks: in a context where the Fed maintained its accommodative policy, the high levels of base interest rates in these countries[5] contributed to an appreciation of their currencies against the dollar, especially since these may also have been driven by the rise in commodity prices (food in Brazil,

5 In Turkey, the central bank's base interest rate stood at 14% at the beginning of May (against 8.25% at the height of the health crisis), 12.75% in Brazil (against 2%) and 4.25% in South Africa (against 3.5%).

►2. Ten-year sovereign yields in European countries and yield curve in the United States, France and Germany in December 2021 and June 2022

in %



How to read it: the yield curve on a given date (right) is the graphic representation of yield on government bonds on the y-axis against the maturity of the bond in years on the x-axis. For example, on 15 June 2022, the US government 10-year bond yield was 3.33%, whereas the US government 2-year bond yield was 3.20%. The difference between these two bonds (13 base points) is therefore less than on 1st December 2021 (87 base points): visually, the curve "flattens". Last point: 15 June 2022.
Source: IHS Markit

ores in South Africa). Increases in the Fed's rate, actual or planned, have then reversed this trend at certain times (►Figure 3).

The Russian central bank uses monetary policy in response to international sanctions

In Russia, monetary policy was used in response to economic sanctions imposed following the outbreak of the war in Ukraine. The various western measures taken at the start of the war, especially the freezing of Russian Central Bank (RCB) reserves held abroad and the exclusion of some Russian banks from the SWIFT system, in fact caused the rouble to fall by almost 50% (►Figure 4), and the Russian financial market to collapse (MOEX index fell by 46% on 24 February, closure of the Moscow Stock Exchange for almost a month). There was a risk that this depreciation of the currency would cause a significant increase in the cost of Russian imports, and would fuel an already high inflation (9.2% year-on-year in February). The RCB therefore reacted strongly,[6] by raising its base interest rate from 9.5% to 20% from 28 February, and it required Russian exporters to convert 80% of the foreign currency obtained into roubles.

This monetary response was aimed at attracting capital flows to the rouble, and flows of revenue from hydrocarbon exports, and as a result the Russian currency was able to return to, and even exceed, its level prior to the start of the war. Since then, the RCB has reduced its rate four times, bringing the base interest rate to its level before the war. ●

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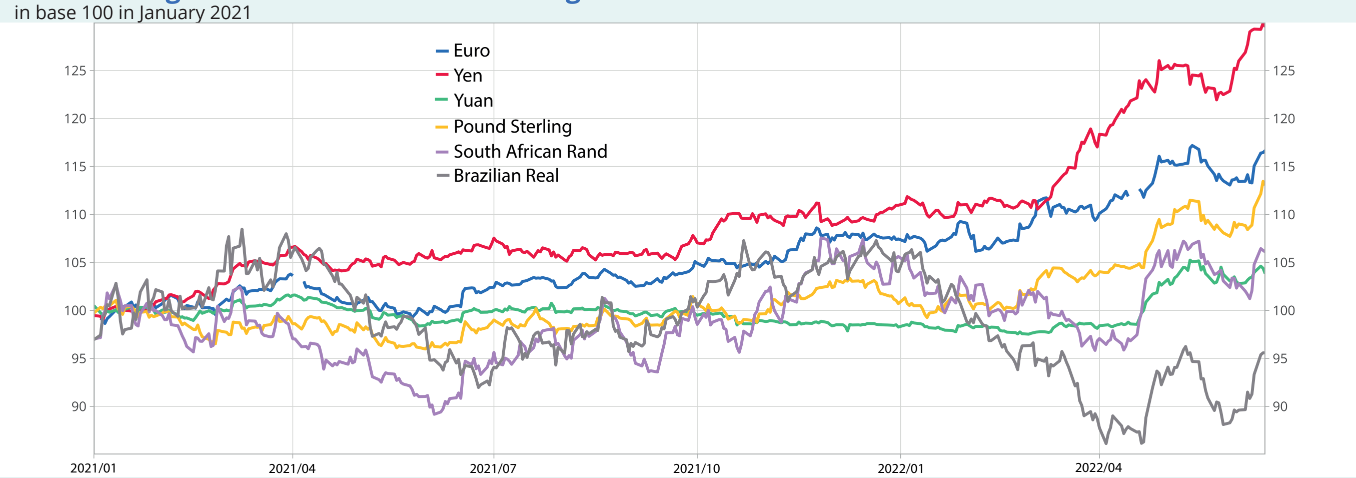
6 Meaille, D. et E. Perego (2022), L'impact des sanctions financières sur la Russie, blog de l'Association française de science économique (AFSE), April-May 2022.

►3. Exchange rate of several currencies against the dollar

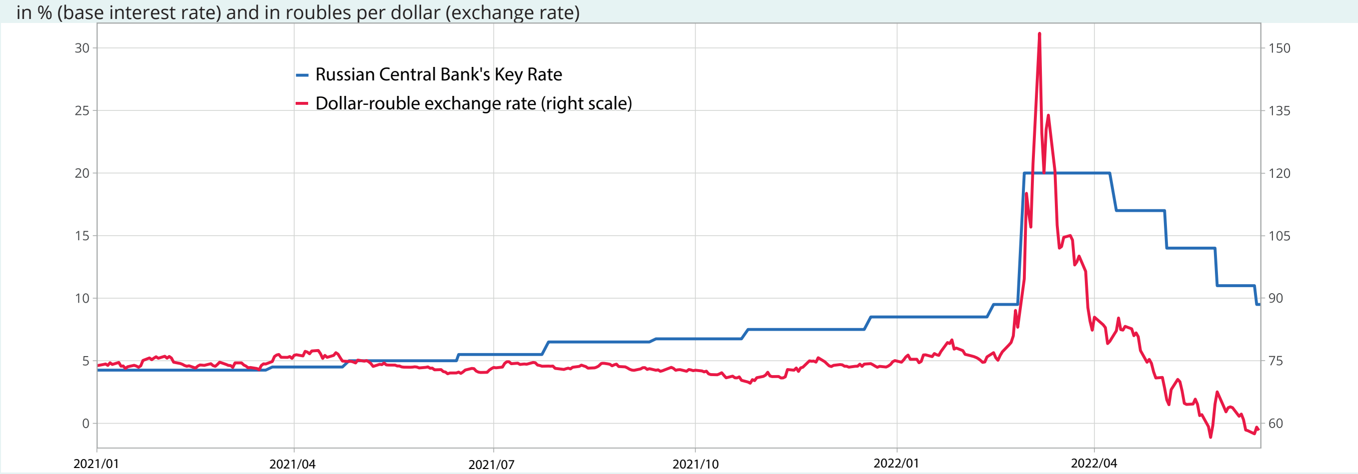
in base 100 in January 2021



How to read it: a growth in the curve means that the dollar appreciates compared to the currency concerned.
Last point: 15 June 2022.
Source: IHS Markit

►4. The RCB raised its base interest rate to offset the devaluation of the rouble

in % (base interest rate) and in roubles per dollar (exchange rate)



How to read it: on 15 June 2022, 1 dollar was worth 58.3 roubles, and the base interest rate of the Russian central bank was 9.5%.
Source: Banque centrale russe, IHS Markit