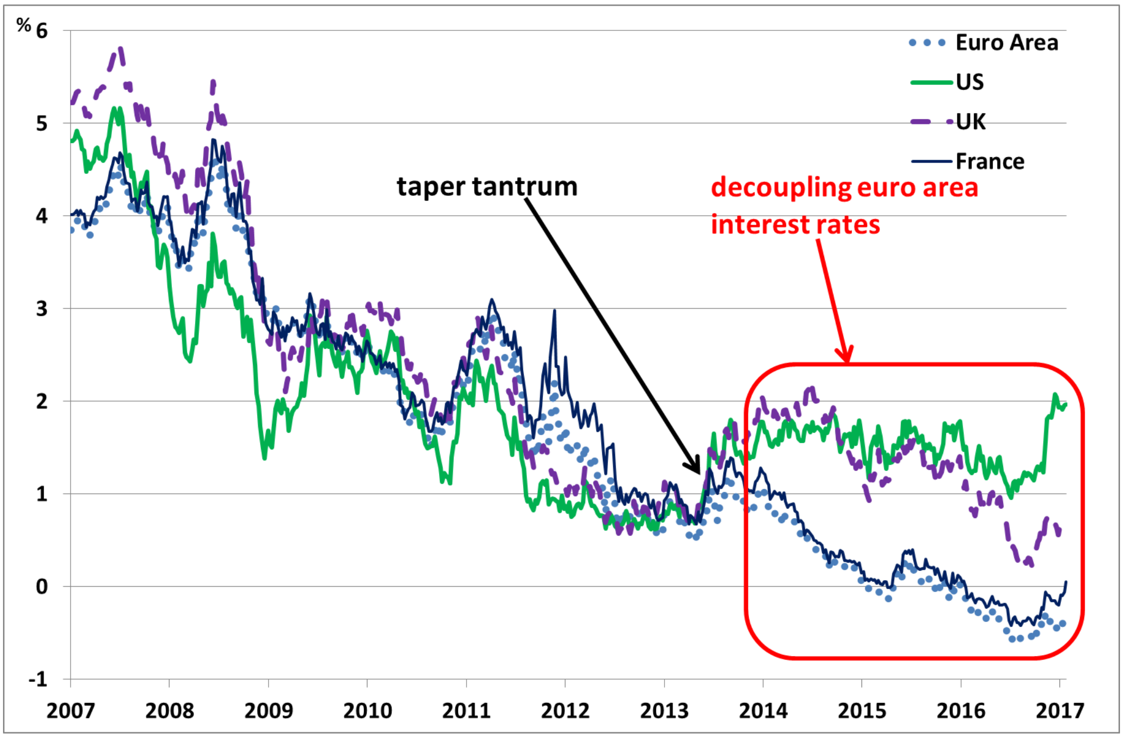
US elections, interest rates and Europe's monetary independence

by Benoit Mojon

The ECB unconventional monetary policy has largely succeeded in decoupling nominal interest rates in the euro area from those in the United States since 2014, as warranted by their respective macroeconomic conditions. This has been especially true since the rise in US interest rates after the election of Donald Trump, particularly for rates up to 5 years.

Figure 1: 5 year interest rates (Euro area AAA, US, UK and French treasuries, in %)



Sources: Bloomberg and ECB

In Figure 1, we report interest rates on Treasury bonds of 5 year maturity for the euro area (EA) member states that have the best ratings, the US, the UK and France. These interest rates tend to move together. It is striking for US and UK interest rates throughout the last decade. In continental Europe, interest rates also tend to swing with their US and UK counterparts up to 2013 only. The common wisdom is that US rates lead and EA ones follow the movement. However, the picture has changed since 2014 when the ECB expanded its unconventional monetary policy.

Larger decoupling between US and EA rates after Donald Trump's election

After the election of Donald Trump the spillover of the sharp increase in US interest rates has been very limited on the EA. This is true both in nominal terms as well as for *ex ante* real interest rates. Indeed, long-term inflation expectations as measured by surveys of professional forecasters have remained very stable over the last ten years.

From the month prior to US election on November 8, 2016 to January 2017, the interest rates on US 5 year treasury bonds have increased by about 70 basis points. This is mainly because investors expect both economic growth and inflation to accelerate if the new administration cuts taxes, boosts investment and even raises tariffs on imports. Meanwhile, EA 5 year interest rates have increased only by 20 basis points. Since mid-January French rates have increased above EA AAA as they frequently do before important elections.

By contrast, during the "Taper Tantrum" (from April to June 2013) , when US Treasury yields surged because investors believed that the Federal Reserve would soon raise policy rates, a comparable increase (of about 70 basis points) in 5 year US interest rates coincided with a 45 basis points increase in the 5 year French rate.

The role of the euro area monetary policy

Short to medium-term interest rates are mostly influenced by monetary policy. They mainly reflect expectations of future monetary policy decisions. The significant decoupling of EA rates from its US counterparts, which started in 2014, has been striking, especially when compared to the absence of decoupling for the UK (except very recently). Through its monetary policy actions, the ECB has managed to largely shield EA financial conditions from the forces that determine US and global financial conditions.

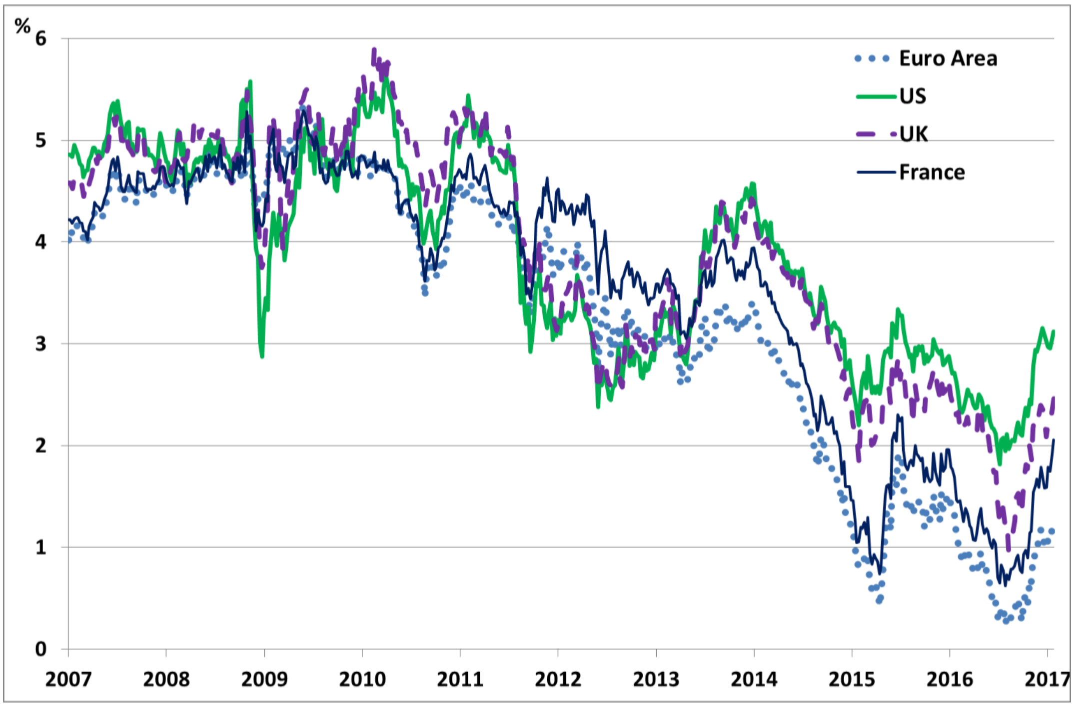
In December 2016, the Federal Reserve raised its policy rates and is expected to raise it further in 2017. By contrast, ECB non-conventional measures are still in place and investors expect EA interest rates to stay much lower than their US counterparts for several quarters.

The stance of the ECB monetary policy is the most likely reason why EA rates of up to 5 years maturity have been decoupling from their US counterpart.

Longer-term recoupling when the monetary policy impact fades away

As seen in Figure 2, interest rates at longer maturities (5 to 10 years), which we measure by forward (5 years in 5 years) interest rates have kept swinging together throughout the last decade. There are some differences here and there. For instance, the French forward rate increased above the US one during the EA sovereign crisis in 2011-2012, it fell below in 2014 and rebounded at the end of 2016. However, variations in forward rates have remained remarkably parallel across the Atlantic, including after the election of Donald Trump. The same forces seem to move US, UK and EA interest rates up and down. At such long horizons, interest rates are likely to reflect common real factors, such as oil prices, or longer-term ones, such as shifts in productivity trends, rather than domestic monetary policies.

Figure 2: 5Y-5Y forward interest rates (Euro area AAA, US, UK and French treasuries, in %)



Sources: Bloomberg and ECB

Nota: 5Y5Y forward interest rates reflect the market perception of the 5 year maturity interest rate that will prevail 5 years from now. For instance, in January 2022 the French treasury should be able to borrow at about 2% and the US treasury at about 3%.

How does the ECB monetary policy contribute to decoupling?

The ECB non-conventional monetary policy is currently based on three main instruments: forward guidance, asset purchases and long-term liquidity provisions (TLTROs). First, through forward guidance, the ECB commits its key policy interest rate "to remain at present or lower levels for an extended period of time, and well past the horizon of [its] net asset purchases". Second, through the asset purchase program (commonly called Quantitative Easing), the Eurosystem buys Government bonds, thereby pushing interest rates down at different maturities. The program was announced in January 2015 and is intended to last until at least the end of 2017. Third, since June 2014, the ECB TLTRO (Targeted Long Term Refinancing Operations) has offered liquidity to banks at a four years horizon. The final operation will take place in March 2017. For banks that meet the criterion, the interest rate can be as low at -0.4% for a funding instrument that they will pay back as late as March 2021.

Those three instruments reinforce each other and work efficiently to keep EA nominal interest rates low (or negative) for horizons of several years. Thus monetary policy is powerful and effective in setting monetary conditions that are adapted to the EA situation. These exceptionally low rates facilitate deleveraging while stimulating investments. They reduce the interest bill of member states and hence taxes. This helps the recovery of the EA and a sustained adjustment in the path of inflation closer to 2% than has been the case since 2013.

Thus, the reinforced decoupling between US and EA nominal interest rates up to 5 years, following the election of Donald Trump, provides some evidence of the ECB ability to pursue a policy fully tailored to internal macroeconomic conditions and not unduly sensitive to external influences and spillovers. By that standard, the non-conventional monetary policy put in place by the ECB has confirmed and strengthened the monetary sovereignty of the euro area.