



## Battling a common adversary

Fed, ECB may be heading for alignment

by Marcello Minenna and Edoardo Reviglio in Rome

Tue 8 Mar 2016

The financial markets at the end of last year were convinced that the Federal Reserve and the European Central Bank were moving on diverging paths. In fact, the world's two leading central banks may be aligning their policies more closely than generally believed against the common adversary of deflation.

We will know more after the ECB's monetary policy meeting on 10 March. Mario Draghi, the ECB president, would be well advised to propose an interest rate cut from minus 0.3% to minus 0.5% (or even lower) and the launch of another round of quantitative easing. We could call this 'QE3.0', with a rise in monthly asset purchases to €80bn from €60bn, and maybe other unconventional measures.

In view of worries on the governing council about the impact of further-reaching measures, especially on banking profitability, the ECB's action is unlikely to go so far. But Draghi must keep faith with previous statements and take some significant easing steps. Otherwise, especially after latest data showing negative inflation in the euro area in the year to February, he and the governing council will give the impression that the ECB has abandoned its mandate of keeping inflation close to 2%.

The past two months have seen notable changes in market perceptions. After the Fed's December rate hike of 0.25 percentage points, the US manufacturing sector's position (already hit by the super-dollar) has worsened. Prices and wages continue to develop less buoyantly than expected.

In a Congressional hearing on 11 February, Janet Yellen, the Fed chair, did not rule out negative rates, which would be an absolute novelty for the US.

The US and Europe are both marked by very low inflation. In the past few years, we have seen large-scale contrasts between the two currency areas, but perhaps these are now becoming less acute.

At the end of 2015, the US economy was closing its seventh year of expansion, with strong consumption and unemployment of 5%. The euro area was struggling to sustain export-driven

recovery, hampered by the enormous problem of banks' non-performing loans. The result has been a weaker euro against the dollar exchange rate, down over 20% in the past 18 months.

Back in October, many analysts believed the euro-dollar rate was heading for parity. Two months of markets unrest have changed this prediction.

The Chinese industrial juggernaut is the sick man of the world economy, with dismal results in foreign trade. Exports fell 25% in dollar terms in February from a year earlier, the biggest one-month decline since early 2009, after an 11% drop in January. Imports fell 14%, after a 19% decline in January.

The collapse in Chinese demand and the entry of Iran on to the global market have exacerbated the oil supply glut, generating a much weaker oil price – forcing developed countries to 'import' deflation.

The danger is that households and enterprise become accustomed to stagnating prices and modify their long-term investment and consumption behavior. The economy tends to slow down and this reinforces the trend of inflation declining towards zero – not only in Europe but also in the US and Japan.

This is exactly what the Fed and the ECB have to combat. Watch in future less for divergence, more for signs of convergence as they do their best to win the anti-deflation battle.

*Marcello Minenna is a Rome-based Ph.D. Lecturer at the London Graduate School of Mathematical Finance. Edoardo Reviglio is Chief Economist of CDP Group.*