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Week in Focus

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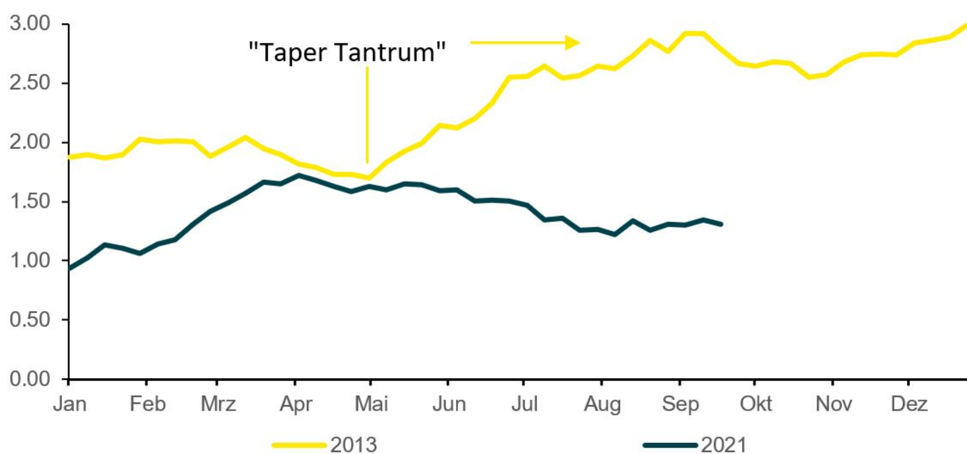
Fed is about to change course - a signal for others?

Next week, the Fed will hold its FOMC meeting. In view of the high inflation rate and considerable progress on the labor market, the Fed could issue another advance warning that it will soon be reducing its bond purchases. Some other central banks are likely to take advantage of the Fed's imminent change of course and also reduce the degree of expansion of their monetary policy. However, this does not apply to the ECB, which is more likely to increase its emergency purchase program once again. **Page 2**

The market is unconcerned about tapering this time
10-year U.S. Treasury yield, weekly data, in per cent



Source: IHS, Commerzbank Research

Preview for the week from 20 September until 24 September 2021

Economic Data Preview: The purchasing managers' indices in the euro area, which had been very high until recently, as well as the Ifo business climate for Germany are likely to have fallen further in September. **Page 7**

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Fed is about to change course - a signal for others?

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Next week, the Fed will hold its FOMC meeting. In view of the high inflation rate and considerable progress on the labor market, the Fed could issue another advance warning that it will soon be reducing its bond purchases. Some other central banks are likely to take advantage of the Fed's imminent change of course and also reduce the degree of expansion of their monetary policy. However, this does not apply to the ECB, which is more likely to increase its emergency purchase program once again.

Weaker Q3 growth fuels doubts about imminent end to QE, ...

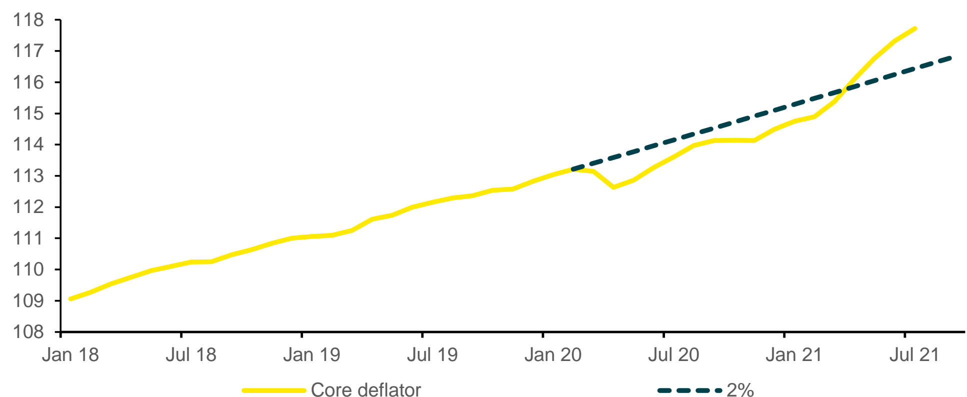
Next week's Fed meeting will take place under the impression of a noticeable slowdown in economic growth. While the U.S. economy has already made up for the Corona slump, available data point to a slowdown in growth to below 4% (quarter-on-quarter, annualized) in Q3. This is well below earlier forecasts.

Together with a recent disappointing employment report for August, this leads some to expect that a reduction in bond purchases ("tapering") is off the table for this year, i.e. the Fed will continue to buy securities for $120 billion every month for the time being.

... but inflation pressure ...

We do not believe so. After all, in December 2020 the Fed cited "substantial progress" in achieving its inflation and labor market target as a prerequisite for tapering. In terms of price developments, this criterion has undoubtedly been met. The inflation rate – based on the Fed's preferred measure, the deflator of personal consumption expenditures – rose to 4.2% in July. Even excluding volatile energy and food prices, inflation was 3.6%. This more than made up for last year's weak price development, which was largely attributable to the Corona crisis. The core index was recently more than 1% higher than if it had risen since February 2020 in line with the Fed's target of 2% annual inflation (chart 1). Corona-related special effects may have played a role here, and the recently released August consumer price data suggest that these are starting to ease. Nevertheless, inflation threatens to make more "progress" than desired, which argues for taking the foot off the monetary policy accelerator.

Chart 1 - More than enough progress towards the inflation target
Deflator of personal consumption expenditures (excluding food/energy), 2012=100. Dashed line: assuming constant inflation of 2% p.a. after February 2020



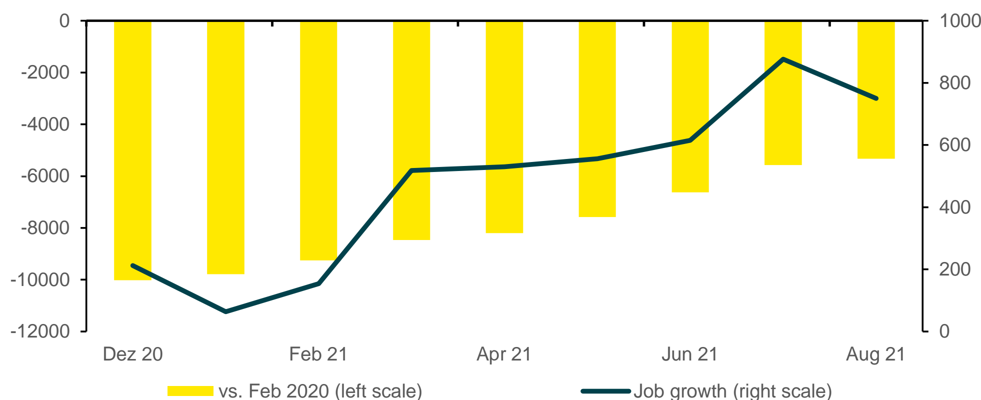
Source: IHS, Commerzbank Research

... and significant progress on the labor market ...

There has also been significant progress on the labor market so far this year, despite disappointing job growth in August. However, a single monthly figure should not be over-interpreted, which was also recently pointed out by John Williams, the President of the New York Fed. Due to the volatility of the labor market data, he recommends looking at the overall development since the end of 2020. This is all the more true since the Fed had announced that it would assess progress toward its objectives relative to the level reached in December 2020. Since then, nearly half of the remaining 10 million jobs shortfall from the February 2020 pre-crisis level has been recovered (Chart 2). In addition, nearly 11 million job openings were registered in July, meaning that there were arithmetically 1.26 job openings for every unemployed person. This suggests that the labor market is not lacking in demand for labor, but

that the supply of labor is still below pre-crisis levels. As soon as potential employees give up their probably also corona-induced reluctance, job growth will accelerate again. This means that the labor market is also on track.

Chart 2 - Labor market on the right track
Nonfarm payrolls, shortfall from February 2020 peak, 3-month average of monthly payroll changes. Monthly data in thousands.



Source: IHS, Commerzbank Research

... argue for clear tapering signal

From the Fed's point of view, the progress made should therefore be sufficient to tackle the exit from the bond-buying program. It is therefore to be expected that the Fed will give another clear signal next week that tapering is imminent – after all, the markets have been promised sufficient advance warning. The actual decision can then be expected at one of the two meetings scheduled for November and December. By the beginning of 2022 at the latest, it is then likely to actually start tapering off the purchase volume. For, in contrast to 2013, the Fed is unlikely to have to postpone the process again because of a strong market reaction (see box).

Tapering is set to proceed smoothly this time

In May 2013, the Fed indicated that it would soon gradually scale back its bond purchases. This caused a price collapse on the bond markets, and the Fed had to postpone the start of tapering until the end of 2013. A similar delay is unlikely this time. After all, Fed Chairman Powell has an important advantage over his pre-predecessor Ben Bernanke: scaling back bond purchases after a prolonged QE program is no longer new territory. The experience gained in 2013 has played a major role in ensuring that the preparations have so far gone smoothly and have not triggered any shocks on the market (see chart on front page).

Another difference is the economic environment. At the time of the first clear signals of an imminent tapering in May 2013, the unemployment rate was still 7.5%. For every unemployed person, there were only 0.35 job openings. Currently, the unemployment rate is 5.2%, and in July there were 1.26 job openings for every unemployed person.

Table 1 - Economic backdrop to tapering decisions
Data at key moments for tapering: May 2013 (first indications), Dec 2013 (actual decision) and current situation

	May-13	Dec-13	Aug-21
Unemployment rate	7.5%	6.7%	5.2%
Job openings per unemployed	0.36	0.40	1.26
ISM services	54.3	52.9	61.7
10y Treasury yield	1.93%	2.90%	1.28%

Source: IHS, Commerzbank Research

Is the Fed giving the signal for a general exit?

The Fed remains the most important central bank globally. A turn towards a less expansionary monetary policy stance is therefore an important signal for the financial markets and for other central banks, which often followed such a turnaround by the Fed with a certain delay. For many emerging markets, such periods have often been difficult times, with the risk of balance of payments crises and other dislocations. What can we expect this time?

Fed's change of course to help some, ...

Inflationary pressures have not only increased in the U.S., but also elsewhere. Among the G10 members, the Bank of Canada, for example, has already started to wind down its bond purchases. The UK, too, would probably like to tighten the monetary reins from a domestic economic perspective; representatives of the Bank of England have already hinted at a first interest rate hike next year. Outside the G-10, New Zealand is already moving toward an even earlier rate hike.

Concerns about the impact of a more restrictive policy on their currencies have so far probably held these central banks back from changing course. A reversal of course by the Fed would give them more room to maneuver, since in the eyes of market participants there would then not be too wide a gap between their monetary policy and the Fed's stance.

... for others, risks are increasing

It is true that in the rest of the world there are also individual examples of central banks that would like to make their monetary policy more restrictive in the Fed's slipstream. This is the case, for example, with the central bank of Russia, which has already raised its interest rates in response to high inflation – but not as much as would actually be necessary. Most emerging markets, however, would much rather see the Fed continue to stay put. This is because they would rather continue to stimulate their own economies with an unchanged expansionary monetary policy and thus help them to overcome the after-effects of the Corona crisis. Important examples of such countries are South Africa and Brazil.

These countries have been helped by the fact that the Fed has at least succeeded in ensuring that the markets do not see the upcoming tapering as a signal for a rate hike in the not-too-distant future. This, the Fed's prudent preparations and the experience with tapering after 2013 have so far made exchange rates react only very cautiously to the Fed's turnaround. This has at least bought time for the more vulnerable emerging markets. The real test for these countries is likely to come when the Fed's interest rate turnaround also becomes clear. Then the calm in exchange rates could be over. However, we do not expect this to happen until the year after next.

... and the ECB has other priorities

The ECB is likely to be largely unimpressed by the Fed's change of course. The euro area economy is still lagging somewhat behind in its recovery from the Corona crisis. At the same time, as the central bank of a large economy, the ECB is not as closely tied to US developments as the emerging markets.

For example, the ECB has recently repeatedly emphasized that it does not want to initiate the normalization of monetary policy until inflation settles at 2 percent on a sustained basis. Despite the currently very high inflation rates, this criterion has not been met, as inflation in the euro area is expected to weaken noticeably in 2022. The ECB argues that a premature tightening of monetary policy would stall an incipient upswing and thus call into question the achievement of the inflation target. Another argument against the start of a normalization of monetary policy in the euro area is that the ECB – unlike the Fed, for example – pays particular attention to the sustainability of public debt. In particular, the ECB is likely to be very keen to keep financing costs low for the highly indebted southern European countries.

Finally, we expect growth in the euro area in the current and next quarter to be significantly lower than expected by the ECB, not least due to the discernibly negative effects of the delta variant. We therefore stand by our assessment that the ECB will probably decide in December to increase its bond purchases once again, presumably by expanding the PEPP.

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