Central bank divergence:
Why it's happening and why it matters
Goldman Sachs Exchanges

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Allison Nathan: In a rare move, the European Central Bank is widely expected to begin cutting its policy rate this week at the same time that the Fed is expected to remain on hold at its upcoming meeting. So how far could central bank divergence run?

Peter Praet: The US has a huge impact on the global financial cycle, but the US is not independent also what the others are doing. So there are spillovers in financial conditions to the other countries, but there are also spillbacks.

Allison Nathan: I'm Allison Nathan, and this is Goldman

Sachs Exchanges. Every month, I speak with investors, policymakers, and academics about the most pressing market-moving issues for our Top of Mind Report from Goldman Sachs Research. In the most recent report, I looked at central bank divergence. The Fed typically leads a relatively synchronized monetary policy cycle across the major economies, but the cycle seems to be shaping up somewhat differently this time. So why is that? And what are the implications for economies and markets?

I spoke to three of the world's top economic minds -- Jan Hatzius, our chief global economist here at Goldman Sachs; Peter Praet, the former chief economist of the European Central Bank; and Maurice Obstfeld, the former chief economist of the IMF. Jan started us off with a useful snapshot of how economies around the world are faring and how central banks are responding.

How unusual is it for the Fed to not lead the cycle? And what's really informing our view in terms of the starting points?

Jan Hatzius: The idea of having flexible exchange rates and independent central banks is that central banks

can look at the needs of their own economies and can then decide to move earlier or later. And the case for the Fed to get started pretty soon, I think it's coming together but it's not as obvious as it is in a bunch of the other G10 economies. Sweden, which has already started, which has a very strong case for easing. The economy has softened a lot more. Inflation is coming down very nicely.

I think the case in the euro area is very strong. The case in Canada is very strong. For the UK, I think you can probably debate it a little bit more because they do have more of an inflation problem, and the disinflation there is lagging somewhat relative to other G10 economies. But I think the fact that the labor market has weakened by more in the UK is an argument for them to get started soon.

Again, the argument for the Fed is coming together. The disinflation is taking longer than we thought at the start of the year for sure, so a delay from that perspective makes sense. But I think the disinflation is still occurring. We're seeing it in the CPI and PCE numbers to a degree. The year-on-year rates have still been coming down. And we're seeing it very clearly I think in terms of the rebalancing of the labor market. So that part is I think getting better.

And then on the real side, yeah, the US economy is still stronger than other G10 economies, but at the margin that is a little bit less true now than it was three months ago. We've seen some deceleration. The first half GDP growth is probably going to be in the sort of low to mid twos as opposed to the 4% range in the second half of last year. We're seeing clearly some softening in the labor market. Job growth has come down. The unemployment rate has drifted up.

So it all seems to me that there's some room for divergence in terms of what the domestic economies need, but not a massive amount necessarily.

Allison Nathan: If we just dig into that a little bit and we think about the fact that all of these economies essentially suffered the same pandemic shock, but when we think about the recovery since, it seems as though the inflation path for the US has been a bit bumpier and the growth path has been a bit stronger. If we think about why that is relative to the other major economies.

Jan Hatzius: I'd agree on the second more than on

the first. I do think the growth path has certainly been firmer. Mostly I think this has been a greater strength in productivity and in particular greater strength in labor force growth. The US productivity performance post pandemic has been not astounding. We're on the 1.5% growth trend that we had prior to the pandemic. But everywhere else, it's deteriorated quite a bit.

And then as far as labor supply is concerned, yeah, the US has seen a lot of great news in terms of, first, the recovery in the labor force participation rate. And then over the last year or so, this big influx of immigrants, which does contribute to potential growth.

I do think that the strength on the supply side is very important because, if I look at growth from a monetary policy perspective, I'm really most interested in growth relative to potential as opposed to absolute growth. And from that perspective, the US doesn't really look that different. There's been a modest amount of labor market loosening in terms of the unemployment rate. There's been a very substantial amount of labor market loosening in terms of jobs-workers gap and measures like that. And that's what we've seen elsewhere as well.

On the inflation side, I'd say the US saw the inflation upturn somewhat more quickly than other G10 economies. And then saw the inflation downturn more quickly than other G10 economies. That sort of reconverged as the US has failed to make progress or maybe even regressed a little bit. Whereas, we've seen generally continued disinflation elsewhere. But if I look at it a little bit more broadly, I actually think it's been reasonably well synchronized.

And I think one important point for me is that, if you'd asked me a year ago or a year and a half ago and had told me US core PCE inflation is 2.8% year on year and the unemployment rate is up to 3.9 and the wage growth is back down to 4.0 and all these things have continued to make progress, I would say the reason why there are these questions around whether they're on the verge of cutting I think is partly the sort of time pattern of how this has happened with the inflation progress much more pronounced than we had expected in the second half of last year. And then us all discovering that, yeah, some of that progress probably wasn't quite real and these questions around the higher sequential numbers. But if you step back, we're in a pretty good position.

Allison Nathan: Understood. As we think about the path ahead and where you expect fundamentals to go, what degree of divergence would you expect? The market seems to be pricing in a moderate amount. Do you think that's reasonable? What's the scope for divergence ahead?

Jan Hatzius: Well, I think there's decent amount of scope for divergence depending on the data. I don't think there's any reason why you couldn't have very large differences in short-term rates and policy rates across the different economies if the data were calling for that. If you go back to, say, the 1990s and 2000s when Japan was the extreme outlier to the low side, there wasn't anything particularly wrong with that. We ended up with much, much higher policy rates in the US than in Japan, but the global financial system coped with it. And I think that would again be the case.

Allison Nathan: Is there any point at which you would think divergence could become problematic?

Jan Hatzius: I think it's always going to feel a little bit more problematic in the short term than in the long term.

And in the short term, markets tend to move very much together because I think there is the worry about sharp and sudden moves in exchange rates. I'm not really worried about it for G10 economies. And I would say I'm also less worried about it for EM economies than I would have been in past cycles, in part because we've seen so much development of domestic debt markets. EM central banks now have a lot more anti-inflationary credibility. They've actually had a pretty good post-COVID inflation episode. They started tightening earlier, which in retrospect, was the correct thing to do. Then the DM central banks, you'd still be a little bit more worried about divergence because the legacy of kind of past debt crises is still there, but it's receding relative to where we were 10 or 20 years ago.

Allison Nathan: So I think it's fair to say that Jan thinks the current focus on central bank policy divergence may be a bit overblown and isn't particularly worried about most potential implications from it. Next, I sat down with Peter Praet, who served as chief economist of the ECB from 2011 to 2019. As you'll hear, Peter has first-hand experience navigating a divergent policy environment.

If we think about rate and hike cycles in the past, normally the Fed leads. But this time around, we are expecting to see a cut from the ECB in June and obviously expectations for Fed cuts have been pushed later and later. So how unusual is that sequence of events really? And how successful have past episodes of central bank divergence been?

Peter Praet: Something we have seen in the past is that the US actually leads the global financial cycle historically. Leading means that you change your policy before the others. The ECB has usually followed by something like three, four months after the Fed, more or less, with some exceptions. And these exceptions, I wouldn't overemphasize them, but the very few exceptions we have seen in the past were not very fortunate. They were not so good decisions, like 2011.

I entered the ECB in 2011. And that time we increased the rates, which was the other direction than the US, but I agree this was an unfortunate decision. And very quickly then we changed the stance. But it's true that the US has a huge impact on the global financial cycle, but the US is not independent, also, what the others are doing. So there

are spillovers in financial conditions to the other countries, but there are also spillbacks.

That means that when rates, for example, in the US go up -- meaning up this time -- or less down than in the other countries, there will be reallocations of portfolios. And a lot of bond portfolios will reallocate to the US, and that would put the long-term rates in the US down. And you remember the conundrum, the long-term rate conundrum of Ben Bernanke when he said we tightened the policy but actually long-term rates are not going up. Basically because the Chinese and others were reallocating portfolios to the US, and that would also influence the US conditions.

So this is not a one-directional game. It's a collective game. But admittedly, the US leads the cycle, has a big influence on financial conditions. This being said, in case of big fundamental divergences, I'll give you one example as the euro crisis where policy diverged enormously between the US and Europe for good reasons, for fundamental reasons. We could manage — meaning the central banks, US, Europe — could manage that divergence for different reasons.

First, it's fundamental. The euro sale compared to the dollar from 1.39 I think to 1.06 in a relatively quick period of time. But we had oil prices also fell dramatically. And the ECB came with a number of innovations in monetary policy. So that big divergence, that was my period actually in the ECB. We had a big divergence of policy with the Fed, but all the conditions actually went very well. Actually, this divergence could be sustained. And in the end, the European economy recovered.

Allison Nathan: Right. So we talked about the differences in economic fundamentals driving in some ways the good example of divergence back in the euro area. So if you think about the economic fundamentals today, how much scope is there for central bank divergence? And does it make sense?

Peter Praet: I think it's a very important question. I would start to say that recently I think markets put a lot of emphasis on divergences. I agree that there are divergences, but there are also commonalities between the two regions. And think about that the sources of inflation, if you compare the US and Europe, the sources of inflation were very different. We had more supply-driven inflation.

US was more demand. Although we had a mix of both, but the US demand part was much stronger than European.

But in spite of that, you had a global financial tightening, monetary tightening. Most central banks synchronize their monetary policy.

Allison Nathan: So is there an argument that there should be divergence here? Or are you saying the commonalities are more important than the differences and there really shouldn't be?

Peter Praet: I think what you see in the markets now makes sense. I think because you have to look forward, the situation is very uncertain. But we all in Europe look at the US elections. We know that fiscal policy continues to be very expansionary. We don't know about the next economic policy in the US. There are different scenarios, and that's really what is worrying. It's not so much what we have seen recently, but I think Jay Powell went a little bit too far at the end of last year by signaling that rates would cut. He didn't even mention the term "rate cuts." I think that was a bit premature because it led to a loosening of financial conditions, which according to some financial

conditions indicators, are now even looser. The lowered expectations in the US of rate cuts were seen by the ECB as welcome news for the ECB because they thought that market expectations also in Europe were too aggressive given this inflation process which is not yet finalized.

And so the market prices that you see now, something like 75 basis point cuts this year, the ECB is very comfortable with that. The US, one, maybe two rate cuts this year or zero, this is basically market prices. So there is nothing special with this. It's even welcome by I would say the ECB, what we have seen now. The big question is what comes after.

Allison Nathan: If the Fed continues to move in a more hawkish direction, will that in itself limit the extent to which the ECB can ease policy? You said yourself growth is much weaker in Europe than in the US. Could that threaten its nascent recovery? And so what are the limits?

Peter Praet: It's a good question. I think there are many of course because it depends on how much will the divergence be. So we can accommodate some divergence in the monetary path, the US and Europe. I think there is

some room for divergence, but you're quite right. It could derail, and this would be difficult because history has also shown that the forex reactions can be very wide, very strong.

Allison Nathan: I followed up on the currency angle with Maurice Obstfeld. He served as chief economist of the IMF from 2015 to 2018, was a member of the Council of Economic Advisors, and is a former UC Berkeley professor of economics. Here he is.

If the ECB, the BOE, these other major central banks, do cut before the Fed, as seems likely right now, what are the implications?

Maurice Obstfeld: The main impact of an asynchronized cutting cycle for them would be that their currencies depreciate. I don't think think ECB cares very much about that because the impact on inflation is not going to be pronounced in an area that is as closed externally as the euro area is. The Bank of Japan is quite concerned about the weakness of the yen and the possible effects on inflation. They're in a more difficult position. They've been increasing from very low levels, and not

increasing quickly enough to stabilize the yen. But it remains to be seen if they will be moved to push interest rates up more quickly.

Allison Nathan: So if we look at everything we've been talking about and the differences in potential paths of central bank policy ahead, do you have any views on the dollar? Is the dollar going to remain as strong as it is? Or are there limits to that strength?

Maurice Obstfeld: Well, the dollar has not yet quite reached the heights of the fall of 2022 when the Fed was energetically trying to catch up to where it thought it needed to be to control inflation. There's certainly room for it to strengthen more. The dollar depends on expectations of the future. So to the extent that the European and UK cuts we've been talking about are already priced in by the market, they're not going to have a big effect when they happen unless there are bigger cuts than we expect now or there are more cuts than we expect now.

But there's also the possibility that the market view of when the Fed will cut gets pushed into the future compared to where it is now. That would contribute to a

stronger dollar as well.

Are there limits? You can always hit a new high, and the US economy is relatively closed. Where would the limit be? It would really come from export industries or import competing industries that are being adversely affected by a lack of competitiveness due to a much stronger dollar and their demands for some sort of protection. And, you know, how that would play out is unclear. We had a similar situation in 1985. The official response was the Plaza agreement to push down the dollar. I don't know if that's something we could expect to see again. I doubt it given the current level of international cooperation that we're seeing on the economic front.

And of course, some of this is going to run into the presidential election in the US and a possible change in administration. And that could have a major effect on how a stronger dollar plays out.

Allison Nathan: That strong dollar thesis is in line with what my colleagues in Goldman Sachs Research are forecasting. Kamakshya Trivedi and Mike Cahill from our Markets Research team echo Peter in noting that macro

divergencies can lead to currency volatility. They say that higher US rates are keeping the dollar strong and add that if the Fed keeps rates steady while the ECB and other central banks follow through with expected cuts, policy divergence would likely keep the dollar stronger for longer.

We'll leave it there for now. Thank you for listening to this episode of Goldman Sachs Exchanges. I'm Allison Nathan. If you enjoyed this show, we hope you follow us wherever you listen to your podcasts and leave us a rating and comment. If you'd like to learn more, visit GS.com where you can find a copy of this report and also sign up for Briefings, a weekly newsletter from Goldman Sachs about trends spanning markets, industries, and the global economy.

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