Banc Ceannais na hÉireann
Central Bank of Ireland
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Implications of euro area-US interest rate divergence for the Irish economy

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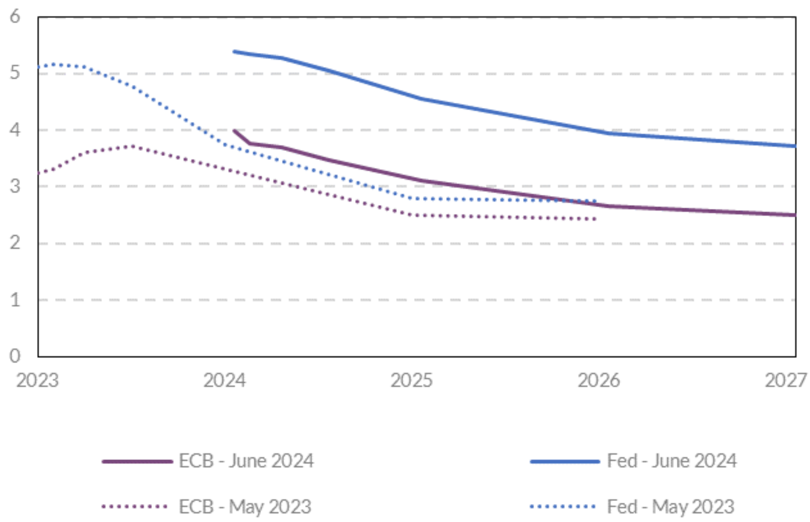
The recent economic performance of the United States has been solid even with historically high interest rates, as confirmed by a series of data releases between end-2023 and early-2024. This has led financial markets to expect the timing of a first interest rate cut to be later than previously anticipated. Markets have also signalled an expectation that the overall extent of monetary policy easing in the US will be more curtailed than envisaged 12 months ago. In the euro area, by contrast, expectations regarding the path of the ECB interest rates have changed to a lesser extent. As a result, financial markets have started to price in some divergence between the monetary policy paths expected in the euro area and in the United States. This is reflected in a widening interest rate differential (Figure 1). Market expectations of policy rates as of early June 2024 (solid lines) point to a significantly wider gap between expected ECB and Fed policy rates out to 2026 compared with market expectations a year ago (dotted lines). The purpose of this box is to assess the possible implications of this divergence for the Irish economy.

Interest rates in the US are set to remain higher for longer than previously expected

Figure 1

Per cent



Source: St.Louis Fed, ECB, Bloomberg.

Note: Chart shows the market implied policy rates for the ECB and Fed.

Transmission channels

The main transmission channels of euro area-US interest rate divergence to the Irish economy are through the trade and the exchange rate. In relation to trade, US economic growth overperformed expectations considerably in the second half of 2023 and early 2024 (Figure 2). In April 2024, the IMF revised upward its projections for US growth by 1 percentage point compared with its October 2023 forecast, largely due to stronger than expected consumption. Ireland, as a small open economy, is sensitive to US consumer demand through exports. Indeed, the US was Ireland's largest market for goods exports and second largest for services in 2022. The sector most exposed to US demand is chemicals and pharmaceuticals, where US exports account for over 40 per cent of the total. The US is also an important market for Irish exports in the ICT sector, both manufactured goods and services. While an increase in US demand stimulates activity in these sectors in Ireland, it may also increase demand and hence prices for a range of global commodities. Such a rise in commodity prices would increase import prices in Ireland, leading to rising costs in exposed sectors and putting upward pressure on inflation.

Growth outlook for the US economy revised upwards since October 2023

Figure 2

Per cent

Source: IMF World Economic Outlook (WEO).

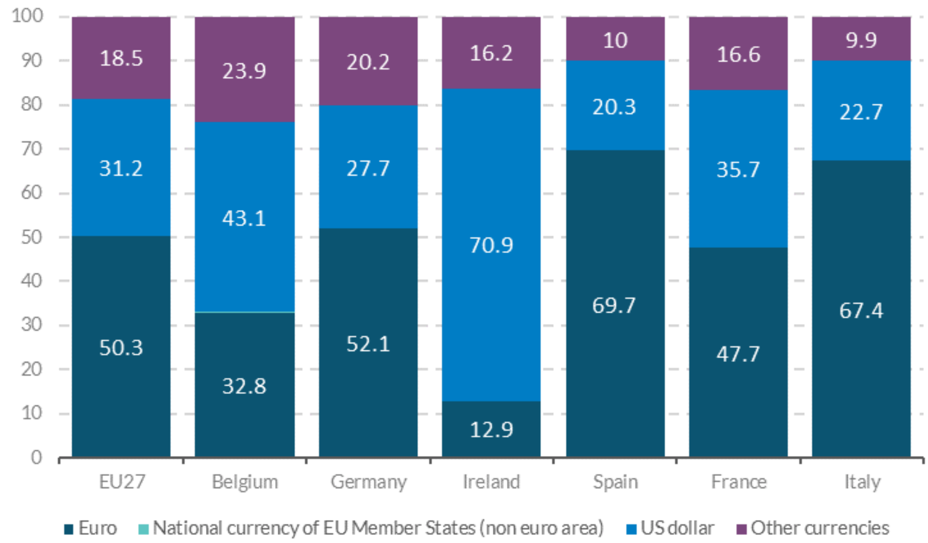
Note: IMF WEO Apr 2024, IMF WEO Oct 2023.

In terms of exchange rate implications, the divergence between Fed and ECB rates could lead to a depreciation of the euro relative to the dollar. In principle, such a depreciation would boost euro area exports, all else equal, as European goods would become relatively cheaper for US consumers. The strength of this mechanism will depend on the currency that European exports are priced in. Gopinath (2015) shows evidence of dominant currency pricing, i.e. a large proportion of global trade is priced in dollars. This is particularly true for Ireland where 70 per cent of manufactured goods exported outside the EU are priced in dollars, a significantly higher proportion than in other EU countries (Figure 2). If exports are priced in dollars, demand is not affected by an appreciation of the dollar, muting the real effects on trade arising from the change in relative exchange rates.

A high proportion of Ireland's manufactured goods exports to outside the EU is priced in dollars

Figure 3

Per cent



Source: Eurostat.

Simulating a US-euro area interest rate divergence: US demand shock

To estimate the potential macroeconomic impact of a divergence between US and euro area interest rates, we perform a simulation exercise using the National Institute of Economic and Social Research's Global NiGEM model in conjunction with the Central Bank's semi-structural model of the Irish economy. The purpose of this exercise is to illustrate the transmission channels of euro area-US interest rate divergence and to estimate the potential effects.

A divergence between US and euro area interest rates may occur for different reasons, including demand shocks, supply shocks, and monetary policy shocks. On the basis that US GDP growth forecasts for 2024 were revised upwards from 1.5 to 2.7 per cent in the most recent IMF forecasts (Figure 1), we focus on a stylised US demand shock. Since US private consumption was the main driver of the IMF's upward revision to GDP – itself revised up from 1.2 to 2.3 per cent in 2024 – we run a positive exogenous shock to US consumption growth in NiGEM of approximately 1.1 percentage points which lasts for

one year. The shock is designed to capture the impact on Ireland of the better than expected performance of the US economy and the related implications for euro area and US interest rates and exchange rates.

The shock has a direct impact on US GDP growth which increases temporarily by 0.6 percentage points in 2024 (Figure 3) and would put upward pressure on US inflation. In the model, the increase in inflation leads to a rise in the policy interest rate, which is assumed to respond according to a Taylor rule. The increase in US interest rates in the simulation is in line with the observed rise in the market-implied path for US rates since October 2023. This creates a transatlantic divergence in interest rates, leading to an appreciation of the US dollar relative to the euro.

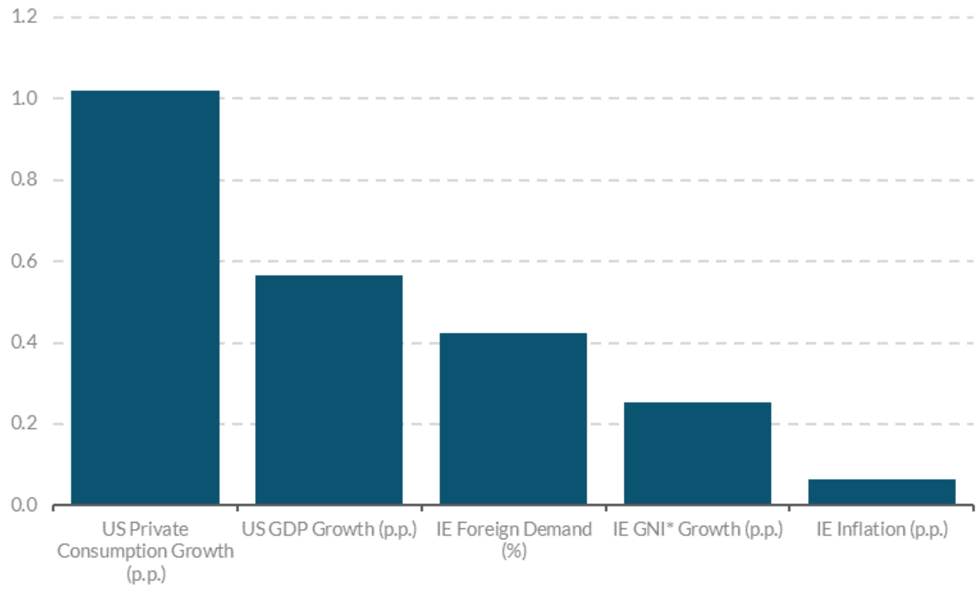
The Irish economy would be affected through the external demand and exchange rate transmission channels discussed above. Higher US GDP growth would increase the external demand for Irish exports by 0.4 per cent in 2024 and boost tradable sector output. Ultimately, our simulation suggests that output (GNI*) growth in Ireland would be 0.3 percentage points higher than otherwise in 2024. In relation to inflation, the increase in economic activity in Ireland would exert some upward pressure on consumer prices. This effect would be added to by higher import prices which would rise due to the depreciation of the euro against the dollar. The combined impact of these effects on overall inflation is estimated to be small, amounting to about 0.1 percentage point in 2024.

It is important to note that the central forecasts in this *Bulletin* already incorporate the latest projections for euro area and US growth, interest rates and exchange rates. Therefore, euro area-US interest rate divergence as contained in current market expectations is reflected in our baseline projections and the simulation results should not be interpreted as representing additional impacts on top of the central forecast.

Macro Impact of a Positive US Demand Shock

Figure 4

Deviation from baseline in 2024



Source: authors' calculations using NiGEM and Central Bank semi-structural model.
Note: These deviations are incorporated into, and not additional to, the baseline forecasts presented in this Bulletin.

Summing up, the market implied paths for euro area and US interest rates have diverged over recent months reflecting new information on the realised and expected performances of both economies. The analysis in this *Box* shows the net impact on Irish activity and inflation of EA-US interest rate divergence in 2024 is likely to be small. Over the longer term, underlying issues such as the prospects for long-term growth in the two economies and differences in investment and productivity growth will have a more material impact on economic growth and inflation in Ireland relative to the effects of short-term divergence in interest rates.