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How far will central banks go to crush inflation?

Dermot O'Leary, Chief Economist
Shaun McDonnell, Economist

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Economic Monitor

Welcome to Economic Monitor – a quarterly publication where we explore the key themes shaping the global economy. In this issue, we ask: how far will central banks go to crush inflation?

Dermot O'Leary, Chief Economist

Shaun McDonnell, Economist

Having been behind the curve in tackling inflation risks at the start of 2022, central bankers have been trying hard to catch up in recent months. The Federal Reserve (Fed) raised interest rates by 0.75% in June, marking its biggest increase since 1994. Having entered the year believing that rates would not need to be increased at all in 2022, it is now expected that interest rates in the euro area will increase by a cumulative 1.5% by December. The Bank of England has raised its base rate for the fifth consecutive meeting with more aggressive hikes likely at its next meeting in August.

Interest rates are increasing in major developed economies at the fastest pace since the early 1980s.

Rapid shift in interest rate expectations

All in all, interest rates are increasing in major developed economies at the fastest pace since the early 1980s. The shift in expectations relative to the start of the year has been dramatic, but a key question now is whether central bankers can engineer a soft landing for the economy or if this rapid rise in interest rates will tip their economies into a recession. Early cycle indicators, such as the housing market, suggest that higher rates are already starting to have a slowing influence.

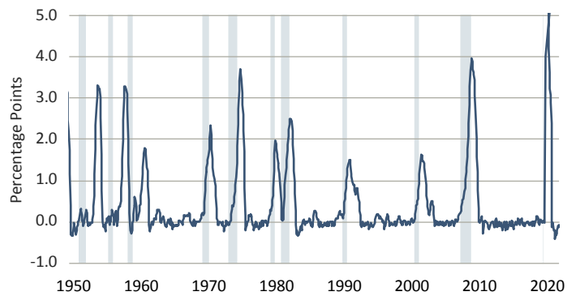
Soft landings are rare events since central banks are often guilty of hiking rates too much. This time around, the task is made even more difficult by the high starting point for inflation and the impact of external factors such as strained supply chains and high energy prices. Domestic policymakers cannot do anything to influence these factors, yet their persistence over a prolonged period increases the chances of inflation becoming more engrained.

Even if one strips out energy, "core" inflation remains above 6% in the US and the UK, and it is above 4% in the euro area. In other words, inflation would be a concern even if these external influences were not present. This is because labour markets remain tight around the world. This, in turn, is pushing up wages and core inflationary pressures. This is where the focus of attention now lies; higher interest rates and quantitative tightening are aiming to slow demand, triggering an increase in the unemployment rate and easing wage pressures.

Lessons from history

The lessons of history suggest that it is exceptionally difficult to engineer a rise in unemployment without triggering a recession. A relatively simple metric – Sahm's Rule – illustrates this well. This rule tells us that a rise in the unemployment rate of 0.5% or more over the course of a year has, without exception, led to recession soon after (see Figure 1).

Figure 1. Sahm Rule Recession Indicator



Source: FRED *Shaded areas represent official US recessions, Sahm's rule shows change in unemployment rate in 12-month time horizon

Figure 2. Federal Reserve projections for the US economy

	Jun 22		Mar 22		Dec 21	
	2023	2024	2023	2024	2023	2024
GDP	1.7	1.9	2.2	2.0	2.2	2.0
Unemployment rate	3.9	4.1	3.5	3.6	3.5	3.5
Core inflation	2.7	2.3	2.6	2.3	2.3	2.1
Fed Funds rate	3.8	3.4	2.8	2.8	1.6	2.1

Source: Federal Reserve

In the latest set of projections from the Fed, the unemployment rate is expected to rise to 4.1% in 2024 from its current level of 3.6% (see Figure 2). In March, the Fed expected the unemployment rate to remain close to its current level throughout the forecast horizon. Despite this more pessimistic view on the labour market, it expects the US economy to grow by 1.7% and 2.0% in 2022 and 2023, respectively. Despite the historical precedents, the Fed is effectively forecasting a soft landing.

In Europe, the Bank of England is facing a similar situation to the Fed, with rising domestically generated pricing pressures stemming from a tight labour market. European Central Bank (ECB) chief economist Philip Lane has argued that the situation in the euro area is different to that of the US and the UK. With core inflation and wages growing at a slower pace, he has a point, but inflation risks stemming from a record low unemployment rate are real, with the recent rise in wage settlements in some parts of the bloc a reminder of these risks.

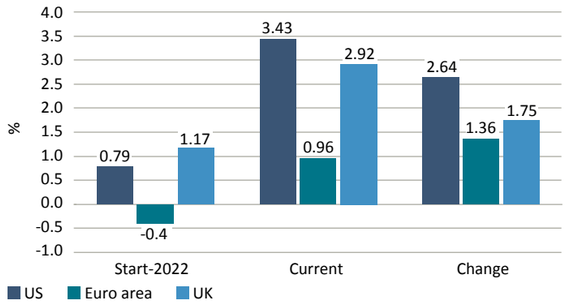
Core inflation remains above 6% in the US and the UK.

More realistic interest rate expectations priced in?

In our Economic Monitor earlier in the year, we argued that interest rates would have to rise significantly more than the market expected at the beginning of the year to move rates back to a "neutral" setting. We argued that this would likely mean a rate of close to 3% in the US. Since then, inflation risks have materialised and this means that interest rates will have to move to a "restrictive setting", likely towards 4%.

The unemployment rate is expected to rise to 4.1% in 2024.

Figure 3. Expectations for central bank rates at end-2022



Source: Bloomberg

Despite the Fed's more pessimistic view on the labour market, it expects the US economy to grow by 1.7% and 2.0% in 2022 and 2023.

Fortunately, markets have moved to price in a much more realistic expectation for interest rates and this has been the major driver of the rise in bond yields and falls in equity valuations since the start of the year. With central bankers going "all-in" in their battle against inflation, and with some countries having not yet reached peak inflation, we have likely not reached the point where language and actions on interest rates from policymakers can change from the extra-hawkish tone portrayed in recent months. For that, the key indicators to watch will be wages and medium-term inflation expectations.

Equity markets have moved to price in lower valuations to reflect the impact of the end of ultra-loose financing conditions and the expectation of cuts to earnings estimates. The scale of these expected reductions will be heavily influenced by the extent to which central banks follow through with the sharp rise in interest rates.

We have likely not reached the point where language and actions on interest rates from policymakers can change from the extra-hawkish tone portrayed in recent months.

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