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MACROECONOMIC *view*

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Monetary policy tightening: too much or too little?

Key highlights:

- The monetary policy stance is in restrictive stance almost everywhere.
- The first wave of inflation focused on energy and goods is rapidly receding.
- The second wave of services inflation continues to swell.
- In the absence of a recession, central banks have no reason to back down.

When the global economy was hit by **a first wave of inflation in 2021,** central banks - with a few exceptions - did not react because this price shock was seen as reversible by itself. Sudden lockdowns, swift reopenings, support schemes to households and businesses... all of these pandemic-related disruptions were meant to disappear, not linger on. In fact, we now see that delivery times for goods are back to normal, that shortages of specific products have been largely overcome and that most commodity prices have retreated from their peaks.

However, when **a second wave of inflation emerged at the start of 2022**, almost all central banks quickly reversed their monetary policy. This second price shock - occurring at a time when the first had not yet subsided - had made them fear that the economy was heading for a 1970s-style inflationary spiral.

Throughout 2022, central banks in developed countries have therefore tightened policy at a pace never (or rarely) seen in the past. The pace has slowed in recent weeks but the trend remains upwards. In less than twelve months, the Fed raised its key rates by a total of 450 basis points, the ECB by 300 basis points, etc. (graph).

The time has come for central banks to take stock before deciding on the next steps. Have they put enough pressure on demand to calm inflationary pressures? Or have they tightened too much, risking a recession? **Is it even possible to control inflation without undermining growth?** These are the key questions.

Overall, economic activity has held up better that feared. Labour markets remain strong, with unemployment rates at their lowest levels in decades. The US economy is slowing, but is not in recession. Europe is close to stagnation but in the absence of winter blackouts, there has been no severe contraction in output. **Lately, with the hopes brought about by China's reopening, there has been a small break in the cloudy outlook**. In January, and for the first time in a year, the IMF raised its world growth forecast. The revision is admittedly minimal (+0.2 points in 2023, from 2.7% to 2.9%, after +3.4% in 2021) but its meaning is symbolic.

As far as inflation is concerned, a downward trend has been underway for several months in many countries. According to our calculations, global inflation will be around 8.5% year-on-year at the end of 2022, after peaking at 9.5% last autumn. This is going in the right direction, but starting from such a high level, central banks cannot be satisfied with it. Moreover, the decline in inflation is not uniform across countries, nor across price components.

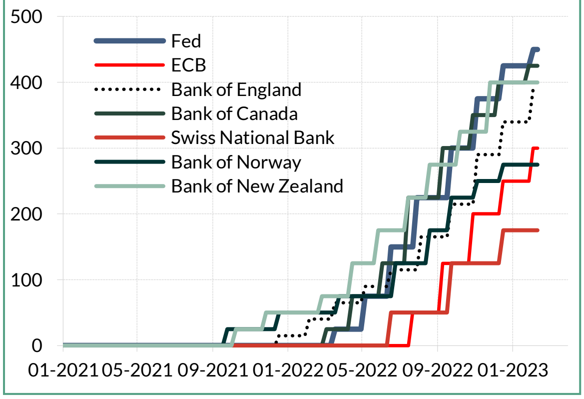
In these circumstances, central banks are entering a critical phase where the scenario of excessive tightening, which would undermine the resilience of the economy, has to be weighed against the scenario of stopping too soon, which would risk rekindling inflationary pressures. The problem is not exactly the same in all regions.

The US Federal Reserve is in the final stages of its tightening cycle. The median view of the monetary policy committee is that there are still two 25 basis point rate hikes to go, before pausing to make sure inflation is indeed converging towards its target. In the absence of a recession, rapid monetary easing seems unlikely. Yet, this is the expectation of a large segment of the market. On the other hand, if wage pressures remain high, the Fed would have every reason to maintain a restrictive policy, or even to tighten further.

The European Central Bank has much less to be happy about than the Fed. The decline in inflation is more recent than in the US. It is starting from a higher level and, for the time being, is mainly limited to energy prices, a component outside the scope of the ECB's decisions. The inflation peak has not yet been reached for food products, manufactured goods, services or wages. **In the euro zone, disinflation is a hope, a projection, not yet a reality**. As a result, the ECB's tone remains hawkish. Rate hikes will continue at a steady pace, and there is no sign of a pause until mid-year at the earliest.

With the exception of Japan, the only country where policy was not tightened last year, other developed countries are also nearing the end of the monetary tightening cycle. Here again, inflation remains far from its target. Overall, beyond the specificities of each country, the common thread is that **monetary policies are now restrictive almost everywhere and will remain so for a while. This is a regime change.** Since the financial crisis of 2008, we have been used to loose or ultra-loose monetary policies. Nowhere today is there much appetite to turn back.

MAJOR CENTRAL BANKS: CUMULATIVE RATE HIKES



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