MACROECONOMIC *view*

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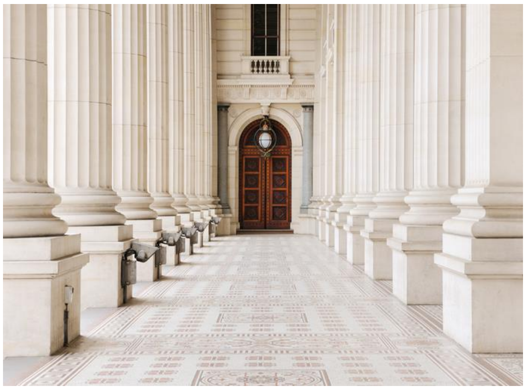
SHOULD CENTRAL BANKERS BE TORCHED?



KEY HIGHLIGHTS

- Central banks have failed in their mission to ensure low and stable inflation. This is not entirely their fault.
- To correct the situation, a nearly worldwide monetary tightening is underway. It is profoundly changing the interest rate regime.

In the space of 15 years, central bankers have gone from being the demigods who solved the inflation problem once and for all to embodying the culprits of the biggest price surge since the 1970s.

How did this happen? What are the implications for monetary policy?

In the US, Europe and some other countries, policymakers have invested central banks with a crucial mission: to ensure that inflation does not deviate too far from a 2% trend per year. This is incorrectly called "price stability". The idea is simple but powerful. To prevent a government from changing monetary policy to its own advantage, an independent body is given this role and made accountable for it. This system seemed to work perfectly. Annual inflation in the G7 countries averaged 3.3% between the mid-1980s and the mid-1990s. After that, and until 2008, the average had fallen to 2%. Alan Greenspan, head of the US Federal Reserve during this miraculous era, was nicknamed the Maestro. Stable and low inflation eliminated one of the factors of economic cycle fluctuations, an important step forward for household and business decision-making.

The financial crisis turned this regime upside down. In the decade that followed, the problem of inflation resurfaced, albeit in an atypical form: inflation was too low (1.3% on average in the G7 from 2009 to 2019), sometimes even flirting with deflation (falling prices). To remedy this, central banks experimented with atypical actions, consisting of setting key interest rates at zero or even below zero and buying financial assets with trillions of dollars or euros.

At the start of the pandemic, central banks already had all the necessary tools to avoid a lasting depression. They were quick as lightning to react and prevent capital markets from running out of liquidity. Key interest rates were lowered and asset purchase programmes restarted. At the same time, fiscal authorities were organizing the largest revenue transfer in history to stabilise the economy. The success was beyond all expectations.

In part, the current surge in inflation is a consequence of the stimulus policies put in place in 2020. Should the stimulus have been less strong or at least withdrawn earlier to avoid this?

It's possible, but history cannot be rewritten. If the Fed or the ECB had tightened their monetary policy in the spring of 2021, instead of waiting until the spring of 2022, they would have been accused of scuttling the recovery.

In part, too, the inflation shock is the result of innumerable disruptions in the global supply chain. Central bankers cannot be held accountable for that. They could not have predicted the repeated lockdowns in China, let alone the Russian invasion of Ukraine.

So, what can be done? Apart from China, nearly all central banks around the world have already started tightening their monetary policy or are in the process of doing so. For example, we estimate that the « global » key interest rate is back to its level at the end of 2019, just before the pandemic (graph). With inflation much higher than then, the tightening will be amplified. The aim is less to weigh on current inflation than to temper inflation expectations.

The case of the ECB deserves a specific comment because, while all central banks face the same dilemma - fighting inflation while avoiding a relapse into recession - it is in the eurozone that the problem is most difficult to solve.

First, business prospects there are more affected than elsewhere by the war in Ukraine. Europe's dependence on Russian supplies of gas, oil and various other inputs is a major vulnerability. Industry is the most exposed sector, which weakens the German economy in particular. Between January and April 2022, the IMF reduced its growth forecast by 0.3 points for the US, 0.6 points for France, 1.5 points for Italy and 1.7 points for Germany.

Moreover, in the eurozone, inflation largely reflects the energy crisis. Monetary policy has no short-term influence on energy demand. Unlike the Americans, it cannot be said that European demand is excessive and must be curbed without delay. In fact, the inflation shock is reducing their purchasing power, leading them to moderate their spending.

Whatever the risks of monetary tightening, it is clear that the ECB has lost patience. **Recent statements by many members of the Governing Council signal that a rate hike is just around the corner.** Many are leaning towards July 2022. As a reminder, the ECB also raised its key rates in July 2008 and July 2011. A bad omen?

WORLD : POLICY RATE (AVERAGE 48 COUNTRIES)

Sources :Thomson Reuters, ODDO BHF calculations

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