Macro outlook– The clouds around the inflation peak

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Key points

- 2022 ushered in a new monetary policy era. A policy-induced recession looks like the price to pay to get inflation back under control after a peak in late 2022.
- Higher interest rates will gradually impair the capacity of fiscal policy to remain accommodative. In the US, "policy paralysis" is on the cards after the mid-terms, while in Europe fiscal policy will still deliver more stimulus in the first half of 2023 to deal with the external inflation shock, but we think this will be the "last gasp" of fiscal activism.
- Supportive fiscal and monetary policy have dissimulated the underlying slowdown in potential growth for two decades. A new growth model is needed, but elusive.

The immediate cost of future disinflation

The inflation shock has defined 2022. Not primarily because as usual, by eroding purchasing power and corporate margins it has hampered consumption and investment – private spending has been remarkably resilient actually in the developed world given the circumstances – but because it has marked the end of an era for monetary policy.

Having missed the signs that what was initially widely seen as a transitory price reset after the post-pandemic reopening was turning into persistent inflation, the key central banks engaged in swift tightening without equivalent since the 1990s. The catch-up took the Federal Reserve (Fed) from what was still a very accommodative stance to properly restrictive territory in about half a year. Combined with Quantitative Tightening, this has produced the steepest tightening in broad financial conditions since the Great Financial Crisis of 2008-2009.

In principle, not all central banks should have followed the Fed. The US had a clear case of overheating to address, after the excessive fiscal stimulus of the late Trump and early Biden administrations, with an extremely tight labour market plagued by a lower participation rate. The Euro area had been more prudent with its fiscal stance during the pandemic and participation is rising there, now exceeding the US level in the 15- to 64-year-old bracket. Yet, the European Central Bank (ECB) has sometimes mirrored the Fed approach – for instance when delivering 75bp hikes. True, the Euro area will likely only hit the upper end of the "neutral range" (1 to 2%) for its policy rate in December 2022, but the starting point was lower than in the US, and we expect the neutral threshold to be exceeded in Q1 2023 (at 2.5%). Combined with a tightening in banks' lending standards, the ECB stance has in our view already taken broad financial conditions into restrictive territory. The ECB's approach, while inflation in the Euro area remains driven by supply-side developments (in particular gas prices) which can hardly be affected by monetary policy, is explicitly focusing on anchoring inflation expectations, but we suspect a significant share of their new-found hawkishness is fuelled by the depreciation of the euro.

Indeed, the world economy – once again in a configuration eerily resemblant to episodes from the 1990s – is adjusting to a stronger dollar fuelled by the Fed's policy. The ECB is actually one of the least affected central banks. Its counterparts in emerging markets have much more to do and we have seen cumulative hikes in excess of 1,000 basis points in some countries (Brazil, Hungary). We are not overly concerned by systemic risks in the emerging world – their intrinsic financial position is much better than in the 1990s, a key difference with that period – but the extreme tightness of monetary policy will seriously dampen domestic demand, especially when fiscal policy will have to adjust to the rise in sovereign refinancing costs (Brazil again). Those who have chosen not to defend their currency and bucked the trend by cutting rates are facing painful hyper-inflation, such as Turkey.

China is the one big exception to this rule. Even if the exchange rate has been softening as a result, Beijing has been able to loosen monetary policy against a backdrop of muted inflation. Yet, the Chinese authorities continue to be reluctant to make full use of their still wide policy space for fear of rekindling financial stability risks, while the shift away from the "zero Covid" policy is tentative at best, which is likely to trigger more pandemic-related disruptions in 2023. China's contribution to world growth will remain subdued in our view.

We are thus in a configuration we have not seen for decades: a policy-engineered slowdown in the world economy. The intensity and duration of this tightening phase depends of course on the speed of disinflation at the epicentre of the problem: the US economy. In the autumn of 2022, some tentative signs were finally appearing that the labour market is softening, which would herald the deceleration in wages into 2023 which the Fed wants to see. The "inflation peak" has probably been hit, which should allow a less rapid pace of rate hikes, but the distance from target, and the risks of further slippage are so high that the "terminal rate" has not been reached (we think it will hit 5%). This means that, given transmission lags, the monetary stance throughout 2023 is likely to remain more restrictive than in the second half of 2022. This is predicated on our belief that the Fed won't want to cut rates as quickly as the market is currently pricing (second half of 2023) since they will want to be satisfied that they have properly broken the back of inflation. The price to pay for this will be a recession in the first three quarters of 2023 in the US which will trigger the usual adverse ripple effects over the entirety of the world economy next year.

Memories of past mistakes often inform policy-makers action. Just like the premature monetary tightening of the 1930s was the mistake Ben Bernanke wanted to avoid at all costs in his management of the aftermath of the Great Financial Crisis of 2008/2009, this time it's the 1974 error which is probably haunting Jay Powell. Indeed, contrary to popular belief, the Fed initially responded to the first oil shock of 1973 by rapidly hiking rates. Its fateful decision came at the end of 1974 when, worried by the significant rise in unemployment, the Fed reversed course although inflation was still in double-digit territory. This laid the ground for rampant inflation throughout the second half of the 1970s, ultimately forcing the Fed into a massive tightening in 1980.

In a way, what lies ahead of us is the mirror image of monetary policy "over-activism" of the last two decades. Central banks had come to the conclusion that it was only by driving the economy "red hot" – well above potential – that they would manage to bring inflation back to target from their stubborn, near zero new trend. Today, the conclusion they have reached is that it's only by driving demand below an already low supply pace that they will be able to bring inflation back to 2%. No pain, no gain.

Fiscal activism's last gasp

While the monetary tightening is synchronized across the Atlantic, the fiscal stance has started to diverge. In the US, the Inflation Reduction Act – which in reality is a Green Transition Act – will probably be the last big program of Biden's mandate as the Republican's midterm gain of the House majority will probably usher in at least two years of policy paralysis. But this is probably "what the doctor orders" at the moment in the US: there is little point in fiscal policy attempting to offset the Fed stance given the need to address the economy's domestically-focused overheating. The situation is very different in the Euro area where governments have engaged in a new series of fiscal stimulus to mitigate the impact of elevated energy prices on households' income and corporate margins in the context of the Ukraine war.

There is still probably some degree of complementarity between fiscal and monetary policy in Europe. Households receiving temporary income support from governments may reduce pressure on more persistent wages, thus limiting the risks of the region settling on a wage/price loop which would force the ECB into even more tightening. A conflict is however likely to emerge towards the second half of 2023 as significant government issuance would clash with the ECB's likely decision to gradually reduce the reinvestment of the bonds it purchased during Quantitative Easing. Even if the European fiscal surveillance system were to allow for another prolongation of the exemption from the deficit reduction rules, we expect the budget bills for 2024, which will start to be discussed in the summer of 2023, will mark the end of fiscal profligacy.

Looking for a growth model

Over the last two decades, monetary and fiscal support has often dissimulated the underlying lack of dynamism of the developed economies, faced with slowdown in productivity adding to the demographic woes. In some countries, and that's certainly the case in the US, the decline in labour market participation is another source of weakness for potential GDP growth. Now that policy support is past its peak, those structural flaws will take centre stage.

The recent experience in the UK is interesting from this point of view. While the content of the plan was deeply flawed – upfront, unfunded tax cuts combined with vague promises about structural reforms – at least Liz Truss' administration tried to address the deterioration in potential growth in the UK. The U-turn on the fiscal stance by the Sunak administration is of course welcome from a financial stability point of view, but what is missing is a plan to re-start the economy.

On the list of macro challenges, we need to add the likely "greenflation" looming – the necessary fight against climate change is forcing the adoption of cleaner, but usually more expensive technologies, while we expect more regions beyond the EU to adopt forms of carbon pricing. "De-globalization" is also a risk, especially for countries which have made the choice of extroverted growth – such as Germany. The US is probably in a more comfortable position than Europe. Its demographic position, although deteriorating, is less problematic, and the country can at least count on cheap, domestically produced energy. The European Union at the time of the pandemic had managed to give substance to its long-term growth strategy by breaking the taboo of debt mutualisation to fund the "Next Generation" programs. We find it concerning that the member states have not found the same capacity to respond to the fallout of the Ukraine war with another concerted investment effort.

While we are confident that by the middle of 2023 the world economy will start improving again, we would warn against any excessive enthusiasm. Beyond the cyclical recovery, many structural questions will remain unanswered.