Economic
INSIGHT

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Powell Rhetoric Overshadows Complexities to Inflation Fight

With the great minds and leaders of the world's most powerful central banks converging last month at Jackson Hole, Wyoming, the key takeaway was clear: Elevated inflation will challenge the effectiveness of traditional monetary policy tools. In fact, some international officials warned the metrics policy makers have historically relied on to rein in price pressures may prove entirely ineffective given the atypical composition of inflation stemming from supply-side constraints and fiscal policy initiatives. Thus, central banks will not only struggle to make an impact on elevated prices, but also to convince market participants they are committed to price stability no matter the costs.

POWELL TAKES THE STAGE

Few, if any, Federal Reserve (Fed) speeches in recent memory have been more anticipated than Fed Chairman Jerome Powell's remarks on Friday, August 26. Taking the stage at the annual 2022 Economic Policy Symposium, "Reassessing Constraints on the Economy and Policy," sponsored by the Federal Reserve Bank of Kansas City, Powell's remarks were brief but to the point: Inflation is still too high, and the Fed is committed to restoring price stability. He said that stable prices are the "bedrock" to the economy, and while it will be painful to get inflation back under control both for households and businesses, failure to regain price stability would mean "far greater pain" in the long run.

"While higher interest rates, slower growth, and softer labor market conditions will bring down inflation, they will also bring some pain to households and businesses. These are the unfortunate costs of reducing inflation. But a failure to restore price stability would mean far greater pain," Powell said.

Of course, a heightened focus on fighting inflation is nothing new for Fed officials. For months now, officials have warned that prices are elevated and a further back up in rates will likely be appropriate to rein in cost pressures. The difference, however, was Powell's acknowledgment of how higher rates not only could but also will harm the economy along the way and that such a painful outcome is justified or even required to reinstate stable

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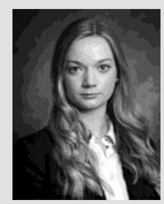

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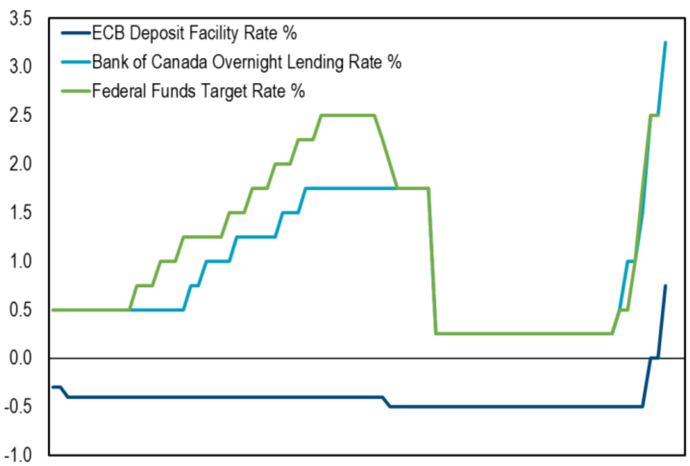
prices. In other words, despite visions of a utopic soft landing fading into the distance, the realization of a hard landing – or at least a less soft landing – will not deter Fed officials from this necessary evil.

According to the latest June Summary of Economic Projections, the majority of Fed officials already saw growth slowing from an earlier projection of 2.8% to 1.7% this year and a terminal federal funds rate of 3.375%. However, given the Fed's increasingly gloomy outlook for a more extended period of hardship, the Committee is likely to materially downgrade its outlook for GDP over the next 12-18 months in the updated September edition, as well as significantly increase the forecast for the terminal rate, which at least some officials have suggested could be 4% or higher.

INTERNATIONAL FOCUS SHIFTS TO INFLATION

Ahead of the Fed's policy decision on September 21, other developed central banks have taken sizable action in the face of heightened inflation. Last week, the Bank of Canada (BoC) and the European Central Bank (ECB), for example, both increased their key lending rates by 75 basis points (bps).



Source: ECB/BoC/Federal Reserve/Bloomberg

Canada was among the first of the developed central banks to increase borrowing costs in the aftermath of the COVID-19 crisis, raising its key lending rate from 0.25% to 0.50% in March. Since the initial increase, the BoC has hiked rates three more times, taking the policy rate to 3.25%. The BoC also formally announced in April the end to the reinvestment phase of its asset purchase program and officially initiated quantitative tightening.

The ECB's 75-bps hike was the largest one-time increase in the bank's near quarter-of-a-century history. It took the key lending rate from 0.0% to 0.75%, an 11-year high and marked the second rate hike in the past three months.

Recall, on July 21, the ECB first opted to raise rates 50 bps, taking the key deposit rate from -0.50% to 0.00%, the main refinancing operations rate from 0.00% to 0.50%, and the marginal lending facility rate from 0.25% to 0.75%. The move marked the region's first hike in 11 years, effectively ending the Eurozone's period of negative rates that began in 2014.

With inflation pushing up to 9.1% as of August, the highest on record, despite mounting evidence of weakness, the European Central Bank is struggling to control price pressures. In fact, following the ECB's policy announcement, ECB President Christine Lagarde held a press conference reinforcing the central bank's focus on taming prices. Lagarde was clear the central bank is – like the Fed – committed to reducing inflationary pressures, while acknowledging the underlying and emerging weakness in the region. "We actually took the decision today that we would continue to raise interest rates… because we believe that we are far away from the rate at which we hope we'll see inflation return to the 2% medium-term target," Lagarde said.

Like the Fed, European officials are increasingly focused on taming rising costs as opposed to insulating the economy from the negative impact of relatively higher borrowing costs, firmly establishing a new, more hawkish position with back-to-back hikes. Furthermore, should inflation warrant it, policy makers are increasingly open to a potential third-round outsized increase in October along with a discussion of quantitative tightening effectively ending reinvestments from the maturing bonds it holds through its 3.3 trillion euro ($3.3 trillion) Asset Purchase Program.

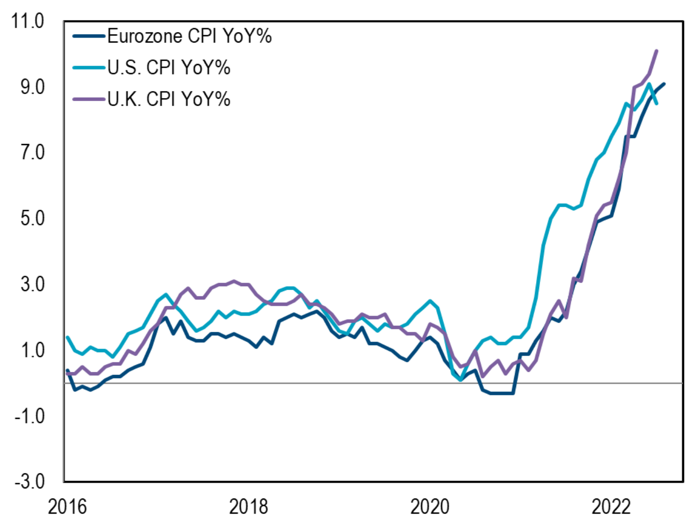
Of course, while the latest move from the European Central Bank – and the BoC among others – suggests policy makers around the world are stepping up their efforts to alleviate price pressures, the ECB's outsized increase does not put any additional pressure on the Fed to act in kind. The ECB is notably "behind the curve" and desperately trying to play catch up, as it has only two rate hikes equaling 125 bps compared to the Fed's four hikes and 225 bps. Thus, whether or not the Fed opts for a similar sized increase, the ECB's September policy decision should not be seen as a deciding factor for the Fed or as adding pressure for the Fed to "match" European counterparts on September 21.

SUPPLY-SIDE INFLATION PRESSURES ACKNOWLEDGED

Complicating the outlook for policy both in the U.S. and elsewhere around the world, is the unorthodox nature of inflationary pressures resulting from production shortfalls in the aftermath of COVID-19 and international conflict, as well as expansionary fiscal policy resulting in trillions of federal dollars flooding into the market.

Amid a fresh round of lockdowns in China and ongoing conflict in Ukraine, much of the world continues to reel from supply-side dislocations and commodity market disruptions. Europe, in particular, is facing an outright – and growing – energy crisis with prices already up a whopping 13% since the start of the year. According to the latest August read, inflation rose 9.1% in the region, marking the ninth straight record increase, with energy costs alone recording near the highest annual growth rate at 38.3%. Excluding energy, inflation in the region rose 5.8%, and excluding food and energy, core inflation rose 4.3%, also a record high.

With energy costs projected to remain elevated as cooler winter temperatures approach and fiscal policy makers struggle to increase – or replace – supply, the landscape for monetary policy makers battling to control prices will become ever more complicated. Germany, for example, according to Bloomberg News, is expected to keep two nuclear power plants open this winter, and policy makers are also discussing power-demand curbs, as well as a price cap on gas, a plan the new U.K. Prime Minister Liz Truss has already embraced. According to reports, Truss plans to spend a combined £130 billion over the next 18 months to cap household energy bills and lower energy bills for businesses, a plan no doubt rooted in benevolent intentions, but seemingly counterintuitive to the central bank's aim to curb an expansion of the money supply and increases the need for more aggressive monetary policy restrictions.



Source: Eurostat/Bureau of Labor Statistics/Bloomberg

Back in the U.S., while prices at the pump appear to be subsiding – at least for the moment – the Federal Reserve is facing a parallel struggle to curb inflation against the backdrop of lingering trade and supply chain limitations, as well as consistent and sizable fiscal policy intervention. Conflicting monetary and fiscal policy directives will not only mitigate the impact of the former on taming inflation, but will also most likely prolong the period of rising rates and the pain it may cause U.S. households.

Whether it is ample spending in the name of capping heating costs in the U.K., or $6 trillion in stimulus to combat the economic impact of policies aimed at stemming the spread of the COVID-19 virus in the U.S., or further fiscal initiatives aimed at easing hardship for Americans facing elevated costs and still a position of unemployment, the massive expansion of governments' balance sheets will only intensify the struggle to tame inflation. After all, as several Fed officials themselves have noted, fiscally-fueled inflation tends to be more persistent in nature, requiring longer-term and painful solutions, in line with Powell's anticipated "sustained period of below-trend growth."

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Glossary

BoC – Bank of Canada

CPI – Consumer Price Index

ECB – European Central Bank

GDP – Gross Domestic Product

YoY – Year over Year

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