Panic sets in



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In our last policy review we described how central bank tightening plans, with the notable exception of China, accelerated from a sedate pace to a disorderly rush for the exit. Over the first quarter of 2022, this rush has turned to panic, as Russia's invasion of Ukraine boosts energy prices further and risks long-term disruption to inflationary expectations.

Fed readies 50 bps hikes

The US Federal Reserve (Fed) implemented a 25-basis point increase in its benchmark federal-funds rate at their March meeting, the first raise since 2018. The Fed's plan, according to Chair Powell, "is to move expeditiously to return the stance of monetary policy to a more neutral level and then to move to more restrictive levels if that is what is required to restore price stability." In practice, this means increasing the benchmark rate to 2.5% this year and then assessing if further action is needed. A shift to restrictive policy is certainly not ruled out. Given how high inflation is, we are highly likely to see a series of 50 basis points hikes. The Fed will also commence running down its balance sheet by a shade under US$100 billion per month, most likely from this quarter.

Whilst freely admitting that "financial conditions generally should move to a more normal level" by using "our tools to moderate demand growth," the Fed's aim is to achieve an economic soft landing, avoiding recession. Indeed, Chair Powell referred to a recent lecture by one of his ex-colleagues, Alan Blinder, who observed that this has only been achieved in 3 out of the 11 tightening cycles in the past 40 years. However, in a rare show of humility, Powell went on to note that "I hasten to add that no one expects that bringing about a soft landing will be straightforward in the current context." With its credibility on the line, nobody should doubt the Fed's intention to restore price stability.

China on the opposite path

The People's Bank of China (PBOC) faces the polar opposite of the Fed's problems, with growth slowing and inflation subdued, reflecting earlier tightening and a strict approach to controlling COVID. Against a 2022 growth target of 5.5%, the State Council is on the verge of rolling out targeted easing as soon as possible. In practice, the PBOC is continuing to focus on favoured sectors, such as high-end manufacturing and rural development, whilst holding back on traditional easier policy, such as rate reductions and further liquidity injections, via cuts in required banking reserves. However, the central bank appears to have weakened the renminbi after its earlier strong run by cutting the official fixing price and it has allowed mortgage rate reductions in an effort to stabilise the housing market. In an interesting development, the PBOC is also consulting on a "financial stability protection fund" which sounds very much like a bad bank to help detect and dispose of distressed debt, a very positive move if confirmed in the coming months. However, with COVID rampant and other major economies likely to see growth slow as monetary policy is tightened, more aggressive policy action is likely if the authorities wish to achieve their growth target for this year.

The ECB's tricky balancing act

In the eurozone, with inflation currently running at 7.5% and likely to average above 5% for the year, the European Central Bank (ECB) is under immense pressure to normalise monetary policy quickly, especially as it is still adding liquidity through quantitative easing. However, the ECB is a forecast-driven institution, and its latest inflation projections see CPI at 2.1% in 2023 and 1.9% in 2024. As such, the central bank talks about 'normalising' monetary policy rather than 'tightening' monetary policy given inflation is expected to be where they want it to be in the medium term. In practice, this means that "if the incoming data support the expectation that the medium-term inflation outlook will not weaken even after the end of our net asset purchases, the Governing Council will conclude net purchases under the Asset Purchase Program in the 3rd quarter." On interest rates the ECB wants maximum flexibility, and it will adjust rates based on its next forecast round in June. Markets, however, are way ahead of the ECB, and are discounting rises of over 100 basis points within the next year. But with growth slowing, confidence collapsing, all while inflation is likely to be four times target at some point this year, the Governing Council faces a very difficult balancing act.

Japan holds its line

The Bank of Japan (BoJ) has also been battling markets, aggressively protecting the upper band of its yield curve control interest rate corridor by buying unlimited amounts of government bonds. These notes have sold off in line with global markets but, much like the Federal Reserve, the BoJ understands the importance of its credibility. Therefore, it has little choice other than holding the line it has drawn itself if it truly wishes to achieve its inflation target of 2% on a sustained basis. Such divergence in the policy stance between the BoJ and Federal Reserve has seen the yen weaken notably, a move which will be welcomed as providing a further inflationary impulse. Perhaps if Japan does actually manage to overcome decades of disinflation, we really are in a new paradigm.

Bank of England sounds more balanced

The Bank of England (BoE), for several months the most hawkish major central bank, raised the base rate by 50 basis points over the quarter to 0.75%, thereby matching the post-GFC high in official interest rates. The bank also started running down its balance sheet by allowing existing UK government debt to mature. However, looking forward, and having made a reasonable start on tightening policy, the latest guidance has sounded a little more balanced, as the trade-off between higher inflation and slower growth is looking far more difficult. For example, in the statement accompanying the last hike, it noted that "developments since the February Report are likely to accentuate both the peak in inflation and the adverse impact on activity by intensifying the squeeze on household incomes" and so whilst "the Committee judges that some further modest tightening in monetary policy may be appropriate in the coming months, there are risks on both sides of that judgement depending on how medium-term prospects for inflation evolve." With markets pricing in a further 150 basis points of rate rises over the next 12 months, the message from the Bank is far more balanced and we should not be surprised to see it push back against this pricing at its next meeting.

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