JOHAN

VAN OVERTVELDT

Central bankers should not bend over

24-01-17

The focus on month-to-month changes in inflation rates is misplaced. Monetary policy action should look forward much more than look back. The room for policy rate reductions is nada at present, and for months to come.

Did you ever hear of "Thunderclap Newman"? For most of the readers of this blog I dare to assume not (and of course my apologies to those who do). Thunderclap Newman was a short-lived British pop band from the tail end of the 1960s. They had one big hit with the song "Something in the air" (listen ***here***, if you're in the mood). Over the last two or three months this song, and more specifically its title, has run through my mind again and again. It sticks there not so much because it is a fun reminder of my early youth, but because of its relevance for today's monetary policy debate.

As headline inflation declined rapidly in the euro area and in the United States, there definitely was "something in the air" on a consistent basis. Crowding the airwaves was an equally rapidly increasing number of people, especially in the financial and the political sphere, calling on the major central bankers to start reversing the steep increase in policy interest rates. Those rate increases have felt since March 2022 in the case of the Fed, the American central bank, and since July 2022 in the case of the European Central Bank (ECB).

Minutes of past Fed meetings indicate that top-level thinking within the Fed was evolving towards that "bend over" scenario. These "dovish statements" added fuel to the “start reducing now” fire. The ECB’s decision makers -despite some disturbing dissonance in Davos- were much more cautious. In fact, they made a point of quite explicitly excluding the start of a policy rate reduction phase. The mistakes made by the ECB at the start of the inflation outbreak probably contribute to the more outspoken reservations of the ECB directors. But let there be no doubt about it: their attitude on future policy rate decisions is the right one. For more than one reason.

First of all there is, after several months of declining inflation rates, the return of rising inflation. This return is exhibited in the euro area as well as in the United States. The December headline inflation in the euro area rose to 2,9% on an annual basis, up from the 2,4% reached in November. In the US the December number came out at 3,4% after an annualized rise of 3,1% in November. Core inflation, i.e. headline inflation with the more volatile energy and food prices taken out, seems to be flattening out in both areas at around 4%. Of course the December rise has a lot to do with what are termed baseline effects due to corresponding low energy prices at the end of 2022.

Secondly, let us also not forget that in several countries official inflation numbers give a misleading impression of the real underlying inflationary forces. Measures taken by governments to keep energy and food prices from rising too much mask the reality. Spain is exemplary in this regard. Of course, such policies weigh on the budget but, as is the case in Spain, the inflow of money from the EU’s Recovery and Resilience Facility hides the budgetary impact of the measures taken to keep food and energy prices low to a substantial extent.

Thirdly, and more importantly, is that the month-to-month inflation numbers are quite meaningless. For example, as shown by Eurointelligence, the month to month inflation rate (not the annualized one!) for the euro zone was

+ 0,2% in October, - 0,6% in November and + 0,4% in December … Nevertheless, each month these numbers come out and markets react immediately on the presumption that with lower numbers central bankers will be quick to start dialing down interest rates (and reversely so in the case of upward numbers). To some extent this rather nonsensical yo-yo is the consequence of central bankers' stressing that monetary policy will be "data dependent". Central bankers should start stressing that data relevant to the longer term inflationary process are dominant in their policy considerations.

Another issue with the present month-to-month circus is that it is fueled by backward-looking data. Monetary policy actions should foremost depend on thorough analysis of future trends relevant for price developments. Better than to look back, is to look forward. Three clearly discernible trends in forward-looking policy analysis should make central bankers very cautious in their rate setting approach. The first is the geopolitical situation. At this moment, a lot of attention is rightly placed on the tensions in the Red Sea. Houthi rebels, supported by the Iranian regime, are regularly shooting at ships passing through this extremely important trade corridor. Will last weeks military action by American and British forces against the Houthis lead to further escalation, or not? If the answer to this question is yes then immediately a number of other considerations relevant for inflation developments will be on the table. For example: what will happen to oil prices if the present Middle East conflict escalates?

What is already now a visible result of the Red Sea tension is a substantial rise in shipping costs. These cost increases will inevitably filter through to final prices and fuel inflation. For example, shipping rates between Asia and Northern Europe are almost double now what they were before the Gaza conflict started.

Moreover, this situation will lead also to further questioning of the reliability of "long" internationally distributed supply chains and will make companies look for "shorter", less vulnerable supply chains. In most cases, such adjustments on the economy's supply side will result in further upward pressure on prices, not least because of the persisting tight labor market conditions in most Western countries.

A second important trend this year for forward-looking analysis is the numerous elections to be held in democracies. No less than 30 democratic countries are holding elections in the course of 2024. Among them are the three largest democracies of the world: India, the United States and Indonesia. A general tendency in election years is for politicians to open up the spigots of the spending pipeline, or at the very least to not start rolling back expenditures. In a world already characterized by massive budget deficits and escalating government debt, electioneering can seriously stoke the inflation fires. Central bankers should keep their eye firmly on their prime task of securing price stability and counter such tendencies in government spending with the appropriate monetary policies, despite the inevitable political pressures to lean back.

A third trend is especially relevant for the euro area, less so for the United States. Recent wage developments in Europe are quite worrying from an inflation point of view. Real wages, i.e. nominal wages adjusted for inflation, are increasing now at an annualized rate of 3%. If the recent uptick in headline inflation is stubborn, further acceleration of real wage increases is to be expected.This is certainly the case in the context of continuing shortages on labor markets. Unless substantial productivity increases occur simultaneously, these wage developments will produce upward pressure on prices.

Central bankers that have a forward-looking approach to their policy making decisions, and most of them do indeed take that approach, cannot be but very cautious. The fight against the inflation monster, to use the terminology of ECB president Christine Lagarde, is far from over. Those shouting and screaming for policy rates to be lowered, clearly have a private agenda driving their push for "lower rates, now". The general public interest dictates, however, present rates to be maintained for at least the coming six months.