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High inflation rates increase downside risks

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Inflation rates continue to rise, prompting central banks to accelerate rate hikes. Last week, consumer price inflation in the US surprised on the upside with a 1.0% month-on-month increase in May to 8.6% year-on-year. With the Reserve Bank of Australia and the European Central Bank, two previously moderate central banks have moved into the hawkish camp. In line with this, the financial environment has deteriorated, with equity prices falling, yields on credit-safe government bonds rising, and credit spreads increasing. For all these reasons, downside risks to real economic growth, i.e. recession risks, have increased. In particular, consumer sentiment indicators are falling as high inflation rates reduce purchasing power. Last week, consumer sentiment in the US for the month of June (preliminary estimate by the University of Michigan) fell to an all-time low. At the same time, long-term inflation expectations (same source) continued to rise (3.3% p.a.).

Uncertainty about future developments is very high for three reasons

First, there is considerable uncertainty about the size of the output gap. Second, the (apparent) understanding of inflation dynamics is low. This applies to both market participants and central banks. As a result, it is also unclear how much economic growth will have to cool down in order to achieve the central bank's inflation target in the medium term. Third, there is considerable uncertainty in the estimate of the relationship between monetary policy and economic growth. How many key interest rate hikes are needed to cool economic momentum to a certain extent? Complicating matters is the fact that monetary policy only affects the economy with a time lag of six to eighteen months, and inflation is a lagging variable to the economy. This creates uncertainty as to whether the central banks will manage a soft landing for the economy or ultimately trigger a recession.

Uncertainty Output Gap

If the economy is already operating very far above potential, a restrictive interest rate policy is necessary (which triggers a recession). If the production level is only slightly above potential, a soft landing is possible. The risk here is that the central bank fails to fine-tune the policy and that overly vigorous rate hikes trigger a mild recession.

Uncertainty Inflation dynamics

In principle, the issue here is whether economic agents are thinking rationally about inflation or merely reacting to past inflation.

Rational Inflation Expectations

In the first model, there is no inflation spiral. When current inflation is above trend inflation, there is a rational expectation that inflation will fall. For the story of only temporarily elevated inflation to remain credible, central banks need to set only moderate actions. Policy rates are raised to a neutral interest rate level. In this case, the real interest rate level remains low (at zero percent). A soft landing of the economy is possible. Until recently, the European Central Bank was in this camp, having only signaled key rate hikes at a moderate pace. Here, the risk lies in a policy that is too restrictive (too rapid increases to an interest rate level that is too high).

Adaptive Inflation Expectations

In the second model, an inflation spiral can be set in motion. This is because there are adaptive expectations that inflation will be high (or even higher) next year because it has been high (or rising) this year. In this case, central banks are under pressure to cool economic activity enough to break the inflation trend. This scenario implies a recession because real interest rates have to be raised significantly into positive territory. No central bank is currently in this camp, but it represents the greatest risk for markets.

Mixed model

A mixed model number three is also conceivable. As long as underlying inflation is at a low level, economic agents do not think much about inflation. The inflation trend fits (perhaps coincidentally) with the rational expectations model. But when inflation rises and remains above a critical level for a long time (the inflation trend rises), a regime change occurs. Economic agents become concerned about future inflation. Currently, the hope of central banks is to just avoid a regime change. Central banks are raising interest rates to neutral as quickly as possible because inflation rates have risen significantly, in order to prevent the tipping point into the inflationary spiral regime. More and more central banks in the developed economies are coming into this camp.

Last week, the formerly moderate (dovish) central bank in Australia (Reserve Bank of Australia) raised the key interest rate by 0.5 percentage points to 0.85%, after having raised the key interest rate by 0.25 percentage points in May. Last Thursday, the European Central Bank announced a gradual rate hike of 0.25 percentage points for July. Another rate hike was announced for September. The surprisingly hawkish statement was that a larger increase (0.5 percentage point) will be appropriate should the medium-term inflation outlook remain (not decline) or worsen. Next Wednesday, the US Federal Reserve will (very likely) raise the federal funds rate another 0.5 percentage points to 1.5% (upper band for the federal funds rate).

Conclusion

A soft landing of the economy is thus possible under three main conditions. First, the output gap is only slightly positive (no overheating). Second, inflation dynamics can be described as either purely rational or rational up to a tipping point. Third, central banks manage to cool economic growth to the exact extent desired. Corollary: Downside risks have increased as inflation rates have risen.

For a glossary of technical terms, please visit this link: *Fund Glossary (erste-am.at)*

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