Walking a Tightrope

Over the past week financial markets have scaled back somewhat their expectations on the extent of central bank rate hikes. This was not driven by news flow. Instead, it may be that markets now believe they have priced in sufficient rate tightening for central banks to get inflation back under control, amid growing concerns about the economic outlook.

The objective of central banks is to achieve a "soft landing". In other words, they aim to tighten policy so that it slows activity enough to bring inflation back to target, without pushing the economy into recession. This has been achieved in the past, but not always, and it has proved particularly hard to do at times of high inflation.

The world economy rebounded very strongly last year, with GDP rising by over 6% on the back of substantial fiscal and monetary policy stimulus. Demand surged, but unfortunately this coincided with disruptions on the supply side of economies, as well as an energy price shock. The result was a surge in inflation.

These supply side difficulties, and the energy price shock have been exacerbated by the war in Ukraine and a new COVID wave in China. To alleviate inflationary pressures, demand and supply need to be brought much closer into line. Given ongoing supply constraints, this means taking action to dampen demand. How much action is the key question, with conflicting views on this.

The Irish economy is enjoying a very robust opening half to the year, while the US economy continues to perform very well, as noted by the Federal Reserve. One would expect a strong pick-up in activity in the EU's Mediterranean economies this summer as well, on the back of a bumper holiday season. The war in Ukraine is also leading to much higher government spending on defence.

Meanwhile, the impact of the surge in inflation on real household incomes and thus consumer spending, could be offset somewhat by a rundown of some of the enormous build-up of personal savings during the past two years. Furthermore, tight labour markets and high inflation runs the risk of a wage-price spiral taking hold.

All this argues for aggressive central bank action, with a need for policy to become restrictive. Indeed, some economists argue that with real interest rates deep in negative territory, the monetary tightening priced in by markets is nowhere near sufficient to dampen demand to any meaningful degree.

On the other hand, though, there has been a marked slowdown in activity in the UK over the spring, with weakness also evident in the German and Chinese economies. There are numerous other downside risks to the global economy, apart from inflation and rising rates. Fragile financial markets would be very vulnerable to aggressive rates hikes and significant quantitative tightening.

COVID could still re-emerge as a major constraint on activity. Indeed, new COVID restrictions are dampening growth in China at present, while concerns remain about a more general slowdown in the Chinese economy. Supply chain disruptions also dampen output as well as adding to inflationary pressures.

The Bank of England and European Central Bank are acutely aware of the downside risks to growth. The risk of a policy error is high as rates are hiked, as avoiding recession and achieving a soft landing is going to be a tough challenge for central banks, given all the competing forces and high degree of uncertainty.

Oliver Mangan

Chief Economist,
AIB

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AIB Customer Treasury Services
DUBLIN / CORK
aib.ie/fxcentre

Customer Treasury Services NI
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aibni.co.uk/fxcentre

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