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UNITED STATES: ABOUT THE TIGHTENING OF US MONETARY POLICY

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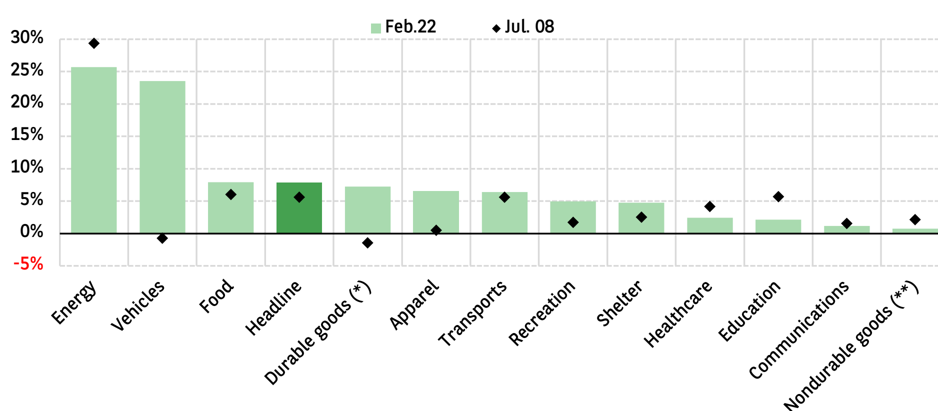
Although the war in Ukraine is casting shadows on the global economy, the Federal Reserve announced that it would rapidly normalise US monetary policy.

The Fed's main arguments for taking action include surging inflation, which is also spreading widely, as well as tight labour market conditions and tensions over wages.

As the self-sustaining nature of price increases is still open for debate, the projected tightening of monetary policy looks surprisingly strong. In an economic environment accustomed to cheap borrowing costs, the Fed's move is not without risks regarding the future path of activity.

UNITED-STATES, CONSUMER PRICES BY MAIN ITEMS (YEAR-ON-YEAR)



* EX. VEHICLES ** EX. ENERGY, FOOD, APPAREL

CHART 1

SOURCE: BLS, BNP PARIBAS CALCULATIONS

Raising key rates in response to a pure energy or food prices shock is a monetary policy mistake that was already committed in 2008. At the time, the Bank of England and the European Central Bank (ECB) raised the cost of borrowing in response to surging oil prices (Brent crude oil rose as high as USD 140 a barrel in summer 2008), just as the subprime crisis was gathering strength and undermining economic prospects. What happened next is well known: after the bankruptcy of Lehman Brothers in September, key rates had to be slashed, right after they were raised. On 16 March 2022, the Federal Reserve announced a new round of monetary tightening in the midst of an energy crisis, even as Russia is waging war on Ukraine. Is the Fed about to make the same policy mistake?

A PERIOD OF EXCEPTIONALLY ACCOMMODATING MONETARY POLICY COMES TO AN END

The initial situations of these two periods seem to be very different. First, inflation was not the same. At 7.9% year-on-year in February 2022, inflation is the highest in forty years and stands 2.3 points above the July 2008 peak of 5.6%. It has also spread much more widely. Far from being fuelled solely by surging energy and food prices[1], price increases have spread to numerous items, including rents or even more durable goods, foremost of which are cars (see chart 1).

1 "Food" and "energy" contributed 36% of the February 2022 inflation figure (7.9% year-on-year). During the previous peak of July 2008 (5.6% y/y), they contributed 66%.

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Exacerbated by the global Covid-19 pandemic, price increases have cut short a historical downward trend resulting from two decades of supply chain globalisation.

Lastly, and most importantly, the Fed's decision comes at the end of an exceptionally accommodating phase of monetary policy, unprecedented in modern US history. Maintained near the lower zero bound since March 2020, real interest rates have plunged into negative territory, sinking to depths never seen before (see chart 2). This was also the case for bond yields, which remained very low thanks to the central bank's securities purchases. The last wave of quantitative easing (QE), which amounted to USD 4,600 billion (20 points of annual GDP), fuelled exceptional money supply growth and helped rekindle inflation, addition to the supply shock (see chart 3 and Wolf, 2021[2]).

The Fed met its initial goal of avoiding liquidity shortages and countering the depressive effects of the Covid-19 pandemic, and the economy recovered beyond all expectations. It has largely surpassed pre-pandemic levels. With the jobless rate dropping below 4%, the US economy is verging on full employment. The keyword thus became the normalisation of monetary policy.

Just how far can the Fed go? According to the latest projections of the Federal Open Market Committee (FOMC), the Fed funds target rate could rise as high as 2.8% over a 15-month horizon, which implies six more rate increases of 25bp each in 2022, and at least three more in 2023. Starting in May, it will scale back the amount of securities outstanding held as part of QE (USD 8,500 bn), at a pace that has to be specified. As presented, the Fed's current road map is much more demanding than the December 2021 version. In the eyes of Fed Chair Jerome Powell, this road map is workable because the US economy is back to full health.

STRESS TEST

The planned monetary tightening appears to be a serious stress test. Since inflation is supposed to decelerate, it implies at least a 5-point increase in real key rates in a little more than a year. This is no small matter for an economy which rely increasingly on credit. In 2021, net private sector borrowing amounted USD 1,596 bn, the highest level since 2007[3]. Temporarily hampered by the Covid-19 pandemic, leveraged loans rebounded strongly, as illustrated by the increase in M&A and securitisation activities (IMF, 2021)[4]. Even as Federal transfers were boosting the cash holdings of companies, their net debt swelled. It has held at high levels as a share of GDP (chart 4).

For certain market participants, such as investment funds taking part in leveraged buyouts (LBO) or Real Estate Investment Trusts, the Fed's action has already had concrete consequences by helping to flatten the yield curve. Transformation conditions tightened while acquisitions demanded high earnings multiples, calming the enthusiasm of investors[5]. The risk of a rapid downturn cannot be excluded, and it was even mentioned in the discussions between central bankers, as illustrated by the minutes of the FOMC meeting[6].

2 Since February 2020, the main M2 money supply aggregate has increased by 24 points of GDP, as much as between 2000 and 2019. See Wolf M. (2022) *"As inflation rises, the monetarist dog is having its day"*, Financial Times, February 22.

3 Household loans and loans to non-financial companies, including net debt securities issues. Source: US Federal Reserve, Financial Accounts of the United States, 4th quarter 2021.

4 The year 2021 was a record year for issues of Collateralized Debt Obligations (CLO): USD 150 bn in the United States according to IMF estimates. See International Monetary Fund (2021), Global Financial Stability Report, Ch. 1, October.

5 Ibid, p.20-21. In 2021, nearly 60% of LBOs represented more than six years of EBITDA (earnings before interest, taxes, depreciation, and amortization), the highest level since 2007.

6 ."*A few [..] participants raised concerns that a relatively flat yield curve could adversely affect interest margins for some financial intermediaries, which may raise financial stability risks*." Source: FOMC Minutes, 15-16 Dec. 2021, pp.4-5.

UNITED STATES, REAL INTEREST RATES

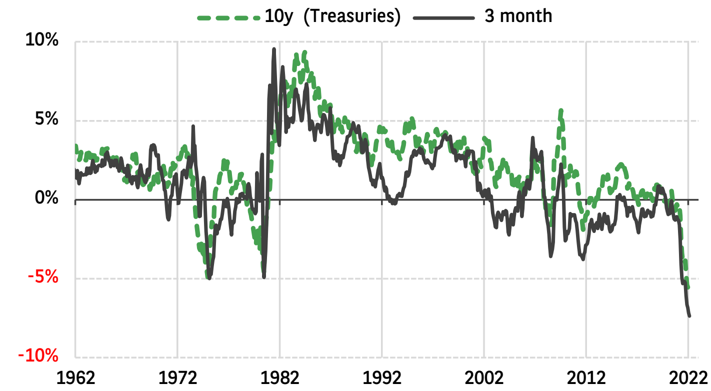

CHART 2 — SOURCE: IMF, REFINITIV, BLS

UNITED STATES, MONEY AND INFLATION

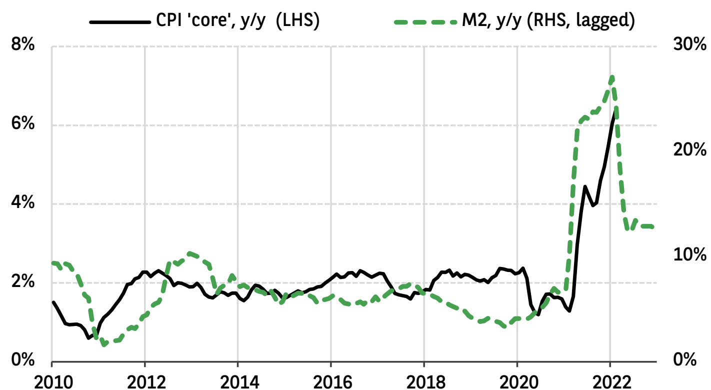

CHART 3 — SOURCE: BLS, FED

UNITED STATES, NON FINANCIAL CORPORATE NET DEBT/GDP

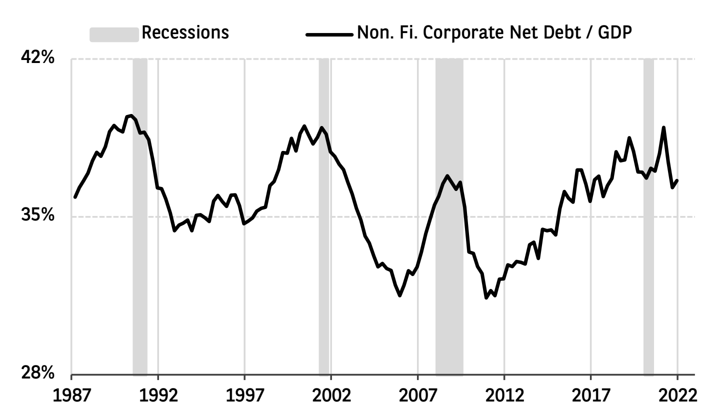

CHART 4 — SOURCE: BEA, NBER. BNP PARIBAS

By striking hard, the Fed is highlighting wage dynamics that are *"incompatible with the objective of price stability"*. Admittedly, at 6.7% year-on-year in February 2022, average hourly wage growth is the highest on record since 1982. Yet the health crisis makes it harder to interpret this trend as it impact the composition of employment as well as the distribution of wages. Looking at the employment cost index, which has fixed weightings and is not subject to the same bias, the slope is less abrupt (+4.4% year-on-year in Q4 2021, in the broad sense of the term, including social welfare benefits). Even so, it is still higher than pre-pandemic trend.

As the Phillips curve would suggest, biggest pay increases occur in sectors where post-crisis hiring needs are high, such as in hotel & restaurant services, transport & warehousing, or retailing. They are also higher than average in professional and business services, which account for nearly a quarter of total employment in private services, and lie at the heart of the digital transformation. Looking at all sectors, higher wages are partly responding to stronger productivity gains, which are also breaking their pre-pandemic trend[7].

All in all, the increase in unit labour costs (wages and benefits as a percentage of real output) is still contained and has nothing to compare with the double-digit figures of the early 1980s. In the breakdown provided by the Bureau of Economic Analysis (BEA), it is not presented as a key factor in the upturn in the price of value added in 2021. The latter is due more to production and import taxes (driven up by higher input costs) as well as to higher margins (table 1).

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It does not seem very evident that a veritable price-wage loop is taking shape in the United States. Although inflation has exceeded all expectations and risks rising further, it does not seem very likely to become permanent or self-sustaining. Yet to make sure it doesn't, the Fed has to get tough, even at the risk of triggering a hard landing for the economy.

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PRICE PER UNIT OF REAL GROSS VALUE ADDED AT 2021 Q3 (NON FINANCIAL CORPORATE BUSINESS)

	USD	Q/Q-4	CONTRIB.
TOTAL	**1.17**	**5.1%**	
UNIT LABOR COSTS	**0.70**	**0.4%**	**0.3%**
UNIT NONLABOR COSTS	**0.29**	**15.8%**	**3.5%**
ow TAXES ON PRODUCTION AND IMPORTS *	0.08	163.3%	4.4%
UNIT PROFITS	**0.18**	**9.6%**	**1.4%**

(*) NETS FROM TRANSFERS AND SUBSIDIES

TABLE 1

SOURCE: BEA

7 In 2020 and 2021, the average annual growth rate of hourly labour productivity in the private sector was 2.3%, whereas the pre-pandemic trend was close to 1%. Source: Bureau of Labor Statistics, BNP Paribas calculations.

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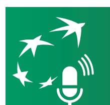

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