THE MONETARY CYCLE: FROM PANIC TO PERSEVERANCE TO PATIENCE

In recent months, the huge and rising gap between observed and target inflation has confronted central banks with an urgency to act. It could be called the panic phase of the tightening cycle. What followed was a swift succession of significant rate increases. Tightening was frontloaded, rather than gradual, to avoid an unanchoring of inflation expectations. This perseverance phase will be followed by a long wait-and-see attitude once the terminal rate -the cyclical peak of the policy rate- will have been reached. During this patience phase of the monetary cycle, the central bank will monitor how inflation evolves. With the risk of further rate hikes having declined, the government bond market should stabilize, which can have positive spillovers to other asset classes. Likewise, the real economy may also sigh a breath of relief, given the reduction in interest rate risk, unless demand and activity would in the meantime have suffered a lot from higher interest rates.

The assessment of the inflation outlook by central banks, international organizations and private sector economists has changed radically over the past twelve months as it became clear that the rapid increase in prices would be persistent rather than transitory.

Inflation reflects an imbalance between demand and supply, the former being bigger than the latter -i.e. demand-side inflation- or a situation of significant increases in the price of key products, such as oil, or even services. In that case one speaks of supply-side inflation.

The eruption of the Covid-19 pandemic, the policy reactions and, since the end of February this year, the war in Ukraine, have created a unique sequence and combination of events in the demand and supply side of the economy, with major repercussions in terms of inflation (*figure 1*). After a plunge in demand due to lockdown, pent-up demand was unleashed. Income transfers from governments supported the dynamism of consumer spending, in particular in the US. Spending shifted between goods (bought on-line during lockdown) and services (post-lockdown). All these factors had a big influence on the evolution of prices.

On the supply side, disruption of global supply chains, reallocation of labour between sectors -sometimes causing major staff shortages, such as in hotels, restaurants and the travel industry- and insufficient investment in production capacity in the past in certain sectors also impacted inflation.

The war in Ukraine made the problem worse. For central banks, the huge and rising gap between observed and target inflation eventually created an urgency to act. This can be considered as the panic phase of the tightening cycle (*figure 2*). In a matter of months, guidance was first changed to signal that rate increases were coming and then dropped altogether, considering the impossibility to determine how much policy would need to be tightened.

What followed was a swift succession of significant rate increases (frontloading), rather than the gradualist, stair step approach that was followed during the previous cycle in the US (*figure 3*). When inflation is persistently very high and nominal policy rates very low, there is a genuine risk of unanchoring of inflations expectations (*figure 4*). Under a gradualist approach, the initial rate increases may reduce this risk somewhat but it may very well increase again thereafter when it appears that the small rate increases have no or hardly any impact on inflation.

Frontloaded tightening on the other hand should lead to a lasting reduction in the risk of inflation expectations spinning out of control. However, the aggressiveness of this approach leads to mounting concern about a hard landing, but during this perseverance phase, this does not stop central banks from pushing the brakes ever harder.

ELEVATED INFLATION, DRIVEN BY DEMAND AND SUPPLY FACTORS

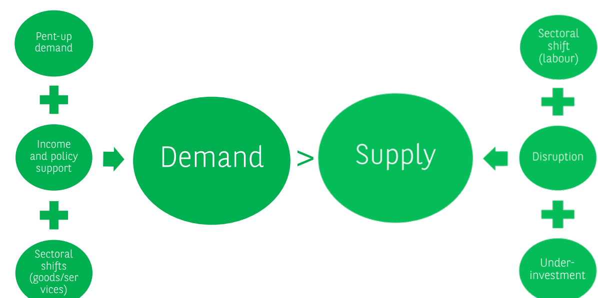

FIGURE 1

SOURCE: BNP PARIBAS

> As policy becomes tighter and tighter, the focus of households, firms and investors next year will gradually shift. As concerns about upside risks to inflation start to wane, fears about downside risks to growth will start to dominate.

Not doing enough in the short run would imply that bringing inflation back to target would be even more difficult and costly. Frontloading implies that the cyclical peak in the policy rate -the terminal rate- will be reached earlier than under a gradualist approach.

During the patience phase of the monetary cycle, the central bank, having done enough of the tightening, can afford to wait and see how the data evolve. With the risk of further rate hikes having declined, fixed income investors will step up their investment in long-dated bonds, to lock in what they consider to be attractive yields. The stabilization of the bond market can have positive spillovers to other asset classes. Likewise, when the central bank is in patient mode, the real economy may also sigh a breath of relief, given the reduction in interest rate risk. Central banks move to a wait and see mode because, one, they hope that the cumulative tightening will be sufficient to drive down inflation to target and, two, because they become concerned about an overkill (*figure 5*). As policy becomes tighter and tighter, their pay-off function changes: further hikes may do little to change the inflation dynamics but imply greater risks of a severe contraction of activity. For these reasons, the focus of households, firms and investors next year will gradually shift. As concerns about upside risks to inflation start to wane, fears about downside risks to growth will start to dominate.

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THE PANIC PHASE OF THE TIGHTENING CYCLE

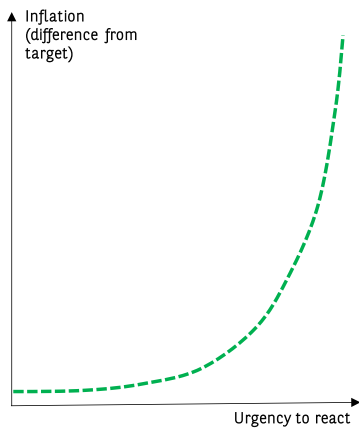

FIGURE 2 SOURCE: BNP PARIBAS

US FEDERAL FUNDS

FIGURE 3 SOURCE: FEDERAL RESERVE BANK OF ST. LOUIS, BNP PARIBAS

FRONTLOADING AND GRADUAL TIGHTENING

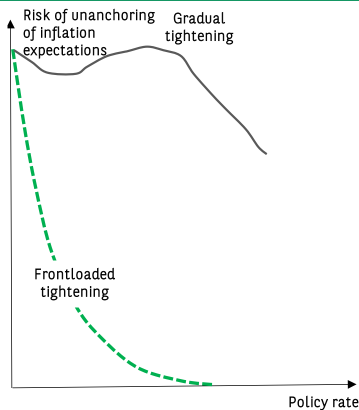

FIGURE 4 SOURCE: BNP PARIBAS

VALUE OF WAITING

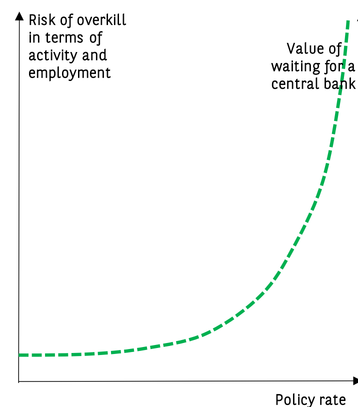

FIGURE 5 SOURCE: BNP PARIBAS