The turn of the central banks

The role of central banker has become increasingly difficult in recent years, not only because of the difficulty of balancing growth, inflation and financial stability objectives, but also because of the challenge posed by the string of three major crises of a very diverse nature in the last decade and a half (the financial crisis, COVID and the war), with widely varying effects on price dynamics. Whereas just two years ago the monetary authorities on both sides of the Atlantic were still concerned about deflationary risks, which forced them to make extensive use of unconventional tools in a bid to avoid the liquidity trap, the challenge right now is how to deal with the most intense episode of price rallies of the last four decades. The biggest expansionary deployment from monetary policy in history is still in force today, and the recent shift in strategy by the world's two major central banks – which let us not forget was intended to encourage an increase in inflation expectations – is currently in its trial phase. Thus, the starting point increases the challenge of dealing with a supply shock while trying to minimise the effects on economic activity and financial stability of the inevitable path to neutrality.

Moreover, the problem is that the rise in commodity prices triggered by the conflict in Ukraine is occurring at a time when inflation has already been exhibiting the effects of the bottlenecks in global production chains for more than a year. In other words, the timing of the disruption is different from that of similar episodes in recent decades, as it has coincided with inflation in excess of 5% in many developed countries, following months of lower than expected prices.

The reality is that when we combine a global supply that is unable to adapt to the surge in demand, bottlenecks in highly sensitive parts of global supply chains, sharp rises in commodity prices (not just energy), geopolitical uncertainty and central banks that are behind the curve, this cocktail poses a threat to the anchoring of price expectations as it amplifies the risks of second-round effects in the price dynamics. The problem with the current inflation dynamics is that they have many layers and it is difficult to discern whether the price increases are spreading to the underlying components, even using traditional measures for core inflation.

That is why the central banks are most concerned about how the war will affect inflation, while its impact on growth appears to be a secondary concern which should, in any case, be addressed through fiscal and income policy. Let us not forget that the central banks' current autonomy, objectives, strategy and configuration are a product of the shocks triggered by the oil crises of the 1970s, orrather, of the initial mistakes made in the economic policy response which led to an inflationary spiral and a period of stagflation. Therefore, theoretically, the lesson should be well learnt.

It is precisely that strong institutional framework created in the 1980s, in response to a situation similar to the current one, that should immunise us against the risks of macroeconomic imbalances, and this is exactly how investors are reading the situation by anticipating a smooth normalisation of monetary policy. Indeed, the key is that interest rates are already rising across the yield curve, yet this tightening of the financial conditions is occurring at a minimal cost in terms of stability in the markets. There have even been a few positive surprises, such as the strong performance of the stock markets following initial setbacks after the outbreak of the war. Thus, for the time being, the price that the central banks are paying for being somewhat behind the curve when the hostilities began is not proving to be terribly high. It is also true that the Fed is accelerating its withdrawal of the stimulus, as following the first rate hike in March it is anticipating a further six this year and, above all, it is expecting this process to end with an interest rate above the long-term equilibrium level (2.4%, according to the institution itself). This is the first recognition by a major central bank of the need to enter into restrictive territory in order to tackle the current price problems.

Ultimately, the question is not whether interest rates will rise (they are already doing so), but rather what dose will be needed in order to keep inflation expectations contained in the aftermath of the energy shock. Thus, more than a decade after the last monetary tightening process in Europe (August 2011), it seems that we are back in the starting blocks, and the only thing remaining is to decide when to fire the starting pistol. From there on, the key question will be how the combination of interest rates, inflation and uncertainty – all at levels much higher than we were previously accustomed to – will interact in our highly indebted economies.

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