The last mile

With the first half of the year now drawn to a close, the business cycle continues to overcome all kinds of obstacles, while significant disparities have opened up both between sectors (better performance in services than in industry) and between regions (greater weakness in China and Europe). In this context, the feeling is that we are close to a turning point, after which the effects of the monetary tightening process that have accumulated in the last year and a half (400 bps in the euro area) will materialise with greater intensity. This will particularly be the case if we see that final tightening of the nut that the major central banks appear to be poised for, amid the risk of an inadequate improvement in core price trends over the coming months if the balance between business margins and wages does not end up rebalancing.

The rate hikes announced following a pause of several months (Bank of Canada and Bank of Australia), the acceleration of the movement towards the terminal rate (+50 bps in the case of the Bank of England) and the more hawkish tone of communications (the ECB and the Fed) reflect the fact that, right now, the monetary authorities are prioritising inflation targets over those related to growth and financial stability. The good news is that the business cycle and the financial system are withstanding the sharpest episode of monetary tightening in recent decades better than expected, now that the issue related to US regional banks has been overcome.

The question is how long interest rates will need to be kept in restrictive territory for and what cost in terms of employment and economic activity will have to be paid before we see conclusive signs of a turning point in inflation. Everything will depend on the evolution of the factors that have supported economic activity in recent quarters: (i) the savings accumulated during the pandemic, (ii) expansionary fiscal policy, (iii) delays in the effects of monetary policy, (iv) the normalisation of the bottlenecks and (v) the resistance of labour markets.

The positive effects of the first three factors will gradually fade over time, and improvements in aggregate supply or the strength of the labour market are unlikely to make up for their loss. As the BIS has also just reminded us, greater coordination between monetary and fiscal policy would make it easier to tackle the last mile on the path to the ECB's target and would allow economic policy to return to the stability zone.

In this context, investors have increased their risk appetite in recent weeks, with equity markets on the rise and stability in the bond market, despite the revision of interest rate expectations. The market sentiment is that the central banks are going to get inflation back down to 2% over the next 18 to 24 months without having to trigger a recession. In any case, if the scenario were to take a turn for the worse, the markets anticipate a rapid shift in monetary policy – a prospect which the central banks do not seem to be entirely comfortable with.

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