Policy Brief

No 39 – November 2022

CEPII

Central Bank Monetary Policy Strategies amid Turmoil in the World Economy

Michel Aglietta & Sabrina Khanniche

Summary

This policy brief addresses the challenges that confronted the main central banks in the face of uncertainties arising from multiple disruptions: the waves of the Covid-19 pandemic since early 2020 to the energy crisis of 2022, to the disastrous events generated by climate change, the war in Ukraine and the real-estate crisis in China. Inflation has surged due to supply-side problems and fiscal policies fostered by socio-political rivalries both within and between countries.

In this environment, the task of central banks to fight high and persistent inflation, while limiting the risk of severe or prolonged recession, is extremely difficult, and particularly so when their lack of cooperation can lead them to overbid one another in raising their policy rate.

To understand better how central banks are responding to inflation surges and financial vulnerabilities, we start from reviews of monetary policy frameworks by the Fed and ECB to highlight why they have been induced to abandon their forward guidance in favor of day-to-day responses to the flow of new events. Since early 2022, the main challenge forcing central banks from easing to restrictive monetary policy has been the surge in inflation triggered by the rise in energy and food prices related to the war in Ukraine in a context of deep uncertainty. However, specific national issues remain key to central bank policies.

Introduction

Central banks are learning from crises to account for long-run trends.[1] Such was the case of the Great Financial Crisis (GFC) that broke out in the summer of 2008. On August 9, 2007, while BNP Paribas had made public that it could not value assets in funds invested in structured credit products, central banks wondered if this was an idiosyncratic event or the harbinger of systemic problems. The answer came on Monday, September 15 with the Lehman Brothers failure. Asked by a senator if it was not best to let the market unfold, then chair of the Federal Reserve ("the Fed") Ben Bernanke said that, if they did that, next Monday there would be no economy left. At about the same time, the European Central Bank (ECB) acknowledged the same systemic crisis when Northern Rock made public that it was unable to roll over its short-term debt in repo (repurchase agreement) markets. This was the start of the so-called "unconventional monetary policies". It was also time to start understanding how and why financial disruptions are linked to long-term macroeconomic trends.

Systemic crises are looming again with the advent of the Covid pandemic followed by radically uncertain events like the war in Ukraine and stringent lockdowns in China after the zero-Covid policy faced infections in several regions and the outbreak of a severe real-estate crisis. In Western countries, surging inflation stemming from supply-side pressures on energy and food prices has led to disruptions in the world economy of a kind unknown over the last forty years.

This paper, therefore, has multiple objectives relating to central banks. First, central banks are reviewing their monetary policy framework to redefine their targets and their forward guidance with respect to economic agents and financial markets. Secondly, they are fighting record-high inflation that has taken them by surprise, while trying to avoid a lengthy recession. Thirdly, they have to deal with the systemic risk of widespread financial crises in emerging and developing countries.

In short, central banks are the key actors in both changes in monetary policy doctrine and in day-to-day responses to surging inflation and financial market vulnerabilities. The challenge facing Western central banks since the early months of 2022, forcing them from easing to restrictive monetary policy, has been the surge in inflation triggered by the rise in energy and food prices related to the war in Ukraine in a context of deep uncertainty. As most central banks felt that they were behind the curve, they adjusted by hiking rates almost simultaneously without any explicit coordination, outbidding one another with the risk of amplifying each central bank action. The inflationary threat should be addressed in a coordinated manner, similarly to the deflationary threat during Covid. An adjacent problem is the vulnerabilities concerning debt sustainability among emerging market and developing countries.

(1) Coeuré B. and Kotz H. H. (2021).

1. Brief assessment of the reviews of monetary policy frameworks in the Fed and ECB

Macroeconomic imbalances and financial turmoil have been ample reasons for the two main central banks to engage in monetary policy reviews to reassess their monetary policy strategies. The most significant change from 2012 to end-2021 that motivated the review of the Fed's strategy was the decline in estimates of the neutral real interest rate r^*, which is the benchmark for the Fed's dual mandate: maximum employment compatible with price stability. r^* is called the neutral rate because it is the rate compatible with full employment, with neither excessive demand nor lack of supply. If r^* declines structurally with a long-run diminution in the marginal productivity of capital, it approaches the zero lower bound. As long as the decline persists, the Federal Open Market Committee (FOMC) is left with less space in its conventional policy to lower the policy rate against a temporary shortfall in demand. That is why the FOMC approved unanimously a new monetary policy strategy on August 27, 2020.

The new strategy maintains symmetrical flexible inflation targeting with a longer-run goal at 2%, so that inflation expectations remain well anchored at 2%. With inflation having run persistently below 2% for a long time, the FOMC announced that it wanted to achieve an inflation rate moderately above 2% for some time, so that inflation expectations were kept anchored at the 2% longer-run goal. Correlatively, it defined maximum unemployment as the highest level of employment that does not generate sustained pressures either way that put the price-stability mandate at risk.

both the European Central Bank and the US Federal Reserve have confirmed their 2% target

The ECB published its new monetary policy strategy in July 2021.[2] There were three motives in undertaking the review. First, while the mandate of price stability is unconditional, the policy framework, which dated from 2003, had to be revised because it had engineered an inflation rate systematically below the 2% target since the Great Financial Crisis (GFC) of 2008. Second, structural changes impinge on the conduct of monetary policy. Third, climate change and the transition to a low-carbon economy will have first-order impacts on macroeconomic outcomes.

The ECB Governing Council should be confident of hitting the target on a durable basis. That is why the new strategy, aiming for 2% inflation over the medium term, takes a symmetric perspective on deviations from the targets, in contrast with the objective of the close but under 2% target defined at the

(2) Lane P. (2021).

creation of the euro. This means that the ECB governing council must treat overshoots and shortfalls as equally undesirable. As much as the real neutral rate has undergone a long-term decline, the inflation target should be raised to give more room to react to a cyclical downfall without risking hitting the zero lower bound.

This new strategy commits the ECB to ensuring that inflation stabilizes at its 2% target over the medium term. The conditional commitment provides a safeguard against premature tightening of monetary policy. It dispels the notion that 2% is a ceiling for inflation. Accordingly, implementing successfully forward guidance requires expert judgement by the Governing Council.

Related problems are financial stability risks to be mitigated by macro prudential policy, with the proviso that inflation expectations are kept firmly anchored at the target. This implies that the spreads between the public debts of the Euro Area (EA) countries relative to the German Bunds do not widen as they did after the GFC.

2. From monetary policy easing to tightening in the US under multiple threats

The Bank for International Settlements (BIS) 2022 annual report elaborates on the dilemma facing the US.[3] In May, headline inflation was hitting 8.6%. Having thought in late 2021 that the burst in inflation was temporary, Fed Reserve officials started to fear that it could become entrenched in public expectations. The three-month average rate of annual wage growth was 6.1%, having doubled in one year, according to the Atlanta Fed. This is why the federal government is facing a dilemma: it fears rising wages while encouraging them to preclude worsening inequalities.

The BIS report distinguishes between low-inflation and high-inflation regimes. The main issue is price contagion. In low-inflation regimes, idiosyncratic price rises (like energy and food prices due to the Ukraine war) do not cause all prices to rise in both cost-price dependency and a mimetic process. In high-inflation regimes, they do. Companies raise prices to deal with rising wage costs, while workers can organize themselves to demand wage increases that keep pace with inflation. This wage price spiral occurred after the oil price shock of 1973. Will it be repeated? Is a new process of greater centralized unionization in the making? According to the *Financial Times*,[4] the Covid crisis and the labor shortage that ensued allowed US workers to bargain for higher wages and better working conditions. In Starbucks, the large chain of stores, workers have established many unions since December 2021. However, none of these new unions has yet been able to negotiate a collective bargaining agreement. It is an important issue because, if some grassroots unions can achieve it, it could spark a national unionization movement, feeding the rise of an entrenched inflationary psychology, as the 1970s, leading to unanchored inflation expectations that would worry the Fed.

For the time being, an upcoming unionization movement would reinforce the Federal Reserve in betting on the strength of the labor market, with the unemployment rate expected to remain steady at 3.6%, and a modest increase in average hourly earnings, so that it could raise its policy rate to 3.2% by end-2022. However, repeated interest rate increases of 0.75% could begin to weigh on consumer spending in the second half of 2022, and a labor market slowdown may be underway; the June jobs report pointed out that both job openings and quits were declining while jobless claims were rising. Therefore, there is a delicate balance to strike between tackling inflation before it gets entrenched and facing a downturn leading to recession, which has become a serious possibility in 2023.

a delicate balance to strike between tackling inflation before it gets entrenched and facing a downturn leading to recession

2.1. Inversion of the yield curve slope as a forerunner of recession

Another important consideration concerning Fed policy shifting from quantitative easing to quantitative tightening is its impact on financial markets. While other central banks following the Fed are also determined to tighten monetary policies, corporate fundraising contracted sharply in the first half of 2022 under multiple disturbances. The impact on financial markets was severe. The S&P 500 fell 18% in Q2, pertaining to bear market territory. Investors have become cautious about lending cash and corporate treasurers about raising funds. In June alone, global stocks fell 8.8%.

The US central bank might interpret the slowdown in raising capital as a positive sign that its policy is working in reducing inflation towards its target. Yet, the sharp swings in financial markets have hit junk bond sales in the US in particular, while high-quality investment-grade issuance has remained more in line with its historical trend. However, the other dimension of monetary policy, especially in the US, acting on central bank balance sheets, might be difficult to manage.

Since the 2008 GFC, fund managers in stocks, bonds and, later, digital assets have benefited from the so-called quantitative easing of central banks. With the spread of the pandemic in March 2020, the Fed rescued financial markets with its quantitative easing program by purchasing huge amounts

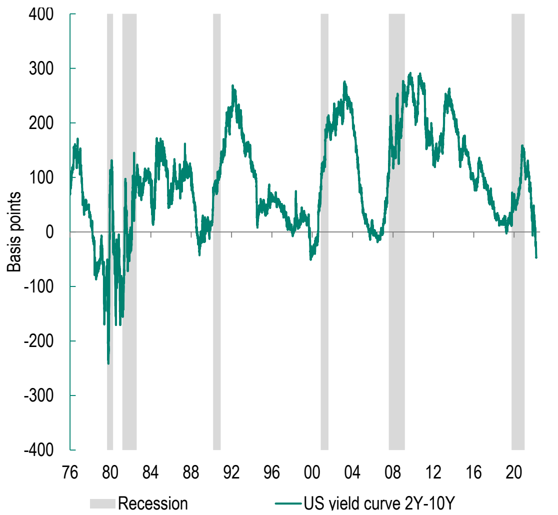
(3) BIS (2022).

(4) “US trade unions: Inside the revival brewing at Starbucks”, *Financial Times Big Read*, September 4, 2022.

of Treasuries ($3.5trn in two years) and mortgage-backed securities ($1.3trn). In March 2022, the Fed owned a quarter of all outstanding Treasury debt and a third of agency mortgage-backed securities. Likewise, the ECB owned 40% of Eurozone member countries' government bonds and the Bank of Japan nearly 50% of Japan's outstanding government debt.

Most importantly, the US government bond market is flashing warning signs in showing an inversion of the yield curve. This means that yields on shorter-dated securities are becoming higher than those on longer-term ones. Specifically, in mid-July 2022 two-year Treasury bills were trading about 0.04 percentage points higher than those of 10-year bonds (Figure 1). Why is this important? Because it can signal a future recession.

Figure 1 – US yield curve slope



Source: Pictet Asset Management, CEIC, Refinitiv, Bloomberg.

Over the past five decades, a US recession has followed every yield curve inversion within six months to two years. The first observance of yield curve inversion this year appeared in March. This indicates a recession by early 2024 at the latest. As of now, this financial indicator tallies with the observed deterioration in consumer and business sentiment.

Surging inflation, despite enforced tightening of monetary policy, has taken the Fed by surprise. It has led Fed president Jay Powell to announce that the US central bank is going to change course about providing forward guidance to both economic agents and financial markets. In the 2022 central bank symposium in Jackson Hall, Wyoming at the end of August, Jay Powell declared that data had become too volatile to support meaningful forward guidance. The economic relationships that underpinned the global order had fundamentally changed, he said; implementing further action to raise interest rates in the second half of 2022 was appropriate in an environment of extreme uncertainty. After two consecutive 0.75% rate rises, inflation was still worse than expected. Most officials foresee the Fed's policy rate reaching 3.5% at end 2022 and close to 4% in 2023.

Nonetheless, there are early signs that business investment is slowing, and the housing market is cooling. Powell said that growth needed to moderate and the labor market had to become less tight. However, the question remains whether a recession is in the making in 2023 to bring inflation back to target.

In August 2022, the outlook worsened markedly. The annual increase in core inflation (year on year) reached 6.3% compared to 5.9% in July – despite a fall in oil prices. The impact on Wall Street was immediate. The S&P500 tumbled by 3.1% and Nasdaq by 4%. In its September meeting, the FOMC raised its main interest rate by 0.75% to achieve a new target range of 3–3.25%. The Fed signaled that this was far from the end of its monetary policy tightening, predicting that rates would reach 4.25 to 4.5% by end 2022, up to a peak of 4.625% in 2023.The latest announcements by the FOMC have significantly affected financial markets with the broadening in the inversion of the yield curve to 50bps. Equity markets continued tumbling in the third week of September; the S&P lost 3% in the week (21% and the Nasdaq fell by 2.5%, both indexes falling respectively by 21% and 30% since the beginning of the year.

the US government bond market is flashing warning signs in showing an inversion of the yield curve

On Wednesday November 2, 2022 the Fed delivered its fourth consecutive 0.75% rise or its policy rate, leading to a target range of 3.75% to 4%. From now on, the FOMC will take into account how far rates have already risen, suggesting a slower pace of rate rise in the future. Traders in federal funds futures have heard the message in anticipating 0.5% rise at the December FOMC meeting.

2.2. Threat to the real-estate sector

The Fed tightening its policy rate caused rates for mortgages to reach 6.66% in October 2022, nearly double their level in March. Home sales plunged because much higher borrowing costs and recession fears discouraged buyers. In August, according to the National Association of Realtors, 20% fewer homes were sold compared to the same month last year.

The slump in the real-estate market had a devastating impact on the income of estate agents and mortgage brokers, who were busy refinancing existing mortgages while interest rates were low.

Applications for refinancing fell by 80% while new mortgage applications dropped 29% in the year to August 2022. Consequently, home sales (seasonally adjusted) receded from 6.5 million at the beginning of 2022 to 4.8 million in August. Since the contribution of the housing sector in US GDP amounts to roughly 15%, including consumption spending on housing services, the impact on the slowdown of the economy might be substantial.

3. Careful ECB adjustment against record high Eurozone inflation disturbed by Italian political crisis

3.1. Energy-driven inflationary pressures

Europe depends heavily on Russian energy. Russia supplies 30% of Europe oil demand needs and 49% of its natural gas imports (BP Statistical Review of World Energy, July 2022). The Eurozone is a large recipient of Russian energy, with Germany and Italy being most at risk from supply restrictions.

Interruptions of gas supplies are an upside risk for energy inflation and a downside risk for growth. Over the summer, Germany triggered the level-2 alarm of the three stages of its national gas emergency plan following the decision by Russia to reduce gas supply through NordStream1 (NS1) by 60%. This means that the government is ready to conserve energy (use more coal and less gas to generate electricity). Stage 3 implies rationing of gas supplies. While Russian gas flows through NS1 were completely halted in early September, many European countries now have storage levels ahead of the targets for coping with the winter.

Russia gas supply disruption raises inflationary pressures and the probability of a recession. This complicates the task of the ECB in the way it conducts monetary policy.

Indeed, September 2022 inflation rose to a new high of 10% Y/Y. Energy prices (10.9% of the Consumer Price Index basket) accelerated for the first time in three months (40.8% Y/Y), and continue to explain most of the monthly rise (44%). Across countries, the CPI rose across the board, ranging from 17.1% in Netherlands to just 6.2% in France, thanks to government measures. Underlying price pressures gained further momentum, with supercore inflation edging further up to 5.6%. A price-wage spiral and de-anchoring of inflation expectations are key threats for underlying price developments over the medium term. The average wage indicators eased to 3.6%, close to the record high reached in Q1. The labor market remains tight, with the unemployment rate reaching a new low of 6.6% in August and the Beveridge Curve shifting upward. So far, expectations for the medium term remain anchored close to the ECB target.

3.2. Dilemma for the Eurozone monetary policy

The ECB is facing its first test with inflation since its creation in 1999. It is an opportunity to show its commitment to price stability. The ECB started the hiking cycle in July. Because it has acted at a slower pace than the Fed, the interest rate differential widened, and the euro continued to depreciate against the dollar throughout the summer of 2022. The ECB accounts of its July committee meeting revealed that the depreciation of the euro was very much discussed and perceived as negative for inflation. The US is a key trading partner of the Eurozone; since exports are invoiced in the US dollar, which has continued appreciating, import prices have increased (31% Y/Y in June). In tightening its monetary policy without any concertation with its partners, the Fed might over hike its policy rate, aggravating export inflation to trade partners, which fuels further inflation in this inflationary environment.

Surging inflation mostly reflects external shocks. The ECB can neither influence energy and food prices nor alleviate supply shortages. Yet, persistent inflation and the strengthening of underlying price pressures raise the case for rapid normalization. The cycle of tightening by other central banks and reduced sensitivity to growth are also supportive factors. At the September ECB meeting, the Governing Council decided unanimously to hike rates by 75bps, the biggest move on record. The looming recession suggests that the window for increasing rates is closing. In such an environment, tightening of monetary policy can impair financial stability objectives as it exacerbates the market fragmentation risk (the widening of government bond spreads vs the Bund).

the ECB is facing its first test with inflation since its creation in 1999

3.3. The risk of fragmentation and Italy

The dilemma must be linked to the disruption in the Eurozone government bond markets exposed to multiple equilibria. Most public debt in the Eurozone is issued in euro, which cannot be controlled nationally. The lack of confidence in financial markets exposes the government bond markets to liquidity and solvency crises, triggering contagion to a bad equilibrium (higher government borrowing costs to rollover debt leading to a self-fulfilling default). In the 2011–12 crisis, this instability was solved when the ECB started acting as a lender of last resort, maintaining countries in a good equilibrium. In such a context, capital flows are sustained at a cost that does not threaten debt sustainability. The ECB has a track record of applying tools that target sovereign spreads. It started with the OMT (outright monetary transactions) in 2011–12 when Mario Draghi, ECB president at that time, promised to do whatever it would take to save the euro. Unlimited purchases of government bonds were key for ECB credibility. Similarly, the ECB took a proactive approach to fragmentation risk during the pandemic crisis with the launch in March 2020 of the Pandemic Emergency Purchasing Programme (PEPP). The ECB new anti-fragmentation tool, the Transmission Protection Instrument (TPI) disclosed in July 2022, aims to keep

the ECB new anti-fragmentation tool disclosed in July 2022 aims to keep peripheral spreads contained peripheral spreads contained (acting in case of divergence versus fundamentals), so that the Governing Council can pursue its inflation mandate via rate hikes serving both price and financial stability objectives.

In the current environment, supportive factors for debt sustainability are numerous. The cost of outstanding debt is low by historical standards. It is tied to the global equilibrium interest rate, *r**, which has been falling over the last two decades, reflecting a glut in savings and shortfall in investment. Savings have kept rising due to an aging population (savings glut of the elderly), growing income and inequality (savings glut of the wealthy) and net external demand for fixed income assets (savings glut of foreigners). Declining investment is very much linked to a productivity slowdown. These secular trends are not set to change in the medium term and have helped governments to sustain their debt. Raising again the marginal product of capital requires new investments that will generate a higher increase in productivity. However, the higher demand for capital would entail higher interest rates. But the resulting higher growth rate should sustain government amid higher tax revenues.

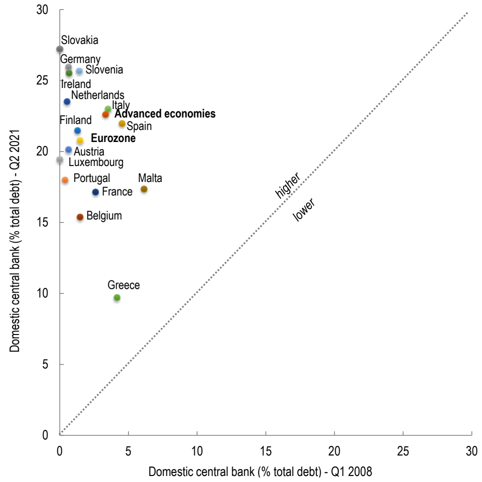
With quantitative easing first introduced in 2015 to achieve its price stability objective, the ECB has become a dominant investor in the government bond market. This has resulted in changes in the sovereign debt investor base. ECB holdings of Eurozone government debt have increased from less than 2% in 2008 to 21% in 2021 (Figure 2). Central banks are sticky holders of debt instruments as they adopt a hold-to-maturity approach. They are therefore unlikely to divest when faced with higher yield volatility and rather act as stabilizing investors. The shift in the Eurozone sovereign debt investor base in favor of the ECB has reduced governments' borrowing costs and refinancing risks.

the credibility of the ECB would depend on its capacity to fight against inflation while avoiding soaring borrowing costs and a public debt crisis

In addition, since the public debt crisis, governments have managed to strengthen their debt structure. The average maturity of public debt in southern Europe ranges from 7 years in Italy to 21 years in Greece. Therefore, a smaller proportion of the outstanding debt must be refinanced every year. This improvement in maturity structure slows the pass through from short-term higher market yields to the average cost of outstanding debt.

There is more that the ECB can do in launching the anti-fragmentation program to manage yield curves in the Eurozone. It is expected to commit itself to buying the bonds of countries whose borrowing costs are pushed to levels beyond those warranted by economic fundamentals. Unlike earlier schemes, which bought bonds according to relative country size, the new plan would target the countries that most need support. However, those countries should be fiscally sustainable and show no serious macroeconomic imbalances. If the ECB is perceived as credible, the Transmission Protection Instrument (TPI) should stabilize investor expectations and avoid slipping into a bad equilibrium when fundamentals do not suggest it. Therefore, the ECB might not need to use it. The conditions should be sufficiently consistent to remain acceptable for countries like Germany or the Netherlands that might object to monetary financing of specific countries, as is forbidden by the EU treaties. As prime minister, Mario Draghi had agreed with the EU on reforms, with a plan to enhance competition to make Italy more attractive to investment and to guarantee the sustainability of the high public debt. Since Italy is expected to be the main beneficiary of the common "Next Generation EU" borrowing, this might appeal to the next right-wing government; however, it is uncertain whether the improbable right-wing coalition would agree to undertake the structural reforms attached to the subsidy and the preferential loan.

Figure 2 – Domestic central bank holding of Eurozone countries' sovereign debt



Source: Pictet Asset Management, CEIC, Refinitiv, "Sovereign investor base estimates by Arslanalp and Tsuda (2014)".

The credibility of the ECB would depend on its capacity to fight against inflation while avoiding soaring borrowing costs and a public debt crisis. Inflation is a key risk for a public debt holder. Debt revenues are maintained if a central bank succeeds in its price stability mandate contributing to public debt sustainability. The outlook for inflation depends on the conflict between Russia and the West. The tensions intensified in early September. The Kremlin said that gas deliveries through the Nord Stream 1 pipeline would be cut off and resume only when the West dropped its economic sanctions against Russia. To make things worse, the OPEC group of countries, which includes Russia, agreed to reduce its oil output. In response, the G7 powers wanted to impose a global price cap on Russian crude oil. A source of possible discord in the ECB Governing Council is the extent and speed of the tightening pace of the monetary policy. The ECB provided forward guidance in September as it expects to hike rates further at several meetings, since policy rates remain well below the levels bringing inflation at target.

In a meeting in Brussels on September 9, Europe's energy ministers asked the European Commission to present mid-September measures to decrease the high energy prices and reduce their impact on households and corporates. In response, the Commission recommended a cap on the revenue of electricity producers with low production costs, a solidarity contribution from fossil-fuel companies, emergency and temporary interventions, including a gas price cap on Russian natural gas, and gas demand reduction across the EU.

However, the combination of the rise in interest rates to fight inflation as decisively as possible and the anti-fragmentation program to avoid divergence in spreads among countries might promise a less troublesome landscape than the 2011–12 monetary-fiscal doom loop. It might lead to a shallow recession followed by a mild recovery. The ECB will be supported by the NextGeneration EU stimulus package involving long-term financing stemming from long-term bonds issued at the EU level under the auspices of the EU Parliament. This financing will be distributed partly in the form of loans and partly in the form of grants to countries that need it the most.

However, a turn for the worse has occurred with the political crisis in Italy. The coalition government led by Mario Draghi collapsed, breaking the broad cross-party consensus that was the essential condition of his premiership. With the rise of the neo-fascist Brothers of Italy, the three coalition parties (the anti-establishment Five Star movement, the right-wing League and Forza Italia) withdrew consent, forcing Italy's president Sergio Mattarella to accept Draghi's resignation and to fix a snap election on September 25. The resulting lack of market confidence in Italian politics has widened the yield spread between Italian and German bond yields. The yield spread between Italian BTP and German Bund (10-year government bond) reached 2.38% in late July (Figure 3). In the parliamentary elections, the right-wing coalition between the far-right Fratelli di Italia and Lega and the center-right was victorious, and Fratelli di Italia leader Giorgia Meloni has become prime minister. Compared with 2018, euro-sceptic sentiment was more moderate during the electoral campaign. After the elections, the 10-year Bund yield climbed to 2.2% and the 10-year Italian BTP to 4.7%, before receding. The spread between the two remains sensitive to the 2023 budget, which will be submitted to the European Commission and then voted on by the parliament. This will be a test of fiscal credibility. Italy is a large recipient of the NextGeneration EU (NGEU) funds. To unlock disbursements, it must achieve milestones and targets to be eligible for the ECB TPI (a necessary condition). While the Draghi

Figure 3 – Italy's 10 year government bond spread vs German Bund

Source: Pictet Asset Management, CEIC, Refinitiv, Bloomberg.

government had been working on it, the risk stems from the right-wing objective to rewrite and amend some of the objectives of the plan. The next NGEU payment is expected in Q4-2022.

3.4. Germany's energy package might further raise energy costs in Europe

Made in Germany, resting on two pillars – free international trade and geopolitical stability –, has been successful. It has been highly dependent on Russian gas deliveries. Its economy is highly carbon-intensive, weak in digital innovation and handicapped with old infrastructures in transport and communication.

Germany announced a €200bn energy package, a stark rejection of the coordinated response advocated by the European Commission

In early October, Germany announced a €200bn energy package to cushion its businesses and consumers from the impact of the energy crisis. This was a stark rejection of the coordinated response advocated by the European Commission. The plan will be mainly financed with debt. On top of €100bn in support already allocated, it will lead to about 8.4% of GDP in energy subsidies, more than double the support provided by Italy and France combined.

Germany justifies this largesse because it is the Eurozone manufacturing engine. However, the package is likely to strengthen demand, which would push up gas prices on Europe's wholesale markets. Given the size of the package, it will broaden the divergence in inflation between Germany and the rest of Europe.

For Europe as a whole, the extraordinary high prices of natural gas have sent headline inflation rates to similar levels as in the US, the euro having fallen to $0.98, its lowest level in the last twenty years. However, core inflation is significantly lower. That is why forecasters in financial markets expect the policy rate to reach 2.9% in the Eurozone as against 4.6% in the US and 5.3% in the UK by June next year. Those forecasts are between 1.5 and 2% higher than they were at the start of August 2022. Deutsche Bank economists forecast that Eurozone inflation will peak at around 9.5% at year-end. However, the fact that inflationary pressures have become much more broad-based is a matter for concern.

4. Inflation forecast exploding in UK: BOE warns of lengthy recession

The Bank of England (BoE) warned on August 7 that UK inflation would hit 13% at end-2022 as the monetary policy committee decided to raise the interest rate to 1.75%. The BOE announced the grim forecast of a protracted recession that would squeeze living standards, with GDP possibly shrinking by 1.5% in 2023. The inflation outlook is so dire that the monetary policy committee has no option but to engineer a severe economic downturn. The news led to sterling slipping 0.6% against the euro.

In July 2022 consumer prices were 10.1% higher than a year earlier. Consumer inflation is forecasted to peak at 13% this year. The UK's higher inflation compared to most West European countries reflects the country's greater use of gas, the strong growth in spending last year and a decline in the employment rate caused by Brexit-related trade frictions. These domestic conditions have led to price pressures intensifying for most goods and services, with dire consequences for the exchange rate. The pound fell 4.5% in August to $1.16, and by almost 3% against the euro. The 10-year UK government bond reached 3% for the first time since 2014. Core consumer prices (excluding volatile food and energy components) are rising at the fastest pace across the group of 10 major economies. That is why the Bank of England and many forecasters expected the country to fall into recession by the end of 2022.

UK's core consumer prices are rising at the fastest pace across the group of 10 major economies

If the central bank drives the UK into recession with the priority of taming inflation while the government increases spending to bolster the economy, this could end up further destabilizing inflation and prompting firmer action from the BoE.

The BoE said the disruption was due to the surge in gas prices driven by the war in Ukraine. Inflation would remain at an elevated level throughout 2023 before sliding down to the 2% target in two years. The peak-to-trough decline might hit household income by 5%, the worst setback since the 1960s, according to available data. The recession, beginning in Q4 of 2022, might last five successive quarters.

Furthermore, the UK has been undergoing major political and constitutional upheaval. In early September, Queen Elizabeth's death occurred just two days after Liz Truss, the new Conservative leader, took office in 10 Downing Street. This started a new period of political and national leadership under the kingship of Charles III – raising the possibility of instability in the UK.

After 10 days of mourning and the queen's funeral, the most practical challenge in this period was Truss's £150bn energy support package. The government energy price guarantee for households, starting on October 1, is implemented through private contracts with suppliers. The support package for business is more complex in conception and implementation. However, the fiscal stimulus is expected to be so massive that it will increase inflation and interest rates, to reach 4.75% by mid-2023. The fiscal expansion was badly conceived; it would have created two massive twin deficits in fiscal and current account balances. The 10-year yield on government bonds surged from 3.5% to 4.3% in just one weekend. The cost of state financing rose to around the same level as in Italy.

The ill-conceived stimulus plan, called a "mini budget" by UK Chancellor Kwasi Kwarteng, provoked a panic in the financial markets. The interest rate on two-year government bonds jumped to 46% and the pound slumped to $1.03 on September 26. All this was exacerbated by the UK pension funds holding Liability Driven Investment derivatives, which ensure that their assets meet their liabilities (*i.e.* the guaranteed pay-outs to pensioners). The yield surge triggered margin calls, forcing the pension funds to post cash as collateral. They sold gilts, which caused a bond sell-off. The BoE warned that the UK was on the brink of a financial crisis and intervened by buying up to £65bn in gilt over a 13-day period to avoid a self-reinforcing spiral that would feed widespread financial instability. Since then, Chancellor Kwasi Kwarteng has been replaced by Jeremy Hunt who has stabilized the situation. He has undertaken a swift U-turn on fiscal measures, but fiscal credibility depends on the political outlook. On monetary policy, markets expect rates to reach about 5.2% by the middle of 2023.

Later on, Liz Truss resigned and was replaced on 10 Downing Street by Rishi Sunak as prime minister. Sunak and Hunt made a U-turn in fiscal policy, ditching the tax cutting and borrowing of their predecessors. Sterling recovered somewhat in FX markets. However, the current account deficit was still 5.5% in the third quarter of 2022. It is why the BOE has increased interest rate by 0.75% on November 3.

5. China's contrasting path to the 2022 National Congress

China's stringent zero-Covid policy forced repeated lockdowns in many cities in the first quarter of 2022. Then, the April Politburo meeting marked the start of supportive policies. The benchmark five-year loan prime rate was cut, and the State Council announced stimulus measures accompanied by some loosening of the zero-Covid stance. Unlike in Western countries, inflation has not stepped above 2.5%, food and energy are resilient, and there is ample room for fiscal and monetary stimulus.

China's energy transition and technological advance offer investment opportunities to support "common prosperity" serving the middle class. Pursuing this policy requires bailing out the heavily indebted property sector. The State Council passed a plan to establish a real-estate fund worth RMB300bn to support a dozen property groups. The China Construction Bank and China's central bank will inject RMB80bn into the new fund to help distressed real-estate companies. The rescue comes shortly after property buyers across the country threatened to stop paying mortgages on uncompleted apartments if construction stalled. China's property stocks rallied after the announcement of the bailout.

unlike in Western countries, inflation has not stepped above 2.5%

The persistent zero-Covid policy along with the geopolitical tensions provoked by the war in Ukraine also had negative consequences for venture capital. This mostly affected small and mid-size companies in the second quarter. Foreign money has kept flowing into the biggest firms with a long record of performance. In the first half of 2022, private equity and venture capital funds were down 94% from a year ago. It was the smallest half-year total since 2009. However, no-one doubts that the slump is temporary. Investors are waiting for a signal from the Chinese Communist Party's National Congress because foreign investors know that China is a venture capital market that they cannot ignore.

To accelerate the recovery before the National Congress in the fall, the Politburo decided to mobilize RMB 1 trn of loans for millions of stalled property developments. The People's Bank of China (PBoC) would initially issue RMB200bn of low-interest-rate loans to refinance the stalled real-estate projects, hoping that the state-owned banks would leverage the initial fund by up to five times to reach RMB 1 trn. This would help to fill the funding gap so that unfinished real-estate projects can be completed. However, the banks might have difficulties in making a return on those projects. The construction of millions of apartments nationwide is at stake.

Indeed, the economy has been dragged down by the spiraling debt in the property sector following the default in 2021 of Evergrande, the second largest real-estate developer. Since then, other developers with large offshore debt maturities and weak sales have defaulted. Many developers issuing dollar bonds are priced at a level implying a very high risk of default. Widespread work stoppages on presold homes have spurred a nationwide boycott of mortgage payments, increasing the risk of default among real-estate developers and leading to a collapse in real-estate prices.

the economy has been dragged down by the spiraling debt in the property sector following the default in 2021 of Evergrande

For too long, policymakers have been hesitant about the scale and timing of a bailout, hence unable to restore confidence among home buyers in presold housing. The macroeconomic impact was a severe economic slowdown because the property sector accounts for about one-third of economic output. The problem is exacerbated by the slow pace of bad-debt write-offs among Chinese lenders, despite the rise in defaults. Distressed asset managers prefer to wait until the central government launches a full bailout of the property sector.

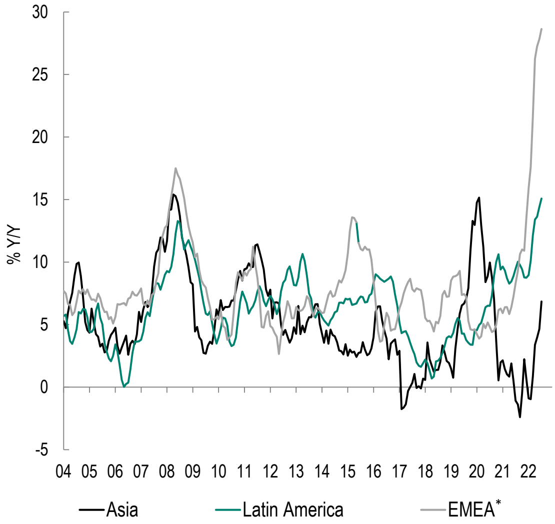
Finally, the State Council decided to raise RMB300bn in credit support through its policy banks. Central government stimulus is combined with looser monetary policy to halt slowing growth while avoiding overloading the country with more debt. Nevertheless, overall growth is likely to remain sluggish for the rest of 2022.

6. Towards a widespread financial crisis in emerging markets and developing economies (EMDEs)?

The war in Ukraine has pushed up food and energy prices, benefitting commodity-exporting countries, notably in Latin America, Middle East and Africa. The positive term-of-trade shock has boosted their fiscal revenues, external accounts and growth. Capital inflows caused appreciation in their currencies. The reverse was true for net commodity importers. Emerging markets, overall, are vulnerable to food inflation as food accounts for more than 40% of the CPI basket in many of them. Food prices have surged amid rising energy and fertilizer prices, supply-chain disruptions due to Covid and the war in Ukraine, combined with a depreciation of some currencies. This is particularly acute in sub-Saharan Africa and Eastern European countries (Figure 4). Emerging markets have been hurt by a sell-off as

the war in Ukraine has pushed up food and energy prices, benefitting commodity-exporting countries, notably in Latin America, Middle East and Africa

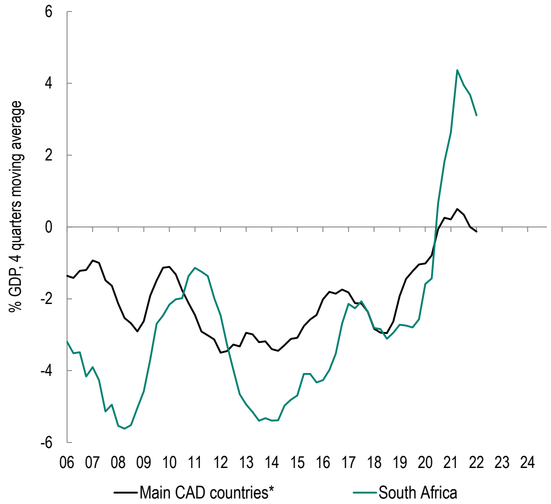
Figure 4 – Emerging markets food inflation



* EMEA: Emerging Middle East and Africa.

Source: Pictet Asset Management, CEIC, Refinitiv, Bloomberg.

Figure 5 – Emerging markets' main current account deficit countries



* Non-weighted average of 8 current account deficit (CAD) countries: India, Indonesia, Argentina, Brazil, Mexico, Poland, South Africa & Turkey.

Source: Pictet Asset Management, CEIC, Refinitiv, Bloomberg.

the Fed accelerated the hiking cycle in June, while the fear of a global recession has intensified, causing the dollar to appreciate amid rising risk aversion. In particular, the frontier markets (mostly net food importers) are the most at risk, notably because the current environment complicates their access to financial markets while they show big imbalances and large external financing needs (Figure 5). Most emerging markets exhibit better fundamentals than in past shocks, yet the capital outflows dynamic is similar to the 2013 "Taper Tantrum" or the RMB depreciation in 2015. When Ben Bernanke announced in summer 2013 that the Fed would start tapering its asset purchases, and China decided in August 2015 to devalue the Renminbi, emerging markets sold off.

while debt distress is spreading and growth is sharply slowing, the big question is whether China will agree to participate in a multilateral debt-restructuring program

In Sri Lanka, the people threw out a reckless and corrupt government. The event suggests that trouble is coming in many other EMDEs. Sri Lanka had run a budget deficit in excess of 10% GDP in 2020 and 2021. Public debt jumped from 94% of GDP in 2019 to 119% in 2021, while Covid-19 severely damaged tourism. Meanwhile, rice production plummeted, creating a current account deficit and foreign exchange shortage. Combined with the lack of foreign exchange reserves to service its debt issued in USD, Sri Lanka defaulted in May 2022. As a result, the IMF declared that Sri Lanka's public debt was unsustainable.

Sri Lanka will not be an isolated case. Many other EMDEs are suffering from high food and fuel costs. For the whole group of countries, the IMF is forecasting a sharp slowdown from 6.8% in 2021 to 3.6% in 2022. Growth is weakening while borrowing costs expressed in dollars are rising amid rising interest rates and USD appreciation. Furthermore, according to the World Bank, 25% of EMDEs' external debt is owed to China.

In the past, such developments often triggered balance-of-payment crises in indebted dollar-dependent economies. Currently, some large national economies – like those of India, Brazil and South Africa – can borrow in local currencies as domestic investors hold most of their debt. However, this is not the case for many EMDEs that are net fuel and food importers, requiring them to service dollar-denominated debt.

Beyond Ukraine, benefitting from donations to keep meeting payments on an otherwise unsustainable debt, there are many countries, such as Ghana, Pakistan, Egypt, Laos and Argentina, whose bond yields are spiraling higher and that are at risk of default. Egypt's current account deficit reached a record high in Q1 2022; net foreign assets have weakened while external financing needs remain wide. The low level of yield in real terms raised the capital outflows. The Egyptian pound is at risk of depreciation so as to reduce the balance-of-payments imbalances.

IMF managing director Kristalina Georgieva warned in July that more than 30% of emerging and developing countries were at or near debt distress, and that the number for low-income countries was 60%.

With its Belt and Road Initiative (BRI), China is the largest creditor to many EMDEs. A substantial number of infrastructure projects financed by China's development banks and large state-owned commercial banks have failed to earn a commercial return and are in debt distress. However, the recipient countries, rather than the lender, are the culprits, since other investments have been successful. Examples are the 750km railway line from Addis Ababa in Ethiopia to Djibouti, which has cut the travel time from three days to

12 hours, the line from Mombasa to Nairobi in Kenya, and hydropower dams built by Chinese contractors in Uganda.

While debt distress is spreading and growth is sharply slowing, the big question is whether China will agree to participate in a multilateral debt-restructuring program for Belt and Road countries under the auspices of the IMF and the Paris Club. China has various reasons to be reticent about participating in a procedure led by Western countries in a context of geopolitical rivalries. The times are tough for multilateralism.

In Asia, Indonesia and India are the most affected. The Bank of Indonesia avoided raising its interest rate because higher commodity prices have shielded the Indonesian rupee in the short term. However, the depreciation pressure on the Indonesian rupee is a matter of concern because Indonesia's ratio of external debt to GDP is high. The risk premium has increased substantially with capital outflows and FX depreciation. High exposure to USD debt will force Indonesia to raise interest rates to defend its exchange rate.

While it has less external debt, India is vulnerable due to its current account deficit. Its import dependency generates a foreign exchange passthrough, with an impact on domestic inflation. The depreciation of the Indian rupee raises the energy bill and creates a vicious circle between a larger fiscal deficit and currency weakness. The Reserve Bank of India raised its policy rate by 40 basis points (bps) in May 2022. It may push the interest rate to 6% from its rate of 4.4% in May 2022.

Taiwan, Japan and South Korea are more insulated from the Fed's tightening, at least in the short term, since their robust current account surpluses protect against their currencies depreciating against the dollar. Exports of tourism services shield Thailand while goods exports protect Malaysia.

All in all, the World Bank is warning of global recession risks.[5] If central banks go on raising interest rates separately and excessively, global economic growth will decline to 0.5% in 2023. The World Bank is thus urging monetary authorities in large countries to coordinate their actions to reduce the overall amount of tightening, while urging governments to provide targeted relief to vulnerable households.

Conclusion

Multiple interacting crises make this policy brief extremely difficult. The macroeconomic landscape is changing day by day, in a context of geopolitical rivalries and more structural changes involving political ecology that make this decade crucial. Because monetary policy is the main topic of this paper, central banks are the relevant actors in both changes in monetary policy doctrine and day-to-day responses to inflation surges and financial market vulnerabilities.

Both the European Central Bank and the US Federal Reserve have confirmed their 2% target, but they interpret it as a medium-term one in dealing symmetrically with upside and downside deviations to enhance forward guidance.

The challenge facing Western central banks since the early months of 2022, forcing them from easing to restrictive monetary policy, was the burst in inflation triggered by energy and food prices related to the war in Ukraine in a context of deep uncertainty.

In its annual report, the Bank for International Settlements provides a framework that insists on debt sustainability and price contagion as the issues.[6] The report distinguishes between low-inflation and high-inflation regimes. In low-inflation regimes, idiosyncratic price rises do not cause every price to rise; in high-inflation regimes, they do so under an entrenched inflationary psychology that threatens to de-anchor inflation expectations. Globalization makes domestic inflation more sensitive to foreign (than domestic) labor market slack; hence, the flatter Phillips curve since the 1990s.

the inflationary threat should be addressed in a coordinated manner, as was the deflationary threat during Covid to avoid the excessive monetary policy tightening

As most central banks felt that they were behind the curve, they have adjusted by hiking rates almost simultaneously with the risk of amplifying each central bank action. When a country hikes rates, import price inflation strengthens the case for a coordinated monetary policy setting as the currency appreciation is accompanied by depreciation elsewhere. The inflationary threat should be addressed in a coordinated manner, as was the deflationary threat during Covid. If so, it might be possible to avoid the excessive monetary policy tightening associated with a detrimental impact on growth.

The adjacent problem is the vulnerabilities concerning debt sustainability among emerging markets and developing countries. This paper provides multiple cases of different situations; those countries are suffering in varying degrees from the geopolitical fragmentation worldwide, while coordination between the G20 powers is at stake.

(5) World Bank (2022).

(6) BIS (2022).

References

Arslanalp S. and Takahiro T. (2014), "Tracking Global Demand for Advanced Economy Sovereign Debt", *IMF Economic Review*, Vol. 62, no. 3, pp. 430–464.

Boone L., Jorda O., Schularick M. and Taylor A.M. (2022), "Debt: the eye of the storm", the 24th Geneva Report on the World Economy, CEPR press.

Coeuré B. and Kotz H.H. (2021), "Lessons learned from crises, New Doctrines in Central Banking", *Revue d'Économie Financière*, no 144, 4° trimestre.

Carstens A. (2021), "Central banks adapt to new challenges, New Doctrines in Central Banking", *Revue d'Économie Financière*, no 144, 4° trimestre 2021.

Claeys G. and Demertzis M. (2022), "A new European tool to deal with unjustified rising spreads", *Blog post*, Bruegel, June.

BIS (2020), "Annual economic report", June 30.

BIS (2022), "Annual economic report", June 26.

ECB (2021), "An overview of the ECB's monetary policy strategy", ECB Economic Bulletin, Issue 5/2021.

Goodhart C.A.E. (2010), "The changing role of central banks", *BIS Working Papers*, no 326.

Inagaki K and Lewis L. (2022), "Japan's moment of truth", Financial Times, July 5.

Lane P. (2021), "The monetary policy of the ECB, New Doctrines in Central Banking", *Revue d'Économie Financière*, no 144, 4° trimestre.

McKinsey Global Institute (2018), "Solving the productivity puzzle", Report, February 20.

Obstfeld M. (2022), "Uncoordinated monetary policies risk a historic global slowdown", *Real time economic issues watch*, Peterson Institute for International Economics, September 12.

World Bank (2022), "Is a global recession imminent?", *EFI Policy Note* 4, September 15.

About the authors

Michel Aglietta is emeritus professor at the University Paris Nanterre and scientific advisor in CEPII.

Sabrina Khanniche is senior economist at Pictet Asset Management.

Contact: michel.aglietta@cepii.fr – skhanniche@pictet.com

Policy Brief

CEPII

CEPII (Centre d'Études Prospectives et d'Informations Internationales) is a French institute dedicated to producing independent, policy-oriented economic research helpful to understand the international economic environment and challenges in the areas of trade policy, competitiveness, macroeconomics, international finance and growth.

CEPII Policy Brief
CEPII's insights on international economic policy
CEPII – Paris – 2022 – Published on 25.11.22
No ISSN: 2270-258X

Managing Editor: Vincent Vicard
Production: Laure Boivin
Editorial Director: Antoine Bouët
Head of Publications: Isabelle Bensidoun

CEPII
20, avenue de Ségur
TSA 10726
75334 Paris Cedex 07

contact@cepii.fr

www.cepii.fr

Press contact: presse@cepii.fr

RESEARCH AND EXPERTISE
ON THE WORLD ECONOMY