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Two central banks – one problem: recession may follow inflation

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The record inflation rates of the past months have put pressure on the European Central Bank (ECB) and the US Federal Reserve to combat the sharp price increases with a more restrictive monetary policy. Whereas the Fed began its monetary policy turnaround already in March, it was not until the Governing Council meeting of July 2022 that the ECB changed its course. This Focus explains the different pace of the monetary policy measures thus far adopted by the two central banks with the dissimilar economic and labour market developments after the pandemic. In hindsight it can be said that both central banks have responded too slowly overall and stayed in crisis mode for too long. The late monetary policy turnaround of the Fed and ECB amid continuing very high inflation rates now demands even more determined action. Against this backdrop, given the necessary cycle of interest rate hikes, the 'soft landing' will become a balancing act in both currency areas. The Fed currently appears to be determined to bring price rises under control at all costs. It is accepting the risk of a recession being triggered by a tighter monetary policy with its eyes wide open. As the ECB has taken longer to change its course, the window for comprehensive rate hikes to fight inflation appears to be much smaller because of the impending economic slowdown in the euro area. The ECB is in a difficult position, and it appears less clear whether it can steadily pursue its course – although unlike the Fed, it only has a price stability mandate.

Record inflation rates put pressure on ECB and Fed

Consumer prices in the US and the euro area have been well above the central banks' 2% target for well over a year. This is mostly the result of global effects such as surging demand for energy and raw materials in the course of the global economic recovery after the first year of the pandemic. The demand that has been fuelled by the opening of the global economy is being bolstered by household savings accumulated during the pandemic. But this demand is meeting with a supply that remains limited as a result of renewed lockdowns in Asia and ongoing supply chain disruptions. Furthermore, Russia's attack on Ukraine has exacerbated the tense situation in global commodity and food markets since February of this year. For one thing, the war has led to shortages and disruptions to supply chains. For another, cuts in supplies, economic sanctions and the associated geopolitical uncertainty are disrupting price formation in energy and food markets. Accordingly, energy and food inflation have greatly contributed to the overall rate and pushed it up again significantly. Besides the global dimension, however, domestic factors also play a considerable role in explaining the high inflation rates in the US and the euro area. Thus, global surplus demand for internationally traded goods and commodities is likely to have strengthened the price setting power of businesses.[1] In addition, households and businesses have revised their inflation expectations upward in response to the structural, global changes caused by the pandemic, an extended period of higher inflation rates and the war in Ukraine. Amid stretched labour markets, the risk of a wage-price spiral has recently grown significantly in the US and euro area.

Inflation levels not seen for a long time and rates breaking one record after another have now led central banks to rethink their policies too. As recently as in autumn 2021, both the US Federal Reserve and the ECB still expected inflation to remain elevated only temporarily and normalise in the following year. When it became clear at the end of 2021 that this reasoning no longer held any merit, the Fed changed its course. It has begun to significantly reduce its balance sheet and lifted the Federal Funds Rate by 300 basis points since March 2022. It considers further increases to be warranted for as long as it takes to noticeably improve the inflation outlook.

In the euro area, as is so often the case, the situation is more difficult. Particularly under the impression of the Ukraine war, but also a weaker economic starting point after the pandemic relative to the US, the ECB waited until the second quarter of 2022 to change course, lifting interest rates by 50 basis points (BP) in July and 75 BP in September. Further interest rate hikes are likely to follow until mid-2023, although the slowing business cycle or a resurgence of the euro crisis could soon lead to calls for a premature end to the interest rate cycle.

This Focus explains the different pace of the monetary policies hitherto adopted by the Fed and ECB with the dissimilar developments of the respective GDP and labour markets after the pandemic. This study also shows that the dynamic driving the underlying price pressure, particularly in what are referred to as the core components, i.e. excluding energy and food prices, is similar. This could become a problem for the euro area in particular. If this dynamic translates into accelerated wage growth, the ECB will need to make a quicker and, most of all, sharper correction to bring inflation under control.

It is now deemed almost certain that if inflation rates remain on the same level or continue rising, the 75-basis-point interest hike of September will be followed by further steps in the same order of magnitude in October and December.[2] The delayed tightening of monetary policy in the euro area compared with the US poses particular challenges for the ECB in the current phase of the economic downturn. These are compounded by the specific structure of the monetary union and the mixed development in the euro area, so that continuing on the path of interest rate hikes will be significantly more difficult for the ECB than for the Fed.

US: faster economic recovery and …

In the course of the coronavirus pandemic, economic output in the US contracted by nearly 9% from the first to the second quarter of 2020. However, US gross national product (GDP) returned to growth already from mid-2020. The recovery was bolstered by an expansionary monetary and fiscal policy so that US economic output exceeded the pre-crisis level already in the second quarter of 2021.

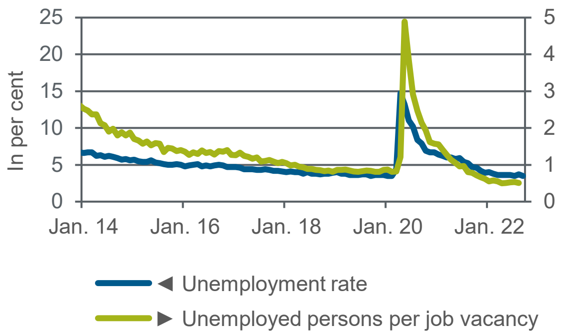
… less economic fallout from the war

As the US is significantly less dependent on imported fossil fuels and has much fewer economic ties to Russia and Ukraine than the euro area, for example, the war is having a limited economic impact on the US.

US labour market remains hot, risk of a wage-price spiral

The positive economic development in the US has led to a strong rebound of the labour market. In September the unemployment rate was back on the pre-crisis level of 3.5% (Figure 1). The robust recovery has caused labour demand to exceed labour supply. In August 2022, there were only 0.6 unemployed persons for each job vacancy in the US.

Figure 1: US labour market recovery nearly completed

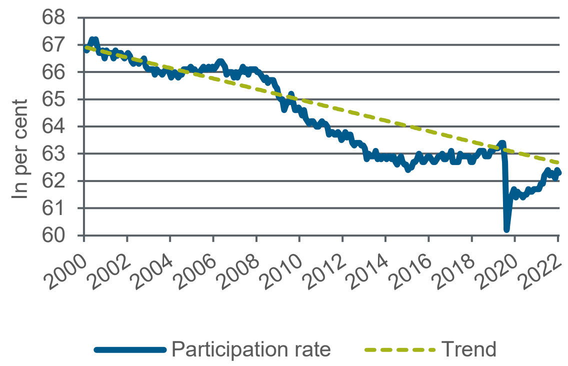


Source: U.S Bureau of Labor Statistics, KfW Research.

In the wake of the coronavirus crisis, many Americans had turned their backs on the labour market. The sharp economic slump significantly reduced their chances of finding new employment and the closure of schools made it difficult to reconcile work and family life. In addition, many people were afraid that taking on work would increase their risk of infection and, not least, the stimulus cheques and increased unemployment benefits reduced the need to go back to work. The rebounding economy, the phasing-out of government support measures and the weakening of the pandemic, however, have caused the participation rate to rise again substantially in the past months (Figure 2). It is still one percentage point below its level of early 2020, to be sure, but a return to the pre-crisis level appears unlikely given the trend of a declining participation rate that has been going on many years now. This decline is the result of demographic change. The share of retired workers is increasing over time. Whereas in 2010 only 13.1% of Americans were over the age of 65, in 2019 that age group already made up 16.5% of the population.

Figure 2: Participation rate is nearing the pre-crisis trend

Trend based on the average decline in the participation rate between January 2000 and February 2020.



Source: U.S Bureau of Labor Statistics, KfW Research.

Another factor is that many older workers went into retirement at the start of the pandemic. Despite the economic rebound, most of them will no longer be available to the labour market in the future. At the start of the year, 3.0% of Americans quit their jobs voluntarily (Figure 3). That was the highest rate since records began in December 2000. In August, voluntary resignations still stood at 2.7%, which was clearly above the pre-crisis level.

Figure 3: Record-high level of voluntary resignations

Source: U.S Bureau of Labor Statistics, KfW Research.

The high demand for labour amid a limited labour supply has led to significant wage increases in the past months. In September 2022, average hourly wages in the US were nearly 5% above the previous year's level. Increases in wages and salaries have recently increased significantly and are now 2.8% above the trend of the past years (Figure 4).

In summary, it can be said that the mandate of the US Federal Reserve to ensure maximum employment already appeared to have been fulfilled in the spring of this year, allowing the Fed to focus on the second goal of its double mandate, which is to maintain a stable price level. The fact that the labour market still does not show any weakness gives the US central bank scope to continue acting aggressively against high inflation rates.

Figure 4: Wage increases well above trend

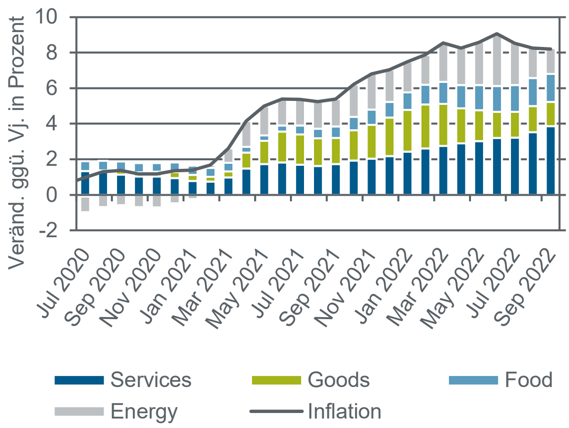
Trend based on average wage and salary increases between Q1/2018 and Q4/2019.

Source: U.S Bureau of Labor Statistics, KfW Research.

Price pressure in the US broader than in the euro area

The strength of the US labour market has direct effects on the possible further development of the inflation rate. Rising wages in the US lead to higher costs for businesses. Passing these costs on to consumers in the form of higher prices will increase the risk of a wage-price spiral. The US Federal Reserve is keeping a close eye on this development as it could drive up prices that are already on a high level. The US inflation rate has been above the 2% target of the Fed already since March 2021 (Figure 5).

Figure 5: Price pressure remains broad



Source: U.S Bureau of Labor Statistics, Bloomberg, KfW Research.

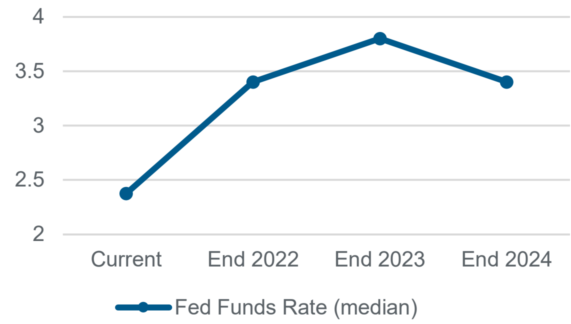
The increasing inflation rate was first attributable to base effects and strong growth in demand in individual sectors resulting from the economic opening. However, in recent months the price level was also pushed higher by increased energy costs and persistent supply chain issues. The fact that the cost of living has been increasing for Americans on a broad front is illustrated not least by the rising cost of housing. It accounts for roughly one third of the representative basket of goods on the basis of which inflation is measured and was 6.6% above the previous year's level in September 2022. Thus, inflationary pressure in the US generally covers a broad range of areas. That means even if the inflation rate has recently dropped slightly as a result of falling energy prices, the Fed remains under pressure to act.

The Fed initiated the interest rate turnaround earlier

The realisation at the start of the year that the broad price increases were not of a temporary nature prompted the US Federal Reserve to respond to the record high inflation levels in March by changing the course of its monetary policy. Since then, it has lifted the key interest rate by a total of 300 basis points. It has also pushed ahead with the reduction of the USD 8.5 trillion balance sheet. In June it began by not re-investing expiring bonds worth USD 47.5 billion. The monthly sum was raised to USD 95 billion by September. There will be further key interest rate rises at the coming Fed meetings. According to the minutes of the September meeting, the Federal Reserve expects the key interest rate to rise to a median rate of 3.4% by the end of the year (Figure 6) and the market is even pricing in many more interest rate hikes. In the months ahead, the Fed can be expected to continue tightening its monetary policy for as long as it takes until a clear effect on demand and, hence, inflationary pressure becomes evident. Federal Reserve Chair Jerome Powell recently emphasised once again that creating price stability was the supreme dictate and that the monetary authority was also prepared to accept 'economic pain' to achieve this.

Figure 6: Further interest hikes will follow

Median of the Fed dot plots of September 2022



Source: Federal Reserve Bank, KfW Research.

The Fed's priority is to fight inflation

The Federal Reserve is up against broad price pressure and a tight labour market in which a wage-price spiral may form. After believing for a long time that the high price increases were primarily driven by temporary effects, its mood has clearly shifted in recent months. The aggressive monetary policy turnaround is being accompanied by clear communication. The aim is to prevent any doubts that fighting inflation is absolute priority and that interest rates will continue to be lifted until clear successes are identifiable. The Fed's balancing act is to slow down price increases without putting the brakes too much on the economy. Federal Reserve Chair Jerome Powell recently pointed out that the danger of recession was definitely real. The dot plots too (Figure 6) indicate that economic activity will likely remain weak in the next two years as they imply an expected key interest rate reduction in the year 2024. The Fed appears to believe that the fight against inflation will lead to a 'hard landing'.

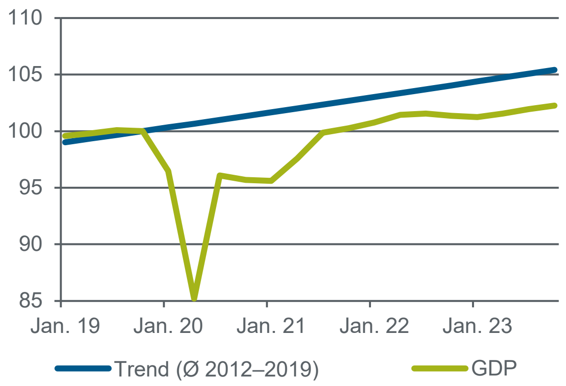
Euro area: recovery with one foot on the brake …

The economic recovery in the euro area has been slower than in the US. The quarter-on-quarter decline of 11.7% in the second quarter of 2020 was even steeper than in the US. To be sure, GDP recovered again strongly in the third quarter of 2020, but the subsequent further pandemic waves and associated restrictions caused growth to fall significantly behind that of the US from the fourth quarter. After clearly above-potential growth of 4.6% in 2021, GDP was also back to the pre-crisis level. However, large euro area member states such as Germany and Spain have still not returned to the level of their annual economic output at the end of 2019. This year, catch-up effects from the pandemic as well as fiscal incentives from the European recovery plan will still lead to strong growth particularly in France, Italy and Spain despite the war in Ukraine.

After a growth rate that is likely to be between 2 and 3% this year, however, the consequences of Russia's attack on Ukraine will be clearly felt in 2023. Annual growth can then be expected to drop to near zero, and negative growth in 2023 as a whole is also within the realm of possibility. That is most likely to occur if Russia stops natural gas supplies or the EU imposes an equivalent embargo. This would put even more pressure not just on industrial production but also on household consumption demand.

Current studies expect the forecast economic output to then drop by 1.2 to 2.2% depending on the severity of the assumed scenario[3]. Besides, it is not yet possible to fully predict how heavily the Chinese Government's strict zero-COVID policy will weigh on growth in Germany and the euro area through renewed supply chain disruptions in the near future.

Figure 7: Euro area economic output well below pre-crisis trend for the foreseeable future



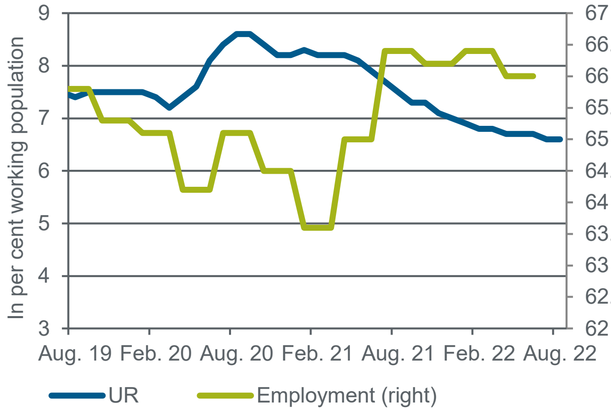
Source: Eurostat, KfW Research, own calculations.

... but with a robust labour market development

The labour market in the euro area has developed significantly more positively than the GDP growth rate after the pandemic slump. The seasonally adjusted unemployment rate of 6.6% has dropped back below the pre-crisis level of 7.5%, while the number of people in employment has risen to 161.5 million, surpassing the 161.4 million before the crisis. Only the participation rate and the number of hours worked were still 0.1 percentage points and 1.8%, respectively, below the level at the start of the pandemic.

The reasons for the stronger labour market development in the euro area compared with the US are partly related to the crisis response, partly structural. Thus, many euro area governments helped businesses and employees with bridging payments or short-time work allowance programmes. At the same time, the labour market in the euro area is much more rigid and regulated than in the US. The combination of these factors has helped keep unemployment in check and prevented employment levels from dropping too steeply.

Figure 8: The labour market in the euro area is proving to be relatively crisis-proof

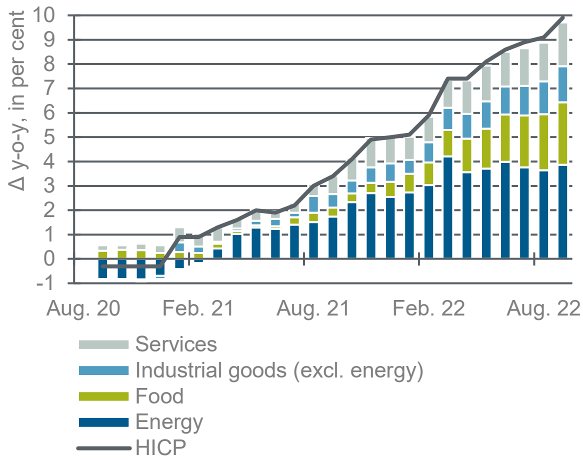


Source: Eurostat, KfW Research, own calculations.

Euro area price increases more strongly driven by energy costs

Although base effects and pandemic-related special effects such as the temporary reduction of VAT rates in Germany at the beginning of 2022 have dropped out of the measurement, consumer prices have climbed to ever higher record levels in the past months. In September, euro area inflation reached 9.9%, the highest level ever measured since the currency union was established. This was primarily the result of the rise in the price of energy, especially gas and oil, from the second half of 2021. The political as well as economic uncertainty unleashed by the outbreak of the war in Ukraine have also caused prices to rise further. This applies equally to food prices, which have also increased more than average in the past six months. The factors listed here have led to a rise in the overall inflation rate in particular. The core rate, by contrast, was a much lower 4.8% in September.

Figure 9: Energy prices are the main driver of inflation

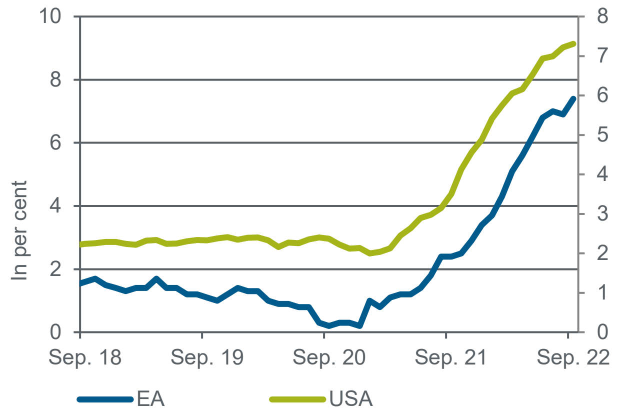


Source: Eurostat, KfW Research, own calculations.

This is one of the main differences to the US, where the overall rate and the core rate have risen almost in lockstep and the price pressure is also coming from the core components of the consumer price index. Surely, another reason for the lower core rate in the euro area is that the costs of owner-occupied dwellings are not captured in consumer prices, unlike on the other side of the Atlantic. In the US, this item accounts for nearly one quarter of the basket of goods, recording a price increase of 6.7% on the previous year in September.

The lower core rate compared with the US does not mean all is good, because …
It would be reckless to conclude that the ECB can sound the all-clear just because euro area core inflation is lower than in the US. It is now also higher than at any time since the currency union was created. Moreover, it is more than twice as high as the pre-pandemic long-term average. In addition, an alternative measure of the core inflation rate, the trimmed-mean inflation rate, shows that the dynamic of the increase in euro area inflation is similar to that in the US, and the gap is significantly narrower.

Figure 10: Inflation trends in the euro area and US are similar



Source: ECB Statistical Data Warehouse, 15% trimmed mean HCPI; Cleveland Fed, 16% trimmed mean CPI, KfW Research, own calculations.

The monthly rate of increase (twice the variation of the price index) in the euro area is actually significantly higher now than in the US, where it has stagnated of late. This suggests that inflationary pressure has broadened significantly and is likely to continue growing in the months ahead.

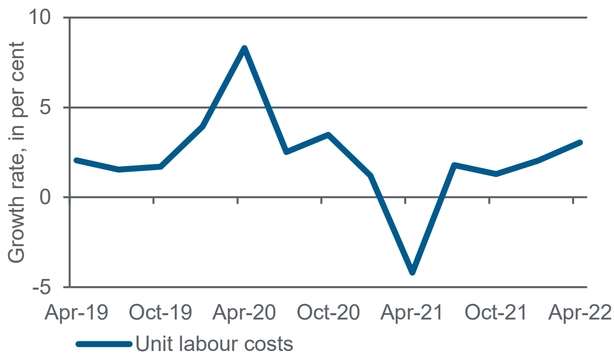
It is therefore important for the ECB not to look through the energy price-related high overall rate. To be sure, the further course of the war in Ukraine poses a substantial upward risk to energy price trends and, with it, the overall inflation rate. A further increase in energy and food prices must be expected particularly with a view to the autumn and winter months of 2022. Sooner or later, however, this effect will level off, so that the contribution of energy price inflation to the overall rate could decrease or even turn negative by the end of 2023.

We therefore believe it is likely that the overall inflation rate will potentially drop below the core rate from mid-next year. The core rate will likely remain steady on a high level if supply shortages persist, inflation expectations remain high and trade unions succeed in securing higher collectively bargained wage rates. The latter scenario and the resulting increased risk of a wage-price spiral no longer appear likely compared with the past ten years.

… wage growth potentially needs to catch up
The reasons for stronger wage growth in the coming years partly lie in the high inflation rates themselves. In the past, a positive correlation existed between high inflation rates and higher collectively agreed wages. That meant higher and more frequent wage adjustments[4]. At the same time, the labour market recovery and labour shortage indicate that workers' bargaining position is likely to improve in the coming years.[5]

Planned or agreed wage increases, especially in the low-wage sector of some member states, are a further aspect. The direct effect on aggregate wage sums is likely to be small[6]. Nevertheless, the minimum wage increases are also likely to have an effect on aggregate wage growth in Germany and other member states of the euro area[7]. The German Council of Economic Experts estimates the additional impetus of the effects on euro area core inflation described here to be 0.1 percentage points in 2022 and 0.3 percentage points in 2023[8].

Figure 11: Development of labour cost



Source: ECB, KfW Research, own calculations.

However, what runs counter to wage increases rising strongly relative to the historic average is the structural weakness of the labour market in southern Europe. Besides, the economic downturn in the coming year is likely to keep wage increases within bounds.

In hindsight, the ECB changed course too late …
What are the consequences for the ECB's current and future monetary policy? Unlike the Fed, the ECB could only bring itself to take cautious steps in the spring of this year, such as the termination of its Pandemic Emergency Purchase Programme (PEPP) at the end of March 2022. Against the backdrop of the war in Ukraine, it was still acting on the principle – especially in March – of preventing a possible economic downturn with gradual, flexible steps and as much discretion as possible. In hindsight, that was too late, but given the high uncertainty to which the ECB was exposed, things could also have turned out differently. Ultimately, however, the severity of inflationary pressure from energy and food prices, compounded by persistent supply chain problems in China, forced the ECB to change its course from June 2022[9].

In addition, the ECB ended the net purchases under the Asset Purchase Programme (PPA) (from early July 2022) and lifted the key interest rates by 50 basis points at the ECB Governing Council July meeting and 75 basis points at its September meeting[10]. In order to address the risk of the inflation outlook continuing on a high level or even increasing, two further interest hikes of 50 or 75 BP are likely to follow in October and December 2022. By the end of the year, the key interest rates in the euro area will probably rise to around or slightly above 2 per cent.

… and is therefore likely to raise interest rates much less aggressively than the Fed
Although the ECB can be expected to soon lift key interest rates further in the coming months, the rate rises in the euro area will probably remain within bounds compared with the US and end somewhere between 2 and 2.5%. This is because the ECB changed its monetary policy course with a delay

compared with the Fed, in combination with current global developments. As a result of the weakening global growth outlook after the recovery from the pandemic and the negative impact of the war in Ukraine, the ECB will not be able to lift interest rates sharply anymore next year without risking a recession in the euro area. That has created a conflict for the ECB as it prioritises its price stability mandate over economic concerns.

This is mainly the result of the specific structure of the currency union, for the existence of which the ECB bears a shared responsibility ex officio. Widening the periphery spreads over the Bund well beyond the current measure of around 200–250 BP (Italy) would likely present new challenges for the ECB. This limits the potential for interest rate hikes from the outset and poses the risk of ending the cycle of rate hikes prematurely. To be sure, the policy of reinvesting the repayment amounts from the PEPP that are to be invested by the end of 2024 can be a short-term countermeasure. Furthermore, at its July meeting the ECB adopted a new anti-fragmentation tool, the Transmission Protection Instrument, or TPI, which aims to ensure reasonable financing conditions and the smooth transmission of monetary policy across all euro area countries even in an environment of rising interest rates[11]. And the question also arises how to deal with the remaining (government) bonds accumulated on the ECB balance sheet since 2015 and how this can be reconciled with the trade-off described above. But unlike the Fed, the ECB has not yet publicly addressed this debate nor presented a clear reduction pathway towards balance sheet normalisation.

Conclusion: What remains are two central banks and one problem

On the one hand, compared with the Fed, the ECB had good reasons for initiating monetary policy normalisation with caution. One of these reasons was the different economic context. Russia's war of aggression against Ukraine, in particular, exacerbated the already high economic uncertainty. However, in hindsight it is also true that both central banks reacted too late and stayed in crisis mode for too long. This is due in part to the systematic underestimation of the inflation rate, a mistake which, to the central banks' credit, other institutions and forecasters also made. Besides, both central banks undertook a strategy revision in the past two years with a general orientation that tends to favour the fight against low inflation rates.

A soft landing is becoming increasingly unlikely

From this perspective, the necessary cycle of interest rate hikes will make a 'soft landing' a balancing act for the relevant central bank in each of the currency areas. While the Fed accompanied its aggressive interest rate policy shift with clear and unequivocal communication, including on balance sheet normalisation, for example, in the euro area some questions remain unanswered (balance sheet reduction), or it is hoped that they will never need to be answered (Anti-Fragmentation Tool).

The delayed monetary policy turnaround of the two central banks amid continuing very high inflation rates now demands even more determined action. The Fed currently appears to be eager to bring price rises under control at all costs. It is accepting the risk of a recession being triggered by a tighter monetary policy with its eyes wide open. The Fed's forecasts indicate that even the monetary policymakers in Washington believe a soft landing is becoming increasingly unlikely. The ECB initiated the turnaround later and more cautiously than the US Federal Reserve. The window for comprehensive rate hikes to contain inflation therefore appears to have shrunk considerably because of the impending economic slowdown in the euro area. The ECB is in a difficult position and it appears less clear whether it can remain consistently on course – although unlike the Fed, it only has a price stability mandate.

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[1] Cf. Schnabel, I. (2022, 11 May): The globalisation of inflation [speech], ECB

[2] Cf. ECB (2022, 8 September): Combined monetary policy decisions and statement

[3] Cf. German Council of Economic Experts (2022): Updated economic outlook for 2022 and 2023 (in German), Kasten 3, p. 39

[4] Cf. German Council of Economic Experts (2022): Updated economic outlook for 2022 and 2023 (in German), Abbildung 11, Kasten 2, p. 26

[5] Cf. Herold, J. G. (2021): Are higher interest rates and inflation ahead? A long-term view beyond the pandemic, Focus on Economics No. 336, KfW Research

[6] Cf. Deutsche Bundesbank (2022): Monthly Report February 2022, 74(2)

[7] Cf. Koester, G. and Wittekopf, D. (2022): Minimum wages and their role for euro area wage growth, in ECB (ed.), Economic Bulletin (3), p. 44–49

[8] Cf. German Council of Economic Experts (2022): Updated economic outlook for 2022 and 2023 (in German), Kasten 2, p. 25–26

[9] Cf. ECB (2022, 9 June): Combined monetary policy decisions and statement

[10] Cf. ECB (2022, 21 July): Combined monetary policy decisions and statement; ECB (2022, 8 September): Combined monetary policy decisions and statement

[11] Cf. ECB (2022, 21 July): The Transmission Protection Instrument, Press Release; Lagarde, C. (2022, 28 June), Price stability and policy transmission in the euro area [speech], ECB