QNB Economics
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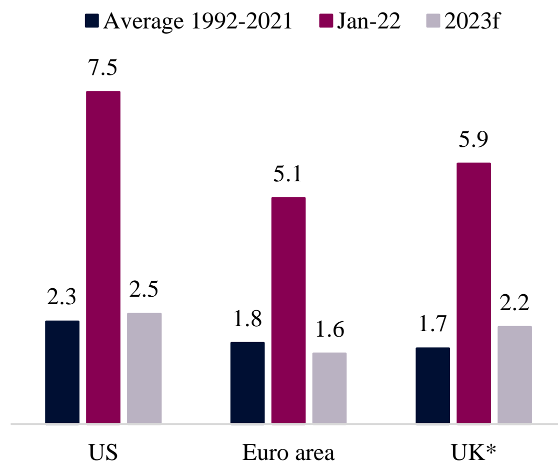
Economic Commentary

Central banks may jump start, then slow the pace of interest rate hikes

Consumer price inflation in the US, UK and Euro area is the highest it has been since the early 1990s and may still rise further in the next few months (Chart 1). That is likely to continue to generate uncomfortable headlines for policymakers at the Bank of England (BoE) US Federal Reserve (Fed) and European Central Bank (ECB).

Chart 1: CPI in major advanced economies
(Percent change year-on-year)



* UK latest inflation: December 2021
Sources: National sources, Bloomberg, QNB analysis

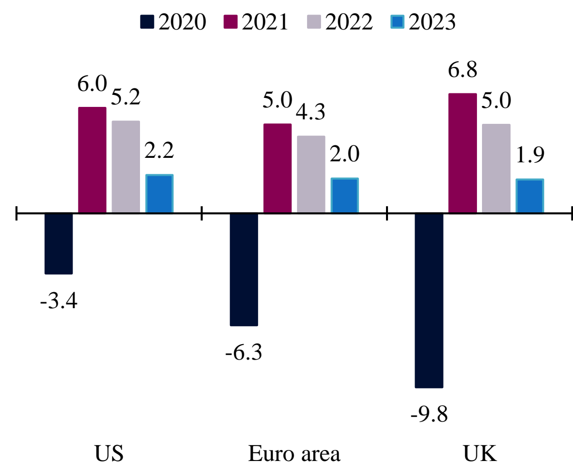
Policy stimulus in response to the global pandemic has been substantial over the past two years. In addition to fiscal stimulus from governments, central banks provided monetary stimulus via both interest rate cuts and asset purchases. Such extensive policy support was necessary to prevent a much deeper and longer recession. Indeed, it helped major advanced economies recover strongly in 2021 (Chart 2).

The unprecedented nature of both the pandemic and emergency policy stimulus meant that the impact on the economy was uncertain. As it happened, stimulus cheques sent to households in the US, and furlough schemes across all three major economies, were particularly effective at supporting incomes and consumer demand. Demand being stronger than supply has pushed up on consumer prices (CPI), driving inflation in major advanced economies.

Another factor pushing up on inflation is the recent rise in energy prices. Energy demand was supported by policy stimulus and has recovered gradually as the pandemic has evolved. Whereas energy supply was cut sharply at the peak of the pandemic and has recovered more gradually leading to tighter energy markets and higher prices. Energy has a large weight in the calculation of inflation in advanced economies and energy prices take some time to pass-through the economy. Therefore, energy price increases over the past few months mean that inflation is likely to rise further before peaking later this year.

The BoE has already raised UK interest rates twice, starting in December. And the Fed has accelerated tapering of its asset purchases so that interest rates can be increased from March. In contrast, a weaker recovery and lower inflation in the Euro area mean that the ECB is not expected to raise interest rates until the second half of the year.

Chart 2: GDP in major advanced economies
(Constant prices, percent change year-on-year)



Sources: International Monetary Fund, QNB analysis

The fact that inflation is so high, and likely still rising, is putting monetary policy makers under pressure to tighten policy aggressively. We expect central banks to rapidly remove emergency support, but be reluctant to hike rates too far too fast. Three key points support our view.

First, inflation is high now, and could rise further before peaking, which risks de-anchoring inflation expectations. Since the adoption of inflation targeting in the 1990s, central banks have placed great emphasis on anchoring inflation expectations to their inflation targets. However, with inflation being

at such high levels, and likely to rise further over the next few months, there is an increasing risk that inflation expectations slip the anchor, leading to an upward wage-price spiral. Therefore central banks need to act sooner, rather than later, to remove emergency stimulus to retain credibility with inflation targeting.

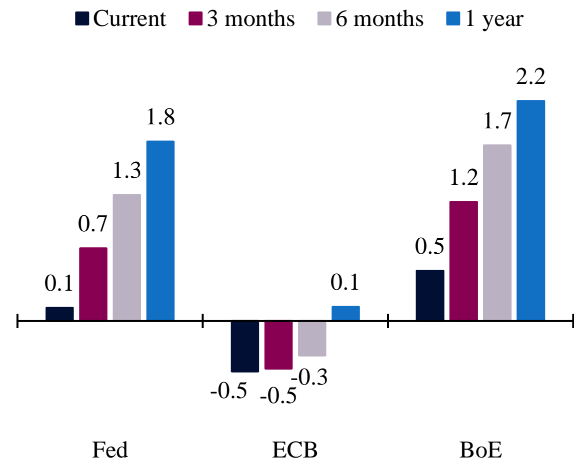
Second, record low interest rates have caused serious distortions to financial markets. Many asset prices are influenced by the discounted cash flow (DCF) method of valuation, where the value of future cash flows are reduced, or discounted, by the interest rate. This means that raising interest rates too quickly could lead to a sharp decrease in some asset prices. Therefore, central banks will need to be careful to clearly communicate their intentions and may be unable to raise rates too rapidly for fear of causing financial instability.

Third, economic recovery has been rapid in 2021, but is expected to naturally moderate in 2022 and 2023. This expected cooling off of the recovery in economic activity (GDP) should allow inflation to return towards target without the need for much higher interest rates (Chart 2).

Central bankers have been "talking tough" to maintain the credibility of inflation targets and ensure that inflation expectations remain anchored. They must now "walk the walk" and demonstrate action. As a result, we could see an aggressive 50 basis point (bps) hike or a series of monthly 25bps hikes, from either the Fed or BoE in the next few months. However, this could easily trigger volatility in financial markets and may even cause sharp falls in some asset prices.

Chart 3: Market implied policy rates

(Percent year-on-year)



Sources: Bloomberg, QNB analysis

We then expect a return to a more steady and gradual increase in interest rates, which is broadly consistent with market expectations (Chart 3). If central banks choose to raise interest rates more aggressively, then there is a substantial risk that they cause instability and volatility in financial markets.

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