Banc Ceannais na hÉireann
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Box B: QB 3 – July 2022

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Developments in Monetary Policy and the International Economic Outlook

By the Monetary Policy Division

The longer than expected nature of the global inflationary shock, exacerbated by the war, pre-existing supply chain issues and further lockdowns in some countries, are generating an erosion of disposable incomes and increases in production costs. This is starting to hit consumer and business confidence, while supply chain constraints and war-related disruptions continue to affect international trade. As a result, global growth is expected to slow down compared to pre-war forecasts, but the strong growth momentum coming out of the Covid-19 pandemic means that most economies are expected to be able to avoid a recession. [1]

In the first quarter of 2022, euro area seasonally adjusted GDP had increased by 0.6 per cent compared with the previous quarter (up from a 0.3 per cent increase in the fourth quarter of 2021), and by 5.4 per cent compared to the first quarter of 2021. Trade disruption, shortages of materials, and high energy and commodity prices that are stemming from the war are expected to continue to weigh on confidence and dampen growth, especially in the near term. This is reflected in the Eurosystem staff projections, which have revised down significantly the growth outlook for 2022 and 2023 and now foresee annual real GDP growth at 2.8 per cent in 2022, 2.1 per cent in 2023 and 2.1 per cent in 2024. In the US, GDP declined by 0.4 per cent quarter-on-quarter (a yearly increase of 3.5

[1] Compare, for instance, the IMF's World Economic Outlook released in April. Global GDP growth projections for 2022 and 2023 were revised down by 0.8 and 0.2 percentage points, respectively, to 3.6 per cent both years, compared to the January 2022 edition; this was mainly due to the effects of the war in Ukraine.

per cent, down from +5.5 in the previous quarter); this slowdown can be partly attributed to the effects of inflation (+8.3 per cent in April). UK GDP grew by 0.8 per cent in the first quarter.

In April 2022, the euro area seasonally adjusted unemployment rate was 6.8 per cent, stable compared to March and down from 8.2 in April 2021. US unemployment was at 3.6 per cent in April, while it stood at 3.7 per cent between January and March in the UK.

Euro area annual HICP inflation (according to a flash estimate) was 8.1 per cent in May 2022, significantly up from 7.4 in April, a new record high. Monthly inflation stood at 0.8 per cent. Although energy remains by far the most significant contributor to euro area inflation (standing at 39.2 per cent annually in May 2022), other components of inflation have seen significant increases and are all well above the ECB's 2 per cent medium-term inflation target, with strong and persistent month-on-month price increases for the last several months. HICP excluding energy rose by 4.6 per cent annually, up from 4.1 in April, while prices of food, alcohol and tobacco rose by 7.5 per cent in the year. Inflation in the US was 8.3 per cent in April (8.5 in March), while in the UK it rose to 9.0 per cent in April, up from 7.0 in March.

This widespread surge in inflation is leading all major central banks to normalise their monetary policy stance, which had reached unprecedented degrees of accommodation in response to the large negative shock of the Covid-19 pandemic.

In the US and the UK, monetary policy normalisation is well underway. At its June meeting, the Federal Open Market Committee (FOMC) of the US Federal Reserve decided to increase the target range for the Federal Funds Rate by 75 basis points to a range of 1.50 to 1.75 per cent, and signalled that ongoing increases in the range will be appropriate. This follows a 50 basis point rise at the previous meeting and is the largest increase in the policy rate in almost 30 years. The FOMC had also previously decided to start a process of reducing its holdings of Treasury securities and agency debt and agency mortgage-backed securities, beginning from June 2022. This will be done by adjusting reinvestments of maturing securities. For three months, the Federal Reserve will reinvest principal payments from Treasury securities exceeding a cap of $30bn and from agency debt and mortgage-backed securities exceeding $17.5bn (i.e., up to $30bn and $17.5bn respectively will not be reinvested); after the three months, these caps will be doubled.

In June, the Bank of England's Monetary Policy Committee (MPC) voted by a majority of 6-3 to increase the Bank Rate by a further 25 basis points to 1.25 per cent, after similar 25 basis points increases in the previous four meetings. Based on its assessment of the economic situation, the MPC judged that some further increases in the policy rate may be appropriate in the coming months. In light of its February 2022 decision to reduce the stock of UK government bond purchases, securities under the Asset Purchase Facility maturing in July will not be reinvested.

The current context of high inflationary pressures and a strong labour market underpin the normalisation of the ECB monetary policy, which was already highly accommodative pre-pandemic and was eased further in response to the pandemic. However, the ECB Governing Council (GC) reiterated that the high uncertainty characterising the current macroeconomic and geopolitical environment warrants a data-dependent, flexible and gradual approach to monetary policy normalisation. In particular, the Russian invasion of Ukraine has prolonged the energy-price shocks responsible for the largest component of euro area inflation, while post-pandemic supply-chain bottlenecks persist. These factors negatively affect consumer confidence, and are leading to a large deterioration in the euro area terms of trade.

At its June 2022 meeting, the GC concluded that the conditions which, according to its forward guidance, should be satisfied before it starts raising the key ECB interest rates, have been met. As a result, the GC decided to end net purchases under its asset purchase programme (APP) as of 1st July 2022 and announced that, in line with its policy sequencing, it intends to raise the key ECB interest rates by 25 basis points at its July monetary policy meeting.

The GC also communicated its expectation to raise rates again in September, possibly by a larger increment if the medium-term inflation outlook persists or deteriorates. Beyond September, the GC anticipated that a gradual but sustained path of further increases in interest rates will be appropriate.

After an ad-hoc meeting that took place on 15th June, the GC stated that the ECB would act against resurgent risks of fragmentation of its monetary policy as a result of market developments following the announcement of the end of net asset purchases. To ensure monetary policy transmits evenly across all euro area jurisdictions, the GC decided that it will apply flexibility in PEPP reinvestments, while also tasking Eurosystem committees to accelerate the completion of a new anti-fragmentation instrument.

The difference in approach and timing of policy actions between the ECB on one side, and some other central banks like the Federal Reserve and the Bank of England on the other, lies in the different nature of the inflationary shocks, as well as labour market dynamics and other macroeconomic developments across these different jurisdictions. Unlike in the US, the increase in euro area inflation in the past year was not mainly a result of a strong increase in demand internally, but rather a consequence of global factors. Partly as a consequence of unprecedented fiscal stimulus, consumer demand in the US is now well above pre-pandemic levels, creating demand-driven, domestic inflationary pressures. That is still not the case in the euro area, where apart from government expenditure, consumption and investment in the first quarter of 2022 remained below levels seen in the last quarter of 2019. Similarly, while the labour market has rebounded strongly, hours worked outside of the public sector remain below pre-pandemic levels in the euro area. In addition, the negative effects of the war in Ukraine on both inflation and growth are felt more strongly in euro area

economies, due to the high dependence of Member States on Russian energy imports and the larger economic links with Russia and Ukraine as a result of their proximity.

Figure 1: Components of inflation

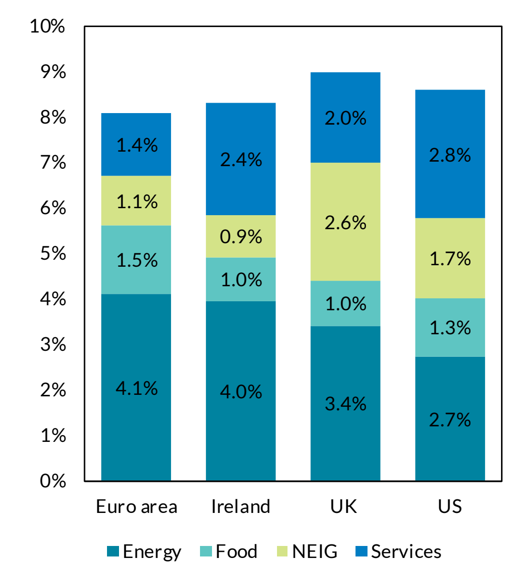
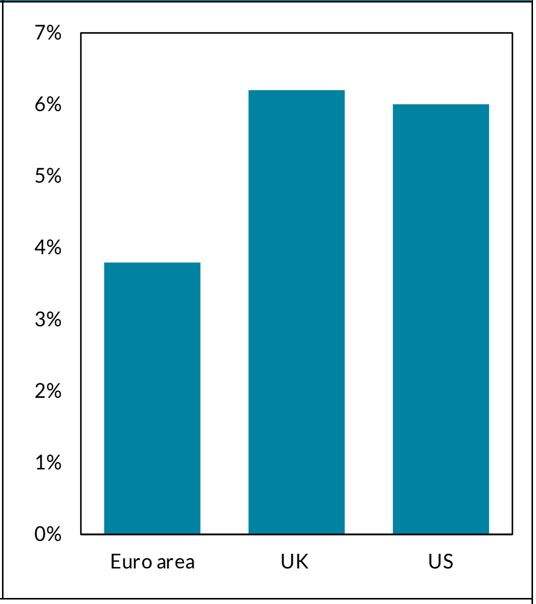


Figure 2: Core inflation



Source: Eurostat, CSO, ONS, BLS, and Central Bank calculations
Note: Inflation numbers refer to the flash estimate for May for euro area inflation, and April elsewhere. Core inflation excludes energy, food, alcohol and tobacco. NEIG stands for non-energy industrial goods.

The largest part of the rise in inflation in the euro area is due to imported energy, as well as food (where inflation is also in large part linked to the effects of the war), as shown in Figure 1. On the other hand, the US and UK have significantly less exposure to Russian energy, and their inflation was more demand-led, as can be seen from the larger components of inflation arising from services and non-energy industrial goods, particularly in the US. Nevertheless, core inflation in the euro area has risen to well above the ECB target of 2 per cent (See Figure 2), as firms hit by rising costs have been passing these costs through to consumers.

While euro area inflation is still mainly due to surging energy and food prices, inflation pressures have recently broadened and intensified, with prices for many goods and services increasing strongly. This is reflected by inflation projections being revised up again and significantly, with inflation now expected to remain undesirably elevated for some time.[2] At the same time, the higher price of energy (which in the euro area is mostly imported) effectively reduces households' disposable incomes and leads to a deterioration in the trade balance. As a result, consumption may weaken, and there is a risk of this leading to a slowdown in economic growth, calling for a careful approach to policy, in order to

[2] The Eurosystem staff projections released in June foresee annual inflation at 6.8 per cent in 2022, before it is projected to decline to 3.5 per cent in 2023 and 2.1 per cent in 2024 – significantly higher than in the March projections.

avoid the risk of amplifying these shocks and to assess the response of the economy to any policy change. Therefore, the GC has judged it to be appropriate to continue to normalise its policy and end its current expansionary stimulus, while maintaining a careful approach with flexibility and optionality to strike a balance with the headwinds facing the economy.