ECONOMIC VIEWPOINT

# Central Banks Are Clearly No Longer Comfortable with High Inflation

## More Interest Rate Hikes Are on the Horizon

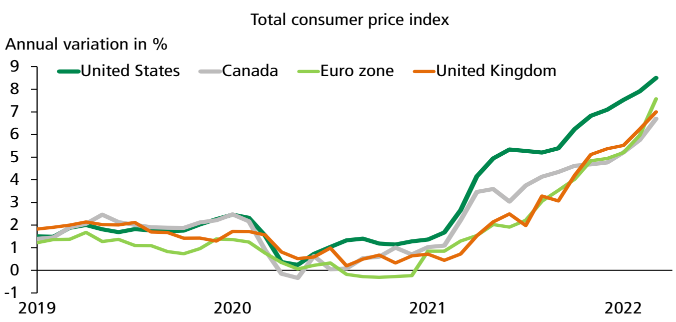
By Hendrix Vachon, Senior Economist

In an *Economic Viewpoint* earlier this year, we said raising interest rates isn't the best way to deal with supply shocks. At the time, we also had good reason to believe some of the ongoing supply issues would clear up this year, helping to bring down inflation. Unfortunately, that's looking less and less likely, and central banks now appear more willing to act forcefully. Continuing to hike interest rates won't fix our supply problems any faster, but it may slow demand growth and help anchor medium- and long-term inflation expectations. And while higher rates could hurt economic growth in the short term, in the long run it's better for central banks to meet their inflation targets.

### Inflation Forecasts Have Been Upgraded

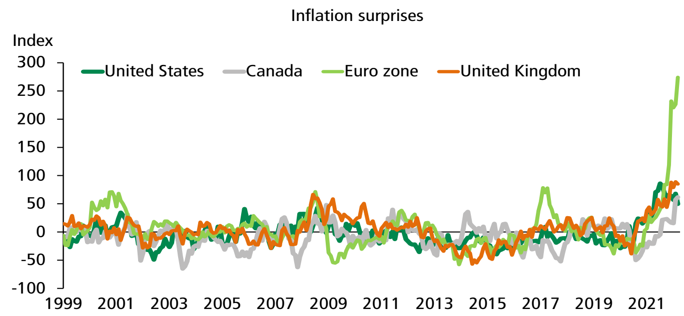
Inflation forecasts have been revised upward several times in recent quarters, and they could be upgraded again in the coming months. The most recent revisions were prompted in part by the war in Ukraine and other new supply shocks. Oil and natural gas prices have risen since the Russian invasion, as have the prices of some metals and agricultural products. The war has also created new global supply chain issues hitting the automotive industry and other sectors. Inflation is now above 6% in several countries (graph 1). In the eurozone where the war is having a more visible impact, recent price surges were much worse than expected (graph 2).

**GRAPH 1**
**Inflation continues to rise**




Sources: Datastream and Desjardins, Economic Studies

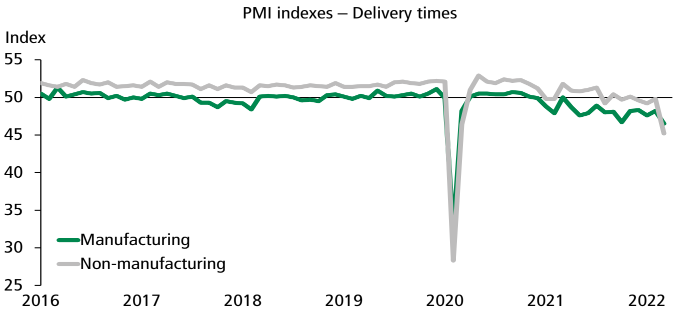
**GRAPH 2**
**Recent inflation readings have been especially eye-popping in the euro zone**




Sources: Citigroup, Datastream and Desjardins, Economic Studies

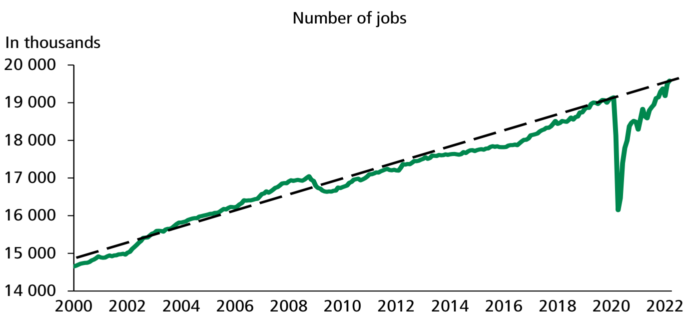
Then there's the pandemic, which isn't going away as hoped. With cases rising in many countries, we could see lockdowns or high employee absenteeism further disrupt production and global supply chains. China's zero-COVID policy with its strict lockdowns is especially worrying. In fact, recent indicators out of China point to even longer delivery times (graph 3 on page 2).

**GRAPH 3**
**Recent indicators out of China point to new supply chain challenges**



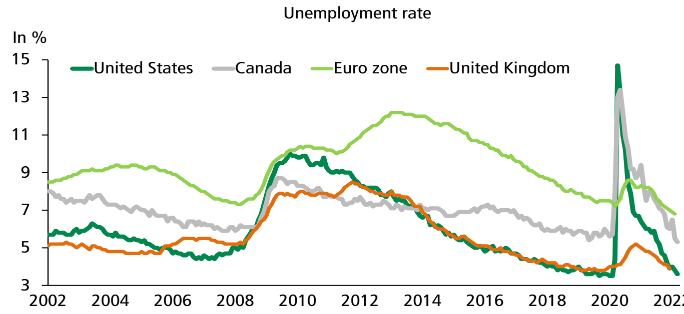

Sources: National Bureau of Statistics of China and Desjardins, Economic Studies

**GRAPH 4**
**Canada's employment rate is 2% higher than it was pre-pandemic and is back to its historical trend**



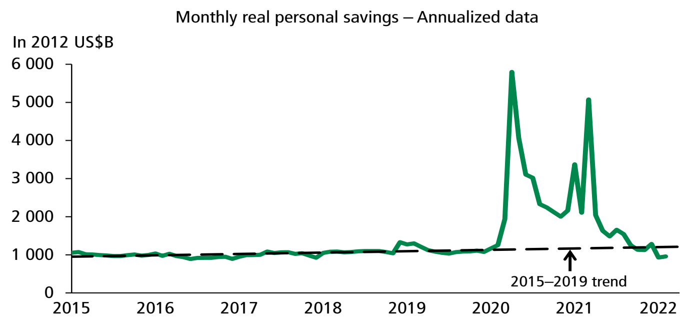

Sources: Datastream and Desjardins, Economic Studies

**GRAPH 5**
**Unemployment is down sharply**




Sources: Datastream and Desjardins, Economic Studies

**GRAPH 6**
**A lot of savings have been accumulated during the pandemic in the United States**




Sources: Bureau of Economic Analysis and Desjardins, Economic Studies

And we can't forget about demand, which is proving to be stronger than expected, especially in Canada where the Omicron wave had only a limited effect on real GDP despite tighter public health measures. The Canadian labour market has been remarkably resilient, which should continue to support consumer spending. In March, employment was about 2% higher than it was before the pandemic and had returned its historical trend (graph 4). Canada's unemployment rate is at a record low 5.3%. In many other countries, the unemployment rate is also down considerably in recent months, in most cases approaching or dipping below pre-pandemic levels (graph 5). Unemployment in the eurozone stands at 6.8%, the lowest level recorded since the common currency was established in 1998.

The excess savings accumulated during the pandemic could also stimulate demand (graph 6). Now that public health measures have been lifted and people are gradually returning to their normal lives, they may be tempted to spend more of that excess savings. This could overheat the economy and add further price pressure. Excess savings could also help consumers absorb higher prices. Consequently, high inflation could persist longer.

## Inflation Expectations Are Starting to Be a Concern

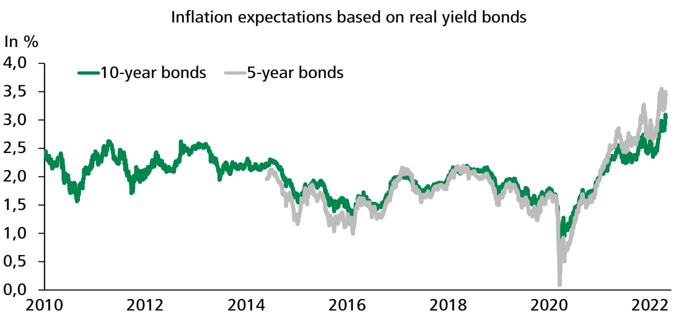
In addition to supply and demand issues, expectations could also become a major source of inflation. When individuals and businesses believe inflation will remain within the target range over the medium to long term, they're less likely to respond to short-term price fluctuations and trigger a price-wage spiral that keeps inflation high. On the other hand, if they grow accustomed to faster price increases and expect them to continue for years, high inflation could become entrenched and require more interest rate hikes to curb it. That's why central banks monitor inflation expectations closely, especially long-term expectations, which tell them whether expectations have become more durably unanchored.

In the United States as in many other countries, one-year inflation expectations are up (graph 7 on page 3). But five-year expectations are also trending higher, which could become a problem if it continues. The Federal Reserve Bank of New York publishes an estimate of 3-year inflation expectations—halfway between short- and long- term expectations. For several months now, it has shown high inflation expectations. We can also track inflation expectations by looking at the bond market. The

**GRAPH 7**
**Inflation expectations are on the rise in the United States**


* University of Michigan consumer sentiment index; ** Federal Reserve Bank of New York.
Sources: University of Michigan, Federal Reserve Bank of New York and Desjardins, Economic Studies

**GRAPH 8**
**Bond market inflation expectations remain on an upward trend**




Sources: Datastream and Desjardins, Economic Studies

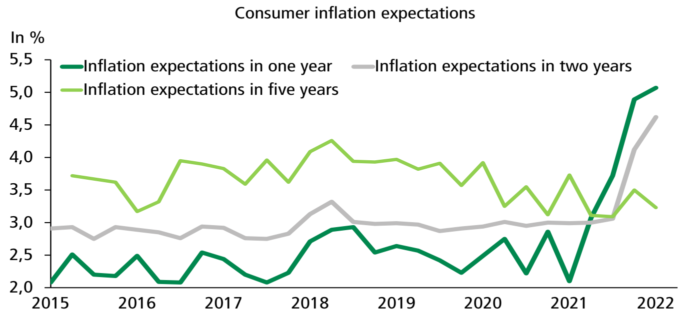
spread between nominal bond yields and real bond yields is used to estimate how much inflation the market expects. Once again, the numbers suggest expectations are on the rise in the United States (graph 8).

In Canada, a consumer survey conducted by the Bank of Canada (BoC) also shows an increase in short-term inflation expectations. Two-year expectations are up recently as well, but longer-term expectations remain under control (graph 9). There's also a business survey that provides interesting insights into the future course of inflation in Canada. Businesses expect wages to rise significantly, but generally believe they'll be able to pass on those higher costs to consumers (graph 10). That means inflation could be with us for a while. In a perfect world, wage increases would be largely offset by productivity gains rather than price increases.

## Wages Are Picking Up in the United States

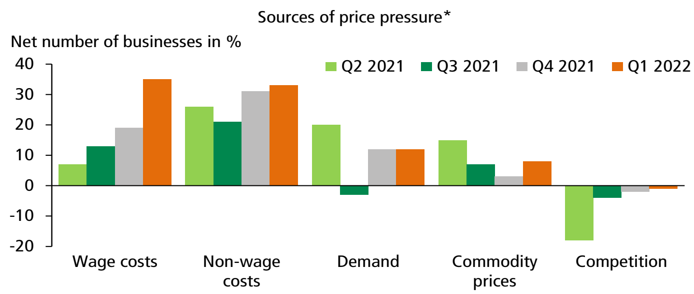
The worst-case scenario for central banks is when an initial spike in inflation leads to higher wages and other costs that trigger additional price increases. This is called an inflationary spiral. In a recent *Economic Viewpoint*, we said that the wage situation was more worrying in the United States. According to the Federal Reserve Bank of Atlanta, wages are growing more than 6% year over year and don't appear to be slowing down (graph 11). However, inflation isn't the only thing to blame for higher wages in the United States. Structural changes in the job market causing labour shortages are exacerbating the problem.

**GRAPH 9**
**In Canada, long-term inflation expectations remain well anchored, but not medium-term expectations**




Sources: Bank of Canada and Desjardins, Economic Studies

**GRAPH 10**
**More Canadian businesses intend to pass on rising costs to their clients**



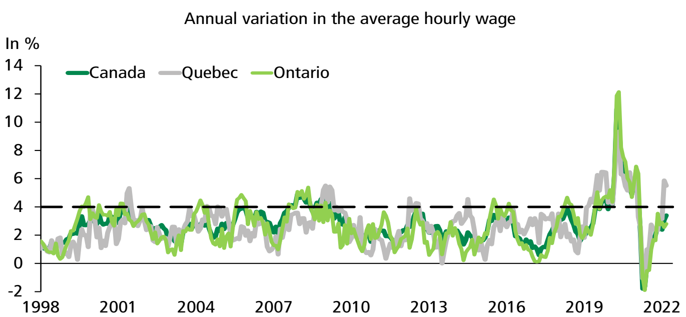

* Number of businesses reporting upward pressure on output prices minus the number reporting downward pressure.
Sources: Bank of Canada and Desjardins, Economic Studies

**GRAPH 11**
**Wages are growing fast in the United States**


Sources: Federal Reserve Bank of Atlanta and Desjardins, Economic Studies

Elsewhere in the world, wage data isn't as telling. Some countries have a bigger lag in their reporting, so it may just be a matter of time before they show the same uptrend. And inflation hasn't risen as fast everywhere. It has gone up slower in a number of European countries, which could explain why wages there haven't increased yet. Less severe labour shortages than in the United States could keep labour costs in check, however. But labour shortages are a major issue in Canada, and recent data shows annual average hourly wage growth approaching 4% (graph 12). Wages are already up more than 5% in Quebec.

**GRAPH 12**
**Wage growth is nearing 4% in Canada**




Sources: Datastream and Desjardins, Economic Studies

It's too early to say whether we've entered a wage-driven inflationary spiral, but the risk is real and needs to be monitored closely. The longer inflation hangs around, the more workers are likely to ask for pay raises to keep up with higher prices. As the food service, arts, tourism and other hard-hit industries during the pandemic fully reopen, labour shortages could get even worse.

## Central Banks Have Changed Their Tune

Persistent supply shocks, increasing demand, inflation expectations that could become unanchored, and wages that could fuel an inflationary spiral all have central banks on high alert. Many central banks have changed their tune and their monetary policy since the beginning of the year. There's now a greater sense of urgency to tighten monetary conditions.

The BoC was the first major central bank to hike interest rates by 50 basis points in this monetary tightening cycle. It raised the target for the overnight rate from 0.50% to 1.00% in mid-April. It typically raises rates 25 basis points at a time. During a meeting of central bankers at the International Monetary Fund (IMF) on April 21, the BoC Governor even opened the door to a steeper interest rate hike in June. The BoC also decided to trim its balance sheet by letting bonds mature and roll off. By the end of next year, the BoC could reduce its asset holdings by about a third.

The Bank of England (BoE) almost raised rates by 50 basis points in March. The Monetary Policy Committee vote was very tight. In the United States, the Federal Reserve (Fed) is signalling a 50-point hike in May and possibly another at the following meeting. Jerome Powell's March 21 remarks at a conference of the National Association for Business Economics (NABE) in particular got the market's attention. He cited the urgency of acting quickly. "[T]he risk is rising that an extended period of high inflation could push longer-term expectations uncomfortably higher, which underscores the need for the committee to move expeditiously […]."[1] Fed Vice-Chair Lael Brainard made similar remarks on April 5 while telegraphing a swift reduction of the Fed's balance sheet. "The Committee will continue tightening monetary policy methodically through a series of interest rate increases and by starting to reduce the balance sheet at a rapid pace as soon as our May meeting. Given that the recovery has been considerably stronger and faster than in the previous cycle, I expect the balance sheet to shrink considerably more rapidly than in the previous recovery."[2] At the recent IMF meeting of central bankers, comments from Jerome Powell reinforced the likelihood of a fast tightening.

The European Central Bank (ECB) hasn't started raising rates yet, but its messaging has shifted as inflation continues to surprise. In the meantime, the ECB continues to buy assets, unlike most other central banks. The Bank of Japan also continues its asset purchases, but inflation is much lower in Japan. It remains to be seen how long this will last. Producer prices continue to grow at a very fast pace in Japan, and the yen has depreciated by more than 10% since the beginning of March.

## We Now Expect Faster Interest Rate Hikes

In light of the deteriorating inflation picture and hawkish signals from central banks, we've upgraded our interest rate forecasts a few times over the past few months. We now expect the BoC to hike the overnight rate by 75 basis points at the beginning of June. Thereafter, two more hikes of 25 points should be add so the overnight rate could stand at 2.25% by the end of the summer. That would bring the main policy rate 50 points higher than it was at the end of the previous monetary tightening cycle.

In the United States, the upper range of the federal funds rate is expected to hit 2.75% by the end of the year, with two more hikes in early 2023 bringing it to 3.25%. While it raises rates, the Fed will also be trimming its balance sheet. More aggressive tightening in the United States would make sense given its higher inflation, tighter labour market, as well as with the greater risks for unanchored inflation expectations and inflationary spiral.

---

[1] Jerome POWELL, *Restoring Price Stability, 38th Annual Economic Policy Conference National Association for Business Economics*, Washington D.C., March 21, 2022.

[2] Lael BRAINARD, *Variation in the Inflation Experiences of Households, At the Spring 2022 Institute Research Conference, Opportunity and Inclusive Growth Institute, Federal Reserve Bank of Minneapolis*, Minnesota, April 5, 2022.

Meanwhile, we expect the ECB to raise interest rates at least twice by the end of the year, ending the negative interest rate policy it introduced in September 2014. It will probably add a few more hikes in early 2023. But that still wouldn't be enough to catch up with the BoE, which has already signalled it intends to raise its key rate to around 1.50%.

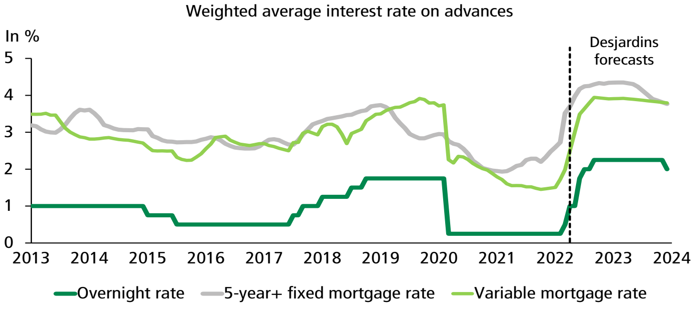
Monetary tightening won't address today's supply shocks, but it could slow demand growth and help keep inflation expectations well anchored in the long run. It remains to be seen whether that will be enough to bring inflation back near 2% by the end of next year. There is a lot of uncertainty. On the other hand, even partially absorbing some of the supply shocks over the coming quarters could help cool inflation. Central banks will not be dogmatic, and they will reassess their strategies as these shocks evolve.

## Economic Growth Could Slow in the Short Term

When central banks have fought against high inflation in the past, they've often slowed the economy so much that real GDP contracted and unemployment shot up. Although it's not our main scenario, the risk of recession increases with each additional interest rate hike. We've already downgraded our growth forecasts for the next few quarters and expect Canada's unemployment rate to edge up in 2023. If the economy moderates like this, we could even see an interest rate cut at the end of next year if inflation is under control. We've also downgraded our economic growth forecasts for a number of other countries.

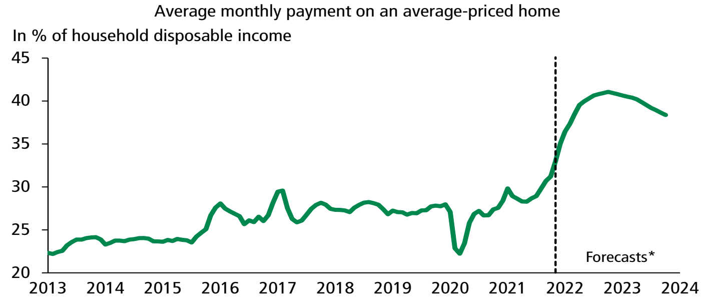
Canada's housing market is one reason we expect the BoC to raise interest rates fewer times than the Fed. Higher interest rates will significantly reduce affordability, putting home ownership further out of reach for first-time buyers. Mortgage rates will soon surpass their 2019 levels (graph 13). Assuming a stabilization in house prices, the forecasted increase in interest rates would add several hundred dollars to the monthly payment for an average house in Canada. At the start of 2023, the average monthly payment could exceed 40% of average household disposable income (graph 14). The deterioration would be even worse assuming higher interest rates, or if house prices continued to rise in the short term. However, home prices will likely begin to decline as interest rate hikes erode affordability. Smaller homes could also become more popular, helping to drive down the average sales price. The end of blind bidding could lower prices as well. Conversely, the housing shortage and strong immigration-driven demographic growth could buoy prices.

**GRAPH 13**
**Fixed mortgage rates have already jumped, while variable rates will track main monetary policy rate**




Sources: Bank of Canada and Desjardins, Economic Studies

**GRAPH 14**
**Monthly payments will increase significantly for new home buyers**



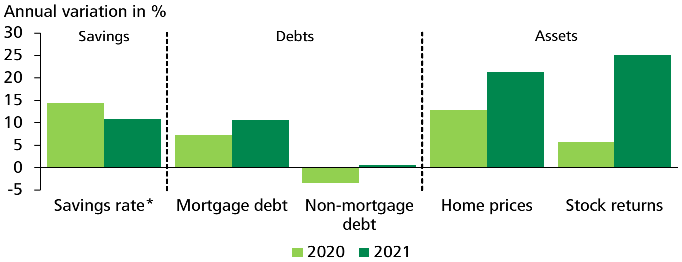

* Assuming the average property price remains constant, with a down payment of 20%.
Sources: Bank of Canada, Canadian Real Estate Association and Desjardins, Economic Studies

Financial market stability will also be put to the test. In recent years, ultra-accommodative monetary policy has inflated the value of a number of assets. A quick policy about-face may have the opposite effect. We could see continued stock market volatility and more modest gains in the coming months. There's also a risk of widespread financial instability. Financial markets don't perform as well when volatility is high. Businesses and financial institutions could find it harder to refinance, potentially leading to more bankruptcies. The negative fallout could be amplified by an increase in risk premia.

That said, there's going to be pain somewhere. Inflation will come down only if central banks can moderate the economy through a variety of channels, including the housing and financial markets. Nevertheless, some factors could also help households absorb higher interest rates. In many respects, household finances are in better shape since the start of the pandemic (graph 15 on page 6). Savings are up, some debt is down, and asset values are very high. BoC Deputy Governor Sharon Kozicki touched on this during her March 25 speech.[3] And like most commodity-producing economies, Canada stands to benefit from higher oil and other commodity prices. Even the United States could benefit from increased investment in the oil and gas sector.

[3] Sharon KOZICKI, *Household differences and why they matter*, *Federal Reserve Bank of San Francisco Macroeconomics and Monetary Policy Conference*, California, March 25, 2022.

**GRAPH 15**
**Household finances improved in Canada in 2021**




f: Desjardins forecasts; * Level in percentage.
Sources: Statistics Canada, Datastream, Canadian Real Estate Association and Desjardins, Economic Studies

## In the Long Run, Fighting Inflation Is Still the Best Approach

In an *Economic Viewpoint* about a year ago, we talked about the importance of keeping inflation low, stable and predictable—even if it increases the risk of a recession in the short term. The long-term benefits should outweigh. First, it protects the purchasing power of people whose wages don't rise at the same pace as prices. This is often the case for people living off their savings, including retirees and beneficiaries of social programs, many of which aren't indexed to inflation. And not all wage earners have the same bargaining power. Some workers could remain penalized in the long term. Low, stable, predictable inflation also makes it easier to see how prices for goods and services are changing and helps people make better spending and investment decisions. At the same time, low inflation encourages business investment by reducing the uncertainty associated with sharp price fluctuations. Interest rates tend to be lower over the long run when inflation is under control, which encourages investment. That's because interest rates don't reflect high inflation risk premia. Ultimately, economic growth should be stronger and more stable in the medium to long term if inflation is kept in check. Unemployment should also be lower.