ECONOMIC VIEWPOINT

More than a Year into Central Banks' Battle, Inflation Is Easing but Still a Concern

By Hendrix Vachon, Principal Economist

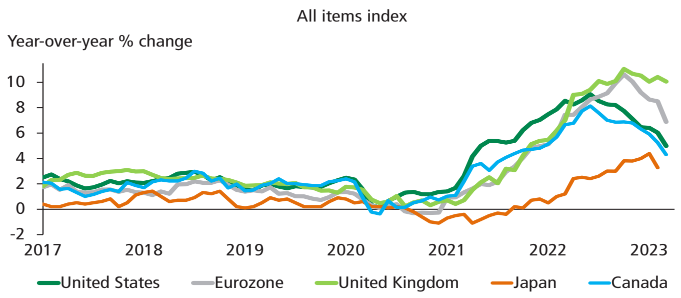
Inflation has been dominating the economic headlines for some time now, having forced central banks to take action and introduce substantial rate hikes. Although it's still too early to declare victory, the good news is that inflation has started to ease in most countries. So far, the improvement is mostly due to lower energy prices, however. To make a lasting return to low inflation, central banks still have more to do to curb demand. That means keeping interest rates where they are, or higher still, for several more months to come. That's not welcome news for borrowers, and it may seem counterintuitive that central banks are intentionally slowing the economy. But abandoning anti-inflation measures too early would have even more serious consequences.

Inflation Has Eased, but Not Enough

Over the past few months, it's been encouraging to see inflation start to fall in several countries (graph 1). In the US, it now stands at 5.0%, down from its June 2022 peak of 9.1%, and Canada's inflation rate recently fell to 4.3%, compared to 8.1% in June. 2022 saw inflation exceed 10% in many places in Europe. While the eurozone has since made good progress, with the inflation rate now standing at 6.9%, the same can't be said for the United Kingdom, where it's still hovering around 10%. Japan has the lowest rate of inflation at under 4%, although it's still above the official target of 2%.

Crucially, we've yet to see a broad-based decline in inflation across many goods and services. A sharp drop in energy prices has been the main contributor to the slowdown so far. Last June's inflation high in Canada and the United States coincided with the cyclical peak for oil prices, which were up more than 70% year-over-year at the time (graph 2 on page 2). Things have changed considerably since then, with oil prices now lower than they were a year ago, having a significant deflationary effect. The same thing happened with natural gas prices, which had spiked in Europe in particular, and the prices of some agricultural products have also come down (graph 3 on page 2). But at the end of the day, there's been little improvement in non-energy and non-food inflation in the US and the UK (graph 4 on page 2), and there still appears to be an upward trend in the eurozone and Japan. The situation is more encouraging in Canada.

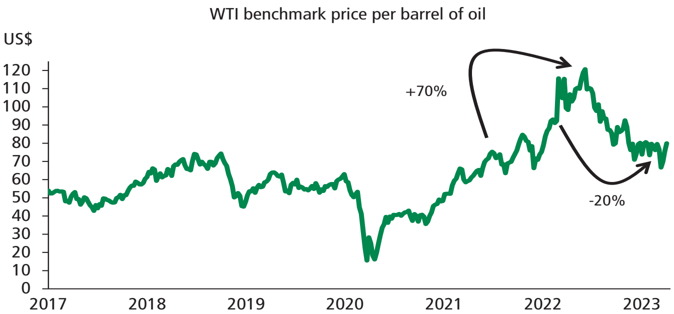
GRAPH 1
Inflation Is Falling in Several Economies



Sources: Datastream and Desjardins Economic Studies

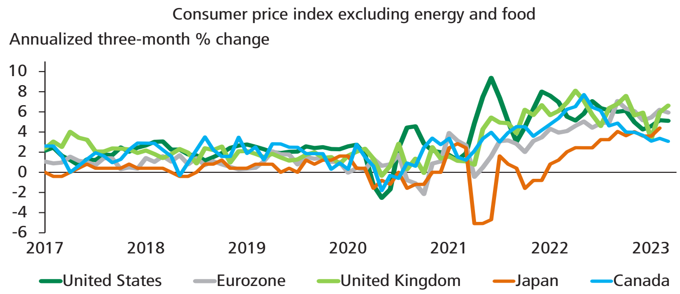
It bears mentioning that inflation is generally a measure of price changes over the span of a year, which can conceal some favourable trends. For example, prices might spike for a month or two and then stabilize, which wouldn't have an immediate impact on the one-year inflation rate. Canada has seen a considerable drop in three-month non-energy and non-food price changes (graph 5 on page 2). The US is also seeing a slight downward trend, whereas things look mostly stable in Europe. Prices are continuing to trend higher in Japan.

GRAPH 2
Lower Energy Prices Are a Major Contributor to the Decline in Inflation



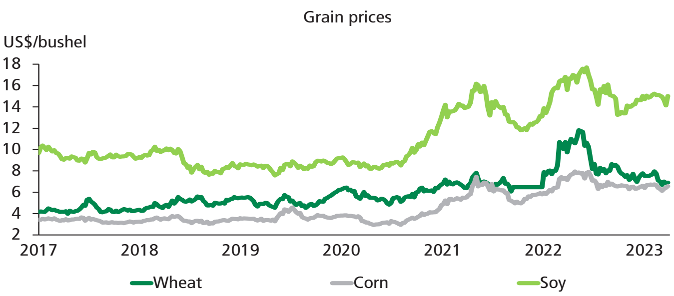
WTI: West Texas Intermediate
Sources: Datastream and Desjardins Economic Studies

GRAPH 5
Canada Is Faring Well in Recent Inflation Trends



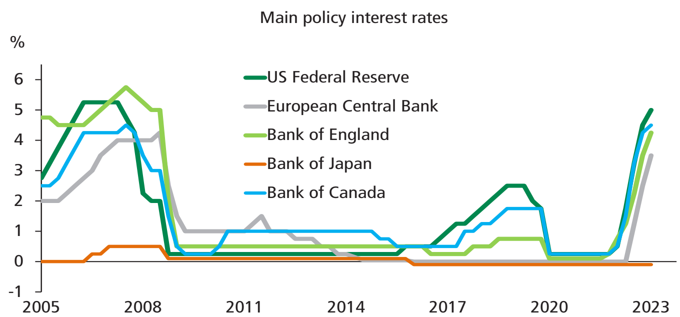
Sources: Datastream and Desjardins Economic Studies

GRAPH 3
Some Agricultural Product Prices Are Also Trending Back Down



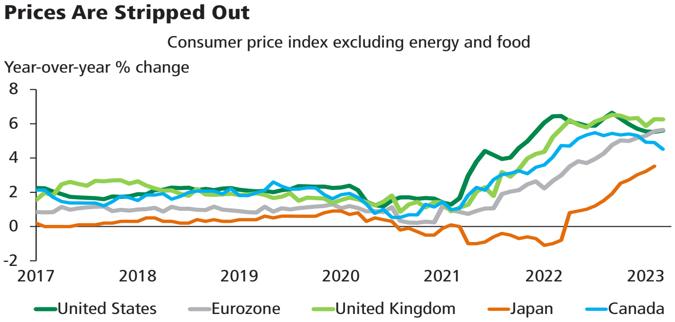
Sources: Datastream and Desjardins Economic Studies

GRAPH 6
Monetary Tightening Has Been Substantial



Sources: Datastream and Desjardins Economic Studies

GRAPH 4
Inflation Improvements Are Less Visible When Energy and Food Prices Are Stripped Out



Sources: Datastream and Desjardins Economic Studies

Interest Rate Hikes Are Designed to Curb Demand

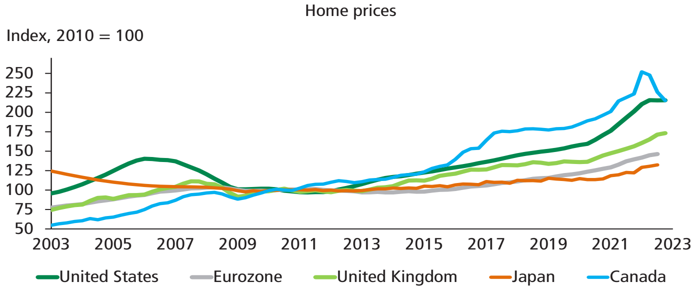
The past year has seen many central banks announce substantial policy rate hikes in an attempt to tackle inflation (graph 6). In Canada, the overnight rate has returned to its pre-2008/2009 financial crisis cyclical peak of 4.50%. In the US, the upper bound of the federal funds rate is currently sitting at 5.00%, just 25 basis points shy of its 2007 cyclical peak. The Bank of England's main policy rate is currently 4.25%, and the European Central Bank's is 3.50%. The Bank of Japan has yet to announce a rate hike. Having historically struggled with deflation, it's waiting to ensure that inflation is firmly in positive territory before taking any action.

By raising interest rates, central banks are attempting to curb demand, on the basis that a better balance between supply and demand will bring down inflation and keep it low. But it takes time for interest rate hikes to take full effect. So far they've mostly shown up in the housing market, which has slowed in several countries, including Canada, where home prices have fallen considerably (graph 7 on page 3). Otherwise, these past few months have seen many economic indicators remain strong (graph 8 on page 3). Europe in particular saw an upside surprise this winter, with warmer-than-usual weather helping to avoid an energy crisis despite supply disruptions due to the war in Ukraine.

The Labour Market Is Overheating Again

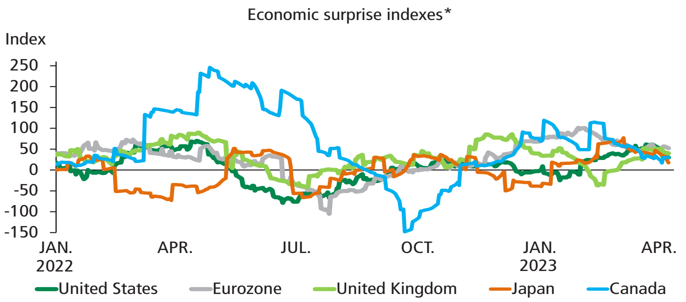
A strong labour market and the resulting pressure on wages are signs that demand is still too strong. The unemployment rate remains very low in many countries (graph 9 on page 3), and labour shortages are continuing to affect a lot of companies, which are struggling to keep up with demand. Wage growth remains well above the average for the previous

GRAPH 7
The Real Estate Market Has Slowed in Several Countries, including Canada



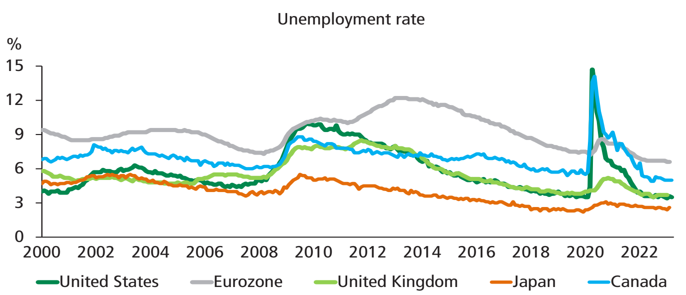
Sources: Bank for International Settlements and Desjardins Economic Studies

GRAPH 8
Economic Data Has Been Better than Expected in Recent Months



* A positive reading indicates that the economic data has exceeded expectations.
Sources: Citigroup, Datastream and Desjardins Economic Studies

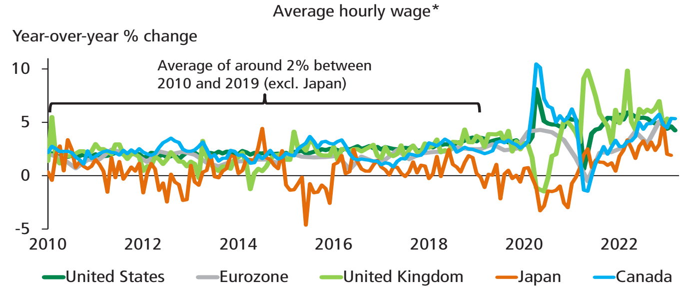
GRAPH 9
Labour Markets Remain Strong in Major Economies



Sources: Datastream and Desjardins Economic Studies

decade (graph 10). The average hourly wage is up more than 5% compared to last year in both Europe and Canada. In the United States, year-over-year wage growth has slowed to nearly 4%, but that still doesn't seem low enough to sustainably return to 2% target inflation.

GRAPH 10
Strong Wage Growth Is Not Conducive to a Lasting Return to Low Inflation

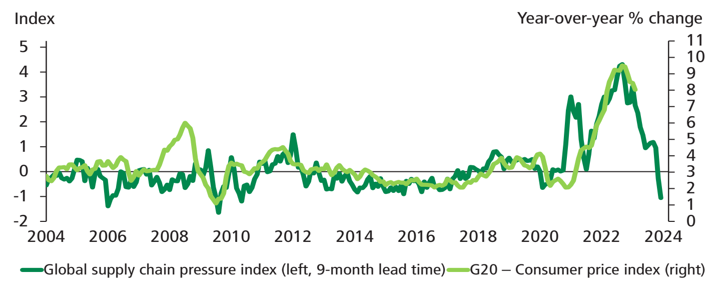


* Except for the United Kingdom (average weekly wage) and Japan (average monthly wage)
Sources: Datastream and Desjardins Economic Studies

A Supply-Side Boost

Luckily, some improvements on the supply side should give central banks a hand. During the pandemic, supply chain disruptions led to higher costs for companies and contributed to rising inflation. Now that these disruptions have mostly been resolved, it's reduced some costs for companies and should help to cool inflation (graph 11).

GRAPH 11
Improved Supply Chains Are Good News for Global Inflation



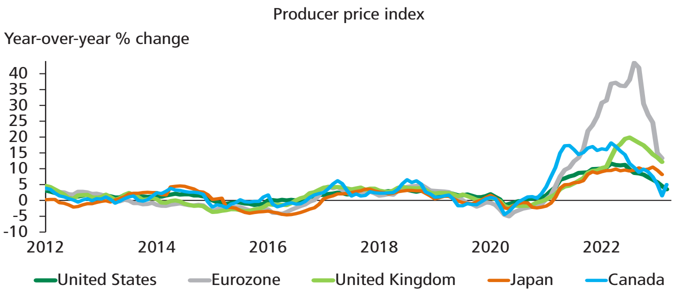
Sources: Federal Reserve Bank of New York, Organisation for Economic Co-operation and Development and Desjardins Economic Studies

Falling energy and other commodity prices are also bringing down some costs for companies and should help lead to a more broad-based decline in inflation. Producer price growth has already moderated considerably (graph 12 on page 4).

There are concerns that companies will instead take advantage of this to increase their profits. It's true that profits did grow considerably during the pandemic, as seen in data for publicly traded companies (graph 13 on page 4). But closer analysis shows that the phenomenon was mostly concentrated in the energy, commodities and IT sectors (graph 14 on page 4).

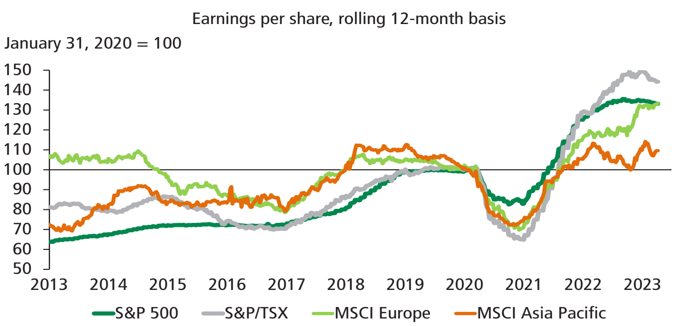
Between competition and central banks' efforts to slow demand, there should be incentive for companies to pass on their cost savings to consumers, at least in part. And while not all of their

GRAPH 12
Producer Price Growth Has Slowed Sharply



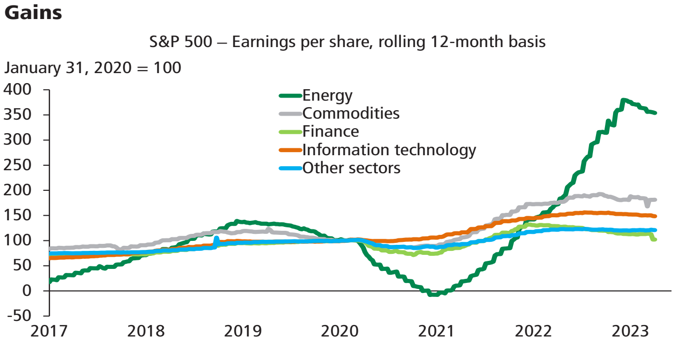
Sources: Datastream and Desjardins Economic Studies

GRAPH 13
Profits Surged during the Pandemic



Sources: I/B/E/S, Datastream and Desjardins Economic Studies

GRAPH 14
The Energy and Commodities Sectors Saw the Biggest Profit Gains



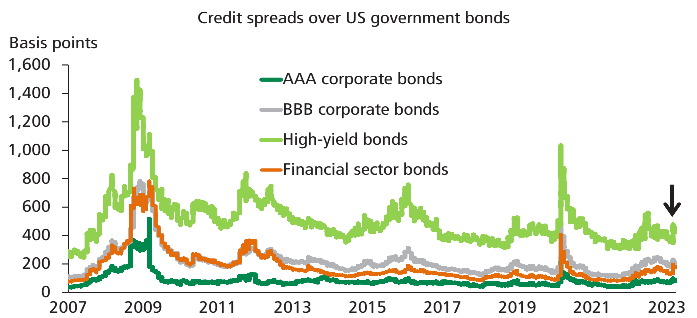
Sources: Datastream and Desjardins Economic Studies

costs are decreasing, lower average cost growth should still support lower consumer price growth. Some companies may also decide to take advantage of cost decreases to raise employee wages. Provided they're not accompanied by additional price increases, this shouldn't lead to a wage-price spiral.

Financial Tensions Could Also Help Temper Demand

Early March was marked by tensions in the banking system with the collapse of Silicon Valley Bank, among other incidents. It caused a number of analysts to reconsider whether central banks need to keep raising rates. That's because these tensions could help slow the economy by tightening credit conditions. Changes in credit spreads, which reflect the premiums demanded by investors to assume risk, can give us an idea of how much credit conditions are being tightened. Credit spreads did widen in March, but not substantially compared to historical data (graph 15).

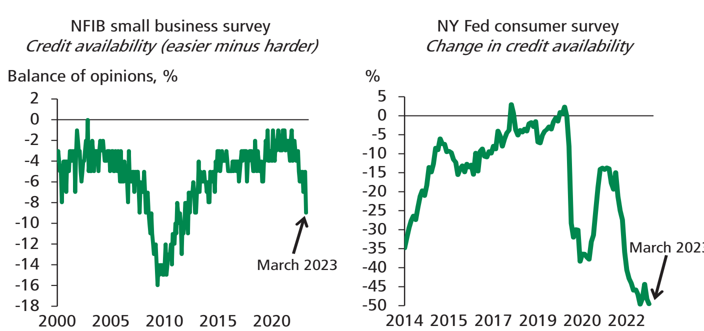
GRAPH 15
Credit Spreads Widened with US Banking System Stress in March



Sources: Datastream and Desjardins Economic Studies

But central banks will probably still want to tread more carefully, keeping upcoming rate hikes small or adopting a more gradual pace of monetary tightening. Investors may also remain cautious over the next few months, and credit conditions could quickly deteriorate. According to US lending data, there appears to have been some deterioration in March (graph 16). A more prudent approach wouldn't necessarily be at odds with central banks' objective of reining in inflation. If they do put an early end to their rate hikes, it will be because they have good reason to believe the economy has cooled enough to return inflation to target.

GRAPH 16
Access to Credit Appears More Difficult in the United States



Sources: National Federation of Independent Business, Federal Reserve Bank of New York and Desjardins Economic Studies

Why Not Just Forget the Inflation Target?

It might seem counterintuitive that central banks need to slow the economy to return inflation to target, which is around 2% in most countries. It's difficult to see how low unemployment or strong wage growth could be a bad thing. And everyone likely knows someone suffering from the recent interest rate hikes. But the situation would be even worse if central banks simply sat on their hands.

Inflation affects everyone—unequally, perhaps, but no one is immune. The biggest impact is the loss of purchasing power, and those whose incomes are increasing the least suffer most. Over time, consumer spending takes a hit, and less spending means fewer jobs. So really, who needs central banks to raise rates to slow down the economy and the labour market when inflation alone could manage it perfectly well? Not to mention that interest rates would probably end up rising anyway, even if central banks didn't intervene. Seeing inflation become entrenched, investors would demand higher interest rates to keep their savings from losing purchasing power over time. Medium- and long-term interest rates would be most affected, influenced by changes in the market's inflation expectations and uncertainty surrounding future price developments. Ultimately, higher interest rates would end up curbing lending and investment.

The ideal scenario is a return to low, stable inflation, where people's purchasing power will be protected and interest rates will be lower than they are right now. This will drive spending and investment.

Could Raising the Target Be a Solution?

Deciding where to set the inflation target is itself a complicated issue. Why 2% and not 3%? A less strict inflation target might make things easier for central banks. But there are a few things to consider.

First, raising the target while inflation is still high could send the wrong signal. What would stop central banks from simply moving the target again? It could create more uncertainty about future inflation, and likely send medium- and long-term interest rates higher.

Interest rates would likely rise anyway, even if central banks did convince us that they wouldn't touch their target again. It comes down to the difference between nominal and real interest rates. The interest rates you see posted everywhere are nominal interest rates. They correspond to the real interest rate plus the projected rate of inflation. If the inflation target were raised, future inflation would be higher than it used to be, which would push nominal interest rates up. So raising the inflation target wouldn't help borrowers get better rates on their loans. They might get a short period of relief, particularly if central banks appear more dovish over the short term and more geared toward economic growth, but the whole interest rate structure would just end up adjusting itself upward based on the new inflation target.

Historically, the main argument for raising the inflation target has been to give central banks more room to stimulate the economy, which is the opposite of what's happening right now. It was a hotly debated topic during the last decade, when inflation was running persistently below target. Many central banks kept interest rates very low for a long time in an attempt to raise inflation, without much success. The Bank of Japan and European Central Bank even adopted negative interest rate policies. In theory, if the inflation target were higher, central banks would have more room to lower real interest rates further in order to stimulate the economy. If the inflation target is 2% and the policy rate is 0%, that means a real rate of -2%. But if the inflation target were 3% with a policy rate of 0%, that would mean a real rate of -3%, which would do more to stimulate lending and investment.

Technical details aside, the main takeaway is that right now, central banks don't need more room to stimulate the economy. The issue at hand is how to slow the economy, and there's no limit to how high central banks can raise interest rates. It makes more sense to save the inflation target debate for the next time we're dealing with low inflation.

What Do the Next Few Months Have in Store?

In conclusion, there's no easy exit from our current situation. Tackling inflation requires slowing the economy in order to achieve a better balance between supply and demand. While there are positive supply-side developments limiting business cost growth, there's still a need for measures to curb demand. The good news is that we're starting to see inflation come down, and Canada seems to be better positioned than other major economies. The Bank of Canada has hit pause on further rate hikes, and we expect it to continue holding steady over the next few months if inflation continues to fall. Elsewhere in the world, rate hikes are expected to continue, but the worst of the monetary tightening seems to be over. By summer, several central banks may decide to pause their rate hikes if we see enough of an improvement in inflation. The risk of renewed financial stress is another factor at play.

The bad news is that the economic data is expected to deteriorate over the coming months, with the lagged effects of past interest rate hikes starting to show up. But without such a deterioration, inflation might not come down fast enough, forcing central banks to raise interest rates further.

We believe that a mild recession and a more balanced labour market will help bring inflation back down to between 2% and 3% in many countries by the end of 2023 or early 2024. If all goes well, that will mean interest rate cuts along the same timeline, paving the way for a new period of economic growth in the years to come. We don't, however, expect interest rates to return to their pre-pandemic average.