Following a raft of decisions recently from major central banks, finews.com talked with economist Stefan Gerlach about putting the puzzle pieces together.

The Swiss National Bank (SNB) raising its benchmark rate by 75 basis points on September 22 was a harbinger of things to come as central banks struggled to combat stubborn inflation. The European Central Bank, Federal Reserve, and Bank of England followed suit with rate hikes of equal magnitude. The question now is whether they have gone too far too fast.

To take stock of what the recent rate hikes portend, finews.com talked with EFG chief economist Stefan Gerlach. In his role as deputy governor of Ireland’s central bank between 2011 and 2015, he attended ECB governing council meetings, giving him insight into central bank policy workings. «As a central banker, you should not respond to inflation, you should respond to the factors that drive inflation,» and what the drivers are is more important than how inflation is measured, Gerlach says.
Stefan Gerlach: «The Fed is driving an interest rate Ferrari»
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Cost-Push vs Demand Pull

Currently, different factors are driving inflation in the US and Europe, and in looking at developments it comes down to the classic view between cost-push versus demand-pull inflation. In the US, it is a case of demand-led inflation stemming in part from the Biden administration stimulus plan which includes infrastructure spending.

Conversely, in Europe, inflation is being pushed higher by supply elements including energy prices, and the war in Ukraine disrupting the supply chain, among other factors.

For Gerlach, another major factor has to be considered in how central banks develop their inflation-fighting strategies. «The situation is very different across countries, and it matters how the housing market functions.»

Housing Market Considerations

Broadly speaking there are differences between the housing markets of major Anglo-Saxon nations and those of Switzerland and Germany, and that matters in a central bank's inflation-fighting approach. In the former, mortgages are quite commonplace, while in the latter, renting is much more prevalent. Moreover, in Switzerland with some 30 percent of prices administered, there is far less volatility in housing markets.

For now, the pinch from higher rates has yet to work its way through to the housing market. «It takes some time for rate hikes to be fully felt. House prices haven't started to tumble yet. But come spring I am worried that in some countries this will have a very severe impact on the housing market,» Gerlach says.

Supply Chain Pressures

Another driver of inflation has been the disruption of supply chains around the world, but something he sees that is waning and will be reducing supply bottlenecks. «There's good evidence that some of the supply chain issues are being resolved,» says.

Evidence for this can be seen in the global supply chain pressure index (GSCPI) from the New York Federal Reserve. Although the GSCPI increased moderately in October, that came after five consecutive months of easing. The year-to-date developments «suggest that global supply chain pressures are falling back in line with historical levels,» according to the NY Fed.
Have Banks Over-Tightened?

Gerlach says the ECB will have to do less tightening than the Fed in that scenario. Overall, «this period of massive interest rate increases may be slowing down and maybe even ending soon. Of course, this will vary across countries. Perhaps the UK and the euro area will end up not raising rates very much further,» he says.

This leaves the question of whether central banks have hiked rates too quickly. On one hand, it could be argued that starting a moderate series of rate hikes sooner would have avoided some of the current inflationary pressures. To be sure, the war in Ukraine was a big shock. Nevertheless, «looking back, they should have tightened monetary policy earlier. That is clear,» Gerlach says.

Fed Driving a Ferrari

Now it seems like central banks are overcompensating for that missed opportunity. Since beginning its series of rate hikes, the Fed has ratcheted up its benchmark rate by 375 basis points.

«375 basis points by the Fed is a little like taking your Ferrari, and you start driving 250 km/h. At that speed, plenty of things can happen even if the first minutes of the drive went fine.»

Inflation Winds

Now it remains to be seen when and if the series of rate hikes by various central banks start putting downward pressure on inflation and what that means for upcoming policy meetings. At the very least, some of the supply chain pressures are easing, and there are also reports predicting a slowdown in the real estate markets.

«I think the worst is behind us, and then we'll see if some central bank's over-tightened,» Gerlach said adding that «inflation will generally start falling off in January onwards, perhaps even December. It could fall quite precipitously in some countries,» he predicts.

«I think the risk of a recession for in the next year is pronounced because of these massive interest rate increases that we've seen in the US. They haven't worked their way through the economy yet.»

Recently Fed Chairman Jerome Powell along with other officials indicated they would prefer to
reduce the pace of interest rate hikes. Yesterday's consumer price index report might give them justification to do so. Consumer prices rose 7.7 percent in October, still comparatively high, slowing from 8.2 in September and the four-decade high in June of 9.1 percent.

«I think basically, we will see slower increases from now on. It would not surprise me if the Fed went for 50 basis points in December or even for 25 basis points if inflation moderates.»

It looks like the Fed might soon be able to start tapping the brakes on that Ferrari.

**Stefan Gerlach** is the chief economist at EFG Bank in Zurich. He served as deputy governor of the Central Bank of Ireland from 2011-2015 and attended the meetings of the ECB’s Governing Council. Before that, he was a professor of monetary economics and managing director of the Institute for Monetary and Financial Stability at Frankfurt’s Goethe University. He was also an external member of the Monetary Policy Committee of the Bank of Mauritius and a Member of the Monetary Experts Panel of the European Parliament’s Committee on Economic and Monetary Affairs. From 2005-2007 he served as secretary to the committee on the global financial system, chaired by vice-chairman Don Kohn of the Federal Reserve Board, at the BIS. From 2001-2004 he was the executive director and chief economist at the Hong Kong Monetary Authority and Director of the Hong Kong Institute for Monetary Research.