SALT INSIGHT

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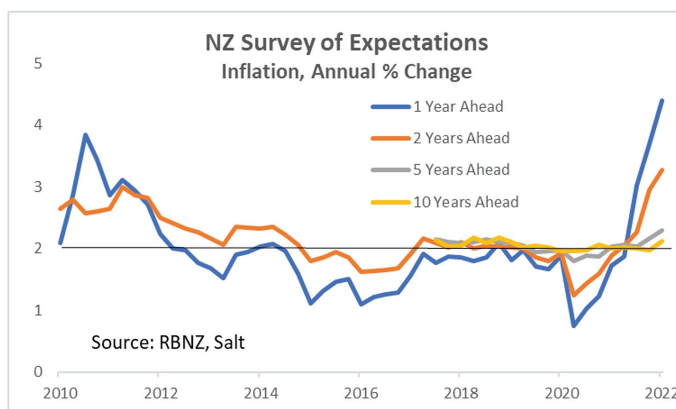
Central bank credibility and recession risk

Central banks value their credibility and guard it assiduously. Without credibility they are at risk of markets ignoring their economic and market prognostications and, more importantly, inflation expectations becoming "unanchored" from their mandated target, making it more difficult for said target to be achieved. Credibility is hard won and easily lost.

The Reserve Bank of New Zealand (RBNZ) will have felt a modicum of discomfort at the latest release of its own Survey of Expectations showing inflation expectations higher over all time periods. Near term expectations are usually heavily influenced by the current rate of inflation, but they will have taken more note of the move higher in the 5-year expectations. While they are unlikely to be losing much sleep over the 2.3% recorded for that timeframe, they wouldn't want to see it move too much higher.



Having persisted with the transitory inflation narrative for too long, most developed economy central banks find themselves behind the inflation curve and suffering, to varying degrees depending on the bank, a loss of credibility.

Yet at the same time, those same central banks continue to offer guidance of an only gradual withdrawal of monetary stimulus.

Having made one mistake, the level of fear of making another one is understandably high. Indeed, the dramatic flattening of the yield curve, particularly in the United States, points to market concerns that the US Federal Reserve is on the cusp of a second mistake by potentially tightening too aggressively and causing a recession.

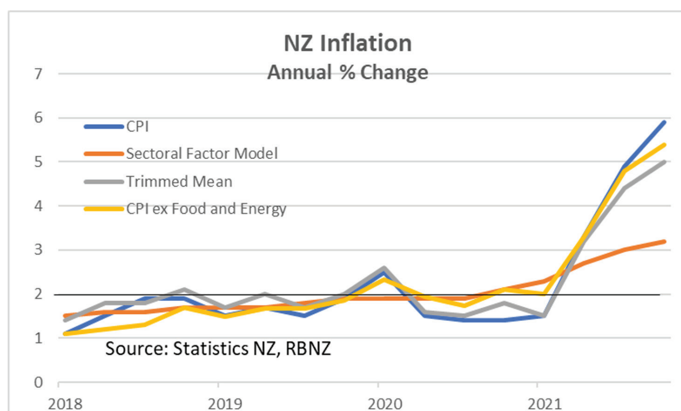
That seems to us to be a rather narrow perception of the risks now facing many central banks. There are, in our view, a couple of risks that banks should be wary of as they seek to convince us that they can rebuild shaken credibility by getting on top of inflation at the same time as engineering the much hoped-for "soft landing".

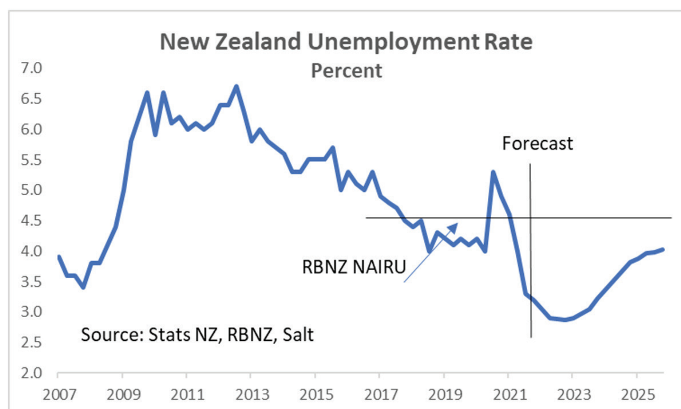
As well as tightening too fast causing a recession, tightening too slowly now risks inflation becoming more entrenched and interest rates needing to move higher and be there for longer, which would be equally, if not more disruptive to economic activity. labour market outcomes and asset markets.

The job ahead for central banks is thus a complicated one. They need to admit the mistake and articulate the plan to get on top of inflation at the same time as generating a soft landing for the economy. This is even more complicated given our expectation that growth was already likely to slow and CPI inflation likely to moderate this year, but that persistent core inflation would require ongoing withdrawal of stimulus.

The RBNZ, with two 25bp hikes in the can, is the most advanced (of the central banks we monitor closely) in the stimulus withdrawal process. They would have delivered three hikes if it hadn't been for the sudden move back into Covid lockdown the day before their August Monetary Policy Statement.

Even after those two hikes, New Zealand's Official Cash Rate (OCR), at 0.75%, is still 125bp lower than the assumed neutral rate of 2%, and thus still stimulatory. That's with headline inflation at 5.9%, all key measures of core inflation higher than 3%, the unemployment rate at an historical low of 3.2% and likely to head lower, and wage inflation accelerating.





Despite its earlier-than-most moves to withdraw stimulus, the RBNZ is still significantly behind the curve and has a lot of work to do.

They did warn us before they started the stimulus withdrawal that they intended taking a cautious approach given the Covid risks that were (and still are) ahead of us at the time.

In our view, Covid is not sufficient reason to be overly cautious. Sure, it's tough for many businesses right now, but that is not a problem for monetary policy – that's a problem for targeted fiscal support to solve. The RBNZ's sights must be firmly fixed on the inevitable recovery from the latest Covid wave and the likely exacerbation of supply and demand imbalances.

House prices are already softening and the RBNZ will be wary of contributing to a more precipitous decline. But we also need to put that concern in the context of the recent history of house price gains. We are expecting a cumulative 10% fall in house prices over the next two years. That would take house prices back to where they were in the middle of 2021. And the RBNZ has openly stated they believe house prices to be around 15% over-valued.

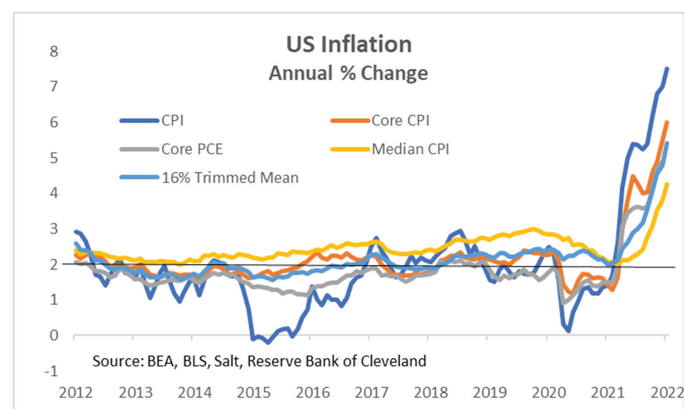
A nominal price decline on that scale, spread over two years, is less concerning to cash buyers and mortgage-free homeowners, in an environment of elevated broad inflation and wage gains. However, the cost of borrowing would also rise, cramping some mortgagors' ability to over-borrow against the security of a given property asset. Given high existing debt levels, having higher debt servicing costs but a stagnant investment would hurt activity.

When the considering the respective recession risks of going too fast, or not going fast enough, the path of likely least disruption seems to argue for a two-step interest-hiking process.

The first step of an adjustment cycle is not the time to be timid, especially with credibility already dented. This argues for a faster pace of tightening when the OCR is on the low side of neutral. Two 50bp hikes in short order (March Monetary Policy Statement and April Monetary Policy Review) would see us closing in on neutral.

Front-loading hikes seems to us to allow a more cautious and nuanced second step in the rate hiking process once neutral is reached. Most New Zealand forecasters, including the RBNZ, are forecasting a terminal rate higher than neutral – a replacement of stimulatory monetary policy with restrictive rates. Going harder now should reduce the amount of work the OCR might have to do post-neutral and may even result in an earlier easing of conditions back to neutral.

In the United States the Federal Open Market Committee has barely started. They have brought forward the conclusion of their asset purchase program but today are still printing money. The Fed funds rate is zero with the unemployment rate at just 4%, the annual rate of wage



growth (average hourly earnings) is 5.7%, CPI inflation is at 7.5% and all core measures of inflation are above target.

The President of the Federal Reserve of St. Louis and a current voting member on the FOMC, James Bullard, is arguing for a similar front-loading of interest rate increases. He has stated his preference for 100bp of Fed fund hikes by July. Given the meeting schedule between now and then, that would require one of those hikes to be 50bps. Markets are now pricing seven 25bp Fed fund hikes this year.

At the same time, our global equities partner, Morgan Stanley Investment Management, sees US recession risks as low. While that can change quickly, they are not currently on recession watch. There is a degree of over-heating in parts of the US economy, but key immediate triggers for recession are still absent.

Hiking faster now when there is a clear buffer to neutral and recession risks are low helps regain lost credibility. It also reduces the risk of super-sized hikes down the road which would ultimately prove more damaging to growth, jobs and asset markets.

Walking the tightrope of removing the excess monetary accommodation left behind from the pandemic shock, without triggering an adverse contraction in activity and negative asset price reaction will be delicate. However, it should be well advanced before the run-up to US Congressional Election in November threatens to introduce an unwelcome dose of politics into the decision-making process.

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