Wide Angle Shot: Central banks & inflation 1970s back? No, for real rates yes!

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At present, elements of economic and monetary policy conditions are reminiscent of the 1970s. However, a differentiated view is warranted; there are differences in economic structures and monetary policy compared to back then. However, for short-term real rates — despite ECB's policy turnaround — we will first end up in the deep negative range of the 1970s and then probably remain in negative territory.

Inflation: Made in Beijing, Moscow, Brussels or Frankfurt?

After the surprisingly strong — albeit turbulent — economic recovery from the pandemic, the next phase of weakness (even without a comprehensive gas embargo) beckons with the escalation of geopolitical tensions due to the Ukraine war. This is especially true for Western Europe. Here economic growth could be closer to one per cent in 2023. A noticeable **growth slowdown coupled with high inflation** (at least above the 6% mark inside the euro area this year) represents a delicate environment for ECB. Under normal circumstances, concerns about the economy are accompanied by inflation-dampening effects, so central banks ease monetary policy to support the business cycle. In the current environment of **pronounced inflation risks** ECB considers a certain normalisation of monetary policy or a less expansionary monetary policy to be appropriate despite downside risks to the economy. This is true even if **many inflation drivers** in **Western Europe** are clearly **supply-side driven.** Inflation is made in Beijing, Moscow or Brussels here, less so in Frankfurt. Nevertheless, vigilance is needed as **already** in the **course** of the **economic recovery** in the aftermath of the **Corona crisis inflation** has **proved more persistent** than previously assumed. Inflationary pressures in Europe are also increasingly broad-based and entrenched. **Core inflation** inside the euro area is running at 3%+ currently, the **highest level for years.** Overall inflation has already reached historic heights not seen for decades in Western Europe. Now the Ukraine war is threatening new trouble on the inflation front, a broad-based global price shock beyond the energy sector is looming. And on the other side of the Atlantic, there is already increasing discussion about whether the US **Fed has been too hesitant for too long**. Or in other words: Now Fed must aggressively tighten monetary policy. The idea of "letting the economy running hot" with inflation being elevated "only temporary" has failed miserably. For the **US Fed**, the **market** is currently **pricing** in a **discernibly restrictive key interest rate path** with the risk that Fed will first have to push up the key interest rate very high before easing it again somewhat.

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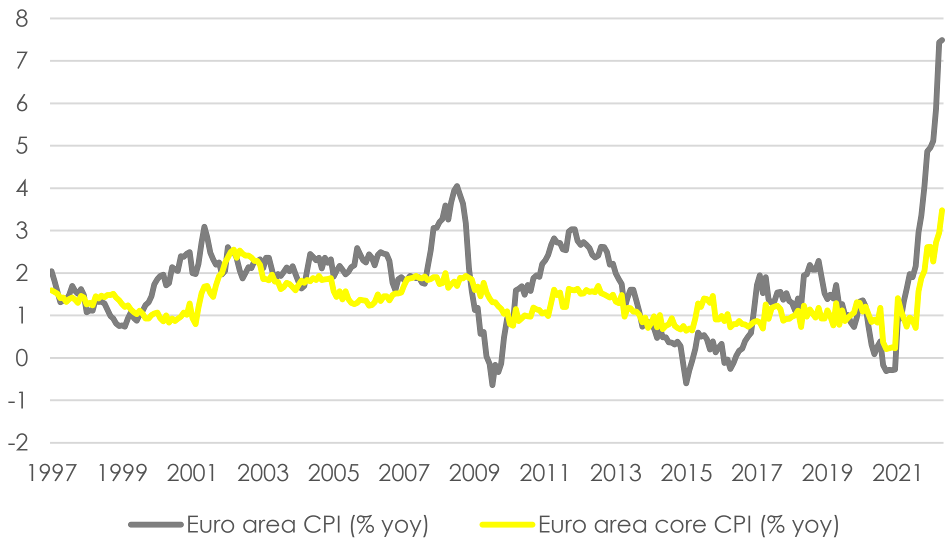
Euro area inflation: CPI (% yoy)



Eurostat, RBI/Raiffeisen Research

Inflation pricing well above 2%, inflation premium on capital markets

In light of the developments on the **USD money** and **bond markets** in recent weeks, it should come as no surprise that the **interest rate landscape** in **Europe by no means declined** in recent days and weeks as is **usual in times** of (geopolitical) crisis. This was only the case in an initial reaction to Russia's invasion of Ukraine. Back then the 10-year German government bond yield briefly fell back below the zero per cent mark. However, it was not long before the pre-war level was reached again, which was then even clearly exceeded. For the first time since 2014, the **10-year German government bond yield** is now once again **recognizably trading above one per cent**.

It is **short-** to **long-term inflation expectations** that have once again **increased significantly** on **financial markets** since the **beginning of** the **war** and thus boosted the euro area yield level into a new territory. Inflation expectations for the euro area priced on the financial market have **clearly exceeded** the **2 percent mark** and are thus at the **upper edge** of the **ECB's tolerance range** (and this also taking into account possible risk and/or liquidity premiums in this market segment). Currently, longer-term **inflation expectations on capital markets** are even **noticeably above medium-term inflation estimates** of the **economists surveyed** by the **ECB** (even though these have recently increased significantly and are also close to 2 %). In this respect, for the first time in years, there is a positive so-called **"inflation premium"** on European fixed income markets. In other words, the financial market expects significantly more inflation in the medium term than economists. Here inflation is expected to consolidate above ECB's target value. Not to forget that **ECB** has **prominently discussed** the **importance** of **inflation expectations** in its strategy adjustment process (see here). And the medium and longer-term inflation outlook should not be weighed down in the coming years by special factors that were formative in the 2010s inside the euro area (e.g. deleveraging in the private sector in some euro countries, very low inflation in Germany and internal devaluation in relation to this in some euro countries). **Sustained positive (nominal) yield levels** for benchmark interest rates in the euro area also show that **financial markets** are **now clearly expecting** a **monetary policy turnaround** by the **ECB** despite a muted outlook for economic growth.

The first step will be a **clearly communicated phasing out** of substantive **net bond purchases** and the **second step** will be **key interest rate hikes**. A hectic departure from this long-communicated guidance does not seem advisable; interest rate hikes are possible in July even with this guidance. A **reduction** of the **accumulated bond**

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holdings, as the US Federal Reserve intends, or even an **outright end** to the **regime of generous central bank liquidity**, on the other hand, are **not (yet) an immediate topic** at the **ECB** (especially since even the Fed will maintain a larger balance sheet in the future). We currently consider a **first ECB rate hike in Q3** likely, by the **end of the year** the **policy of negative ECB key rates** could be **more or less clearly ended** with two or three rate hikes. However, ECB will from our understanding subsequently **retain** the **necessary flexibility** to react to changes in the inflation outlook and to accelerate or decelerate monetary policy normalisation. It cannot be completely ruled out that ECB will at some point have to act as pragmatically as the US Fed did with regard to key interest rates. At the same time, the **exit** from the **ultra-expansive monetary policy** is much more **complicated** at the **ECB** than at the Fed. The ECB has **used many more unconventional monetary policy instruments** and **expanded its central bank balance sheet** (in relation to GDP in the euro area) **much more**. The latter, in combination with the (unresolved) **sovereign bond market fragmentation** inside the euro area, suggests a balanced approach to exiting the regime of ultra-expansionary monetary policy in Europe. We believe that ECB will allow itself some leeway to raise key interest rates, but at the same time will **keep** a **careful eye** on **liquidity** and **financing conditions** in terms of **bank lending** and on **credit** and **sovereign bond markets**. In this respect, a **renewal** of **long-term refinancing operations** can be expected in the coming years. Even a more **selective market-stabilising bond-buying programme** cannot be ruled out either (see a noteworthy speech by French central bank governor).

Euro area: Inflation pricing on financial markets (%)

Refinitiv, RBI/Raiffeisen Research

Focus on inflation expectations

In light of **stagflation risks** outlined above, parallels are being made — some of them prematurely — to the **1970s**. Especially since inflation rates in the USA and Europe are currently at their highest level since the end of the 1970s and the beginning of the 1980s. And back then, too, war-related energy price shocks stifled economic development and fueled inflation. At that time, **some central banks underestimated** the **inflationary shock** — something ECB is currently being accused of — or had less clear inflation fighting mandates than today. However, as a reminder, in the **USA** and **even** in **Germany** the **inflation rate** was **already above** the **average of 2%** in the **1960s**. While this mark was exceeded in Germany from early 1970 to 1984, the phase of elevated inflation in the US lasted as long as 20 years (from 1966 to 1986). Therefore, the **starting position** is somewhat **different today** coming from a low-flation regime. More importantly, we do **not think** that **leading central banks** like the Fed and the ECB will **simply repeat** the **mistakes** of the **1970s** and allow the **current price shock** to become permanently **embedded** in **people's** and **investor's minds** in the form of **higher**

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inflation expectations. Moreover, at present **monetary policy reaction functions** of major leading central banks **should not be reduced** to the **key interest rate policy** only. And with regard to the **scaling back** of **unconventional monetary policy measures**, the Fed in particular, but also the ECB, have proven to be quite flexible compared to expectations some months ago. The latter speaks in favour of a clear focus on the inflation fighting mandate.

Moreover, **in contrast** to the **time 50 years ago**, central banks currently have at **their disposal many more (market) signals** with regard to **inflation expectations**. This is especially true on the (international) financial market. And there are no signs of a de-anchoring here yet. However, vigilance is called for and, if necessary, we expect clear signals — and or U-turns, as we have already seen in part from the Fed and ECB. We do not think that the leading global central banks have invested decades in anchoring inflation expectations to now simply give away this macroeconomically and socially important advancement.

Differences between today and the 1970s

There are also some **moderating factors compared** to the **1970s**. For instance, the **structure of the economy** is different today than it was 50 years ago. The economy in the early 1970s was much more dominated by the industrial sector, which was used to accessing cheap and, above all, stable-priced oil. Today, however, the leading developed countries are certainly less dependent on crude oil prices and industrial sectors in general, which could imply lower growth losses and inflation spikes. Furthermore, the **oil price shock** is **currently** even more **moderate than in the mid and late 1970s**. Since then, entrepreneurs have had to learn to live with sharp price spikes, even if price spikes still hurt. In this respect, the current energy price shock is not the same as the energy price shock of yesteryear. Moreover, the **wage-setting process** has certainly changed permanently. Both the better understanding of price action on the labour side and the far more intense competitive situation on goods and labour markets reduced the extent of inflation-prolonging second-round effects or of upward price spirals. The importance of collectively agreed wages has also tended to decline in recent decades. Furthermore, **we enter** the **current phase** with **inflation expectations still well anchored** and moderate wage increases, especially in Europe.

However, there are also signs of **increasing (structural) price pressure** due to further shortages of other energy sources, more sustained price pressure in the agricultural sector, shortages to other input factors (industrial metals, fertilizers) and supply chain frictions. The latter being connected to the war in Ukraine and the state of economic warfare with Russia plus global supply chain strains. In this respect, **medium-term inflation risks** should not be underestimated, as we also express in our **euro area inflation forecast** for **2023**. Here we see inflation remaining well **above 3%** in 2023, Moreover, some structurally price-driving factors could possibly intensify in the coming years (e.g. aging population in the established economies) and new factors have been added (shift from maximally price-efficient to more robust supply chains, costs of climate policies or ESG-preferences). However, as mentioned above, we do not see the leading central banks and also the ECB as "inflation-blind". In this respect, not everything necessarily points to a one-to-one repetition of the inflation and stagflation scenario as in the 1970s.

Real interest rates back to the 1970s, then stuck in the 2010s?

In principle, the **ECB's looming monetary policy shift** (or phasing our of "permanent crisis policies") is both **appropriate** and **to be welcomed**. However, it is also true that despite the ECB's cautious turnaround in monetary policy this year and perhaps further interest rate hikes next year, **real interest rates** in the meaning of money market rates or **savings interest rates minus inflation** may **fall back** to the **level of the 1970s**. To

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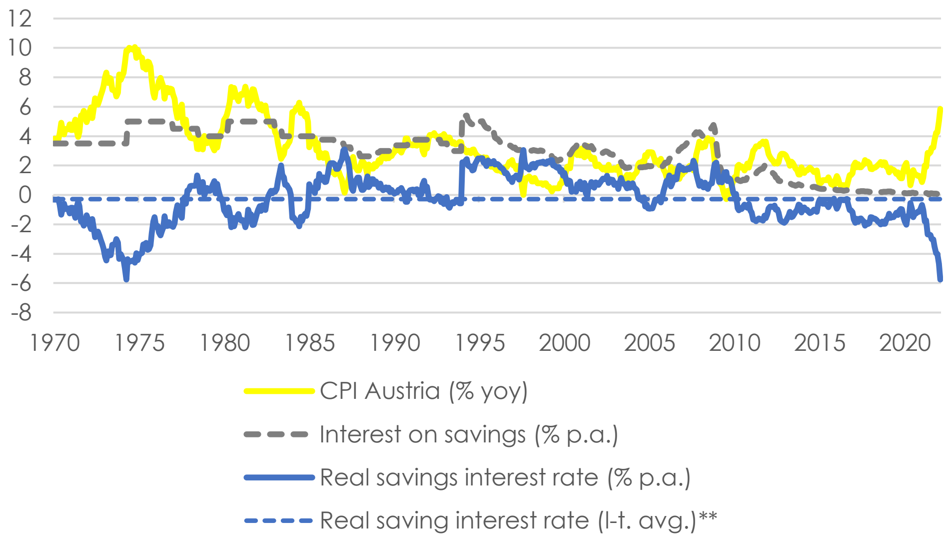
put it bluntly, we may not fall back into a 1970s scenario in macroeconomic terms, but for savers it may feel very similar. After the **likely inflation peak** in Europe in 2022 and 2023 with **deeply negative real interest rates**, we still do not expect real interest rates inside the euro area to inch well into positive territory and rather **anticipate an environment** as in **2009** to **2020** with **moderately negative real interest rates**. A return to positive real interest rates seems hardly possible in the euro area, where the scope for interest rate policy should be structurally more limited than in the USA.

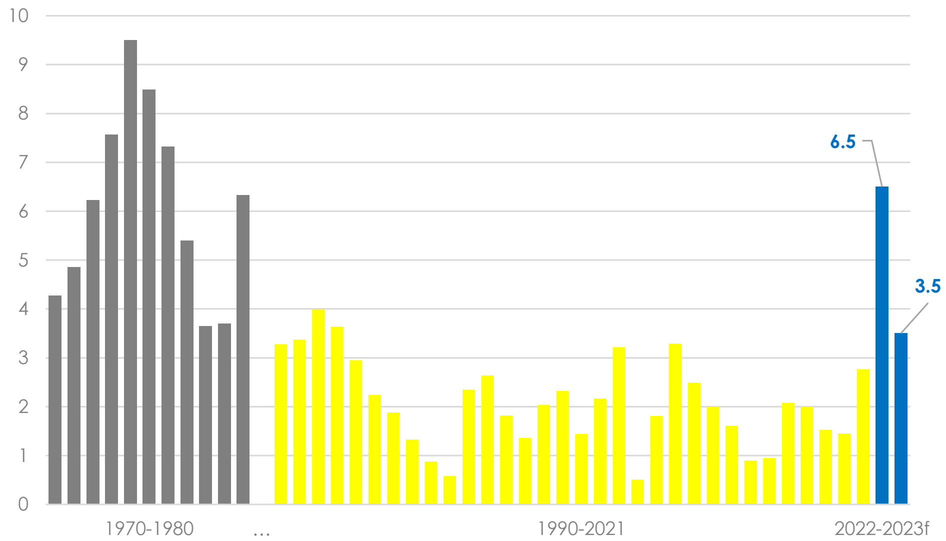
Real interest rates Austria: Actual and 1970ies*



Statistik Austria, OeNB, RBI/Raiffeisen Research

** Latest data point Feb 2022; ** long-term average real savings interest rate at -0.3%*

Long-term inflation rates Austria & forecast 2022/23



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