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OPINION

No more excuses — central bankers need to get back ahead of the curve

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Markets Insight

The ECB and BoE should not wait too long before easing their policy stance

Central banks have been traumatised by the great inflation crisis of 2021-22. The combination of unprecedented supply and demand shocks fuelled a once-in-a-generation surge in consumer prices, catching policymakers off guard.

Their models failed to capture the so-called structural breaks in real time. As a result, central bankers have lost confidence in their capacity to forecast inflation, and have become more data-dependent and backward-looking in their reaction function.

Central bankers need to take a bolder approach and trust their forward-leading indicators in order to avoid yet another policy mistake. In their defence, they are working in unfamiliar conditions — a new era, in which many old policy rules no longer apply and the slightest slip-up can provoke outsized financial market reactions that only further distort their operating environment.

But getting ahead of the curve would also help central bankers reduce the market's oversensitivity to their communication.

In Europe, the European Central Bank and the Bank of England should not wait too long before easing their policy stance. For all the concerns over the last mile of the disinflation process being the most difficult to close out, encouraging signs of normalisation in consumer prices and wages are accumulating.

This means central banks can start "dialling back their restrictive policy stance", as they politely put it, while keeping policy rates above the so-called neutral level during this last mile.

There is little evidence backing the hawks' view that the risk of cutting rates too early outweighs that of cutting rates too late. On the contrary, keep rates too high for too long, and central bankers risk jeopardising a still fragile and uneven economic recovery. The bigger risk we see is that by the time inflation has returned to more acceptable levels, the labour market — which is already slowing — may have weakened much more.

True, services inflation has remained sticky around elevated levels, slightly below 4 per cent in the Eurozone and 6 per cent in the UK, with little evidence of a quick drop in the near term. The drivers of this stickiness include strong fundamentals such as resilient consumption and a tight labour market, but also one-off effects that are unlikely to be repeated in the future. In the UK, the traditional price resets were stronger than expected in April, but leading indicators suggest inflationary pressures will ease going forward.

At the same time, we believe that the hawks' concerns over a wage-price spiral are misplaced. In the euro area, negotiated wage growth rose by a stronger than expected 4.7 per cent in the first quarter of this year. However, this was entirely driven by Germany, reflecting the delayed effect of recent wage deals catching up with higher inflation.

The rises included large bonuses and one-offs in specific sectors where real wage growth has been lagging for a long time. Once these inflation compensation effects fade, we expect wage growth to normalise.

Outside Germany, wage growth has been easing faster than expected. With inflation back near the 2 per cent target, future negotiated wages should continue to moderate because of implicit or explicit indexation to past inflation. Moreover, high frequency wage indicators as well as business surveys send a similarly encouraging signal.

In a blog published the same day as the first-quarter wage data, the ECB noted that its wage tracker using more timely data capturing the forward implications of pay deals was pointing to weaker momentum for the rest of the year.

In the UK, wage growth has remained firm but the labour market has been weakening recently, consistent with further normalisation later this year.

Last but not least, there are good reasons to be confident that domestic inflation will continue to normalise as corporate profit margins decline, in effect absorbing a large part of the increase in wages. Productivity growth has remained subdued so far, but a stronger cyclical recovery would also help mitigate any further rise in unit labour costs.

Overall, we believe that the disinflation process in Europe remains firmly on track. If central bankers can regain trust in their forward-leading indicators and support the recovery rather than postpone it, this should support the prospects for European fixed income and equities in the second half of this year.

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