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R&R Weekly Column
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Why It Will Be Difficult For Central Banks to Return Inflation To Their Targets

There is a lively debate over how long central banks will continue to increase their policy rates. Clearly lots of ground has been covered by the world's major central banks in order to rein in inflation, but there is the widespread expectation that more needs to be done to ensure that inflation will remain low, and as close as possible to their pre-pandemic and pre-war target levels. Let's look at the three major central banks, knowing well that other G10 central banks have followed and will continue to follow a similar pattern.

The US Federal Reserve has started its tightening cycle sooner than any other developed economy's central bank (though after some key emerging market central banks, which moved in anticipation of the Fed's decision in order to avoid a repetition of the "taper tantrum" of 2013-14). The Fed started to increase rates in March 2022, and has brought their Fed funds target range from 0-0.25% to 5.00-5.25%. This tightening cycle has had some effect, as both headline and core inflation have dropped, according to various gauges. For example CPI is now at 3.0% and core-CPI is at 4.8%. But as the labour market remains resilient and wage growth quite dynamic, the Fed has signalled that it intends to increase rates at least another couple of times before year end, with July being the first of such occasions.

The ECB started increasing rates later than the Fed and from a lower starting point, as the deposit rate was -0.5% at the beginning of the campaign. Now the deposit rate is at 3.5% and the ECB has already announced that it intends to hike rates again in July. With headline inflation at 5.5% and core inflation at 5.4 % the ECB will likely continue increasing rates into the autumn, and possibly winter. September remains a possible time for a rate increase.

The Bank of England continues to be in the most complicated situation, as inflation remains stubbornly high, a result not just of the Ukrainian war-induced energy shoc, but also of the self-inflicted Brexit, which now a large part of the population is regretting. Headline inflation is at 8.7% and core inflation 7.1%. In June, when headline inflation remained at 8.7% instead of falling to 8.4% as expected, the Bank of England decided to increase rates by 50bps instead of the 25bps anticipated by market participants. Now it's clear that the BoE will increase rates again in H2 2023, starting from August, and a cumulative increase of Bank Rate to 6% is almost certain by year-end.

So, all major central banks will increase rates further in coming months, and - after having reached their "terminal rates" - they will keep rates at a high level for a period of time longer than the market currently expects, just to make sure that they have finished the job of killing this sort of inflation, which has proven to be much stickier than was initially anticipated.

But the real question is: will central banks manage to bring inflation down to their original targets, on a sustained basis? Central banks can certainly temporarily bring inflation down, possibly to even below their targets, especially when base effects work in their favour. But in the medium term, inflation is likely to remain higher than initially thought, and certainly higher than pre-pandemic and pre-war levels, for the various reasons we have discussed on previous occasions (such as the tech and ecological transition, de-globalisation, the balkanisation of global supply chains, and the re-distribution of income from capital to labour). And so the question is whether central banks will make an extra effort to bring inflation down from 3-4% to their target of 2%.

We do not think it is the case that they will, as the price in terms of loss of output and increase in unemployment is too high for any central bank to bear, however independent they may be. Even if they are politically independent, central banks do not want to be responsible for adding further fuel to the electoral competitiveness of populist parties, which thrive from this combination of high inflation and sluggish growth.

This does not mean that central banks will ask for an upward revision of their inflation targets. Nor will governments rush to do so, as they do not want to be accused of having failed on their promise of reining in inflation. They will likely de-facto accept an above target inflation, patiently waiting for the system to adjust to the new price level and hoping that this will remain a one-off adjustment process, rather than a continued feature of the next few years.

Our Recent Publications

- *The Wagner Coup: What Happened And What To Expect Soon?, by London Politica, 13 July 2023*
- *The Impact of Prigozhin's Armed Rebellion On the Stability of Putin's Regime, by Marco Lucchin, 11 July 2023*
- *Central Banks Between Delusions And Certainties, by Filippo Ramigni, 27 June 2023*
- *Key Takeaways from Antony Blinken's Visit to China, by London Politica, 23 June 2023*

Looking Ahead

The Week Ahead: EZ And UK Headline Inflation Expected To Fall; Core Inflation To Rise In EZ, While Remaining The Same In the UK

In the US, in June, retail sales are expected to advance by 0.5% m-o-m (*p:* 0.3%) and IP is likely to stall (*p:* -0.2%)

In the EZ, in June, headline inflation is likely to ease off to 5.5% y-o-y (*p:* 6.1%), whereas core inflation is expected to increase to 5.4% y-o-y (*p:* 5.3%).

In the UK, in June, headline inflation is seen easing off to 8.2% y-o-y (*p:* 8.7%), whereas core inflation is expected to stay the same at 7.1% y-o-y. June's retail sales are expected to shrink by 1.5% y-o-y (*p:* -2.1%) and advance by 0.2% m-o-m (*p:* 0.3%). In July, Gfk Consumer Confidence is seen contracting by to -26 (*p:* -24).

The Quarter Ahead: China Reacts Angrily To a NATO Statement; NATO Summit In Vilnius And Ukraine; Spanish Elections

China promises a 'resolute response' to any NATO expansion in Asia. Beijing expressed strong dissatisfaction with a NATO statement that presents China as a significant obstacle to the security and interests of the military alliance, resulting in an angry response. The presence of four Asia-Pacific leaders at the NATO summit suggests that Ukraine is not the only major security issue. ***NATO summit was held in Vilnius.*** NATO summit declaration reports that 'Ukraine's future is in NATO'; however, the alliance declined to set a timeline for Ukrainian accession. In fact, Biden said war with Russia must end before NATO can consider membership for Ukraine. Zelenskyy reiterated that the best guarantees are for Ukraine to be in NATO.

Ahead of Spanish elections. The Spanish elections will be held on July 23 to elect the 15th Cortes Generales of the Kingdom of Spain. According to the polls, Spain's opposition conservative People's Party (PP) is ahead of the ruling Socialists (PSOE) of Prime Minister Pedro Sanchez. However, according to the PP falls short of obtaining a decisive majority.

Last Week's Review

Real Economy: US Inflation Eased Off; Inflation Fell In France And Italy, While Continued to Rise In Germany

In the US, in June, both headline and core inflation rates eased off to 3.0% y-o-y (*c:* 3.1%; *p:* 4.0%) and 4.8% y-o-y (*c:* 5.0%; *p:* 5.3%) respectively. The Michigan Consumer Sentiment edged up to 72.66 (*c:* 65.5; *p:* 64.4).

In the EZ, in May, IP contracted by 2.2% y-o-y (*c:* 0.2%; *p:* -1.2%). In July, ZEW Economic Sentiment Index shrank to -12.2 (*p:* -10).

Among the largest EZ economies, the headline inflation rate: *i)* increased to 6.4% y-o-y (*p:* 6.1%) in Germany as expected; *ii)* fell to 4.5% y-o-y (*c:* 4.5%; *p:* 5.1%) in France; and *iii)* decreased to 6.4% y-o-y (*c:* 6.8%; *p*: 7.6%) in Italy.

In the UK, in May, the unemployment rate edged down to 4.0 (*c:* 3.8%; *p:* 3.8%). May's IP shrank by 2.3% y-o-y (*c:* -2.3%; *p:* -1.6%).

Financial Markets: Stock Prices Increased; Yields Edged Down; Dollar Index Fell, While Oil And Gold Prices Rose

Market Drivers: In the US, stocks surged during the week due to positive investor response to data indicating a continued cooldown in inflation. The dollar index fell to a 16-month low and 10Y UST yields fell back below 4.0% on soft US inflation. European government bond yields fell also as investors perceive that the end of the policy tightening cycle is nearing.

Global Equities: Increased *w-o-w* (MSCI ACWI, +3.4%, to 696.22). The US S&P 500 index edged up (+2.4% w-o-w, to 4,505.42). In the EZ, share prices were up (Eurostoxx 50, +3.9% w-o-w, to 4,400.11). In EMs, equity prices moved up (MSCI EMs, +4.9%, to 1028.49). Volatility fell to 13.77 (VIX S&P 500, 52w avg.: 24.6; 10y avg.: 18.5).

Fixed Income: *w-o-*w, the 10-year US Treasury yields were down (-23 bps to 3.83%). The 2-year US Treasury yields decreased (-18 bps to 4.77%). The German 10-year bund yield edged down (-16 bps to 2.48%).

FX: *w-o-w,* the US Dollar Index decreased (DXY, -2.3%, to 99.96; EUR/USD -2.4%, to 1.1). In EMs, currencies increased (MSCI EM Currency Index, +1.6% w-o-w, to 1,704.94).

Commodities: *w-o-w,* oil prices increased (Brent, +1.4% to 79.63 USD/b). Gold prices rose w-o-w (+1.4% to 1,959.30 USD/Oz).

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The picture in the front page comes from this website

Abbreviations, Acronyms and Definitions

a	*Actual*	*LN*	*Northern League, Italy*
AKP	*Justice and Development Party, Turkey*	*M5S*	*Five Star Movement, Italy*
ann.	*annualized*	*m-o-m*	*Month-on-month*
ARS	*Argentinian Peso*	*mb*	*Million barrels*
avg.	*Average*	*mb/d*	*Million barrels per day*
bn	*Billion*	*MENA*	*Middle East and North Africa*
BoC	*Bank of Canada*	*MHP*	*Nationalist Movement Party, Turkey*
BoE	*Bank of England*	*mn*	*Million*
BoJ	*Bank of Japan*	*MPC*	*Monetary Policy Committee*
bpd	*Barrels per day*	*NAFTA*	*North-American Free Trade Agreement*
bps	*Basis points*	*NATO*	*North Atlantic Treaty Organization*
BS	*Balance sheet*	*OECD*	*Organization for Economic Cooperation and Development*
c	*Consensus*	*Opec*	*Organization of Petroleum Exporting Countries*
C/A	*Current account*	*p*	*Previous*
CB	*Central bank*	*P2P*	*Peer-to-peer*
CBB	*Central Bank of Bahrain*	*PBoC*	*People's Bank of China*
CBK	*Central Bank of Kuwait*	*PCE*	*Personal Consumption Expenditures*
CBT	*Central Bank of Turkey*	*PE*	*Price to earnings ratio*
CDU	*Christian Democratic Union, Germany*	*PM*	*Prime minister*
CNY	*Chinese Yuan*	*PMI*	*Purchasing managers' index*
CPI	*Consumer Price Index*	*pps*	*Percentage points*
DJIA	*Dow Jones Industrial Average Index*	*pw*	*Previous week*
DJEM	*Dow Jones Emerging Markets Index*	*QCB*	*Qatar Central Bank*
d-o-d	*Day-on-day*	*QAR*	*Qatari Riyal*
DXY	*US Dollar Index*	*QE*	*Quantitative easing*
EC	*European Commission*	*q-o-q*	*Quarter-on-quarter*
ECB	*European Central Bank*	*RE*	*Real estate*
ECJ	*European Court of Justice*	*RBA*	*Reserve Bank of Australia*
EIA	*US Energy Information Agency*	*RRR*	*Reserve Requirement Ratio*
EM	*Emerging Markets*	*RUB*	*Russian Rouble*
EP	*European Parliament*	*SWF*	*Sovereign Wealth Fund*
EPS	*Earnings per share*	*tn*	*Trillion*
EU	*European Union*	*TRY*	*Turkish Lira*
EUR	*Euro*	*UAE*	*United Arab Emirates*
EZ	*Eurozone*	*UK*	*United Kingdom*
Fed	*US Federal Reserve*	*US*	*United States*
FOMC	*US Federal Open Market Committee*	*USD*	*United States Dollar*
FRB	*US Federal Reserve Board*	*USD/b*	*USD per barrel*
FX	*Foreign exchange*	*UST*	*US Treasury bills/bonds*
FY	*Fiscal Year*	*VAT*	*Value added tax*
GCC	*Gulf Cooperation Council*	*VIX*	*Chicago Board Options Exchange Volatility Index*
GBP	*British pound*	*WTI*	*West Texas Intermediate*
GDP	*Gross domestic product*	*WTO*	*World Trade Organisation*
IMF	*International Monetary Fund*	*w*	*Week*
INR	*Indian Rupee*	*w-o-w*	*Week-on-week*
IPO	*Initial public offering*	*y*	*Year*
IRR	*Iranian Rial*	*y-o-y*	*Year-on-year*
JPY	*Japanese yen*	*y-t-d*	*Year-to-date*
k	thousand	*ZAR*	*South African Rand*
KSA	*Kingdom of Saudi Arabia*	*2y; 10y*	*2-year; 10-year*