

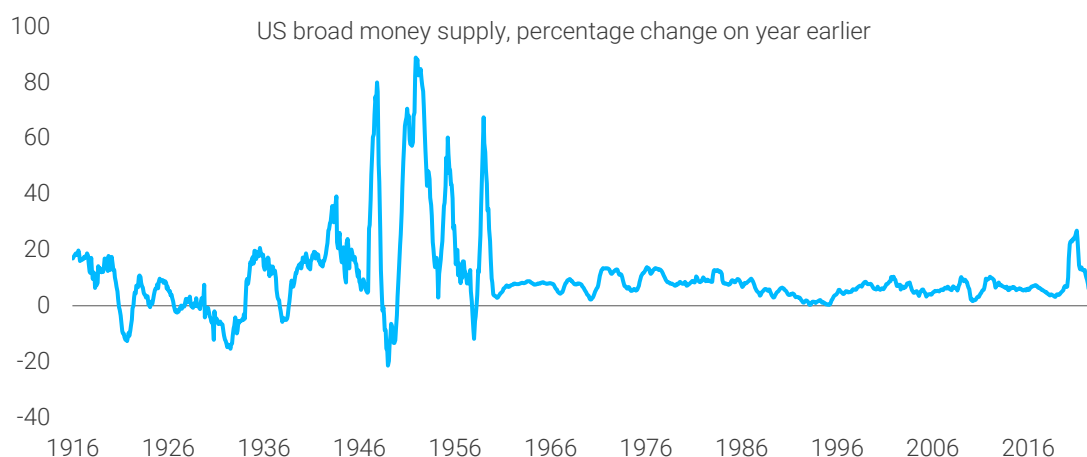
Macro Picture

HOW TIGHT IS MONETARY POLICY (REALLY)?

Dario Perkins

There are various ways to assess the stance of monetary policy. While none of these metrics is perfect, it is clear the authorities have delivered a powerful monetary tightening (regardless of the recent rebound in stocks). Central banks must find a way to maintain their squeeze, without compromising a potential soft landing or undoing what they have achieved so far.

Chart 1: The big monetary contraction (sort of)



Source: FRED, TS Lombard

MONETARY STANCE

There is a lot of confusion about the stance of global monetary policy. Central banks promised “pain” but economic growth looks resilient and risk assets have recently recovered. We assess various monetary metrics, including (i) real interest rates, (ii) model-based estimates of the policy stance, (iii) quantity metrics, (iv) broad financial conditions and (v) debt servicing ratios.

SILENT DESTRUCTION

While monetary conditions are restrictive, central banks can judge the appropriateness of their policies only based on their real economic effects. We find evidence of demand destruction, even if policy lags, temporary factors and a “silent recession” have concealed some of the effects in the aggregate data. The margins are fine, but policymakers could yet deliver a rare “soft landing”.

SKIPS, HIKES AND PAUSES

Central banks are desperate to pause their tightening cycles, so that they can better assess the impact of the policies without pushing their economies into recession. But they need to find a way to maintain their monetary squeeze without fuelling expectations of imminent rate cuts. In this context, talk of “skipping” rate hikes should be seen as a way to achieve “higher for longer”.

HOW TIGHT IS MONETARY POLICY (REALLY)?

Most of the major central banks (ex-Japan) have raised interest rates rapidly over the past 12 months, hitting levels that seemed unimaginable to many investors. Given the starting point, and how far inflation had broken above the authorities' targets, that first stage of rapid monetary tightening was easy to justify. Now, however, the situation is becoming more complicated. Central banks need to figure out whether they have raised rates enough to meet their statutory objectives, and this requires an understanding of their overall policy stance and how it compares with the past. While there is no simple way to measure the cumulative "tightness" of monetary policy, we assess a number of the most popular metrics: (i) real (inflation-adjusted) interest rates; (ii) model-based measures of the policy stance (i.e., a comparison with r^*); (iii) quantity-based metrics, such as lending standards, actual borrowing activity and bank "liquidity"; (iv) broad financial conditions; and (v) debt-servicing ratios. While investors tend to focus on market-based indicators such as financial conditions – which are sensitive to short-term equity moves – the authorities put more weight on broad credit conditions and debt-servicing ratios. On this basis, monetary policy is now restrictive and becoming a definite source of demand destruction.

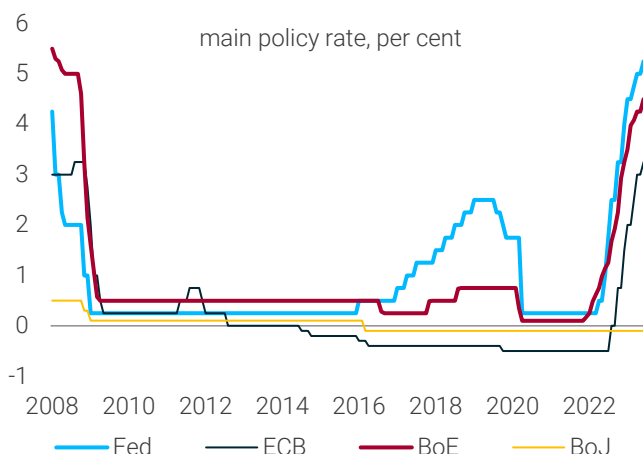
Of course, knowing monetary policy is "restrictive" is not the same as knowing monetary policy is "restrictive enough". Ultimately, central banks can make an assessment about the appropriateness of their policy stance only based on the observed impact of their actions on the economy. And, so far, the global economy has proved remarkably resilient in the face of rapid rate hikes – something that has surprised both the authorities and the majority of sellside economists (who, as a result, have repeatedly postponed their forecasts for impending recession). We think there are a number of reasons for this, including monetary policy lags, expectations of imminent rate cuts (which have drawn people back into housing markets) and the unwinding of temporary factors – especially the bullwhip recession in global manufacturing and the big squeeze from plunging real wages – that damaged economic activity in 2022 but are now starting to reverse. The important point, however, is that much of the demand destruction associated with recent monetary tightening has been "silent" – that is, it has not been evident in aggregate labour-market outcomes. Remarkably, central banks are destroying large numbers of jobs without putting anyone out of work. Since much of the post-pandemic "excess demand" was "unrealized" (in the form of large numbers of unfilled vacancies), central banks have – so far – managed to rebalance demand and supply without causing an overall decline in output or employment.

With monetary policy now unambiguously restrictive and likely to be a drag to global economic growth throughout the second half of the year, central banks are desperate to end their tightening cycles. A rate pause would give the authorities an opportunity to take stock of their actions, without compromising what seemed – not long ago – an improbable soft landing. The challenge for the authorities is to find a way to deliver this pause in monetary policy without financial markets anticipating an immediate reversal in interest rates (which would risk a resurgence in inflation). The latest buzzword in central-bank communication – the "skipping" of future rate hikes – should be seen in this context: it is a clever way to push market expectations towards "tighter for longer" monetary policy. Indeed, in practical terms, trying to convince investors that they are considering further rates hikes is probably the only way the authorities can credibly rule out imminent rate cuts. As the recent experiences of the Reserve Bank of Australia, the Bank of Canada, and the Bank of England highlight, this does not mean the global tightening cycle is now over. But it is clear we are entering a period of (Fed-led) greater pragmatism and gradualism from central banks. This is good news: officials have realized they might be able to achieve their objectives without inflicting too much pain on financial markets and the wider economy.

1. MONETARY STANCE

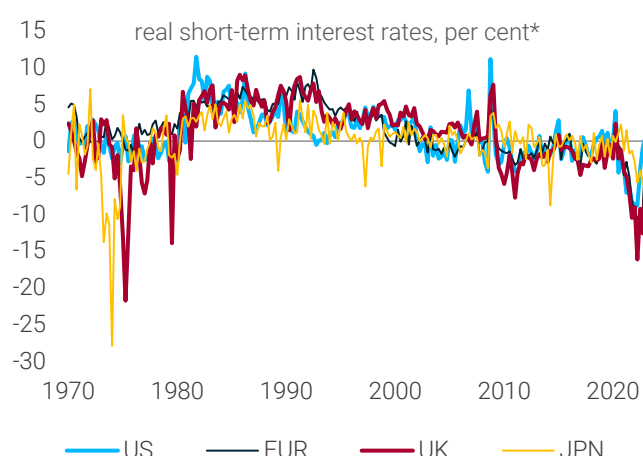
Back in the autumn, central banks were promising “pain” as they tightened monetary policy in an effort to force inflation lower. For a while, the repercussions were clearly being felt in financial markets, with stocks dropping sharply and [an overwhelming majority of investors predicting imminent recession](#). The mantra that had dominated central banks’ thinking in the decade after the financial crisis – “whatever it takes” – had apparently shifted to “whatever it breaks”, with the authorities signalling their unwavering commitment to restoring price stability. Yet, despite the fastest and most significant episode of monetary tightening in modern history, the pain inflicted on global markets – and the world economy at large – has not been as great as feared. Global equities have recovered, and the most hotly anticipated recession in history has not materialized (yet). These developments have left the majority of investors feeling confused. Why hasn’t 500bps of Fed hikes, and similar moves elsewhere delivered greater economic and financial destruction? Is monetary policy not as tight as it seems or are there other factors (such as policy lags and pent-up demand) that have kept the world economy afloat? These are crucial questions for investors as they try to assess the prospects for monetary policy and financial markets in H2.

Chart 2: Synchronized policy tightening



Source: Datastream

Chart 3: Real rates (backward-looking) are low



Source: Datastream, *deflated by quarterly (annualized) inflation rate

Where is the pain?

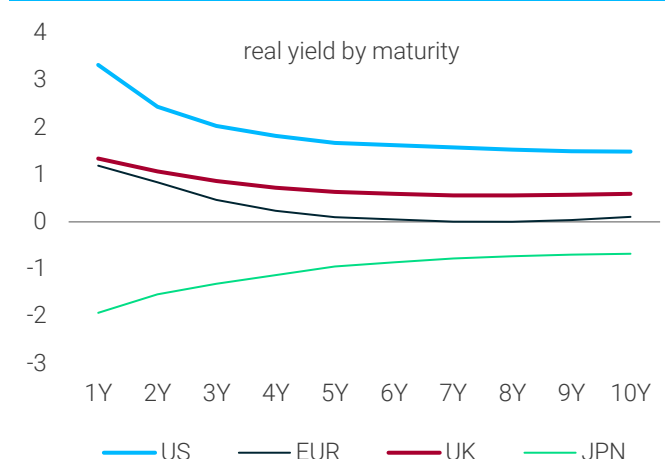
The Fed’s August 2022 Jackson Hole meeting was heralded as a watershed moment for modern monetary policy. In [an unusually short speech](#), Fed chair Jerome Powell issued a blunt warning about “pain for some households and businesses” as the authorities sought to get inflation back under control. By then, of course, global financial markets had already experienced a fair amount of anguish. Bond and equity values were down significantly and full year 2022 produced the worst combination of market returns in more than a century. As monetary authorities in other jurisdictions adopted similarly tough messages, it seemed something profound had changed in the relationship between central banks and financial markets. Their incentives were no longer aligned. Whereas previously policymakers had done everything they could to support asset prices as part of their effort to reflate their economies, central banks were now actively trying to squeeze the financial sector in order to reduce inflation. Not surprisingly, many pundits on Wall Street thought the pain was only just beginning: asset prices would remain under pressure and the global economy would eventually buckle.

Chart 4: Where is the “pain” from higher rates?



Source:

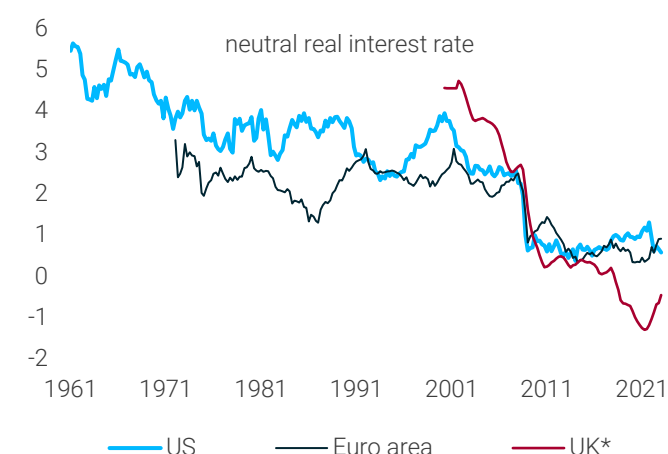
Chart 5: Forward-looking real rates are positive



Source: Bloomberg, TS Lombard estimates

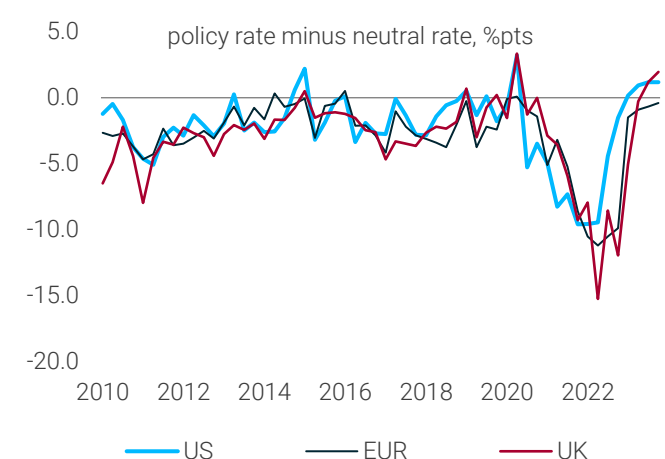
Yet, as Chart 4 shows, it hasn't quite worked out that way. Not only have US equities retraced all of the losses sustained during 2022, but other markets – especially in Europe – have, in fact, risen since their central banks started to ratchet up their policy aggression. While it is true that an increasingly narrow set of stocks has been responsible for the US rally (helped recently by [all the hype surrounding Artificial Intelligence](#)), it is clear that global risk assets have performed much better than the majority of investors expected. Meanwhile, the global economy has continued to defy consensus expectations of an imminent collapse. Despite weak manufacturing activity and a plunge in leading indicators, the continued resilience of services activity and labour markets has forced many economists to postpone their recession calls. Having spent six months discussing a global recession that has not yet materialized, there is a chance we will spend the second half of this year engaged in similarly futile activity – while stock markets continue to rally. So, what's going on? Isn't monetary policy as tight as it seems?

Chart 6: Neutral rates haven't changed since 2019



Source: NY Fed estimates, *Bloomberg, TS Lombard

Chart 7: Rates are now restrictive vs r^*



Source: NY Fed, TS Lombard

Assessing the monetary stance

One possible reason for the continued resilience of the global economy – and, by extension, the recent revival in risk assets – is that despite 400-500bps of rate hikes across developed markets,

monetary policy is not as contractionary as it seems. But this raises obvious questions about how we should measure the monetary stance. Should we focus on nominal rates or real rates?

Monetary “quantities” or the cost of borrowing? Debt-servicing ratios or broad financial conditions? Indeed, there are various possibilities, which we assess as follows:

- (i) **Real interest rates:** Decisions about whether to borrow or save must take account of inflation. Obviously, a 5% nominal interest rate is less of a constraint on the economy if inflation is, say, 7% (real interest rate: -2%) compared with a situation where inflation is 2% (real interest rate: +3%). If the price of the car you want to buy is increasing by 7% per year, why wouldn't you take out a loan with a 5% nominal borrowing cost? With YoY inflation still running higher than nominal policy rates across much of the DM world, there are plenty of commentators who believe monetary policy is “not as tight as it seems”. Yet it is important to remember that it is *expected inflation* that really matters, not the level of inflation that has prevailed for the previous 12 months. Headline inflation, usually expressed in YoY terms, can include powerful base effects, which should have no bearing on financial decisions that are being made today. (Similarly, contrary to what some pundits believe, any rise in measured real rates that comes from the unwinding of base effects is not a genuine shift in the monetary stance.) Given that medium-term inflation expectations have been stable during the recent episode of policy tightening, it is not true that higher inflation has offset central banks' action. Forward-looking real rates are mostly positive.

Implication: Monetary policy is now restrictive

- (ii) **Model-based estimates:** Central banks believe that it is not enough to take account of differences in inflation over time; we also need to assess real interest rates relative to some equilibrium level (r^*). Given differences in debt levels and the structure of the economy through time, a 2% real interest rate in 2023 will not have the same contractionary consequences as a 2% real interest rate had in the 1980s. The problem, of course, is that r^* is not directly observable, which means economists have to try to estimate it using sophisticated econometric models. But these models are not very reliable and include chunky confidence intervals. Worse, estimates of r^* tend to track the actual policy rate. If you are a policymaker setting interest rates in real time or an investor trying to anticipate future moves, it is not obvious that there is any value in these models of equilibrium interest rates. While Chart 7 shows a significant tightening in global monetary policy based on the most popular estimates of r^* , we think it would be foolish to put too much weight on this analysis. It is possible r^* has risen and economists' models will capture this only over time (if inflation stays high).

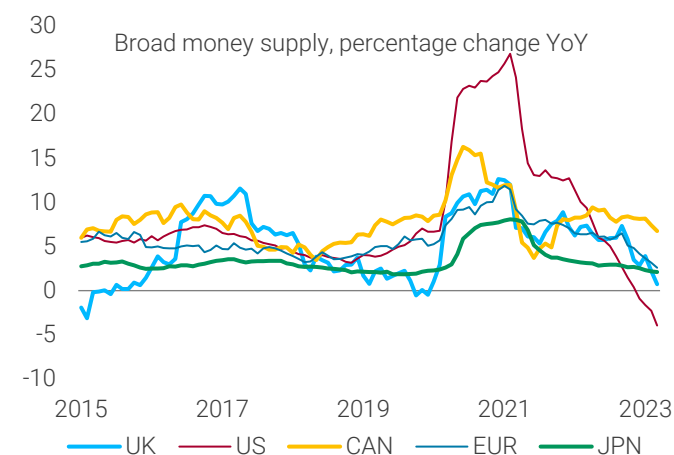
Implication: Monetary policy looks restrictive, but r^* may have risen

- (iii) **Quantities vs prices:** While mainstream economics focuses on interest rates, there are some economists who prefer to look at quantity-based measures of the policy stance – particularly trends in the money supply. These capture the real economy impact of monetary policy, not just the incentives that come from higher/lower interest rates. And credit provision is particularly important in such monetary analysis because credit is the counterpart of the money supply (when banks make a loan, which is an asset, they create a matching liability, namely, a deposit). Right now, of course, the flow of money (and bank lending) has turned decidedly negative across much of the developed world. In some economies, including the US, the money supply is, in fact, contracting, which is something rarely seen in the past (except in extreme circumstances). Because of the recent turmoil in the banking system, we are also seeing a further tightening in lending standards, which is likely to intensify the global monetary contraction in the months ahead. It is important to

remember, however, that the “stock” of money is still much higher than it was three years ago; and it is possible that the huge monetary injections that took place during the pandemic are still filtering through the economy, offsetting some of the negative “flow” effects. We see this most clearly in the US, where households have been running down “excess savings”. As with the recent tightening in lending standards, diminished excess savings could amplify the monetary squeeze.

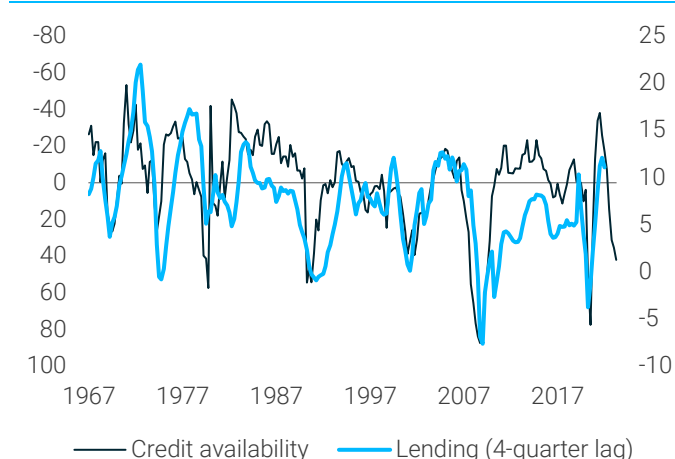
Implication: Monetary policy is highly restrictive and becoming more so

Chart 8: Monetary contraction in quantities



Source: OECD, national sources, TS Lombard

Chart 9: Recessionary contraction in credit?

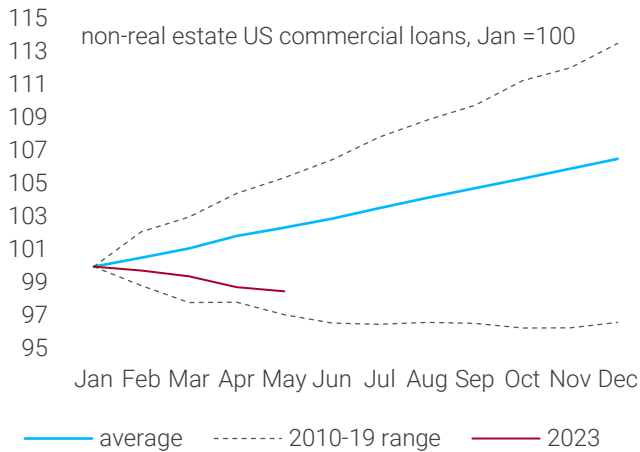


Source: ALFRED, FRED, TS Lombard

- (iv) **Liquidity effects:** Another offshoot of the “quantity approach”, it is always popular in financial markets to monitor trends in market “liquidity”, even if most of the time this concept is extremely fuzzy. When “liquidity” – whatever that means – is increasing, investors are said to be more willing to buy financial assets, which could alter the impact of monetary tightening. In practice, much of the debate about liquidity focuses on central banks’ balance sheets and their interaction with the plumbing of the banking sector. At the start of the year, for example, many investors were worried about the impact of QT, which, it was feared, would drain liquidity from the banking system and provide another layer of monetary tightening – beyond the impact of traditional rate hikes. But now consensus has shifted and an unexpected increase in liquidity has become an ex-post rationalization for the buoyancy of financial markets in H1. These claims are based largely on what has been happening in the US, where the debt ceiling encouraged the Treasury to reduce its account at the Fed (the TGA). As the Fed ran down its TGA, it added fresh reserves to the banking system. But this boost to liquidity is not going to last. Now that the debt ceiling has been raised, the US Treasury will need to rebuild its TGA, which will involve issuing bills and draining bank reserves. Many pundits are convinced this process will compound the impact of monetary tightening in H2, particularly with other central banks – notably the ECB – also set to reduce liquidity. Yet, central banks are aware of these risks and will respond quickly to signs of stress.

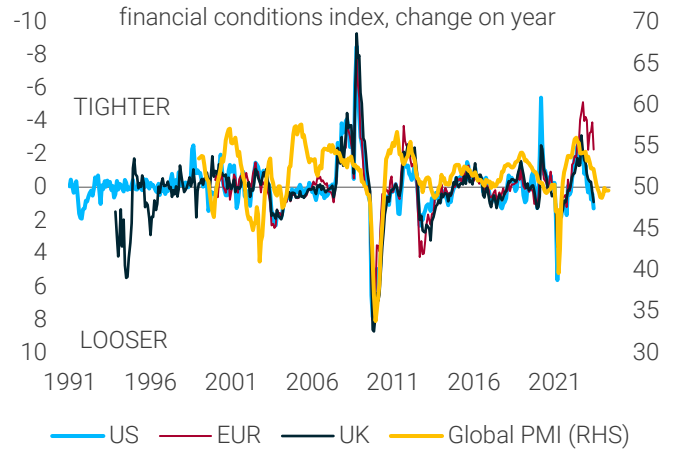
Implication: Something to watch, but unlikely to alter the monetary stance

Chart 10: Bank lending is in decline



Source: Federal Reserve, TS Lombard

Chart 11: Financial conditions have eased

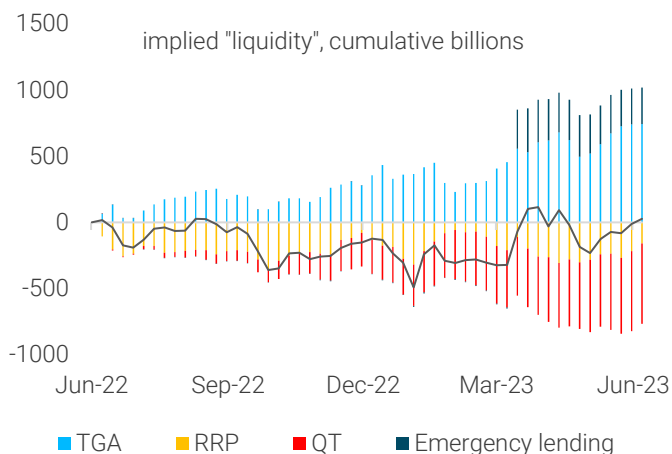


Source: Bloomberg, TS Lombard

- (v) **Broad financial conditions:** We dislike the liquidity concept because it is often little more than an ex-post rationalization for unanticipated market developments. Sellside strategists who failed to anticipate the market rally, for example, tend to blame liquidity rather than acknowledge that the financial system is elastic and true liquidity is endogenous to other forces, such as risk appetite and market sentiment. Meanwhile, we are not convinced there is a causal relationship between central banks' balance sheets and asset prices, beyond what the former implies about long-term interest rates. But an alternative way to capture the interaction between monetary policy and financial markets is to look at financial conditions more directly, with a range of proxies available from public and private research institutions. Chart 11, based on the popular Goldman Sachs indices, shows that broad financial conditions have eased over the past nine months. Taken at face value, this might suggest that financial markets have undone some of the policy tightening that has come from central banks raising interest rates. Perhaps monetary policy is now looser, not tighter! The problem with these indices is that they are somewhat selective in what they include. Does it make sense to put such a large weight on equities but exclude house prices? Or to include spreads but ignore the overall cost of borrowing? We are sceptical.

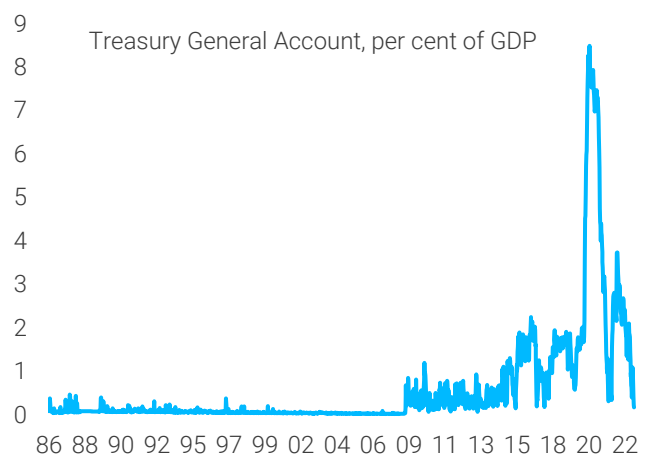
Implication: Monetary policy is not as tight as it seems (but treat with caution!)

Chart 12: TGA drawdown offsetting QT impact?



Source: Federal Reserve, TS Lombard

Chart 13: Treasury will need to rebuild TGA

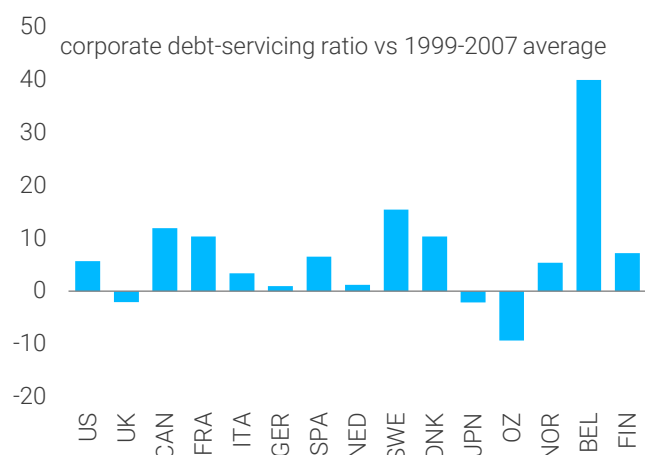


Source: FRED, TS Lombard

- (vi) **Debt-servicing costs:** Monetary tightening not only makes new borrowing more expensive (a flow effect); it also squeezes existing debt holders (another stock effect). So, we can get a sense of the monetary stance based on debt-servicing ratios (DSRs) – that is, the proportion of income spent on making debt repayments. DSRs are useful because they adjust for leverage: when debt levels are higher than in the past, households and companies become more sensitive to a given change in interest rates, especially if they borrowed at variable rates. Since the start of tightening cycle in 2022, we have done a lot of work on debt-servicing ratios and how they are likely to change as central banks raise interest rates (since the underlying data, from the BIS, are hopelessly lagging and will not capture these effects in real time). Charts 14 and 15 show our latest estimates. On the basis of the terminal rates priced into financial markets, our analysis points to sizeable monetary squeeze – particularly in countries with lots of variable-rate mortgages. Many DM households and businesses, in fact, will be paying more on debt servicing than at any time since before the global financial crisis, which means they will have less disposable income to spend on other goods and services in the economy.

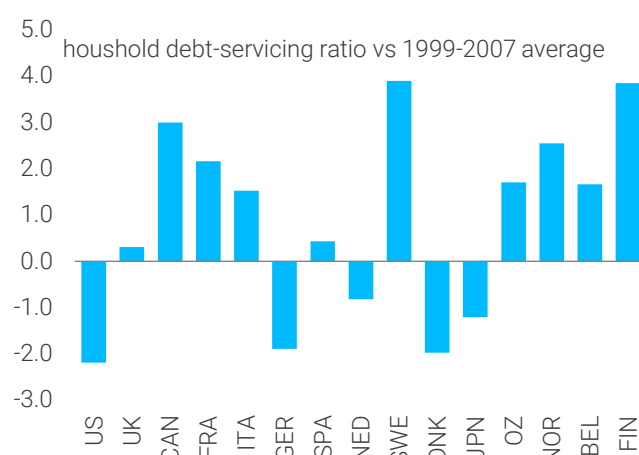
Implication: A big monetary squeeze, especially for highly indebted economies

Chart 14: Monetary policy squeezing corporates...



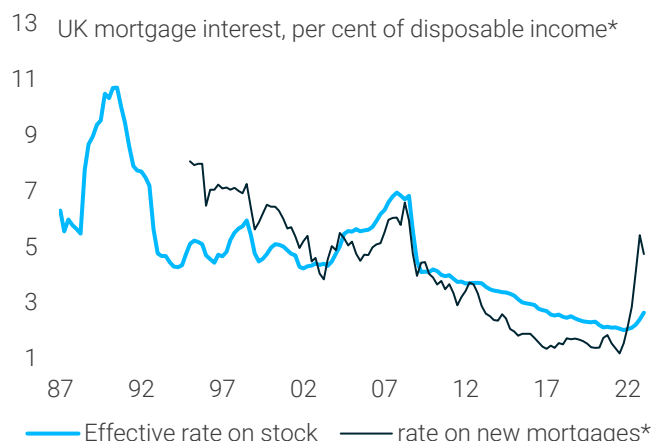
Source: BIS, Bloomberg, TS Lombard estimates

Chart 15: ...and households

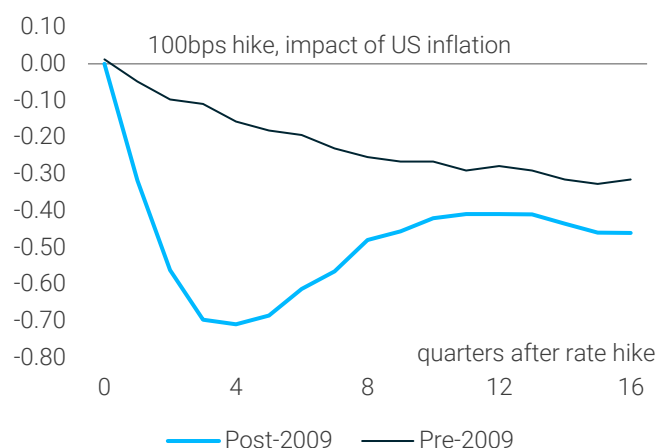


Source: BIS, Bloomberg, TS Lombard estimates

With high inflation keeping (backward-looking) real interest rates negative and financial conditions easing recently, there are some commentators who believe monetary policy is not as tight as it seems. They urge central banks to keep hiking rates until there is a more tangible sense of pain in markets or of a more serious economic downturn. But we do not agree with this sentiment. Not only have forward-looking real interest rates increased significantly, but popular metrics of financial conditions tend to put too much weight on equity markets and credit spreads, which are not a fair reflection of the broad stance of monetary policy. To get a better sense of the overall monetary stance and how it compares with the past, we prefer to focus on DSRs. Though there is considerable variation from country to country, this metric confirms that central banks have engineered a powerful monetary tightening over the past 12 months. And with banks now restricting the flow of credit to the real economy, that monetary squeeze is set to become even more acute in the months ahead – even if central banks hold off from hiking further.

Chart 16: Some countries face ongoing squeeze


Source: Bank of England, TS Lombard

Chart 17: Shorter, less variable lags?


Source: Federal Reserve, TS Lombard

2. SILENT DESTRUCTION

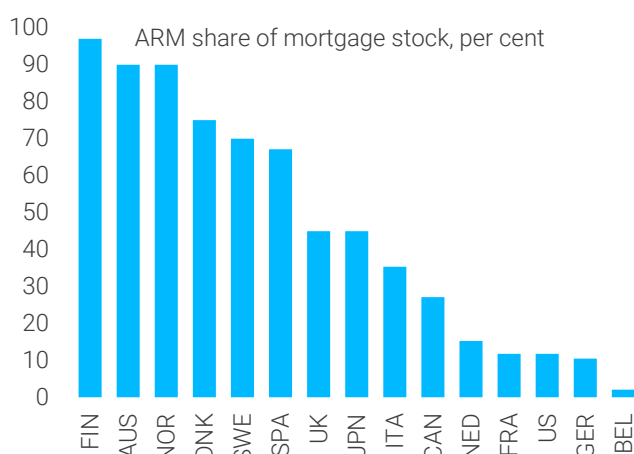
While central banks can be confident that they have tightened monetary conditions – despite the recent buoyancy of risk assets – they will find it more difficult to get a sense of whether they have done enough to meet their statutory objectives. There is a big difference between knowing monetary policy is “tight” and knowing that it is “tight enough” (or even “too tight”), particularly if they want to avoid unnecessary collateral damage to the real economy. Ultimately, the authorities can make an assessment about the appropriateness of their policies only by observing the impact of those policies on GDP growth and inflation. And this is where central banks – and investors – should be careful not to read too much into the continued resilience of the global economy. Not only have temporary factors masked some of the impact of monetary tightening, but we see evidence of “silent demand destruction”, with central banks successfully eliminating some of the demand-supply imbalances that built up during the pandemic. Somewhat remarkably, this has left the world economy on course for a soft landing. With no margin for error and plenty that could go wrong, it would be a shame if central banks now snatched defeat from the jaws of victory, just because they would not tolerate a few more months of high inflation.

Economic resilience

Inflation hawks point to the resilience of the global economy as evidence that central banks have not yet done enough to squeeze demand. Often, this thesis is rooted in an erroneous “Phillips curve” view of the world, which assumes that only a genuine recession will be sufficient to force consumer prices back onto a 2% annual trend. Putting aside [the various problems that arise from trying to apply the Phillips curve to the post-COVID economy](#), it is certainly worth exploring the robustness of the global economy and whether it can tell us anything about the impact of monetary policy. After all, if you had told investors – or policymakers – 12 months ago that the world was about to see 500+bps of rate hikes, most would have anticipated a serious economic calamity, if not a full-blown financial crisis. So why has the world economy seemingly shaken off this wave of aggressive monetary tightening? We see a number of forces at work:

- (i) **Policy lags:** Famously, monetary policy works with [long and variable lags](#), which means that not all the impact of the recent tightening cycle has filtered through to the economy.

There are two areas, in particular, where this thesis has merit. First, we know that banks have only recently tightened their lending standards in response to deposit flight and funding stress. This is a classic example of a lagged and non-linear response to the accumulation of monetary tightening, which is likely to have its most significant macroeconomic impact during the second half of 2023 (even if central banks stop raising interest rates). The other example of a policy lag can be seen in certain mortgage markets, particularly where a large proportion of loans are fixed for two-three years (as is the case in the UK). Again, this means the economic squeeze from monetary policy will continue to build, even if central banks in those parts of the world stop hiking rates.

Chart 18: Variable mortgages – bigger squeeze


Source: TS Lombard based on IMF, OECD, national sources

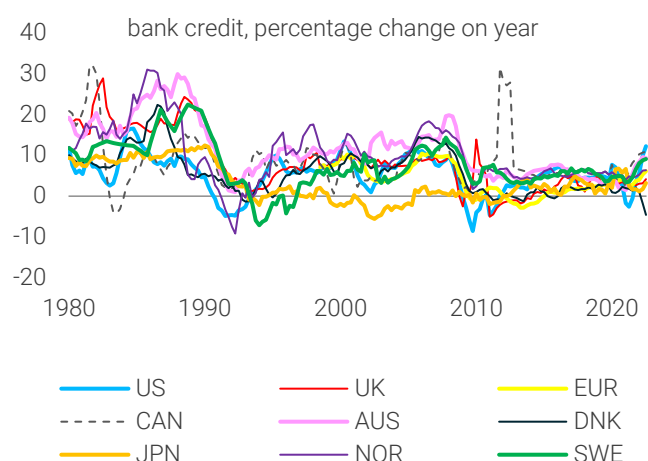
Chart 19: Companies to face continued squeeze


Source: BIS estimates

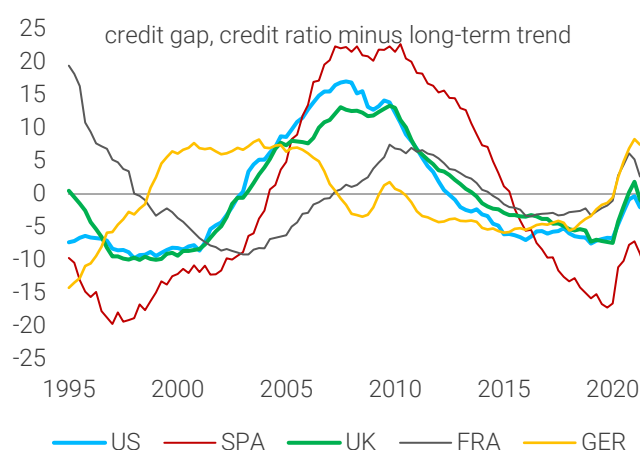
Banking stress and mortgages markets provide specific examples of policy lags, but in general we think the “long and variable” lag thesis is something of a myth. Often, in fact, it is just the result of an academic literature that has failed to identify a precise cause-and-effect relationship between monetary policy and GDP/inflation (rather than its telling us anything profound about monetary transmission). The most recent studies, which deploy more sophisticated econometric techniques, have found shorter and less variable policy lags, with most of the impact of rate hikes typically felt in the first nine months of a tightening cycle rather than over the two-three year horizon that was common in earlier empirical work. And even in the case of policy lags related to the structure of mortgages markets, it is important to remember that this generally does not apply to the US or some of the big European economies, where the majority of mortgages include long-term (10-30 year) fixed borrowing costs. Shorter monetary lags are good news because they mean there is no big overhang of policy tightening still in the pipeline, cutting the risk of errors.

- (ii) **Credit-less growth:** Even if the policy lags are shorter and much of the impact of monetary tightening is already being felt, it is possible that our economies are less sensitive to interest rates than the consensus has been assuming. The reason for this is simple: credit growth has not been an important source of demand in recent times, with the decade after the global financial crisis witnessing only a weak appetite for borrowing (thanks to persistent private-sector deleveraging) and a general reluctance to lend (especially on the part of the largest banks, which faced a more stringent regulatory environment). Charts 20 and 21 show that credit growth has been subdued over the past decade and debt ratios – particularly among households – have declined. Even where leverage has increased, as among US and some European corporates, this was often the

result of financial engineering (equity buybacks, etc.) rather than a form of borrowing that raised capex or boosted employment in the real economy. And if real-economy spending has been more closely tied to income over the past decade, rather than debt accumulation, it is possible that central banks will engineer a significant credit squeeze without triggering a deep recession. This is something to bear in mind during the months ahead, as [investors gauge the impact of tighter lending standards](#).

Chart 20: Credit-less expansion after 2008


Source: BIS, TS Lombard

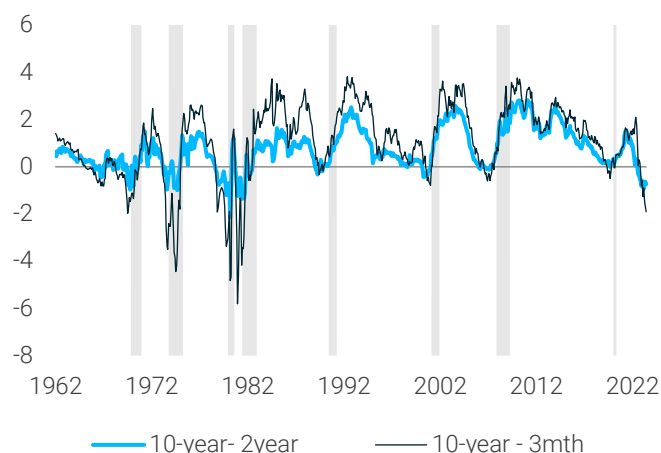
Chart 21: No credit bubbles to burst


Source: BIS, TS Lombard

- (iii) **Fiscal overhang:** It is possible that expansionary fiscal policy has offset some of the impact of monetary tightening, which has also contributed to the resilience of the global economy. On one level, this thesis seems odd because budget deficits have narrowed significantly since their peak during the pandemic. But much of this fiscal improvement was artificial, in the sense that governments no longer needed to support private-sector incomes once lockdowns ended. Looking beyond these effects, there are several ways fiscal policy has remained a source of macro resilience, including the recent energy support programmes in Europe and the US, increased debt-servicing costs (which boost the incomes of private-sector bond holders) and the lagged impulse from governments' COVID cash injections (those pesky "excess savings" again). All these effects are likely to fade, with [US households' excess savings likely to disappear by the end of the year](#) (Though it is possible governments will find [new reasons](#) to keep spending).
- (iv) **Expectation of imminent rate cuts:** Even as central banks have been raising interest rates, a majority of investors have been anticipating imminent monetary easing. Yield curves have been inverted for some time, and those inversions have only deepened as the authorities have become more hawkish. In some sectors of the economy, it is possible that the expectation of rate cuts has blunted the effectiveness of monetary policy by encouraging people to take out loans they otherwise would not have been able to afford. We often hear anecdotes about such psychology taking hold in various housing markets (e.g., Australia, Canada and the UK), where homebuyers are accepting expensive mortgages on the assumption that they will be able to remortgage those loans in 2024 at a lower rate. Perhaps this explains why DM housing activity has bottomed, and there are even scattered signs of improvement (although this might just be a "dead-cat bounce"). Obviously, the risk with such behaviour is that if these expectations turn out to be wrong and interest rates remain high, we could see further waves of financial distress. In general, however, we do not put a great deal of weight on this explanation – especially as there are

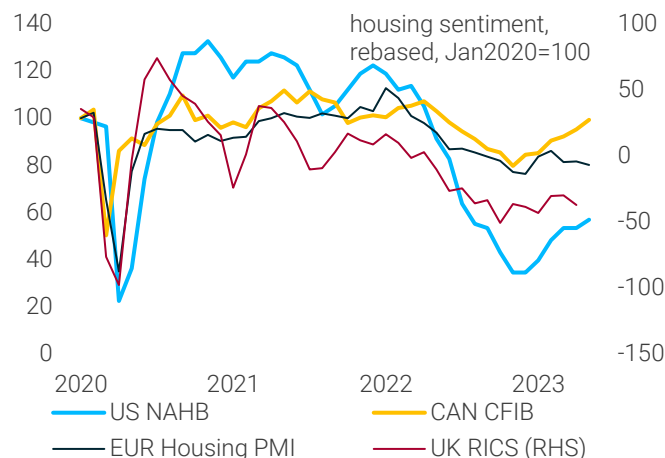
other forces working in the opposite direction. If the expectation of rate cuts reflects anxiety about a recession, banks will be less willing to extend loans.

Chart 22: The steep yield inversion



Source: Datastream, TS Lombard

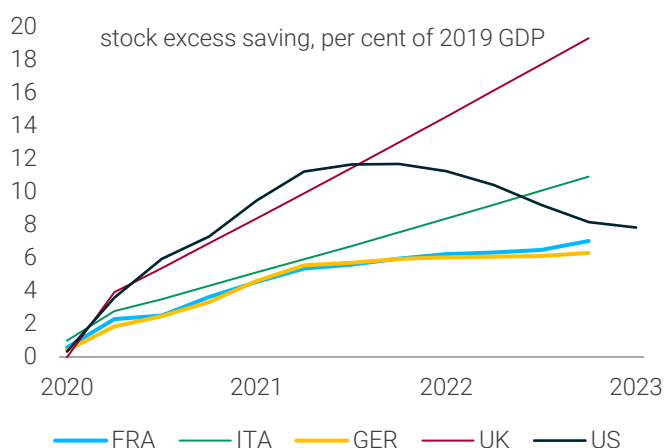
Chart 23: Expectation of lower rates?



Source: Datastream, TS Lombard

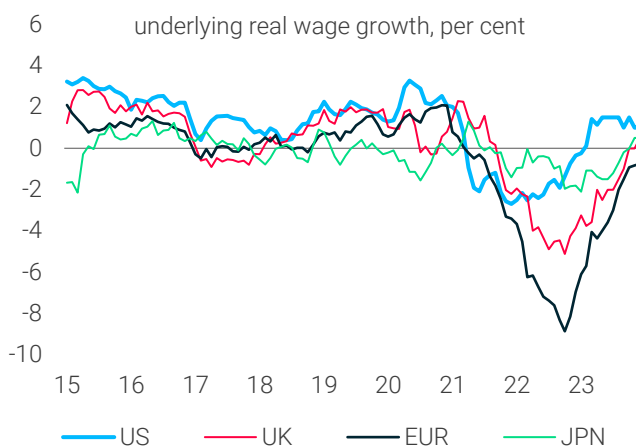
- (v) **Temporary factors unwind:** Monetary tightening is not the only contributor to the current recession consensus. Leading indicators had deteriorated even before central banks turned uber-hawkish, global manufacturing was already in a serious downturn and real consumer spending had stalled. These developments were more the result of the temporary distortions in the global economy than a reflection of underlying business-cycle dynamics. Spending patterns were rotating back to pre-COVID norms, there was a powerful bullwhip recession in global goods markets and one-off increases in consumer prices were a powerful drag on real incomes. The irony is that most of these forces are now starting to unwind, just at the point where monetary tightening is having its most potent effects. The bullwhip manufacturing recession has eased and nominal wages will soon outpace inflation, providing a lift in real incomes. Once we net out these effects, it is possible the world will avoid an outright contraction in GDP and employment, suffering instead a series of rolling sectoral recessions.

Chart 24: Excess savings supported US spending



Source: National sources, TS Lombard

Chart 25: Real wages to start growing again?



Source: national sources, TS Lombard

- (vi) **Silent demand destruction:** Usually, when an economy is “overheating”, central banks raise interest rates with the aim of reducing output and employment. This helps them rebalance demand and supply, which is what triggers the recession. But the current situation is a little different – something the gloomy recessionary consensus does not seem to realize. To the extent there is overheating today, it is largely a story of unrealized demand. Because the supply of labour has decreased since the start of the pandemic, companies are unable to increase their output because they cannot find a sufficient number of workers. This, in turn, has forced many to hike wages significantly in order to encourage people back into the workforce or to poach staff from their competitors. But the crucial point here is that this dynamic has greatly improved the odds of a soft landing. If central banks can rebalance their labour markets by destroying demand that was never actually realized – e.g., by reducing the number of job openings/active vacancies – they can conceivably cure the overheating without putting people out of work. Employment and output might stagnate for a while, but we would not see the classic recessionary dynamic. The authorities would, in effect, be delivering “silent demand destruction”. It might appear that monetary policy isn’t working when, in fact, it is.

The margins for rebalancing labour markets solely via “silent demand destruction” are narrow, which is why the odds for avoiding a recession are finely balanced. But the path definitely exists. Table 1 provides some statistics to back this up. Given the number of unfilled job vacancies – which, for the largest DM economies, comes close to matching the overall post-COVID imbalance in labour markets – the major central banks could eliminate most of the overheating in their economies just by reducing active job openings, rather than putting people out of work. The big question mark, of course, is whether monetary tightening can be calibrated to achieve such a perfect outcome. Since interest rates are a very blunt and inaccurate tool, there is no guarantee that the authorities will be able to eliminate vacancies in the “right” places. If, for example, there is a shortage of workers in the hospitality sector, destroying labour demand in the tech sector is only going to cause greater “mismatch” and a rise in aggregate unemployment. Yet, so far, it seems central banks have managed to stay on this narrow path that leads to a soft landing. Not only is there evidence that central banks have successfully reduced job vacancies, but most of the demand destruction has taken place in sectors that started out with the most acute staff shortages (see here for more).

Table 1: Fine margins for a soft landing – but the path exists

Shift in labour-market tightness since 2019

	US	EUR	UK	JPN
Supply	1.3	2.0	-0.7	0.0
Demand	4.0	3.6	0.6	-0.4
Labour market tightening	2.6	1.6	1.3	-0.4
-Unfilled vacancies	2.8	0.9	1.0	-0.1
-Employment	1.1	2.7	-0.4	-0.3
 Margin for soft landing	 0.2	 -0.7	 -0.3	 0.3
(tightening vs vacancies)				

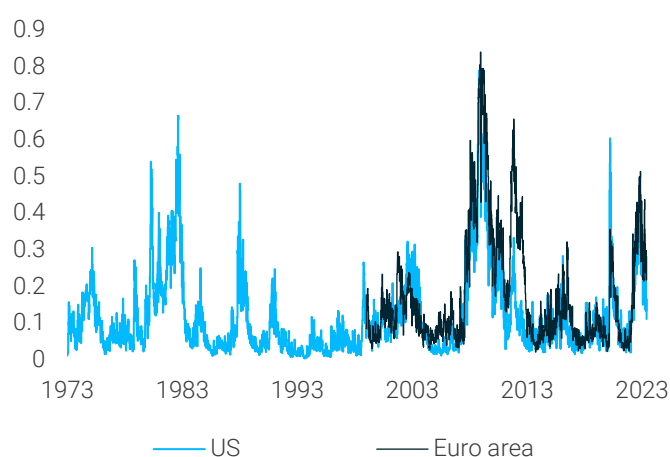
Source: TS Lombard estimates

To sum up, our analysis suggests that not only is monetary policy now genuinely contractionary, but it is also having a significant impact on the global economy. Central banks are successfully destroying demand, but temporary forces (excess savings, policy lags and pandemic distortions) and unrealized demand are obscuring the full effects of their actions on aggregate output and employment. Somewhat remarkably, the world economy appears to be on track for a soft landing, although the margins are fine and there is still plenty that could go wrong. The big question now is whether central banks can continue along this difficult path. With the first part of their tightening cycle over – they have taken policy to a restrictive setting – the authorities must find a way to maintain their monetary squeeze without pushing their economies into unnecessary recessions or releasing their grip too early, which could allow inflation to return with a vengeance.

3. SKIPS, HIKES AND PAUSES

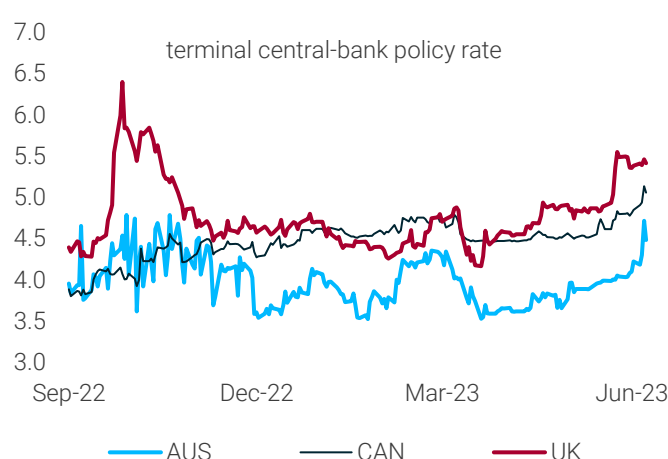
With inflation hitting 40-year highs, unemployment at multi-decade lows and interest rates starting at zero (or lower), rapid monetary policy was a no-brainer throughout 2022 and during the first half of 2023. The authorities needed to get to a restrictive policy setting as soon as possible, especially as they were imagining [a nightmare rerun of what happened during the 1970s](#). Today, however, the case for further monetary tightening has evaporated. Inflation is gradually coming down, economic activity has slowed and central banks (still!) believe there are “long and variable” lags that will deliver continued demand destruction even when they stop raising interest rates. Far from becoming [a textbook example of monetary failure](#), central banks have an opportunity to engineer a remarkable soft landing – which would surely be the finest moment in the history of independent central banking. But to achieve this feat, they will first need to deliver a monetary pause and, moreover, find a way to do this without financial markets anticipating an imminent reversal in interest rates (which could revive those inflation fears). Rate “skips” should be seen in this context, as a way to guide market expectations towards “higher for longer” monetary policy. The global tightening cycle may not be over, but pragmatism and gradualism are finally returning.

Chart 26: Banking scare that forced pragmatism



Source: ECB, TS Lombard

Chart 27: The pause that wasn't



Source: Bloomberg, TS Lombard

The two stages of tightening

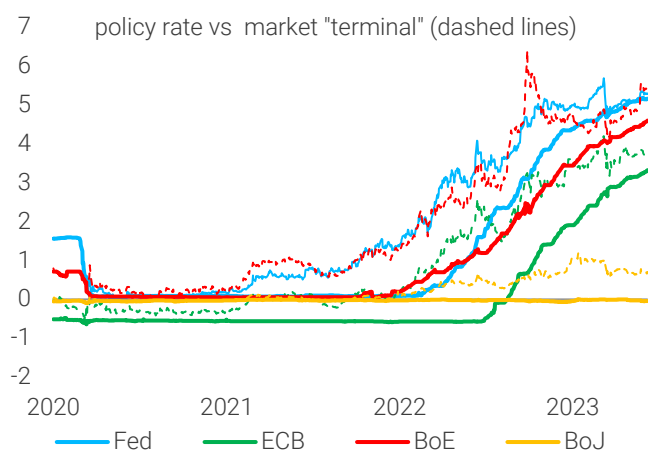
There was always going to be two stages to post-COVID policy tightening: the rapid “normalization” of interest rates followed by the adoption (and maintenance) of a genuinely restrictive policy stance. While the first stage was largely automatic, the second stage would be

“data dependent” – that is, conditional on what happened to economic growth and inflation. We are now firmly in the data-dependent stage of that process. Central banks know that their policies are restraining demand, but they can calibrate their actions only based on how their economies actually perform. And right now, there is a compelling case for monetary gradualism. Inflation is coming down, growth has slowed – with some parts of the world already in technical recession – and lenders everywhere have been tightening loan standards, which could mean another monetary squeeze. Given these trends, it makes no sense for central banks to continue hiking interest rates just because inflation is still above their 2% targets. With global manufacturing in recession, commodity values down and services prices likely to slow – especially in the US, where the CPI includes housing costs – further disinflation now seems inevitable.

Higher for longer

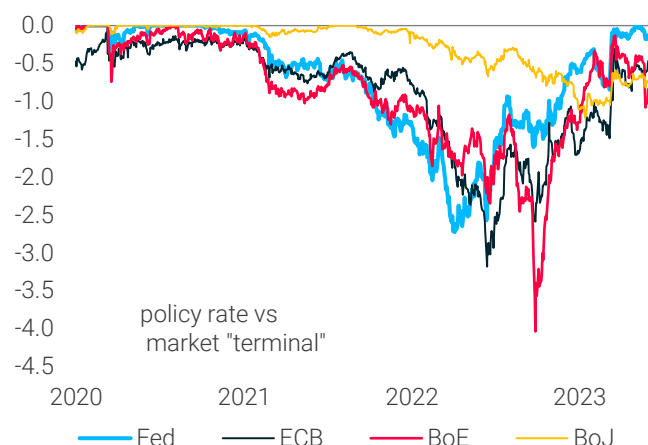
For the past six months, central banks have been trying to convince financial markets that an eventual policy pause would not be the precursor to imminent rate cuts. “Higher for longer” has been their mantra. Yet, deeply inverted yield curves suggest that most investors were not convinced. Indeed, until just a few weeks ago, markets were pricing in the possibility of significant rate cuts by the end of the summer. As far as Fed policy is concerned, there are good reasons for such scepticism. In past tightening cycles, the central bank has often raised interest rates up to the point where something has “broken”, which then leads to a rapid succession of rate cuts. Given the aggressiveness of the hiking cycle in 2022-23, it seemed reasonable for markets to price in a decent probability of the same thing happening again. But from a central bank perspective, such a situation is highly undesirable. The authorities want to maintain their monetary squeeze, with the aim of reducing inflation over time, while financial markets are simultaneously trying to engineer a reversal in those policies. So how can central banks implement their desired policy pause without having to battle investor expectations for imminent rate cuts? It seems from their communications over the past month that central banks have discovered a clever solution.

Chart 28: Market expectations for terminal rates



Source: Bloomberg, TS Lombard

Chart 29: Tightening cycle is almost over?

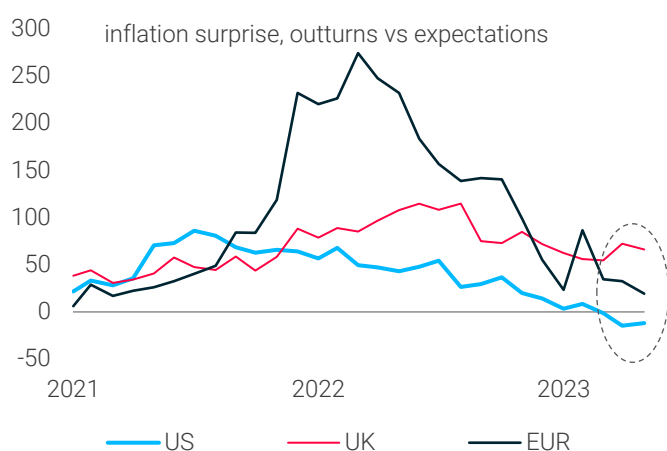


Source: Bloomberg, TS Lombard

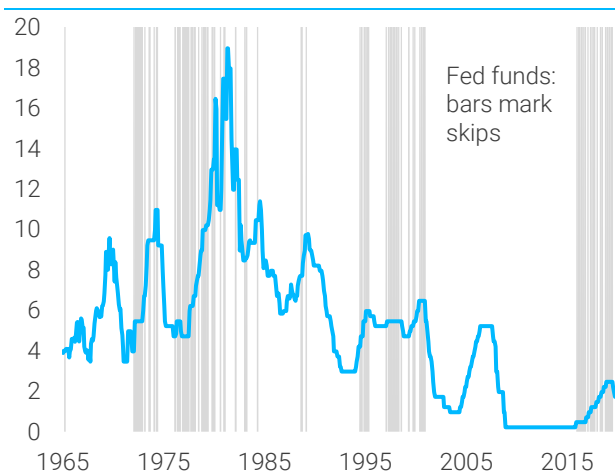
A clever solution – the policy skip

One word has been on the lips of every central banker recently – “skip”. Instead of talking about a policy “pause”, the authorities now talk about “skipping” future rate hikes. This might sound like semantics – especially as central banks have often skipped policy moves in the past and nobody took any notice – but in today’s context it is highly significant because it is a deliberate attempt to maintain the threat of further policy tightening (like a sword of Damocles hanging over financial markets). Whereas a pause would seem to rule out further rate increases, a skip does not do so

explicitly – it suggests merely postponing them. This is a clever solution to the “higher for longer” problem because, in practical terms, having a credible meeting-by-meeting bias towards further policy tightening is the only way the authorities can fight the expectation of imminent cuts. Naturally, there is a decent chance central banks are bluffing. Perhaps they have no real intention of raising interest rates again. But the recent experience of several central banks – namely, the Reserve Bank of Australia, the Bank of Canada and the Bank of England – adds credibility to the rate-skipping mantra. All three central banks have recently been forced to continue their tightening cycles, disappointing market expectations for a lengthy pause. But while it is premature to declare the end of global rate hikes, the important point for financial markets is that any additional action is likely to be gradual and conditional on the world avoiding a recession. This is a very different proposition to the situation 12 months ago, where the monetary authorities were promising to inflict pain on investors.

Chart 30: BoE still has work to do


Source: Datastream

Chart 31: Skips didn't used to be a thing


Source: Federal Reserve, TS Lombard

Bottom line

Twelve months ago, central banks threatened to inflict “pain” as they sought to slow their economies and tame the worst inflation outbreak in half a century. Today, stock markets are higher and the most hotly anticipated global recession in history has not materialized (yet). So, what went wrong? (Or what went right, depending on your perspective.) One possibility is that monetary policy is not as contractionary as it seems. Critics point to real interest rates that are still negative in real terms (at least on a backward-looking basis) and financial conditions that have eased. Yet, looking across a broad range of indicators, it is clear that monetary policy has become significantly tighter over the past 12 months; and, with interest rates and (more important) debt-servicing costs at their highest levels in decades, there is no doubt that central banks’ policies are genuinely restrictive. But this begs an obvious question: why haven’t we seen a more discernibly negative impact on the economy, which continues to defy gloomy expectations? One possible answer is that temporary factors and policy lags have masked some of the impact of higher rates, particularly in sectors that are less exposed to borrowing costs. There is some truth to this, especially with banks having only recently tightened their lending standards. But the more compelling explanation, often overlooked by the consensus, is that central banks have engineered a “silent” form of demand destruction, narrowing post-COVID imbalances by, in effect, destroying jobs and output that had not been realized. While the margins are fine, this has put the world economy on track for what seemed like the impossible – namely, a soft landing. And, more important for financial markets, central banks now seem willing to embrace that possibility.