EcoScope
The Economy Observer

Why global monetary tightening may prolong?

Divergent fiscal policies make the central banks' task difficult

Very high inflation leads to synchronized global monetary tightening

- The monetary policy cycle is increasingly synchronized around the world at present, with China, Russia, and Turkey being the only exceptions among G20 nations. In order to fight exceptionally high inflation, the US Federal Reserve has raised its policy rate five times in the past six months to 3.125% from 0.125%, the Bank of England (BoE) has raised rates seven times since Dec'21 to 2.25%, and the European Central Bank (ECB) has raised it twice to 1.25%. Despite such sharp monetary tightening, none of these major central banks expect to return to their 2% inflation target by CY25 ***(refer to Exhibits 1, 2, 3)***.
- Among emerging market economies (EMEs), India/Philippines/South Africa seems to be the most aggressive, raising their policy rates three/four/five times by 140bp/175bp/200bp to 5.4%/3.75%/5.5%. However, inflation in these nations remained high at 6.9%/6.3%/7.8% YoY in the quarter-ending Aug'22, and is not projected (by their respective central banks) to fall to their respective inflation targets (of 4%/4.5%/3%, as the mid-point of their inflation target range) before CY24/FY25. Similar is the case in most EMEs ***(refer to Exhibits 4, 5, 6)***.
- Moreover, central banks have repeatedly increased their inflation projections in the past few meetings. It is then not surprising that the global monetary policy is synchronized.
- Economics 101 tells us that monetary policy can be effective in mitigating inflationary pressures by curtailing the flow of credit to the real economy, and thus, hurting overall demand. It is not surprising that real GDP growth forecasts have also been cut repeatedly by these central banks ***(refer to Exhibits 7, 8)***, more so in advanced economies than EMEs.

However, divergent fiscal policies make it difficult for central banks

- As expected, this journey of central banks is unlikely to be smooth or easy. The last time we saw such high inflation was about four decades ago, when the financialization of the global economy was not so stark. As per the International Monetary Fund (IMF), global debt, which was stable ~120% of GDP in mid-CY70s and crossed 170% of GDP by the end of the CY80s decade, surged to 190% of GDP by the beginning of the 21st century and touched 225% of GDP before the COVID-19 pandemic ***(refer to Exhibit 9)***. It's needless to state that the role of the financial markets in the real economy was also much lower four decades ago as compared to today.
- In an ideal environment, fiscal and monetary policies should complement each other. Or else, these policies would tend to be ineffective in achieving its objective. This is exactly the risk the global economy seems to be facing now.
- Although the global monetary policy has chosen to fight against inflation, the ongoing turmoil in the financial markets and the fears of an expected recession in the real economy have resulted in divergent fiscal policies. We have already seen two such examples, and would not be surprised if more are followed.
- On 28th Sep'22, the BoE was forced to pause its Balance Sheet reduction plans (which was announced just a week ago on 21st Sep'22), owing to the 'mini budget' announced by the newly elected government in the UK. On 23rd Sep'22, the 'growth plan' unveiled by the UK government included a host of measures '*to release the huge potential in the British economy*'. By canceling the planned rise in corporate tax rate, bringing forward the planned cut in the basic rate of income tax, abolishing the additional rate of income tax completely, and delivering stamp duty cuts, the new government's measures threw a spoiler in the BoE's fight against inflation. All this was in addition to the energy bills support (or energy price guarantee) scheme announced earlier, which effectively capped the energy bill to be paid by a household over the next two years. They surely sent a clear message that growth is their priority, however, they underestimated the costs (***refer to Exhibits 10, 11***).
- In less than a week, the benchmark yield on UK's 10-year gilt surged to 4.4% from 3.2% in mid-Sep'22 and the GBP fell ~6% to 1.07 against the USD – the lowest since the mid-CY80s. These movements triggered material risks to the UK's financial stability, which forced the BoE to pause its balance sheet reduction program and announce temporary purchases of long-dated UK gilts beginning 28th Sep'22 to 14th Oct'22. On the same day, the BoE announced it aims to

Nikhil Gupta – Research Analyst (Nikhil.Gupta@MotilalOswal.com)
Yaswi Agarwal – Research Analyst (Yaswi.Agarwal@motilaloswal.com)

purchase up to GBP65b worth of gilts over the next fortnight, wiping out the previously announced target of an GBP80b reduction in the BoE's balance sheet over the next 12 months.

- **Although the UK received all the attention for such divergence, there have been a couple of important steps taken by US President Joe Biden, which pits US' fiscal policy against the Fe's aggressive monetary tightening:**
  - **The first measure was revealed in Aug'22 when President Biden announced that the Student Loan Relief Program aims to provide debt cancellation of up to USD20,000/USD10,000 to Pell Grant/non-Pell Grant recipients. Borrowers are eligible for this relief if their individual income is less than USD125,000 (USD250,000 for married couples). As per the US Department of Education, if every student eligible for this waiver claims it, up to 43m borrowers could benefit from it, i.e. ~13% of the US population as of CY21. As to the Congressional Budget Office (CBO), the cost of suspending student loan payments and canceling debt would be ~USD430b, spread over the next 30 years or so. Similarly, a blog by the Federal Reserve Bank of New York, titled 'Liberty Street Economics', estimates that the plan will cancel ~USD440b in federal student loans.**
  - **Second, the 'Inflation Reduction Act' (IRA) was also announced, which will bring more small businesses under the ambit of medical insurance, helping them save ~USD800/year, lower prescription costs for senior citizens at USD2,000 per annum, increase tax credits for small businesses involved in R&D, and provide tax incentives for businesses switching to clean energy. Overall, the CBO expects IRA to reduce the cumulative budget deficit by USD238b over a decade. However, it will lead to higher deficit over the next few years (*refer to Exhibits 12, 13)*.**

Conclusion: Divergent fiscal policies can prolong the monetary tightening

- **Considering that such high inflation has been seen for the first time in almost four decades, ~10% of the workforce in European Union and less than 15% in the US have seen such high inflation in late-CY70s or early CY80s. It is then not surprising that while the central banks are now focused on fighting inflation, the general perception, which is more important in politics, is still sympathetic towards growth. In its Sep'22 meeting, the Fed noted, "*We are taking forceful and rapid steps to moderate demand so that it comes into better alignment with supply…Reducing inflation is likely to require a sustained period of below-trend growth, and there will very likely be some softening of labor market conditions…We will keep at it until we are confident the job is done.*"**
- **As mentioned above, if the monetary and fiscal policies are aligned, it is much easier and effective to combat inflation. However, the UK is seeing difficulties in attaining low inflation.**
- **It is fortunate that the divergence in fiscal and monetary policies in the UK has already set an example of the kind of dramatic, but automatic controls that the financial markets can create against such divergences. However, it also suggests that the central bank may be forced to reverse its actions (i.e. monetary tightening) to soothe the financial markets and allow the politics to prevail.**
- **It is highly unlikely that this divergence will continue for long. Loose fiscal policy, amid tight monetary policy, is unlikely to achieve the stated objective of low inflation. If so, either the governments will have to side with the central banks to allow growth to falter or the central banks will be forced to tighten monetary policy, even further, for a prolonged period to counter loose fiscal policy and sustained high inflation. The latter seems more practical than the former.**
- **Alternatively, the political masters may prioritize growth to an extent that they force central banks to abandon their fight against inflation. We hope this scenario does not come to pass, but if it does, it will be probably the worst outcome.**
- **Overall, global monetary tightening needs to be accompanied by appropriate fiscal policy, if the aim of stable non-inflationary growth is to be achieved. Otherwise, the control over inflation, and thus, growth, will be lost, but the monetary authorities will also get discredited.**

Exhibit 1: The Federal Reserve has raised the federal funds rates by five times to 3.125% at present…

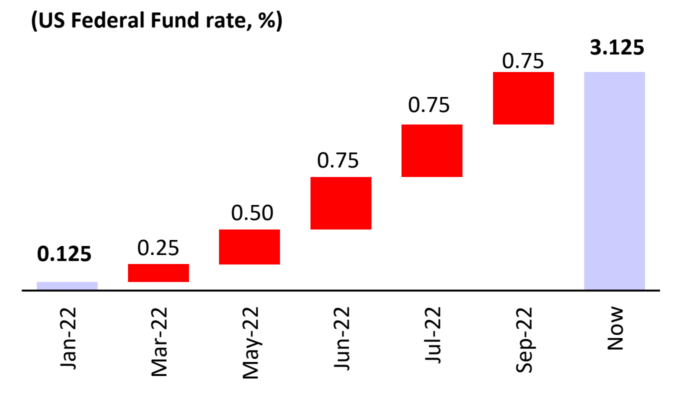
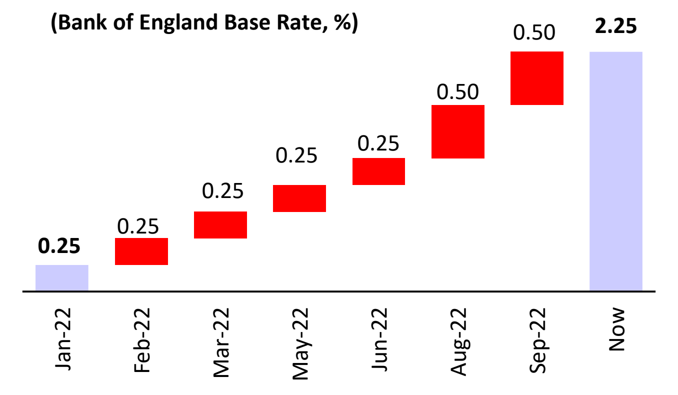
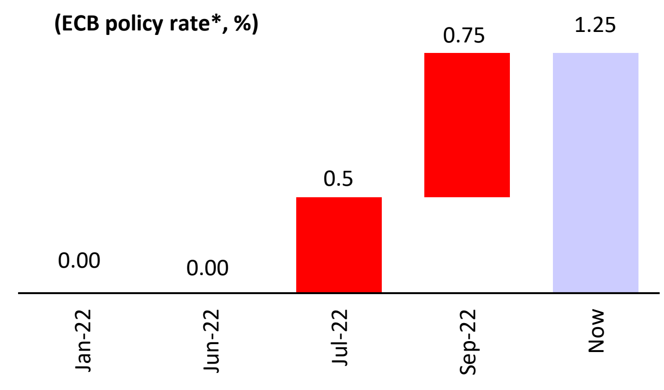


Exhibit 2: …and the Bank of England has hiked its bank rate six times to 2.25% at present



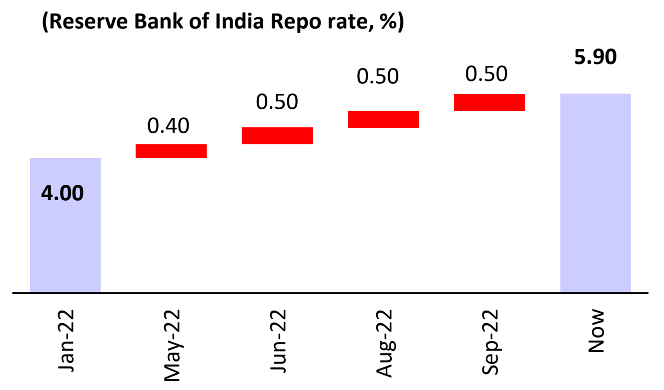
Source: BIS, various national sources, MOFSL

Exhibit 3: The ECB has raised its policy rate twice to 1.25% now from nil until Jun'22



*Interest rate on the main refinancing operations

Exhibit 4: The Reserve Bank of India has raised its policy repo rate four times to 5.9% at present



#Jan-Aug'22

Source: CEIC, various national sources, MOFSL

Exhibit 5: The central bank of Philippines has been even more aggressive with five rate hikes to 4.25%…

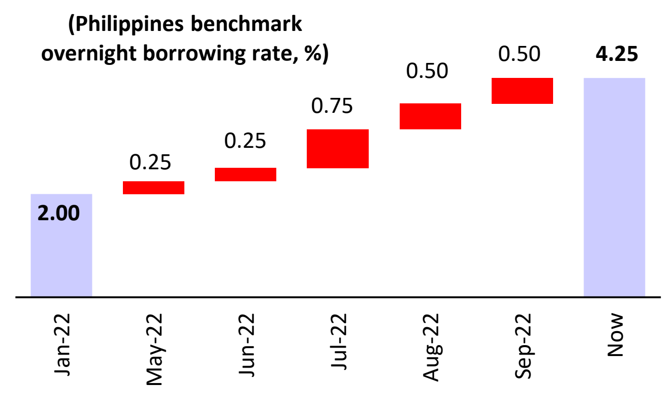
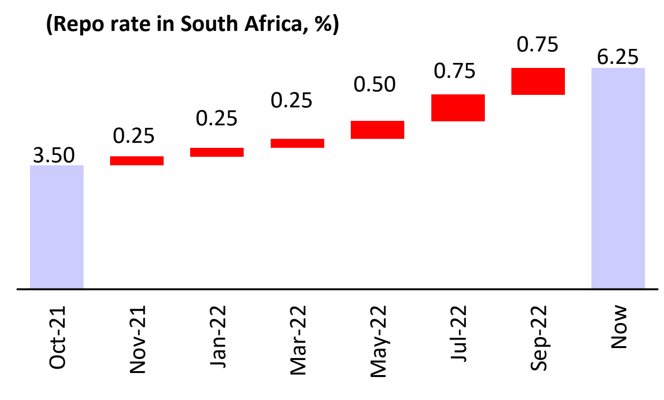
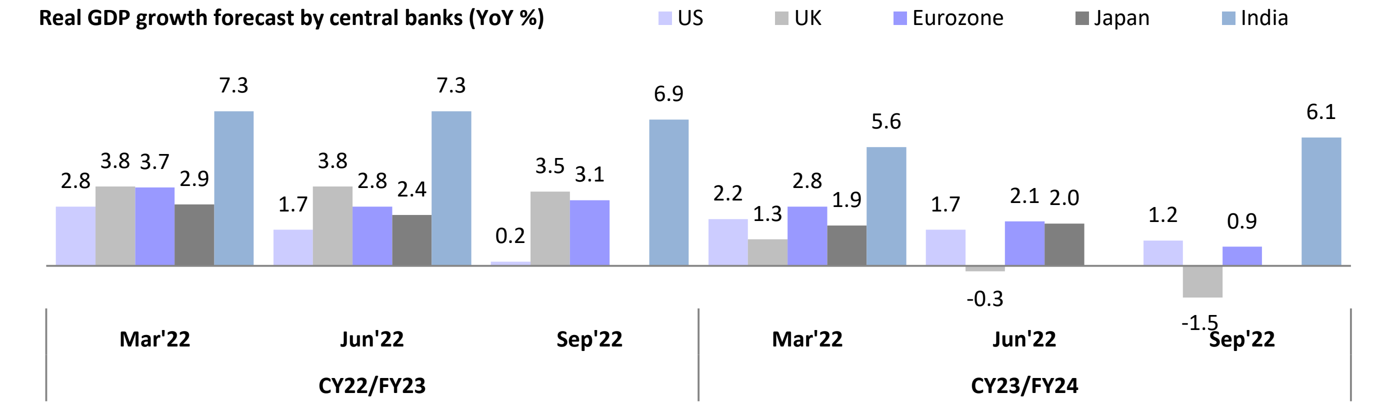


Exhibit 6: …and the South African central bank has also raised its repo rate six times to 6.25%



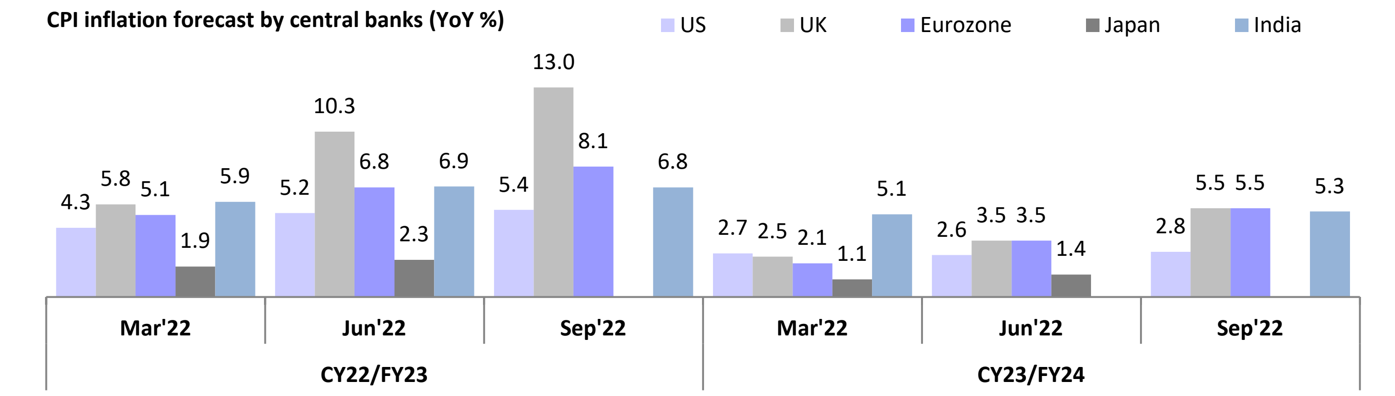
Source: CEIC, various national sources, MOFSL

Exhibit 7: Real GDP growth forecast has been reduced across-the-board for CY22/FY23 as well as CY23/FY24



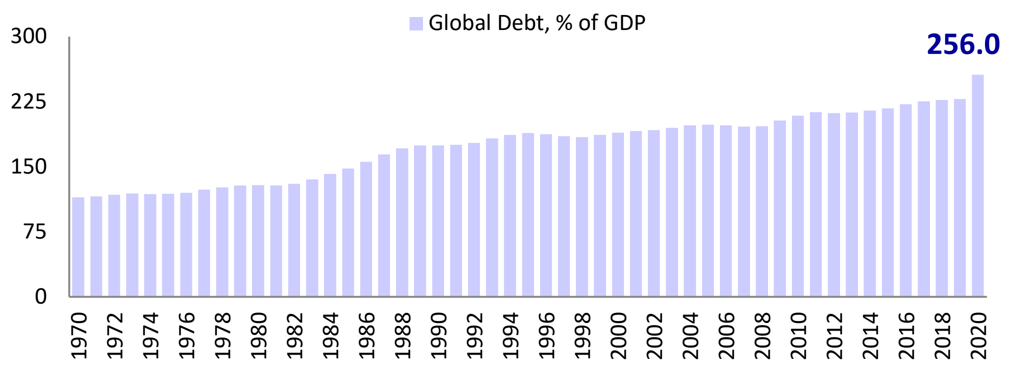
The Reserve Bank of India's FY24 growth forecast during its Jun'22 monetary policy meeting is unavailable
The Bank of Japan will release its outlook report on 28th Oct'22
Source: Various national sources, MOFSL

Exhibit 8: CPI inflation forecast has been raised for CY22/FY23 as well as CY23/FY24



The Reserve Bank of India's FY24 inflation during its Jun'22 monetary policy meeting is unavailable
The Bank of Japan will release its outlook report on 28th Oct'22
Source: Various national sources, MOFSL

Exhibit 9: Global debt rose 28pp to 256% of GDP in CY20



Source: World Bank, IMF, MOFSL

Exhibit 10: No visible signs of lower receipts or higher fiscal deficit in the UK as yet…

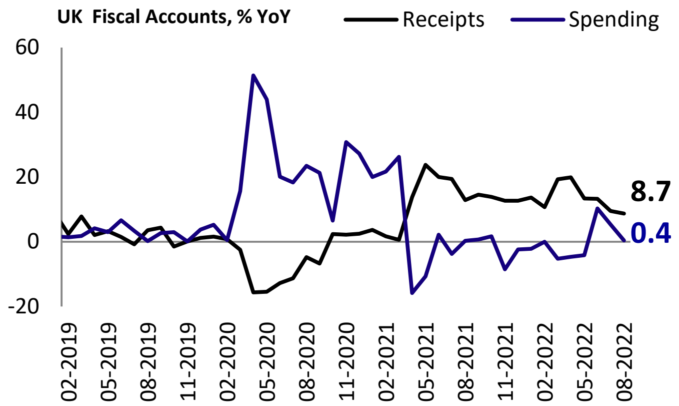
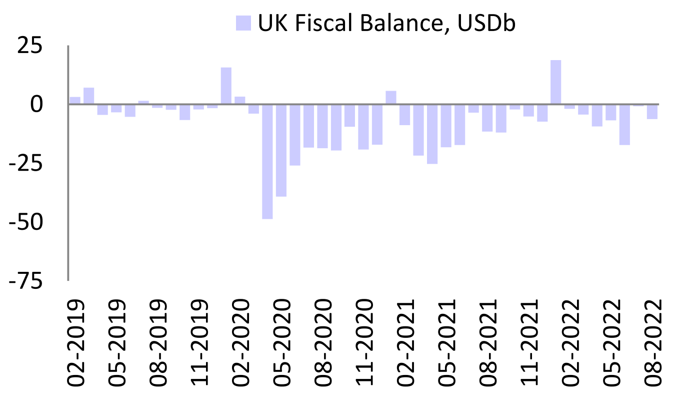


Exhibit 11: …and the fiscal deficit remains subdued at USD6b in the UK



Source: CEIC, various national sources, MOFSL

Exhibit 12: Total spending by the US grew 19.2% YoY in Aug'22 after high double-digit declines over Jan-Jul'22…

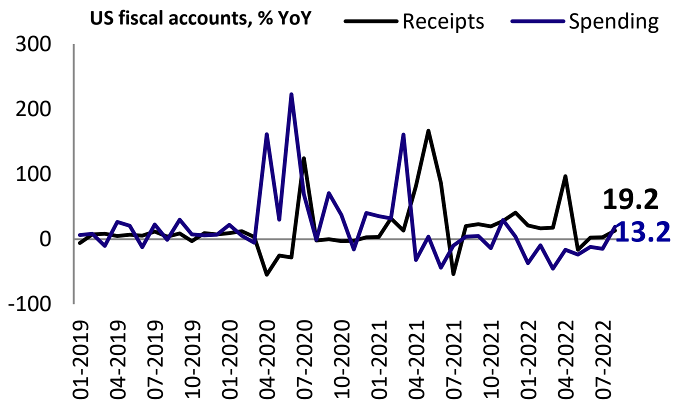
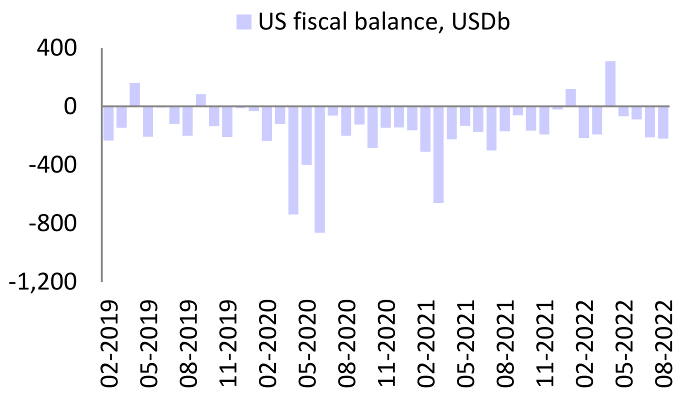


Exhibit 13: …leading to a 13-month high fiscal deficit of USD220b in Aug'22



Source: CEIC, Various National Sources, MOFSL

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