Recent Inflation and Central Banks' Reaction:
Evidence from the US and EU

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The outlook for the global economy continues to weaken as the combination of elevated prices and tighter monetary policy weighs on economic activity. Clearly, inflation has, at a minimum, altered the economic mood, and potentially reset the path of global and national economics worldwide for some years to come. In this report, we will reflect on the potential upcoming recession in the Eurozone and United States (US), while illustrating the stubbornly high inflation in the aforementioned areas.

In the US market, inflationary pressures started to weigh on the economy since the COVID-19 outbreak and the implementation of new fiscal policies. In fact, the Coronavirus Relief Fund provided payments to individuals navigating the impact of the epidemic. Adding to that, on November 15, 2021, President Joe Biden, signed the Infrastructure Investment and Jobs Act into law, providing $1.2 Trillion in new government investments. Nevertheless, the US economy was expecting its economy to bounce back, but they didn't anticipate a massive oil and gas shock, driven by the war between Ukraine and Russia. As a result, inflation in the US has hit record-highs to reach 8.2% in October 2022.

Under Powell's leadership, the Federal Open Market Committee has lifted the federal funds rate from 0.25% at the start of the year to 4% in November 2022. In fact, as inflation remains stickier to the upside, the US Federal Reserve (Fed) is continuously tightening its monetary policy and is likely to further increase interest rates in their next meeting in December. Consequently, the benchmark rate has reached 4%, which is the highest

rate since the US financial crisis in 2007. Nevertheless, the continued tightening of financial conditions is weighing heavily on the economy, particularly on housing, manufacturing and equity markets, which will further weigh on household consumption and business investment over the coming quarters.

In the Eurozone, the zone finds itself in crisis mode as its inflation rate reached a two-digit figure of 10.7% and a big part of the problem is linked to rising energy prices driven by the war between Russia and Ukraine. As a matter of fact, Russia was the main EU supplier of crude oil, natural gas and solid fossil fuels. However, as the Eurozone sided with Ukraine, Russian President Vladimir Putin decided to limit natural gas supplies to European countries. Consequently, the energy crisis remains a threat and political risks are elevated.

Similarly to the US market, the European Central Bank (ECB) raised interest rates by another 75 basis points by the end of October, bringing the benchmark rate to 2%, the highest rate since 2009. From a policy perspective, the stubbornly high inflation means that central banks will likely continue to err on the side of caution. In fact, EU's central bank warned that it expects to raise interest rates further in the near future in an effort to return inflation to its 2% medium-term target.

Moreover, we see growing risks that the energy crisis will persist for a longer period of time, which could further exacerbate the aforementioned risks. While the stock of European energy is sufficient for this winter, a colder-than-expected condition could result in energy shortage. As a result, energy risks will remain a key threat over 2023, and there might not be enough gas supplies in large economies such as Germany and Italy next winter. In addition, elevated energy prices are putting substantial pressure on the current account balances of energy importers, which constitute most European Countries. Nonetheless, the US is energy independent; thereby the country is less affected by the energy crisis than Europe.

Generally, fiscal policies remain an important dynamic supporting economic activity; however, it is not a simple solution in the Eurozone. In fact, fiscal measures remain large and countries wonder over how long their governments can enact these policies for. In addition, the combination of tighter monetary policy and rising fiscal deficits has led to

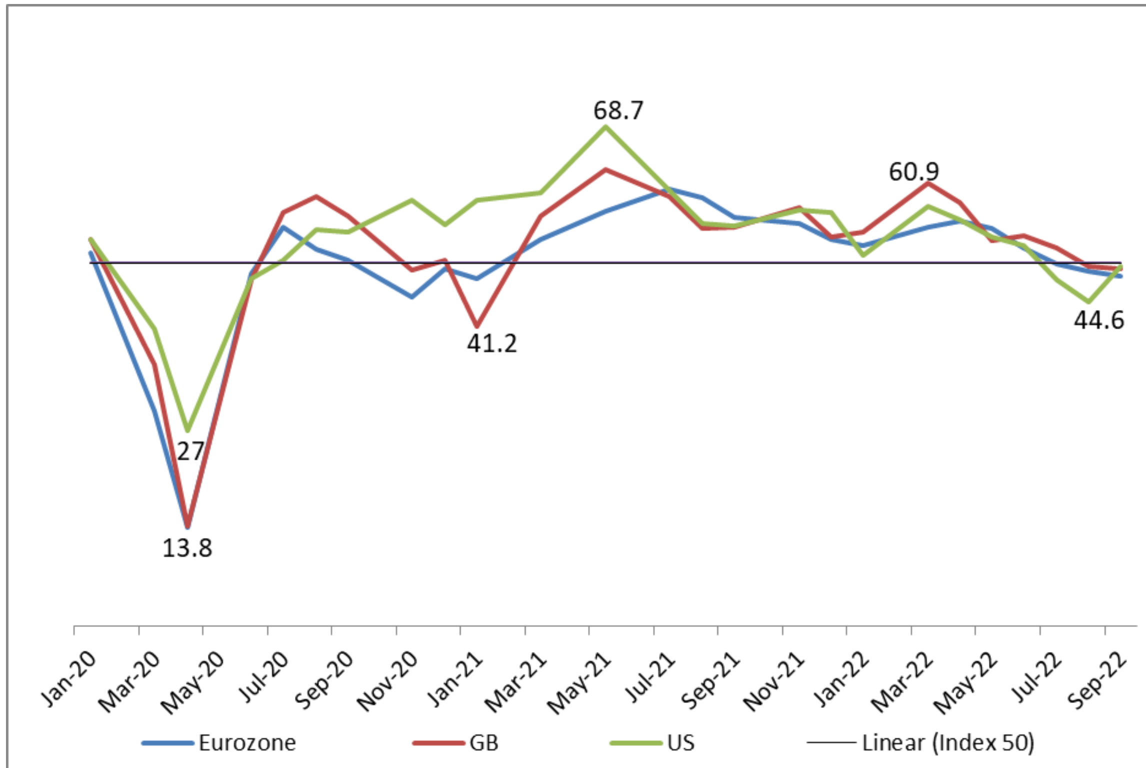
significant financial market volatility. This was best exemplified by the resignation of the UK Prime Minister Liz Truss as a result of her budget plan. In fact, Truss, along with her finance minister Kwasi Kwarteng, announced a new financial plan on September 23rd, that included massive tax cuts with little explanation of how the budget would be balanced. This immediately triggered a major drop in the bond and stock markets, leading to the significant fall of the value of the British pound.

Macroeconomic Forecasts (2019-2026) for Eurozone and US

	Year	2,019	2,020	2,021	2022f	2023f	2024f	2025f	2026f
Real GDP Growth	US	2.30	(3.40)	5.70	1.80	0.30	1.50	1.90	2.00
	Eurozone	1.60	(6.00)	5.30	3.20	(0.30)	1.60	1.70	1.70
Consumer inflation (avg)	**Year**	**2,019**	**2,020**	**2,021**	**2022f**	**2023f**	**2024f**	**2025f**	**2026f**
	US	1.80	1.20	4.70	8.10	4.50	2.50	2.30	2.30
	Eurozone	1.20	0.30	2.60	8.30	5.50	1.60	2.00	2.00
Interest rates (EOP)	**Year**	**2,019**	**2,020**	**2,021**	**2022f**	**2023f**	**2024f**	**2025f**	**2026f**
	Fed Funds rate	1.75	0.25	0.25	4.50	4.50	3.50	2.50	2.50
	ECB refinancing rate	-	-	-	2.50	2.50	2.00	2.00	2.00
Exchange rates (avg)	**Year**	**2,019**	**2,020**	**2,021**	**2022f**	**2023f**	**2024f**	**2025f**	**2026f**
	USD/EUR	1.12	1.14	1.18	1.04	1.00	1.08	1.10	1.10
Oil prices (avg) in (USD/bbl)	**Year**	**2,019**	**2,020**	**2,021**	**2022f**	**2023f**	**2024f**	**2025f**	**2026f**
	OPEC Basket	64.04	41.47	69.89	104.00	99.00	87.00	87.00	84.00
	Brent Crude	64.16	43.21	70.95	105.00	100.00	88.00	88.00	85.00

Source: Fitch Solutions Forecast and Bloomberg,

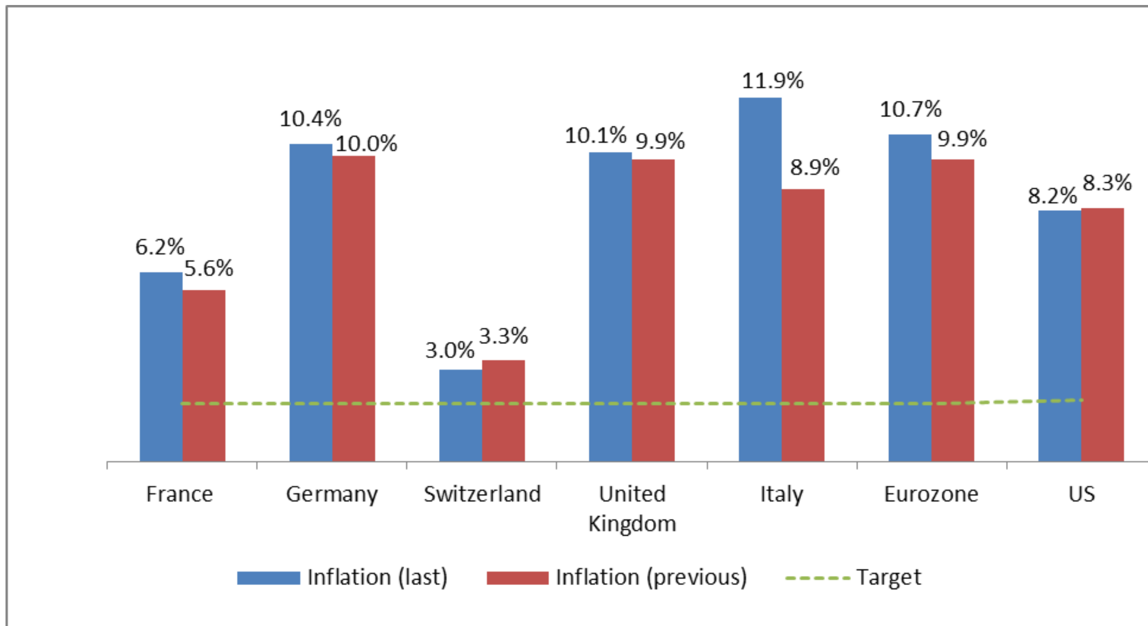
Private sector Slowing, PMI' s index for US and Eurozone



Source: IHS Markit, S&P Global

In the past six months, inflation has far exceeded expectations and European countries are particularly affected. For example, Inflation remains particularly elevated in Germany (10.0% year over year (YOY) in October, the highest rate on record), the UK (10.1% YOY) and Italy (11.9% YOY). In contradiction, inflation is less pronounced in Switzerland at 3% YOY. Furthermore, the Fed and ECB are expected to further increase interest rates in the hope that inflation reaches a target of 2% for US and less than 2% for Eurozone area in the medium rem, as mentioned earlier.

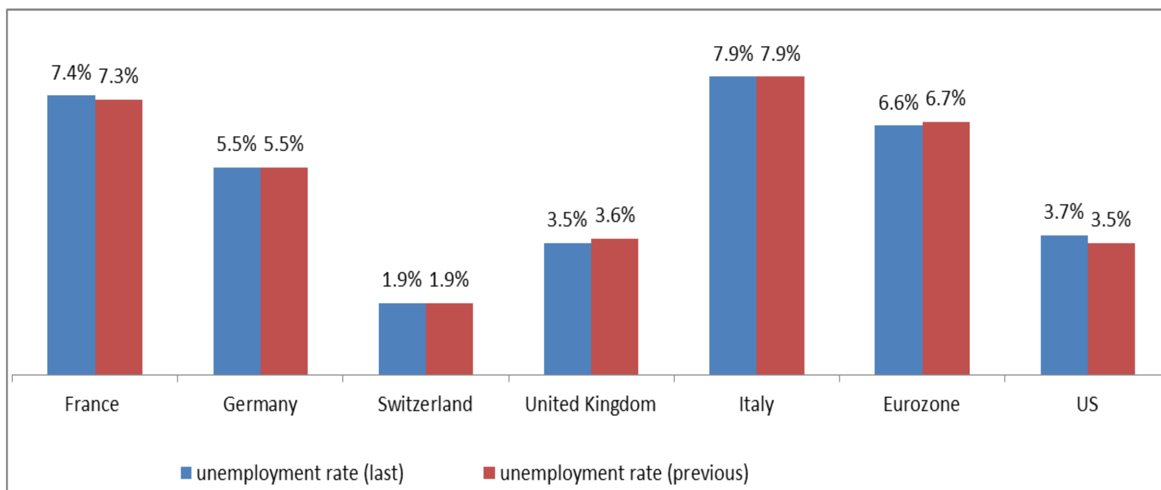
Inflation reaching record-highs



Source: Trading Economics and Blomberg

However, unemployment rate remains almost unchanged in most countries; Italy and France have the highest unemployment rate of 7.9% and 7.4% respectively in October 2022. In contrast, Switzerland has the lowest unemployment rate of only 1.9% in October.

Despite tighter monetary policy, labor market remains strong



Source: Trading Economics

Looking at the US market in the month of October 2022, hiring stayed strong as employers added 261,000 jobs despite high inflation, rising interest rates, and fear of an upcoming recession. As a result, the unemployment rate rose from 3.5% to 3.7% only YOY. Furthermore, in recent months, job growth stayed resilient in the US as companies are avoiding layoffs on fears they won't be able to fill openings when the economy bounces back. In fact, US Jobless claims decreased by 1000 over the week ending November 4, to reach a historically low figure of 217,000, thus confirming that employers continue to resist letting workers go. Nevertheless, the outlook might be turning more negative as companies anticipate a downturn and monetary policies operate with a lag, thus we estimate a modest rise in layoffs over the near term.

In conclusion, inflation has reached record-highs in October 2022 at 8.2% in US and 10.7% in the Eurozone, which is more than triple the central bank's medium-term 2% target. In fact, prices for everything from gasoline to groceries have risen at a torrid pace over the past year. As a result, the Fed and ECB continue to adopt restrictive monetary policies.

The Fed's latest rate hike on November 2nd was criticized by Democrats, who are worried that higher borrowing costs will push up unemployment. Powell expressed his conviction that low inflation was better in the long run for all Americans, even if the short-term cost was high, thereby showing that the Federal Reserve is acting on an independence streak. Similarly, Christine Lagarde, president of ECB, pushed back on political criticism that rapid rate hikes threaten to push the euro zone into recession, arguing that her job was to get inflation under control.

Arguably, the Fed and ECB have earlier lost sight to control inflation, and the cost of bringing it back on target may well initiate a recession. Unfortunately, whenever the next serious downturn hits, the Fed and ECB might not have adequate tools to fight it, thus their credibility is somewhat threatened. Citizens might wonder: what is the point of a central bank that allows inflation to reach high levels while not protecting jobs. However, without an effective central bank, the economy suffers grievously. As the Central banks' aim to lower inflation at all costs, not doing so might create an even more toxic situation known as "stagflation" (high inflation and unemployment). In fact, higher interest rates required to cool demand

and bring inflation back to target will certainly result in job losses and weaker growth and could well trigger a downturn, as is postulated by the well-known "Philips Curve" that depicts an inverse relation between inflation and unemployment. But, eventually, inflation will be back on target, and any immediate recession will end. At that point, once the labour market is back in balance, the federal funds rate will probably settle at about 2.5% according to Fed policymakers.

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