The outlook for inflation and interest rates

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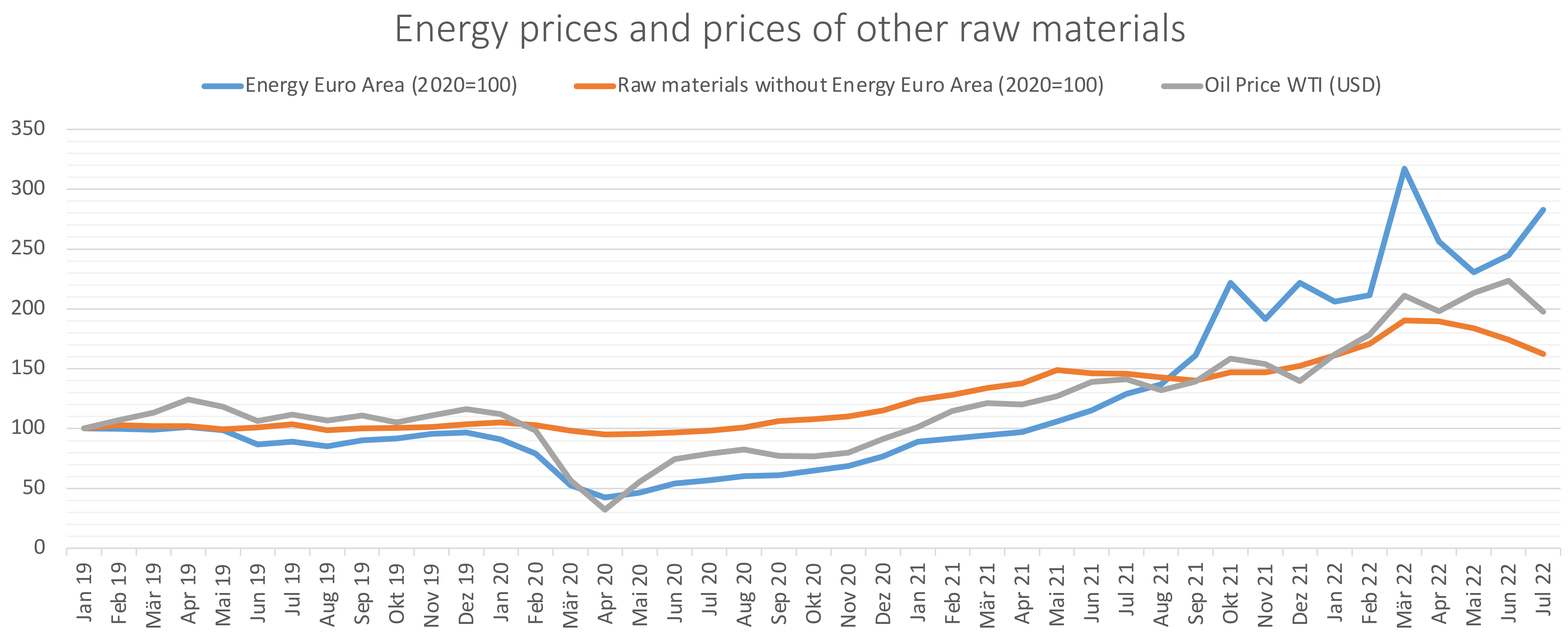
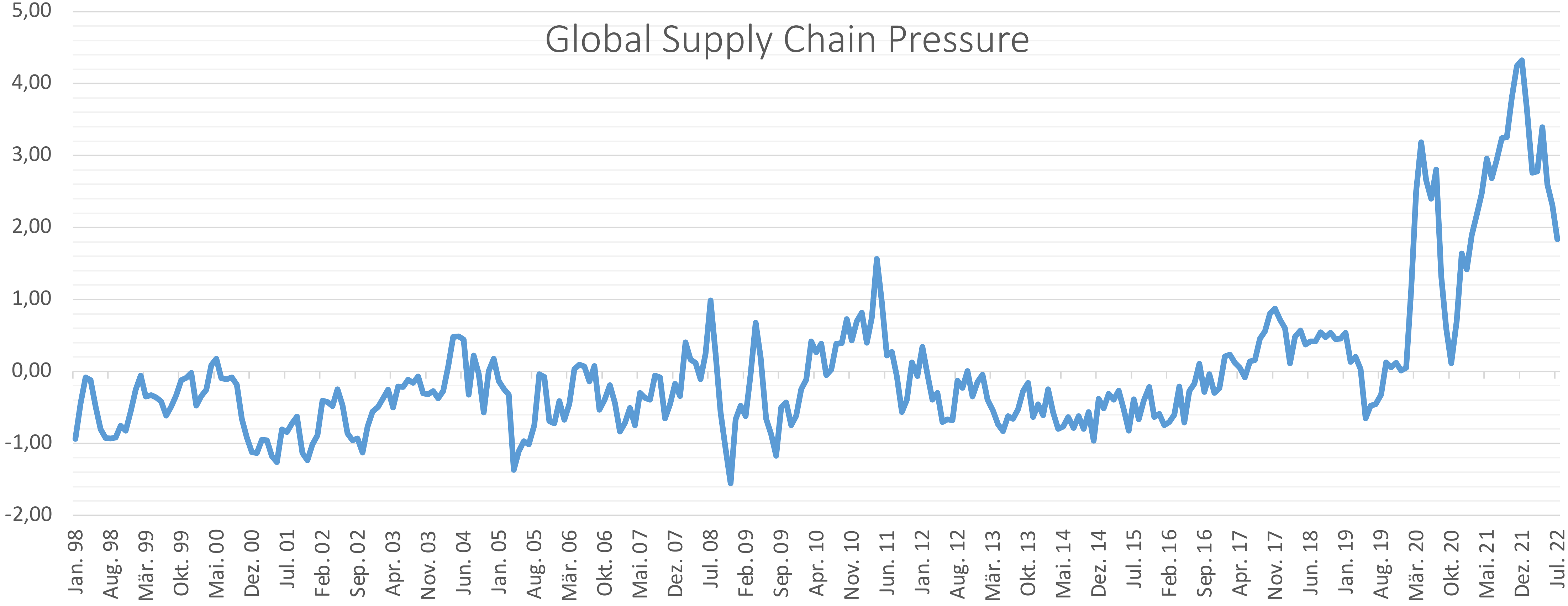
Energy prices and raw material prices have peaked



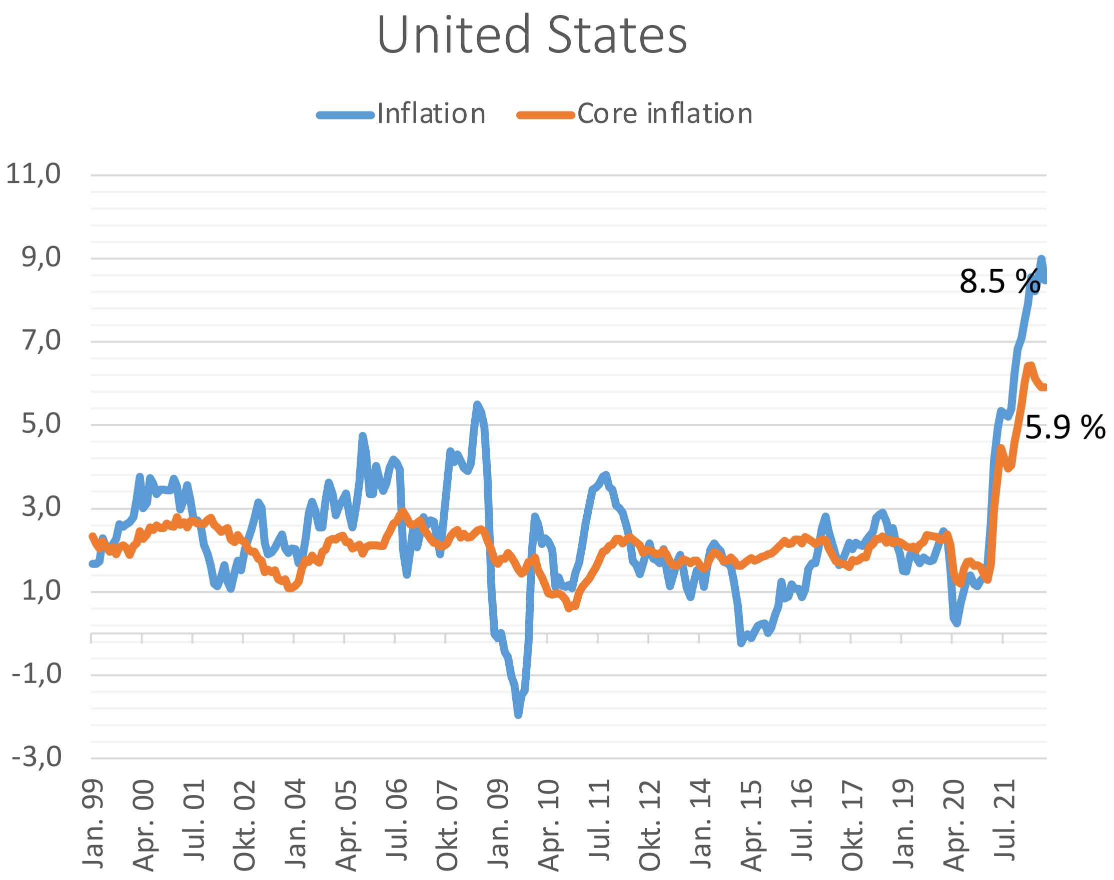
Sources :Deutsche Bundesbank, Federal Reserve Bank St. Louis

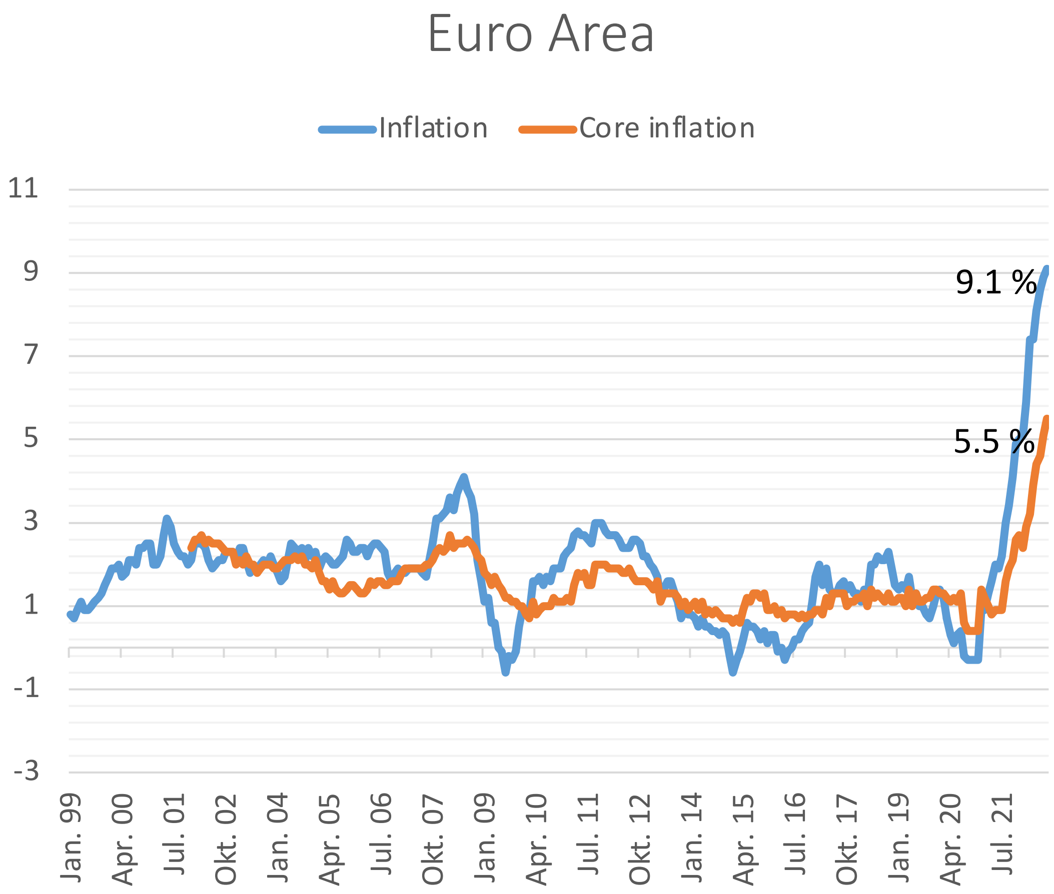
Global supply chain pressures are easing



Source: Federal Reserve Bank of New York

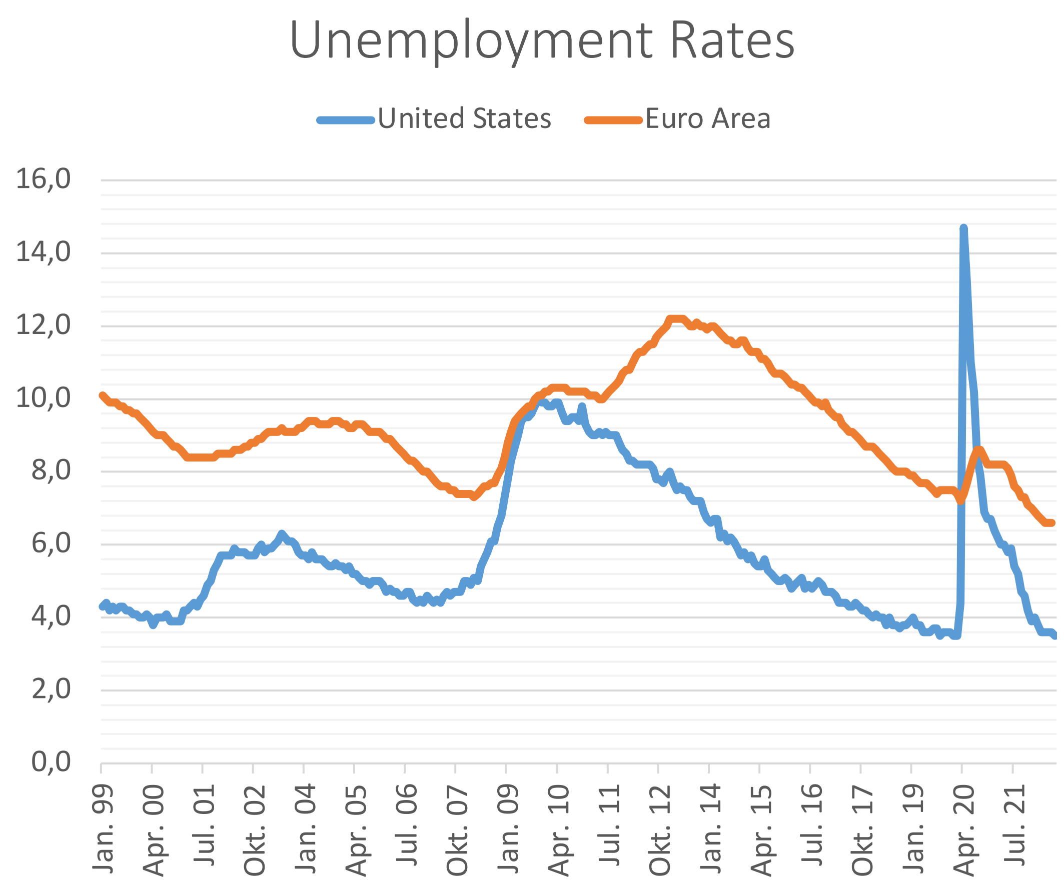
But high core inflation rates show that inflation has become systemic

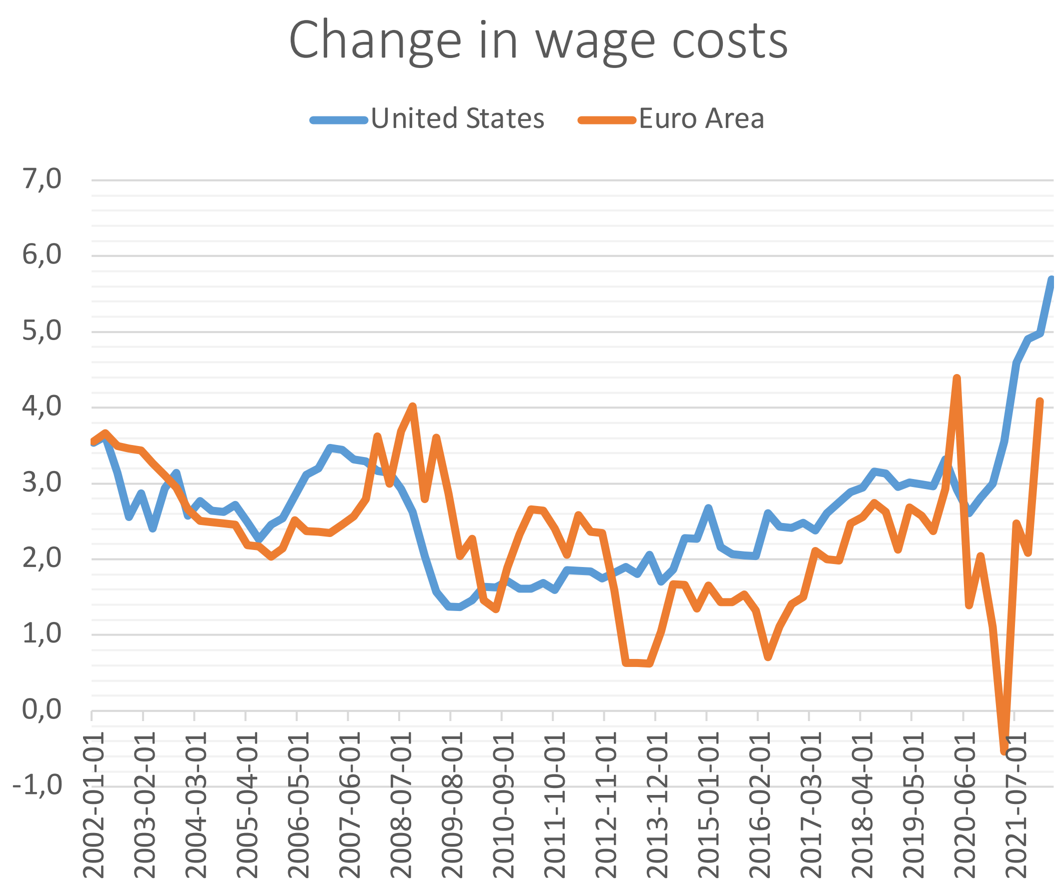




Sources: Federal Reserve Bank of St. Louis, Eurostat

Historically low unemployment rates contribute to wage cost pressures





Sources: Federal Reserve Bank of St. Louis and ECB

How will the central banks respond? Isabel Schnabel (ECB) at Jackson Hole

- **Two broad paths** central banks can take to deal with current high inflation:
  - ➢ Path of **caution**
  - ➢ Path of **determination**
- “Three broad observations speak **in favour of the path of determination**
  - ➢ the uncertainty about the persistence of inflation,
  - ➢ the threats to central bank credibility and
  - ➢ the potential costs of acting too late.”

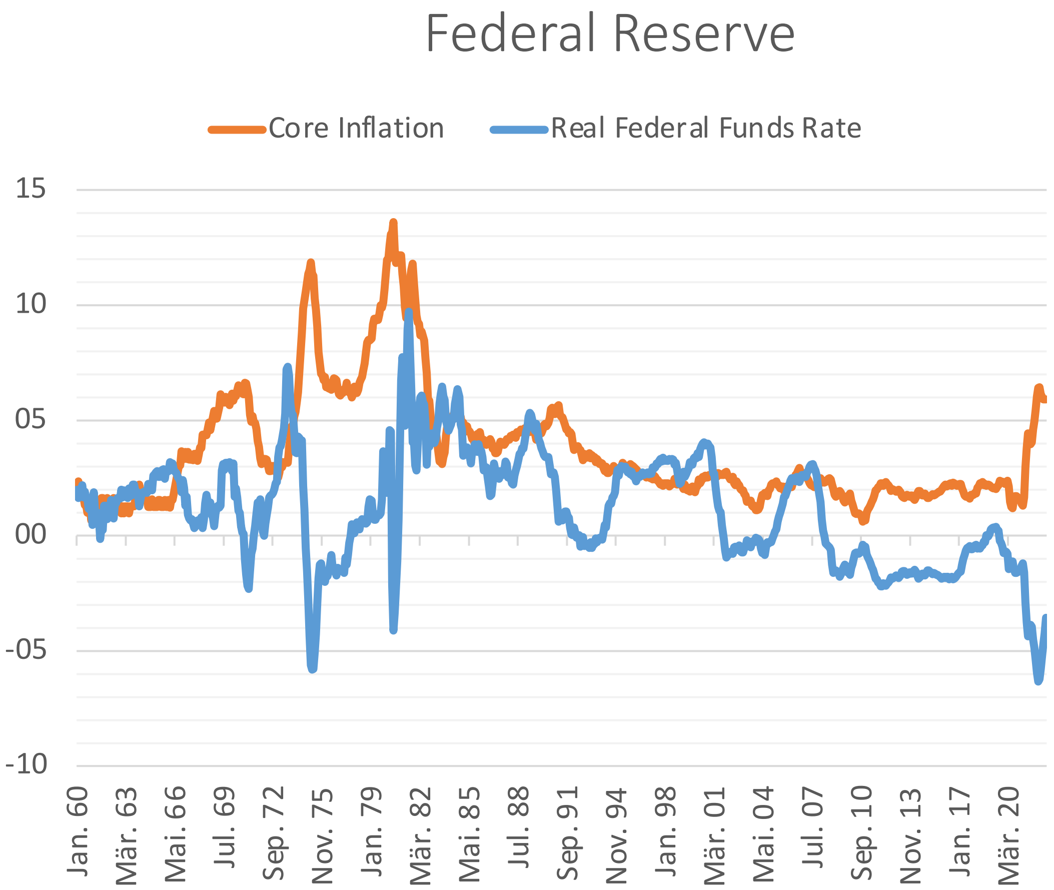
The Taylor Principle as widely agreed recipe for fighting inflation

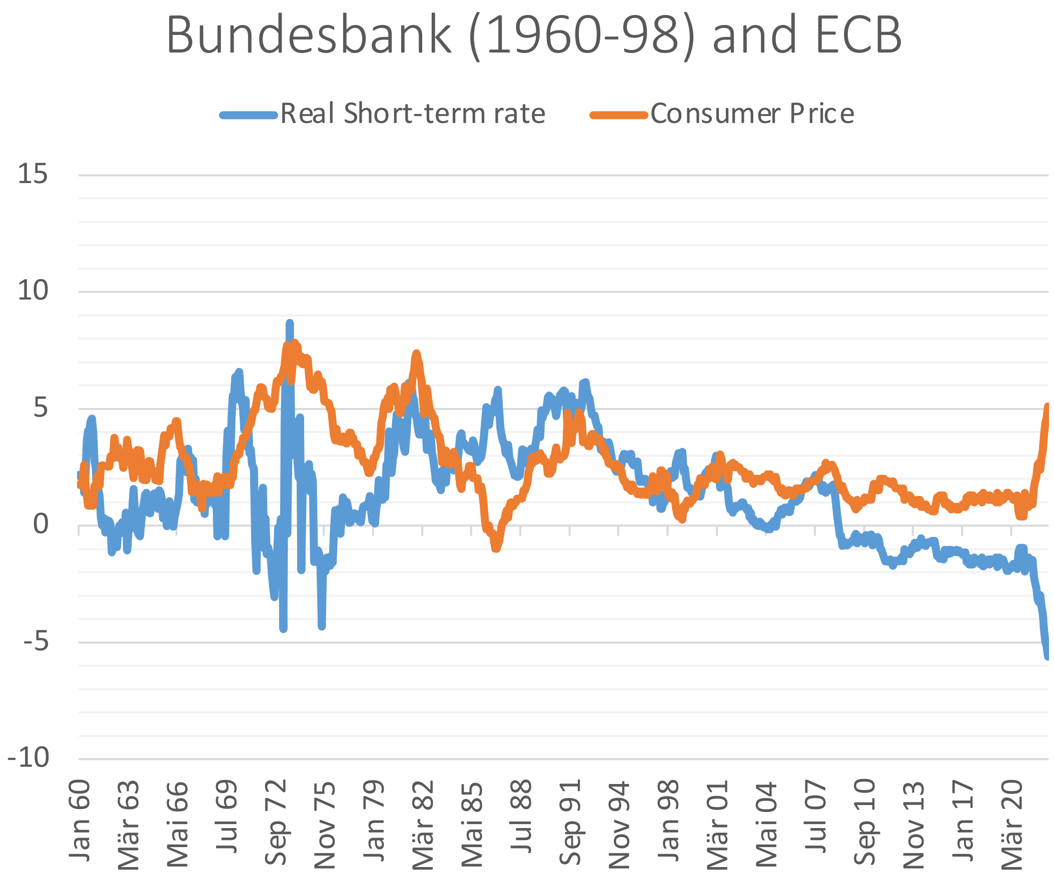
Isabel Schnabel (2022):

- “A cardinal principle of optimal policy in a situation of above-target inflation is to raise nominal rates by more than the change in expected inflation – the Taylor principle.
- **If real short-term interest rates fail to increase, monetary policy will be ineffective in dealing with high inflation.”**

John B. Taylor,Stanford University

The Taylor Principle in the 1970/80s and today



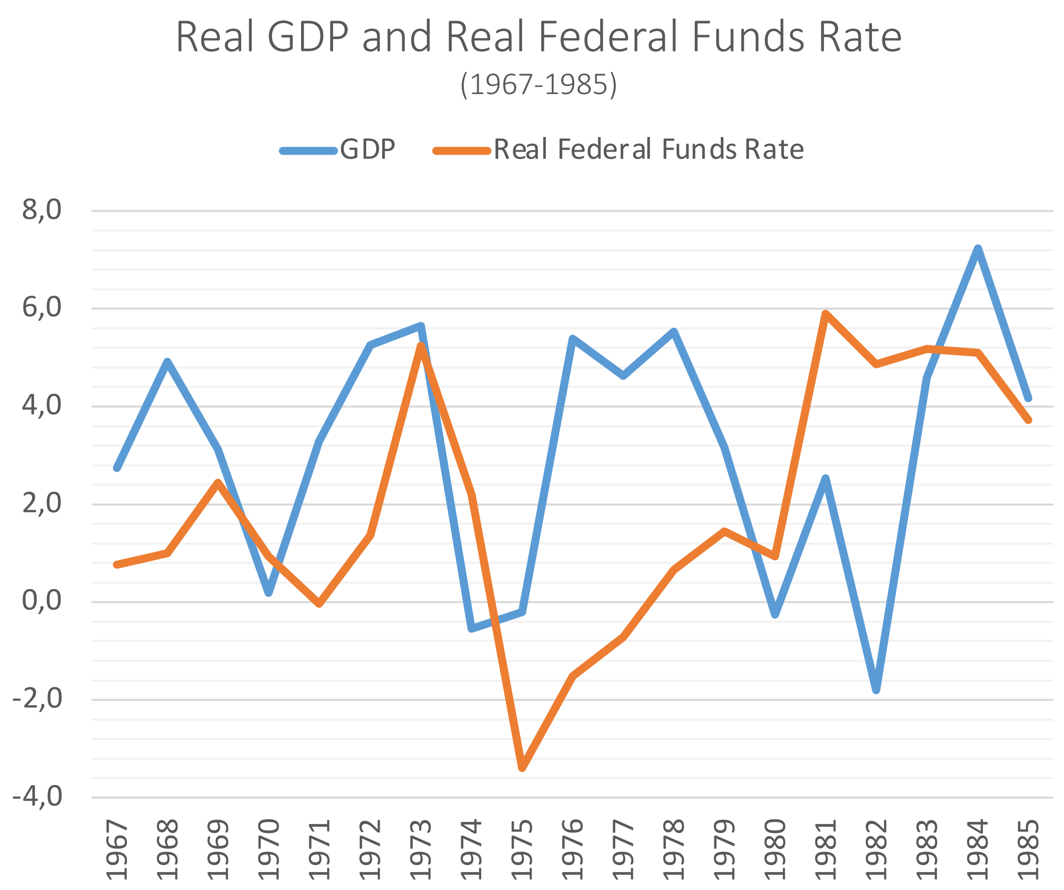


Sources: Federal Reserve Bank of St. Louis, ECB and Deutsche Bundesbank

Higher real interest rates are unavoidable, but they will lead to a recession

Chairman Jerome Powell (2022):

“While higher interest rates, slower growth, and softer labor market conditions will bring down inflation, they will also bring some pain to households and businesses. These are the unfortunate costs of reducing inflation.”



Source: Federal Reserve Bank of St. Louis

Summary

- If central banks decide for the „path of determination“ (Schnabel) and for „taking forceful and rapid steps to moderate demand“ (Powell),
  - nominal interest rates must increase further significantly so that real interest rates will increase and might even exceed core inflation,
  - a recession in the United States and the Euro Area is unavoidable
- If inflation comes down at negative real interest rates and without a recession, economic textbooks must be rewritten