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Completing the post-pandemic landing

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Completing the post-pandemic landing

Key takeaways

- *The global economy is on track for a soft landing, but the outlook has become more uncertain as new challenges loom.*
- *The lingering effects of the rise in the cost of living, large fiscal deficits, heightened policy uncertainty and a stronger US dollar pose risks to the landing.*
- *In such a complex environment, risk management considerations and clear communication are key for central banks to complete the disinflation process while supporting economic activity.*

Introduction

Over the past year, the global economy has been on the path to a soft landing, despite some variation across countries. Inflation has declined from multi-decade highs, with limited impact on growth, employment and financial stability. Nevertheless, a soft landing is not guaranteed and risks loom on the path ahead. The lingering effects of the rise in the cost of living, large fiscal deficits and heightened geopolitical and trade uncertainty pose significant risks to the outlook. As a result, central banks are facing a challenging environment when determining the size and pace of any further monetary easing.

This Bulletin discusses the disinflation journey so far and the contribution of monetary policy. It then elaborates on the key risks to the outlook and concludes with considerations for monetary policy.

The landing path so far

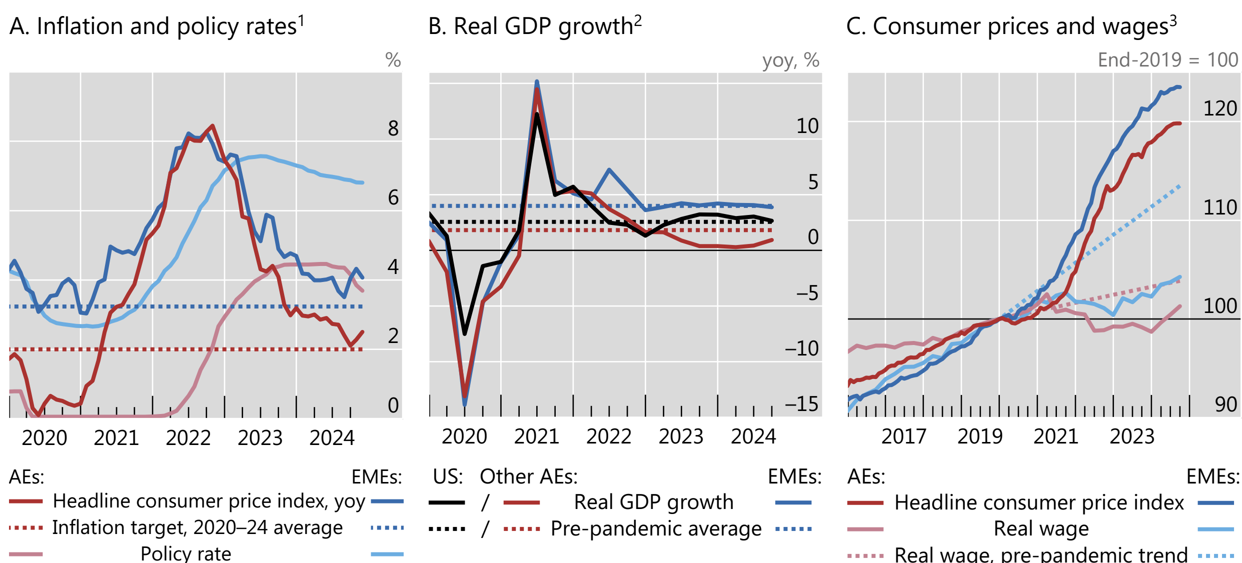
In 2021–22, inflation rates across the globe surged to levels not seen in decades, triggering a period of intense monetary tightening, with policy rates rising by several percentage points (Graph 1.A). Subsequently, inflation moderated rapidly and has returned close to target levels in many jurisdictions. This has allowed central banks to lower policy rates. That said, in a number of jurisdictions disinflation has stalled recently and inflation rates remain above target.

The decrease in inflation has occurred against a backdrop of relatively resilient economic activity. After the initial post-pandemic rebound, real output growth has slowed but recessions were generally avoided (Graph 1.B). Similarly, unemployment rates have remained low, and post-pandemic labour market mismatches, characterised by ballooning ratios of vacancies to unemployment, have been resolved. The monetary tightening has also not triggered major financial volatility as initially feared. In fact, many asset prices have risen to historical peaks and credit spreads have fallen to multi-year lows.

At the same time, there have been important sectoral and regional differences in the disinflation path. The decline in inflation rates has been driven primarily by moderating goods price appreciation, due to

the easing of supply chain constraints and the reorientation of demand towards services. In contrast, the rate of price rises in services has proven stickier. Regarding economic activity, the US economy has shown exceptional dynamism, while other advanced economies (AEs) have exhibited weak economic performance (Graph 1.B).

The post-pandemic inflation surge and retrenchment Graph 1



[1] GDP-PPP weighted averages for 10 AEs and 16 EMEs (CN excluded). [2] GDP-PPP weighted averages for 10 other AEs and 25 EMEs (CN excluded). Pre-pandemic average is for 2015–19. [3] Median of 11 AEs and 17 EMEs (CN excluded). Real wages are constructed as nominal wages deflated by headline CPI; definitions and sectoral coverage differ among economies. Real wage pre-pandemic trend is based on 2015–19. Seasonally adjusted series.

Sources: CEIC; LSEG Datastream; Macrobond; national data; BIS.

Notwithstanding the convergence of inflation towards target levels, the strength and persistence of the inflation surge have left economies with a large increase in the price level. In particular, consumer prices in AEs are on average about 20% higher compared with five years ago (Graph 1.C). An increase of such magnitude had previously taken 12 years. Nominal wages have on average kept pace with the rise in consumer prices. Real wages are currently near pre-pandemic levels in AEs and modestly higher in emerging market economies (EMEs). However, real wages have grown at much lower rates – if at all – compared with pre-pandemic trends.

The role of monetary policy in the landing

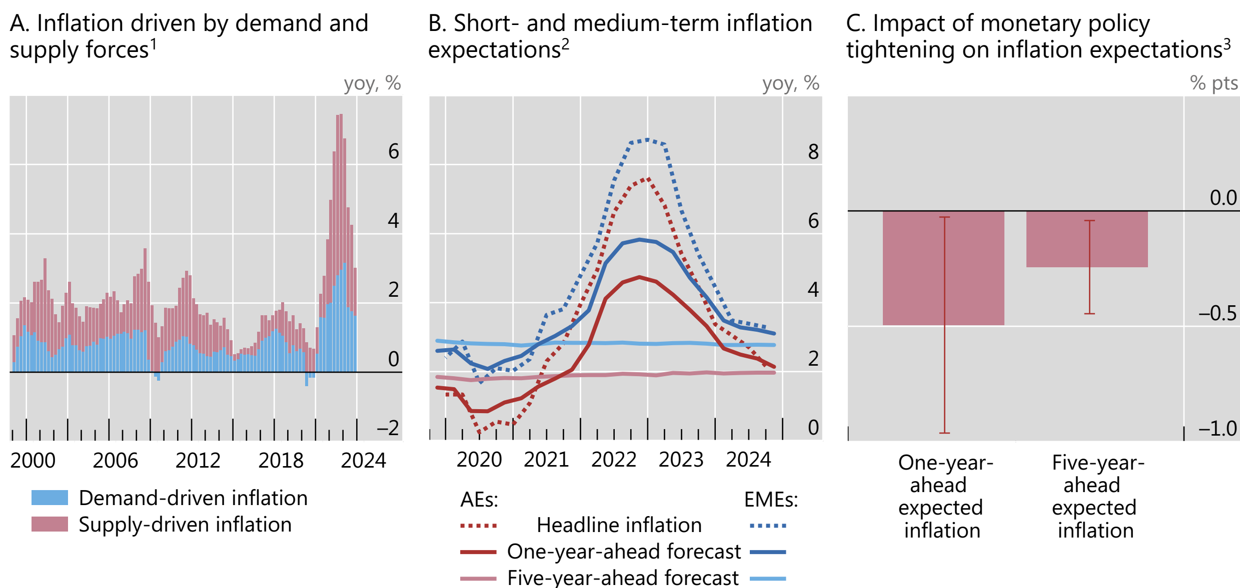
The rise and fall in inflation over the past four years reflected both supply and demand side forces (Graph 2.A).[1] Supply factors included the emergence and resolution of production bottlenecks in the wake of the pandemic and the massive swings in commodity prices following the Russian invasion of Ukraine. On the demand front, the post-pandemic reopening led to a strong rebound in consumption, supported by monetary and fiscal stimulus that were rolled out to address the pandemic's economic fallout.

Monetary policy contributed to the disinflation in two main ways. First, the monetary tightening helped to reduce excess demand, reflected in the decline in the demand component of inflation (Graph 2.A). The demand compression had a modest impact on economic activity because it occurred

[1] This decomposition is based on Shapiro (2022) and Eickmeier and Hofmann (2022). Both approaches rely on the same identifying assumption that changes in supply drive inflation and output in opposite directions, while changes in demand move both variables in the same direction.

against the backdrop of a steeper Phillips curve, characterised by supply bottlenecks due to the pandemic disruptions. Another factor limiting the impact of the tightening on economic activity was the larger share of longer-maturity debt in many economies and the greater resilience of the financial sector, reflecting stronger balance sheets and enhanced prudential frameworks.

The role of monetary policy in the landing Graph 2



[1] Decomposition of headline inflation. Simple averages across AU, CA, EA, GB, KR, SE and US. [2] Headline consumer price inflation. The one- and five-year-ahead inflation forecasts are constructed, respectively, as the weighted average of the current- and next-year forecasts and the four-year and five-year forecasts. Simple averages of 11 AEs and 21 EMEs (CN excluded). [3] Inflation expectations of professional forecasters. The monetary policy tightening represents a 1 percentage point increase in the two-year government bond yield. Error bars indicate 90% confidence intervals. The sample includes AU, CA, CH, EA, GB, JP and US.

Sources: Hofmann et al (2024); Bloomberg; Consensus Economics; LSEG DataScope; LSEG Datastream; national data; BIS.

Second, and probably a more decisive factor, monetary policy played a key role in anchoring inflation expectations, preventing the pandemic- and war-related massive price increases from triggering broader second-round effects. Medium- and long-term inflation expectations remained remarkably stable during the inflation surge (Graph 2.B). Short-term inflation expectations rose, but much less than actual inflation rates, and have now returned close to pre-pandemic levels.

Monetary policy contributed to the anchoring of inflation expectations via three channels. First and foremost, it operated through the credibility of the monetary policy frameworks, built up during the prolonged period of low and stable inflation preceding the pandemic.[2] Second, clear communication from central banks underscored their commitment to bring inflation back under control.[3] Third, words were backed up by actions through policy rate hikes, proving central banks' resolve to curb inflation. Indeed, since the beginning of the monetary policy tightening in AEs in mid-2022, interest rate hikes significantly reduced both short- and medium-term inflation expectations (Graph 2.C). Specifically, econometric estimates indicate that over this period a 1 percentage point increase in two-year bond yields, driven by monetary policy, lowered inflation expectations by approximately 0.5 percentage points for the one-year horizon and 0.25 percentage points for the five-year horizon.

[2] Grigoli and Sandri (2024) find that central bank credibility strengthens the anchoring of household inflation expectations.

[3] De Fiore et al (2024) show that media coverage of monetary policy influences medium-term inflation expectations, with hawkish sentiment reducing inflation expectations.

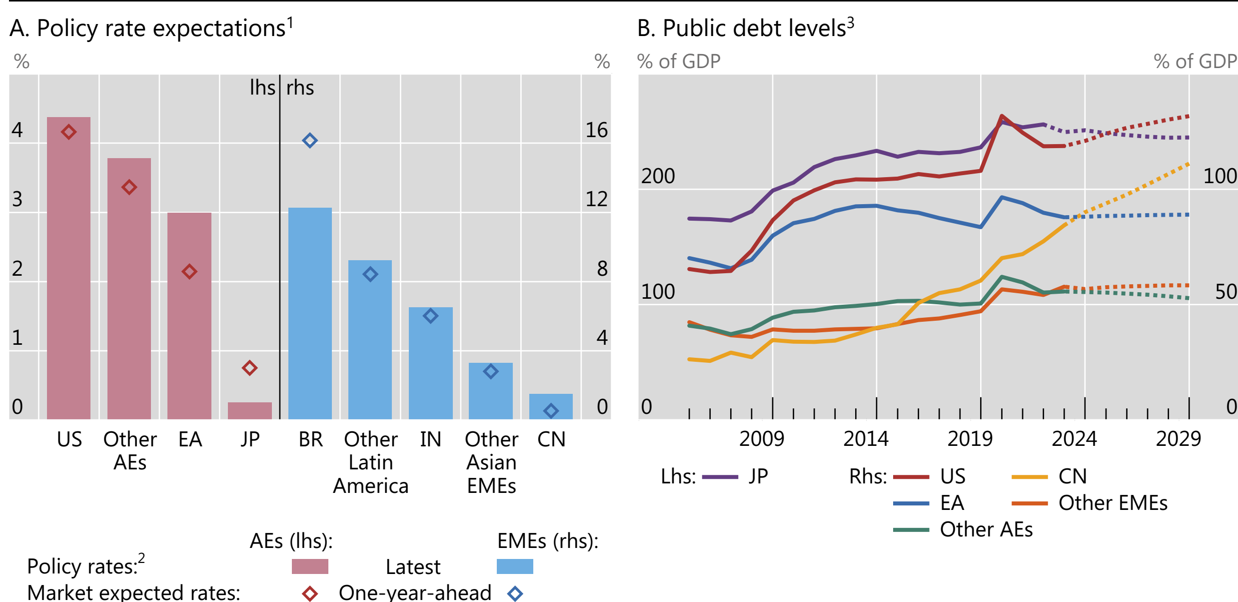
The path ahead

Global economic developments so far point to a soft landing, ie inflation rates coming down to target levels with slowing growth but without recession. Moreover, market participants assess a soft landing as the most likely scenario for the global economy (Bank of America (2024)). That said, the perceived probability of "no landing", ie strong growth and sticky inflation, has increased recently alongside more positive news on global economic conditions.

In line with a soft landing base case, policy rates are expected to fall further in most economies over the year ahead (Graph 3.A). Yet as inflation rates are returning or have already returned to target, monetary policy is also becoming more differentiated across economies. For example, only limited additional easing is expected in the United States, while much lower policy rates are expected in the euro area as the downside risks to inflation from weak activity grow. In EMEs, policy rates are expected to tighten significantly in Brazil and to decline only modestly elsewhere.

However, a growing number of risks and vulnerabilities could change the scenarios for monetary policy, amid greater economic divergence across jurisdictions.

Monetary and fiscal policy | Graph 3



[1] Latest figures. For the regions, GDP-PPP weighted averages for eight other AEs, four other Asian and three other Latin American EMEs. [2] For CN, seven-day reverse repo rate. [3] General government gross debt. IMF definitions and estimates; estimates start in 2024 or earlier, as indicated by the dotted lines. For the regions, simple averages of eight other AEs and 27 other EMEs.

Sources: IMF, *World Economic Outlook;* Bloomberg; LSEG Datastream; national data; BIS.

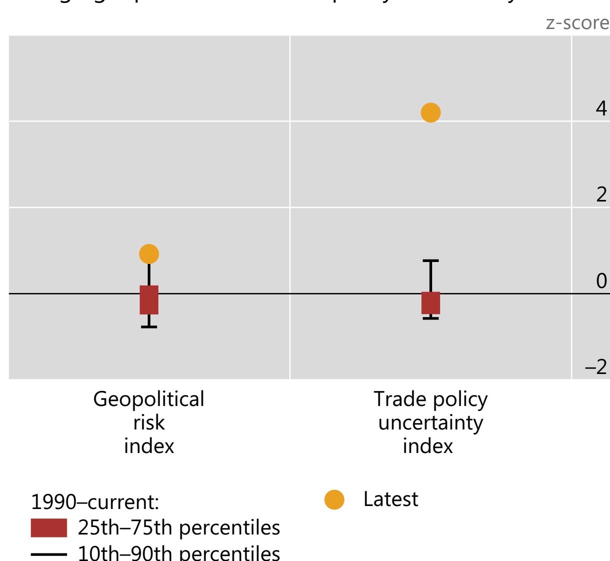
First, monetary policy will face complex challenges posed by the anaemic growth of real wages in the post-pandemic years. As illustrated in Graph 1.C, wages have barely kept up with inflation in AEs and have only grown modestly in real terms across EMEs. If real wages continue to stagnate, this will weigh on economic activity. On the other hand, if workers demand "catch-up" wage increases in excess of productivity, this could exert upward pressure on inflation if it ignites second-round effects. As a result, inflation may turn out to be stickier than currently expected. Furthermore, limited tolerance for further erosion in real wages could amplify the impact of new inflationary shocks. Even if short-lived, such shocks may become more salient and hence lead to more immediate demands for compensation via higher wages or fiscal support.

Second, current fiscal trajectories may underpin inflation and could result in tighter financial conditions. Large fiscal deficits are expected to persist in coming years, sustaining aggregate demand and possibly inflation, especially in economies with already strong economic conditions. Furthermore, fiscal deficits will lead to further increases in public debt levels in some major jurisdictions (Graph 3.B). This could induce investors to demand greater compensation for holding government bonds, tightening financial conditions and weighing on economic activity. Higher government bond yields and high debt could also leave fiscal policy with limited room for manoeuvre in the event of future shocks.

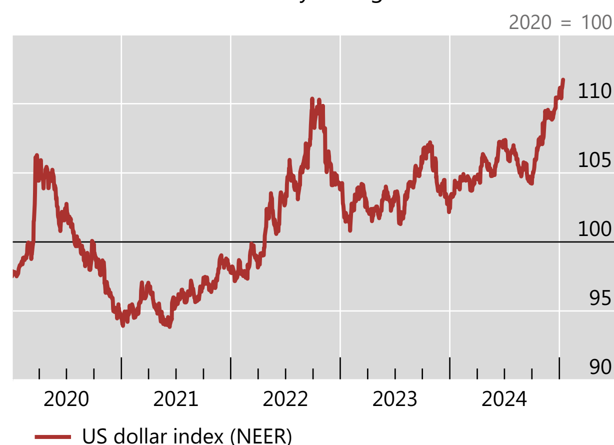
Third, heightened policy uncertainty poses risks to economic activity. Measures of trade policy uncertainty have spiked in recent months, while geopolitical uncertainty has been above average for some time (Graph 4.A). While empirical studies have identified negative effects of trade and geopolitical uncertainty on economic activity (eg Caldara et al (2020); Caldara and Iacoviello (2022)), the implications for inflation are less clear. Weakness in activity is a downside risk for inflation. Conversely, geopolitical events could again be a source of inflationary pressure if they came along with commodity market or supply chain disruptions.

Uncertainty from geopolitics and trade policies amid dollar strength — Graph 4

A. High geopolitical and trade policy uncertainty[1]



B. The US dollar has recently strengthened[2]



[1] Geopolitical risk index refers to the number of articles related to adverse geopolitical events as a share of the total number of articles in 10 newspapers each month. Trade policy uncertainty index refers to the number of articles related to trade policy uncertainty as a share of the total number of articles in seven newspapers each month. [2] BIS broad nominal effective exchange rate (NEER). An increase indicates an appreciation of the US dollar.

Sources: Caldara et al (2020); Caldara and Iacoviello (2022); Macrobond; national data; BIS.

Global trade will probably face increased frictions and fragmentation, with implications for domestic output and prices. Although details of new trade policies are yet to be revealed, a tangible risk scenario is the broad-based imposition of trade tariffs by the United States with retaliatory measures by other countries. Estimates from a range of studies suggest that output will probably drop in the short run, while changes in consumer price are likely to be uneven across economies. The inflationary effects will also heavily depend on the form of tariffs and the specific goods on which they are implemented. A key issue for central banks will be the risk of second-round effects after the initial price pass-through impact of tariffs, particularly given the potentially limited tolerance for further price increases among households.

Challenges to monetary policy may also arise from the global financial environment. The growing differentiation of monetary policy across economies will raise the potential for significant capital flow and exchange rate adjustments. Specifically, the value of the US dollar could continue its recent rise (Graph 4.B)

on the back of higher US interest rates, a stronger US economy and high political uncertainty. This could have stagflationary effects on the global economy due to the dollar's dominant role in trade invoicing and international finance. On the one hand, an appreciation of the US dollar would boost inflation outside the US by increasing import prices and possibly inflation expectations, especially in EMEs. On the other hand, dollar strength would tighten global financial conditions and dampen real economic activity, particularly in economies with weak fundamentals and vulnerable fiscal positions.[4]

Considerations for monetary policy

Going forward, calibrating monetary policy will prove challenging, due to heightened uncertainty. Central banks will need to contend with inflationary pressures from real wage catch-up, fiscal policy uncertainty, economic weakness in several jurisdictions, the possible introduction of trade tariffs and exchange rate adjustments. This challenge is compounded by uncertainty surrounding the level of real equilibrium rates (Benigno et al (2024)).

In navigating these turbulent waters, risk management considerations will be key in guiding central banks' decisions. Central banks will need to strike the appropriate balance between completing the disinflation process and sustaining economic activity, especially in countries where clear signs of economic weakness have emerged. In this context, there is a premium on proceeding with gradual interest rate adjustments, while providing clear communication about the central bank's policy reaction function and its assessment of the economic outlook and surrounding risks.

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[4] See Hofmann et al (2023) for a discussion of the stagflationary global effects of US dollar appreciation.