Exchanges at Goldman Sachs

How Policymakers are

Navigating Stagflation Risk

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Allison Nathan: This is Exchanges at Goldman Sachs and I'm Allison Nathan, senior strategist in Goldman Sachs Research and creator and editor of the firm's Top of Mind report. In this episode, we're focusing on the risk of stagflation. That's the combination of stagnant growth and higher inflation that many of our listeners might remember from the 1970s. Today we're facing two major growth risks that are looming large against a backdrop of alarmingly high inflation.

The first growth risk is the prospect of a policy mistake in the US as the Fed has embarked on a tightening cycle to rein in inflation, which was already running at multi-decade highs before the tragic Russia-Ukraine conflict delivered a sizable commodity shock.

And the second growth risk is the prospect that the conflict deals a crippling economic blow to Europe, in particular given Europe's dependence on Russian energy. How US and European policymakers navigate these risks and their growth and market consequences are Top of Mind.

We first speak to Eric Rosengren, former president of the Federal Reserve Bank of Boston, who believes that, even though the Fed has now begun to hike rates, it remains behind the curve in addressing inflation.

Eric Rosengren: They are definitely behind the curve. Inflation is well above 2%, as we all know, both by PCE and CPI. The unemployment rate is below 4%. So arguably, we're at full employment and certainly below the CBO's estimate of full employment. In that environment, we should see interest rates that probably are a little above neutral. And so if you think eventually we're going to hit an inflation target of 2% and the real rate of interest ought to be positive, not negative, we're pretty far away from that point. So I do think they have a lot of room to catch up.

If any mistake was made, I think it was really not pivoting earlier. So March, April, I think it's quite reasonable to focus on things likely being temporary. As we got into late spring and into the summer, ideally we probably would have pivoted and not had to move so abruptly as we got into this year.

Allison Nathan: And while the Fed has begun to hike rates and the market is very squarely focused on just how quickly they'll continue to do so ahead, Rosengren thinks the Fed could be doing more with the balance sheet with the aim of raising longer term interest rates. How do you think about the effectiveness of shrinking the balance sheet in terms of containing inflation?

Eric Rosengren: My own view may be a little less traditional, so I'm speaking for myself certainly and it may not be reflective of how the committee's thinking about it. I would say the last time we did our exit strategy, the goal was to rely primarily on the Federal Funds Rate for tightening. The problem that we have right now is that supply can't keep up with demand, so obviously raising rates does nothing to increase supply. And so it doesn't solve the supply problem. But the problem really is that demand is greater than supply. So as you're raising rates, less people are going to be buying homes. Less people are going to be buying cars. Less people are going to be buying other goods and services. So you're not expanding supply, but you are reducing the demand.

So there's not a magic to slowing down the inflation rate. You need the demand to slow down enough that the goods being produced are about what we're expecting to purchase. In effect, we probably want people to buy fewer houses and cars for a while. Those are long rates, not short rates. Most people buying cars or houses are buying it through long-term financing. I mean, for many people, they're looking at a 5- or 6-year loan for a car, and you're looking for a long-term mortgage.

That would imply that changing the balance sheet might be more effective than people think. So if we're serious about slowing down the economy to address inflation and one of the areas that is a big purchase is cars and shelter gets a very big weight in the CPI, housing prices and rents have been going up very rapidly, I think that looking at the balance sheet and thinking about whether the exit strategy ought to have more of a role for recalibrating the balance sheet I think would make sense.

One other thing that I would add, if you think about financial intermediaries borrowing at the short end of the market and lending at the long end, if you raise the short-term rate very rapidly, you're flattening the yield curve and giving financial intermediaries less incentive to lend. So either they have to raise their spreads, or they reduce the credit availability to borrowers or they ration credit to people that are most credit worthy.

If instead what you do is focus on the balance sheet, you're steepening the yield curve. That actually makes it more attractive for financial intermediaries to lend so you don't have the same issue with credit availability. So the different tools do have a different impact on who's impacted. So I actually would have on the table maybe not trying to do as much with the Federal Funds Rate and be a little bit more reliant on recalibrating our balance sheet, which is very, very large relative to historical experience, which I doubt the Fed will do.

Allison Nathan: And as the Fed raises rates to rein in inflation, Rosengren sees an increased risk of a monetary policy induced recession.

Eric Rosengren: The faster the Fed has to raise rates, the more unpredictable the outcome and the more likely that you overtighten and cause a recession. So the goal is to slow down demand. But there are a lot of things that can amplify that slowdown in demand, including changes in the labor market that make it much less predictable using our historical equations. So thinking through with all these things that we don't really have in our historical experience, if you decide that in order to bring inflation down you have to raise rates really quickly then my probability for a recession goes up quite dramatically.

The first set of hikes would not be my concern. I think when it really becomes tricky is in the second half of this year. And a lot could happen by the second half of this year. Who knows where oil prices and issues with Ukraine will be? Who knows whether we'll have another variant as we get into the fall? So I think it's pretty unpredictable at this stage, but I do think the faster the Fed moves, the more the risk is. And I would say the risk is more elevated this time than in quite a long period of time.

The last two recessions have definitely been induced by factors, in my view, other than monetary policy. But I would say the risk of monetary policy being the factor this time has grown.

Allison Nathan: Jan Hatzius, our head of Global Investment Research and chief economist, agrees that the risk of a policy-induced recession in the US has risen.

Jan Hatzius: Our baseline is a soft landing, a slowdown in growth, and a significant increase in rates. We now have around 3% for the funds rate by the end of next year. And in that environment, we have growth come down to a 2% pace and then slightly below 2% even beyond that. And that occurs in an environment where more people come into the workforce as COVID fear comes down and financial cushions expire. And that gradually reduces the overheating in the labor market.

But the risk of growth in this state of course goes up if the environment becomes harder to predict, and it's harder to estimate the size of the fiscal drag. We know there is fiscal drag. But whether it's 1 percentage point or 3 percentage points on growth is not easy to know. We don't know the ultimate impact of the geopolitical uncertainties. We know it's going to be negative for growth and positive for inflation but to what extent is harder to know. So of course the risk that policy is not well calibrated goes up.

Allison Nathan: So has recession risk increased?

Jan Hatzius: Yeah, I think it's a more unfriendly environment. Our growth forecast is below consensus. So we're basically saying that central banks are going to deliver contractionary shocks to an economy that is probably already going to disappoint. And of course if you're in a below trend growth environment, there's always the risk that you discover you've pushed the economy below stall speed and that you become a victim of the three-tenths rule in terms of the rise in the unemployment rate, which is visible in the US very clearly in the data and also visible to a lesser degree in other advanced economies. So, yeah, I think the risk that you do see a recession at some point over the next year or two has gone up. And in the conversations that we did have four to six months ago, I think I said risk of recession is certainly there but mainly because of the risk of a renewed very adverse COVID shock. That's of course still a possibility as well.

But I would now say, at the risk of generating a more organic recession or a more traditional recession through the interaction of central bank policy, financial markets, and growth, that's gone up. I don't know whether it's bigger than the risk of a COVID-induced renewed downturn, but it's certainly up there.

Allison Nathan: To gauge the risks of recession in the euro area amid the growth shock from Russia's invasion of Ukraine, we then speak to Philipp Hildebrand, vice-chairman of BlackRock, who believes that the stagflation risks in the euro area have grown sharply in recent weeks.

Philipp Hildebrand: I think stagflation is a real concern. So I was not one who shared great stagflation fears up until a couple weeks ago. In fact, I wrote very explicitly this is not to be compared to the 1970s. We didn't have inflation as a result of overheating and needed to hit hard on the monetary policy breaks in order to get the overheating out of the system. This was all related to the post COVID restart.

Now of course, on top of the preexisting supply shock related to COVID and the restart, we now have another huge supply shock. So it's supply shock layered on top of supply shock. And particularly in Europe, that creates a different outcome where you have not only inflation moving even higher and critically will become more persistent because of this supply shock on top of supply shock, but also because of the energy nature this time principally of the shock on the supply side, it's also going to hit growth.

Now, in the US, we have a relatively large growth cushion. In Europe, the situation is more worrying. Consensus for growth had been about 4% this year in Europe. We think the hit to growth from what we've seen already in terms of the shock is going to be material. And I would expect it to be somewhere in the neighborhood of 2-3 percentage points. That shows you pretty quickly that you're getting uncomfortably close to a zone where stagflation becomes a real risk. And the effects will range from weaker real incomes, lower consumer and business confidence, as well as disruption to supplies of essential input.

So Europe could actually get quite close to some form of stagflation. And if energy supplies were to be significantly disrupted on top of what we've had already, the hit to growth in Europe could be even bigger. And at that point, just arithmetically, we would find ourselves pretty quickly in a downside risk scenario that could take Europe into stagflation.

And particularly if we have to think about Russia cutting Europe off gas as an extreme example, that would create another big growth shock. And we would then be very, very close, if not in the stagflation environment.

Allison Nathan: That said, Hildebrand believes that monetary policymakers have no choice but to press ahead with tightening given the most dangerous risk today in his view, the de-anchoring of inflation expectations.

Philipp Hildebrand: I think we have to expect that inflation will, at the margin, drift higher. And we're going to have more persistent inflation, which also means that we really can't expect, unlike COVID, unlike the financial crisis, we can't expect the central banks to really ease in any effective material way. They're going to have to continue to normalize. I mean, this is what you saw the ECB is persisting on its rolling back purchases.

One of my colleagues recently said, “I think he's exactly right.” The dirty little secret of central banking is we don't really understand that much about how inflation expectations work, right? You know, the story is they're solid because we've done such a good job over decades to create price stability. That's true. But how that expectation gets embedded and how it can come undone is something, at least to my knowledge, that we know a lot less about. So the most dangerous issue is how do we know, how do we see, how do we measure, how do we anticipate the moment where inflation expectations become unstuck?

Central banks must do enough to exude credibility to ensure that long-term inflation expectations don't become un-anchored.

Allison Nathan: But while Hildebrand thinks policymakers will move ahead with tightening, he thinks the full cycle of rate hikes will be shallower than in the past, and central banks will ultimately have to learn to live with higher inflation. I asked him why.

So if you are more concerned about the inflation outlook off the back of this additional supply shock, why would you expect that the normalization will be less than in past cycles?

Philipp Hildebrand: Because it is still mostly a supply-side story. And you would have to absolutely kill the economy to get inflation significantly down. Just to raise rates doesn't ease these mostly energy-driven supply constraints. And so the trade-off, particularly in an environment where growth is weakening, the trade-off is one that no central bank I think will go for.

And so what that means, essentially, I think central banks are now captured in a paradigm where they have to tolerate higher inflation. We've labeled this living with higher inflation. I think that's exactly right. We're going to see some normalization that's appropriate from a macro perspective and is important from a long-term expectations perspective. But it's going to be muted relative to what you would normally expect. And therefore, a consequence will be inevitably having to live with higher inflation.

Allison Nathan: Hatzius, for his part, expects relatively aggressive Fed tightening ahead, which thinks will lead to the Fed Funds Rate peaking in the current cycle in the 3-3.25% range. That would be above current market pricing even despite a sharp rise in bond yield in recent days. We'll certainly be keeping a close eye on what the simultaneous shocks from Fed tightening and Russia's invasion of Ukraine mean for growth, inflation, and markets ahead.

I'll leave it there for now. If you enjoyed the show, we hope you subscribe on Apple Podcasts and leave a rating or comment.

I'm Allison Nathan. Thanks for listening to Exchanges at Goldman Sachs, and I'll see you next time.

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