Easing Inflationary Pressures

After decades of price stability, the return of inflation was one of the big stories of 2022. CPI rates hit forty year highs, reaching double-digit levels in many countries, resulting in a marked tightening of monetary policy and a sharp slowdown in economic activity. Altogether, this inflicted considerable damage on financial markets which endured one of their worst years on record.

There are concerns that with central banks indicating further significant rate hikes are in store in the coming months, the global economy is set for a difficult year in 2023, while at the same time, financial markets will struggle for traction. The recent omens on inflation, though, have been encouraging.

Headline rates are already declining. In the US, the CPI rate has been on a steady downward path since June, falling from 9.1% to 7.1% by November. In the Eurozone, inflation fell from a peak of 10.6% in October to 9.2% by December. Core inflation is also easing in the US, with the core PCE rate falling to 4.7% in November from 5.2% in September. Indeed, the monthly rise in the core index slowed to 0.3% in October and 0.2% in November.

Developments in upstream price indicators suggest there could be a marked fall in inflation in 2023. Supply chain disruptions were a key part of the rise in inflation in 2021-22. However, there has been a marked easing in supply chain constraints as evidenced by the downward trend since mid-2022 in the Global Supply Chain Pressure Index produced by the New York Fed.

Meantime, wholesale oil and gas prices have fallen sharply since the summer. Experts in the UK are predicting there will be substantial falls in the energy price cap set by the energy regulator Ofgem in 2023, which would trigger big declines in the CPI rate. This fall should be replicated in inflation rates in other countries.

Rising retail food prices have been a key factor in the sharp jump in inflation. Global commodity food prices, though, fell sharply over the second half of 2022, reversing all of the upward spike seen following the Russian invasion of Ukraine. This points to a likely cooling of food price pressures in 2023.

There are other encouraging signs also. Inventories are being rebuilt and shipping costs have fallen sharply, further favourable signals that price pressures will ease. PMI surveys also show price pressures are softening. Indeed, a US manufacturing survey for December showed input prices falling at their fastest pace since 2016, bar during the early stages of the COVID-19 pandemic. Meanwhile, the upward pressure on house prices and rents is also moderating, most notably in the US. The lagged impact of the tightening of monetary policy in the past year should also start to dampen inflation in 2023, particularly with demand weakening.

Central banks, though, are of the view that monetary policy will need to remain restrictive for an extended period of time to ensure inflationary pressures are squeezed out of the system, especially given tight labour markets and the pick-up in wage inflation. Thus, they will continue to hike rates in the months ahead, and be reluctant to start loosening policy before year end. A big fall in inflation, though, should provide a boost to financial markets this year, as well as enhancing economic growth prospects.

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