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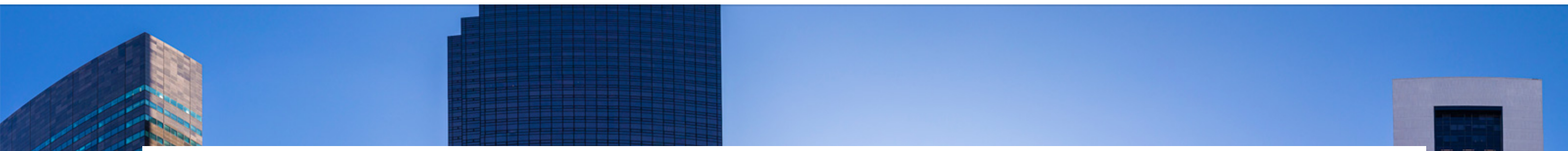


CENTRAL BANK RESPONSE TO INFLATION
February 2022

The battle against inflation: are emerging markets ahead of the curve?

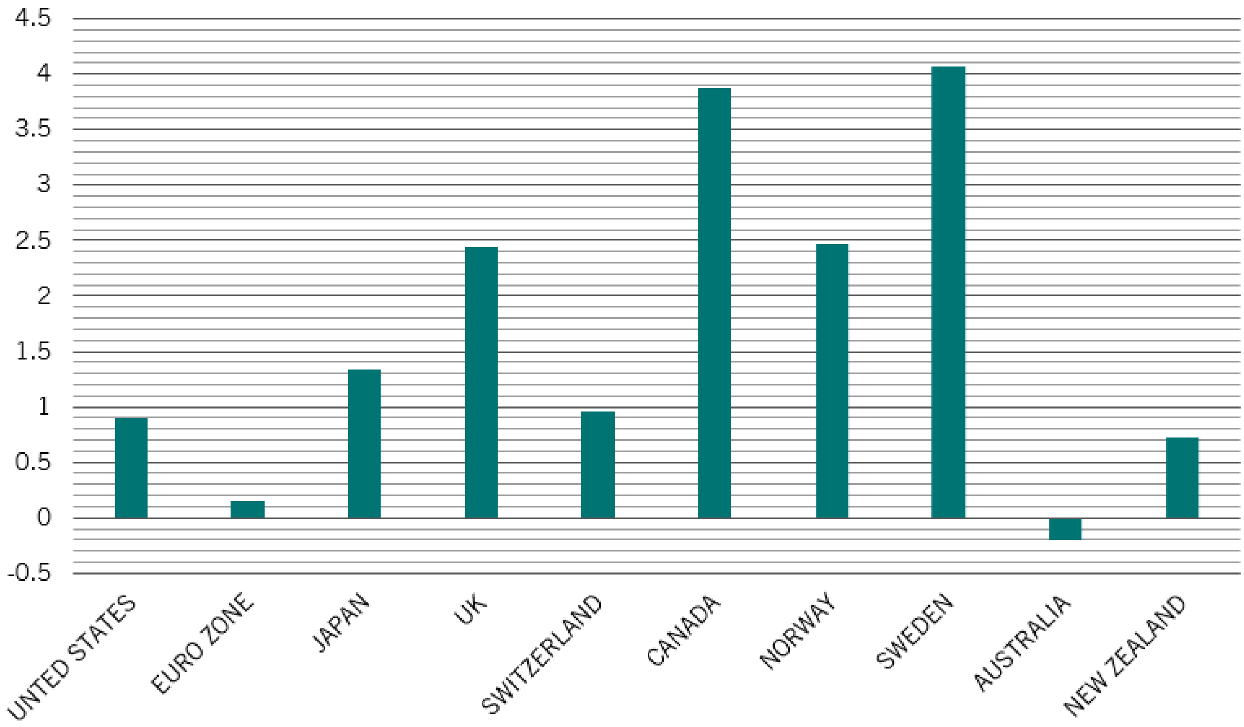
As Covid's impact fades, inflation has become a major worry for policymakers. Surprisingly, emerging market central banks are moving faster than their rich country peers to contain the threat.

Developed economy central banks have fallen behind the inflationary curve, despite increasingly hawkish guidance. The UK, Swiss and Canadian central banks in particular have to tighten monetary policy aggressively if they are to regain control over price pressures, according to Pictet Asset Management's proprietary models.

By contrast, a number of emerging market central banks have been paragons of prudence and will be able to start cutting rates as early as next year – a state of affairs that turns historic norms on their head.

FIG. 1 - Advanced economy central banks behind the curve

Taylor rule estimate for change in key policy rate needed by 2023 subject to financial stability constraint, percentage point increase/decrease in rates



*Estimate based on our augmented Taylor Rule model with financial stability estimates in 2023. Source: Pictet Asset Management, Refinitiv, CEIC. Based on data as at 15.02.2022.

Many developed economy central banks are in a difficult position. Take the Bank of England. Its inflation-fighting credibility has come under pressure from a decade of ultra-easy monetary policy during which time inflation has frequently breached its 2 per cent target. Lately the UK inflation running exceptionally hot – CPI inflation was 5.5 per cent in January and is forecast to breach 7 per cent in the coming months.

At the same time, the UK private sector has a heavy burden of debt, with total credit to the private non-financial sector running at some 160 per cent of GDP – in the early 1990s that ratio was under 120 per cent.[1] This makes the economy particularly vulnerable to interest rate rises.

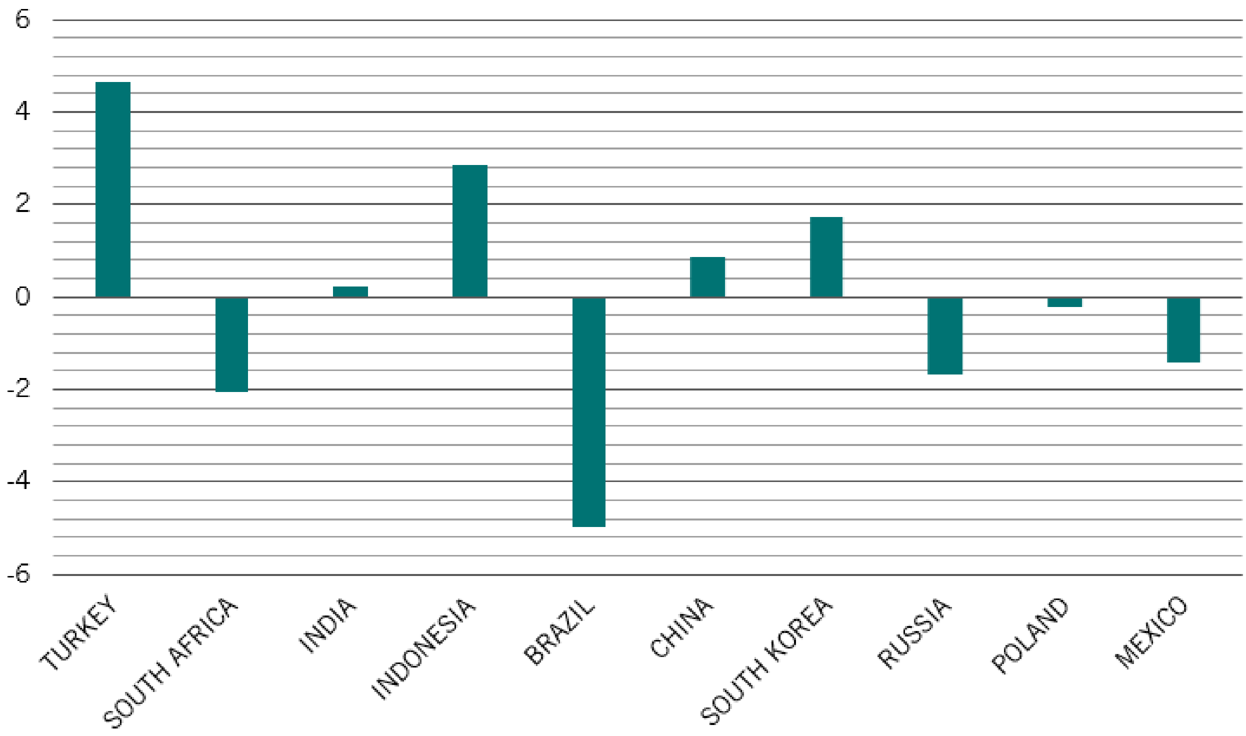
As a result, any rate rises would have to take into account financial stability. According to our Taylor Rule model,[2] we estimate the UK would have to limit rate hikes to 2.4 percentage points above the current 0.5 per cent – still a dramatic move, but one that would balance strains on the economy with recovering Band of England policy credibility (see Fig. 1).

The story is similar for some other developed economies, particularly Sweden and Canada, which, in both cases, need to see rises of around 4 percentage points in 2023 to maintain financial stability.

Emerging market central banks, on the other hand, have largely taken the inflationary bull by the horns, which means they'll be in a strong position to start easing policy in the coming year.

FIG. 2 - Emerging markets central banks ahead of the curve

Taylor rule estimate for change in key policy rate needed in 2023 subject to financial stability constraint, percentage point increase/decrease in rates



*Based on our augmented Taylor Rule model with financial stability estimates in 2023. Source: Pictet Asset Management, Refinitiv, CEIC. Based on data as at 15.02.2022.

Our model suggests that Brazil, Russia, Poland, South Africa and Mexico will be in a position to cut rates in 2023, with Brazil having scope to slash its policy by nearly 3 percentage points from the current 10.75 per cent [see Fig. 2].

In a nutshell, a number of developed economy central banks will have to work hard to restore their credibility. By contrast, emerging market central banks have largely been quick to anticipate and respond to the inflation problem. The trick will be to negotiate a tightening cycle while minimising financial disruption – years of accumulated corporate and household debt thanks to the low rate era could yet cause trouble.

[1] Bank for International Settlements data, to Q2 2021. Data as at 16.02.2022.

[2] We use state-of-the-art semiparametric Taylor Rule to account for a possibly changing Central Bank's responsiveness to macroeconomic fundamentals depending on the state of the economy. In that specification, the policy rate is set as a

nonlinear function of our inflation forecasts, real GDP growth forecasts and real effective exchange rate growth rate.

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