WITH INFLATION AT MULTI-DECADE HIGH TOWARD TIGHTER POLICIES

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1. Central Banks Hike Interest Rates in Sync to Tame Inflation Pressures

During the pandemic, central banks in both advanced and emerging market economies took unprecedented measures to ease financial conditions and support the economic recovery, including interest-rate cuts and asset purchases.

With inflation at multi-decade highs in many countries and pressures broadening beyond food and energy prices, policymakers have pivoted toward tighter policy. As our Chart of the Week shows, central banks in many emerging markets proactively started to hike rates earlier last year, followed by their counterparts in advanced economies in the final months of 2021.

The monetary policy cycle is now increasingly synchronized around the world. Importantly, the pace of tightening is accelerating in several countries, particularly in advanced economies, in terms of both frequency and magnitude of rate hikes. Some central banks have begun to reduce the size of their balance sheets, moving further toward normalization of policy.

Stable prices are a crucial prerequisite for sustained economic growth. With risks to the inflation outlook tilted to the upside, central banks must continue normalizing to prevent inflationary pressures from becoming entrenched. They need to act resolutely to bring inflation back to their target, avoiding a de-anchoring of inflation expectations that would damage credibility built over the past decades.

Monetary policy can't resolve remaining pandemic-related bottlenecks in global supply chains and disruptions in commodities markets due to the war in Ukraine. It can however slow overall demand to address demand-related inflationary pressures, so a tightening of financial conditions is the goal. The high uncertainty clouding the economic and inflation outlook hampers the ability of central banks to provide simple guidance about the future path of policy. But clear communication by central banks about the need to further tighten policy and steps required to control inflation is crucial to preserve credibility.

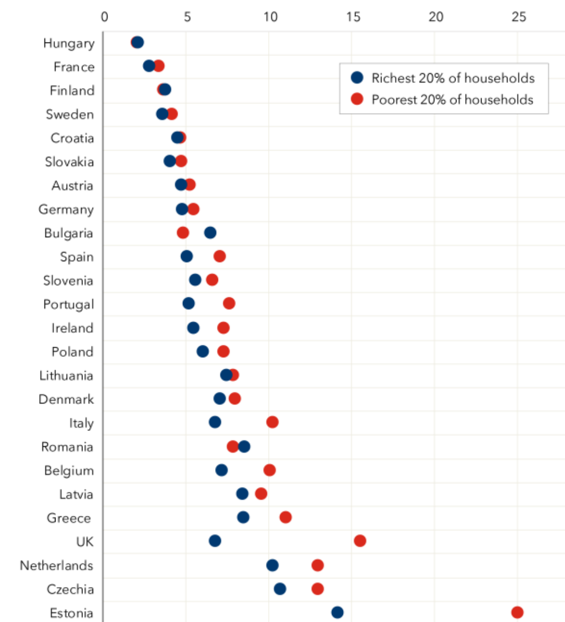
Clear communication is also critical to avoid a sharp, disorderly tightening of financial conditions that could interact with, and amplify, existing financial vulnerabilities, putting economic growth and financial stability at risk down the road.[1]

[1] Central Banks Hike Interest Rates in Sync to Tame Inflation Pressures – IMF Blog

2. How Europe Can Protect the Poor from Surging Energy Prices

An average European household will see a rise of about 7 percent in its cost of living this year relative to what was expected in early 2021. This reflects the direct effect of higher energy prices as well as their pass-through to other goods and services. The large differences in impact across countries reflect different regulations, policy responses, market structures, and contracting practices. The spike in the cost of living could get worse in the event of a cutoff in gas supplies from Russia.

In most European countries, higher energy prices impose an even heavier burden on low-income households because they spend a larger share of their budget on electricity and gas. The chart below shows the divergence in the distributional impact of higher prices across countries and income groups. Moreover, the increasing cost of measures is squeezing economies limited fiscal space as high prices persist. In many countries the cost will exceed 1.5 percent of economic output this year, mostly on account of broad price-suppressing measures.[2]



3. Why Commodity Prices Are Likely to Fall Further

Is this dip in commodity prices just temporary? Or is it a sign that prices have peaked and can be expected to decline further?

Commodity prices are highly correlated. One reason is direct microeconomic linkages. When the price of oil rises, wheat producers' costs increase (because harvesting equipment runs on diesel and fertilizer is made from natural gas), which puts upward pressure on grain prices.

There are two macroeconomic reasons to think that commodity prices in general will fall further. The level of economic activity is a self-evidently important determinant of demand for commodities and therefore of their prices. Less obviously, the real interest rate is another key factor. And the current outlook for both global growth and real interest rates suggests a downward path for

[2] How Europe Can Protect the Poor from Surging Energy Prices – IMF Blog

commodity prices. Not all prices will fall. Different commodities tell different stories. For example, the market price of natural gas in Europe is bound to rise further, as the continent learns to manage winter without Russian supplies. But the trend will likely be downward elsewhere.
In its most recent update, the International Monetary Fund projected global growth to slow sharply, from 6.1% in 2021, to 3.2% in 2022 and 2.9% in 2023. Slower growth means lower demand for commodities, and hence lower prices.

Moreover, as the US Federal Reserve and other central banks tighten monetary policy, real interest rates are likely to rise. This will probably push down commodity prices, and not just because high real interest rates make a recession more likely. The level of real interest rates affects commodity prices independently of GDP, both in theory and empirically.[3]

4. North Macedonia's S&P Global Ratings Outlook

North Macedonia's real GDP growth to slow to 1.5% in 2022, from 4.0% in 2021, on lower external demand (primarily from the EU) aggravated by the indirect effects of the Russia-Ukraine conflict--primarily in the form of higher energy prices. Weaker domestic household consumption due to high inflation and tighter credit conditions will contribute to weaker growth this year. This will be partially mitigated by government consumption and investment growth stemming from higher government spending and investment. Downside risks to the forecast include potential political instability from a remote chance of snap elections and an escalation in the Ukraine-Russia conflict that could cause commodity prices to surge even further. From 2023 onward, it is expected growth to strengthen and average 2.7%.

The general government deficit to remain elevated at 5.1% of GDP in 2022, followed by gradual fiscal consolidation over the next four years. Forecast that North Macedonia will post a current account deficit of 8.3% of GDP in 2022, the highest since 2008, owing to higher costs of energy imports.
International reserves have come under pressure since the beginning of the year, but it is expected buffers to be primarily replenished by external borrowing and incoming net FDI inflows. North Macedonia could get additional financing from the IMF if balance-of-payments pressures increase. Given the new budget and the government's record of under-use of budgeted capex, it is expected the fiscal deficit to remain elevated at 5.1% of GDP in 2022--slightly down from 5.4% in 2021. The budget deficit will be financed via a mix of domestic and foreign borrowing (Eurobonds) as well as previously accumulated liquidity.

Thereafter, it is expected the general government deficit to average approximately 3.2% through to 2025. The government's fiscal consolidation efforts will continue to face challenges including the economy's large informal sector and the indirect effects of the Russia-Ukraine conflict.[4]

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[3] Why Commodity Prices Are Likely to Fall Further by Jeffrey Frankel - Project Syndicate (project-syndicate.org)
[4] S&P affirms N. Macedonia's 'BB-/B' ratings, outlook stable (seenews.com)