Rate hikes in the euro area, under the microscope

Inflation in the euro area continues to be affected by the double impact of the war in Ukraine and the deterioration of the bottlenecks in China due to its zero-COVID policy. The persistence of these factors explains why inflation continues to break records (see first chart) and why the possibility of it climbing to even higher levels in the coming months cannot yet be ruled out. As a result, inflation expectations have been steadily rising in recent months; for example, since January, our forecast for euro area headline inflation in December 2022 has been revised up by nearly 5.0 pps, to around 6.0%.

At this juncture, there is increasing pressure on the ECB to start raising interest rates, something that has not happened since 2011. However, in the current context of an economic slowdown with a multitude of downside risks, is it desirable for the ECB to begin to normalise its monetary policy in the coming months? Would it be better to wait for economic growth to recover?

Benefits of raising interest rates

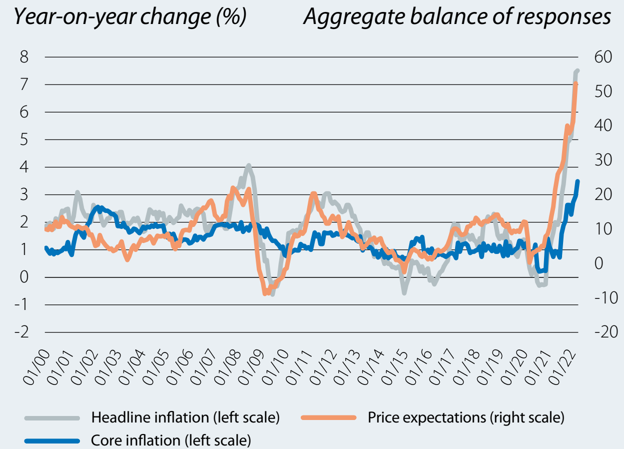
Economic theory tells us that raising rates slows growth in consumption and investment, thereby curbing the advance of domestic demand, helping to control inflationary pressures, as well as keeping inflation expectations well anchored – particularly important in the current context marked by a sharp rise in energy and other commodity prices.

This anchoring of expectations is essential for preventing inflationary shocks like the current one from producing unwanted second-round effects that would intensify the rise in prices and make it chronic. In recent months we have witnessed a significant increase in inflation expectations, both in the financial markets (euro area swaps anticipate inflation of around 5% over the next two years) and among consumers and business leaders, with short- and medium-term expectations at record highs. Although these second-round effects are not yet materialising in Europe, it is a risk that should be taken into account.[1]

On the other hand, it should be noted that the easing of monetary conditions in the euro area is a process that has been going on for years: the outbreak of the financial crisis in 2008 forced policymakers to introduce major monetary stimulus to alleviate its effects, which even needed to be reinforced to prevent the sovereign debt crisis of 2010 from triggering a breakup of the euro area. In fact, the monetary conditions index developed by the European Commission[2] suggests that monetary policy

Euro area: HICP and price expectations

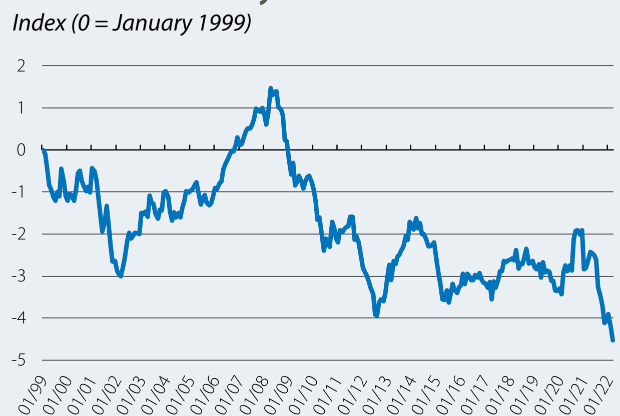
Year-on-year change (%) Aggregate balance of responses



Note: *The series reflecting the aggregate balance of responses is calculated using the price expectations of consumers and of the manufacturing, services and retail sectors published by the European Commission, which reflect the difference between the percentage of respondents who expect the final prices to be higher and the percentage that expects them to be lower.*
Source: *CaixaBank Research, based on data from Eurostat and the European Commission.*

Euro area: monetary conditions index

Index (0 = January 1999)



Note: *Positive and negative values show tight and accommodative monetary conditions, respectively.*
Source: *CaixaBank Research, based on data from the European Commission.*

conditions are currently the most accommodative they have been since the euro was created (see second chart), and this increases the risk of bubbles forming in certain financial markets.[3]

In this regard, a recent report by the European Securities and Market Authority (ESMA)[4] echoes developments in the real estate sector in the euro area since the start of

1. See the Dossier «The response of wages to the rise in inflation» in the MR05/2022.

2. This index is calculated as a weighted average of the short-term real interest rate and the actual effective exchange rate relative to its value in a baseline period.
3. Let us recall the consequences of the dot-com bubble in the early 2000s and the subprime mortgage bubble in 2008, which dragged the global economy into the so-called Great Recession.
4. See «Joint Committee Report on Risk and Vulnerabilities in the EU Financial System». March 2022.

the pandemic: home prices have risen by around 16%, with widely varying patterns from country to country. ESMA is also concerned about the consequences of the rapid expansion of the cryptocurrency market. This concern makes sense if we consider that since the market capitalisation peaked at over 3.2 trillion dollars in November last year, the cryptocurrency market has already suffered a 60% correction.

Costs of raising interest rates

We have already pointed out that, according to economic theory, raising rates has a negative impact on domestic demand. In order to assess the potential impact of this shift in interest rate expectations in recent months, we took the difference between the implicit rate curve for the 12-month Euribor as it stood at 13 May 2022 and at 31 December 2021 – before the surge in market expectations – and we introduced it into CaixaBank Research's model for the euro area (see third chart).[5] If the higher interest rates anticipated by the market were to come to fruition, then euro area growth could be cut by 0.2 pps in 2022, by 0.7 pps in 2023, by 0.5 pps in 2024 and by 0.2 pps in 2025 compared to our baseline scenario (see fourth chart). By component, the impact on consumption would be similar to that of GDP, while investment would be the component most affected, as its growth could be cut by 1.1 pps in 2023 and 2024, and by 0.5 pps in 2025 compared to the baseline scenario. The impact on job creation, meanwhile, would be significantly lower, at around 0.2 pps less than in the baseline scenario on average over the next three years.[6, 7]

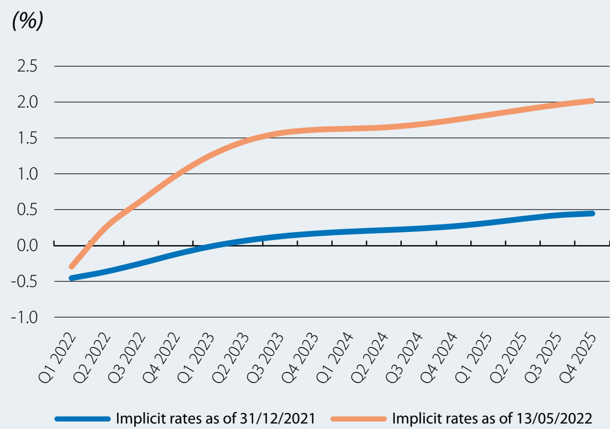
Conclusion

The ECB is facing the dilemma of raising interest rates, at the cost of cooling domestic demand, at a time when the tightening of bottlenecks and, above all, the fallout from the war in Ukraine are already taking a toll on economic activity in the euro area. It should be noted that, based on current market expectations, the cost in terms of economic growth of normalising interest rates is moderate and growth rates above 2.0% are still feasible this year and next.[8] Furthermore, beginning to raise rates would help contain medium-term inflation expectations and reduce the risk of bubbles. This appears to be the ECB's reading of the situation, and all signs point to the fact that it will begin to gradually raise interest rates over the coming months.[9] Indeed, failing to act now could mean having to raise them much more in the future.

Eduard Llorens i Jimeno and Rita Sánchez Soliva

Euro area: 12-month Euribor

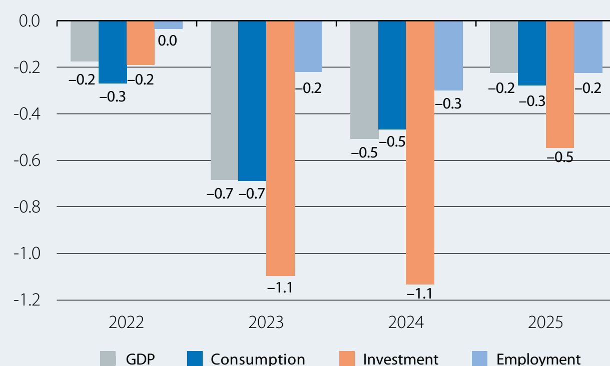
(%)



Note: *In the series of implicit rates as of 13 May 2022, the data up to April correspond to the historical 12-month Euribor.*
Source: *CaixaBank Research, based on data from Bloomberg.*

Euro area: macroeconomic response to rising interest rates

Impact on annual growth (pps)



Note: *The GDP, consumption and investment series are shown in real terms.*
Source: *CaixaBank Research, based on the Working Paper «Modelo semiestructural de CaixaBank Research para la eurozona» of 02/21 (content available in Spanish).*

5. This is a general equilibrium model which is determined by aggregate demand in the short term, while in the long term aggregate supply and demand are equal. For further details, see E. Llorens (2021). «Modelo semiestructural de CaixaBank Research para la eurozona». CaixaBank Research Working Paper 02/21 (content available in Spanish).
6. The response of the different variables to a standard monetary shock (an impact of 100 bps) in our model is very similar to that found in the benchmark models. For more details on the latter, see F. Smets and R. Wouters (2002) «An estimated dynamic stochastic general equilibrium model of the euro area» and E. Angelini *et al.* (2019) «Introducing ECB-BASE: The blueprint of the new ECB semi-structural model for the euro area». European Central Bank Working Paper Series.
7. Beyond the impact on the real economy, rate hikes also exert upward pressure on sovereign bond yields, i.e. the interest which countries pay for issuing debt. However, debt yields and risk premia are still fairly low in historical terms. Moreover, the ECB has already pointed out that once its net asset purchases have ceased, it could take a flexible approach to managing the reinvestments of the assets that mature and could even design new instruments to ensure that monetary policy is transmitted correctly. This is reassuring news for countries with high debt ratios.
8. We are assuming a scenario in which the war in Ukraine does not spread geographically and in which Russia does not completely cut its gas supplies to the euro area.
9. In an entry in the ECB's blog (on 23 May), Christine Lagarde stated that she expects net purchases under the APP to end very early in Q3. This would allow for a first interest rate hike in July and would open the door for rates to emerge from negative territory by the end of Q3.