From soft landing to no landing: interest rates higher for longer

On the catwalk of trendy economic jargon, the latest buzzword that has gained popularity in recent weeks is «higher for longer», referring to interest rates. This is a reflection of the string of positive surprises in the economic activity data, as well as the resistance to downward movements which key components of the consumer price index basket, such as food or services, continue to show. With the threat of recession diluted in the short term in the strength of the labour market, concerns are once again focused on inflation, and the financial markets are now anticipating further official rate hikes up to the 4% mark in the euro area and up to 5.5% in the US. The additional 75 bps relative to the terminal rate anticipated at the beginning of the year have had an immediate impact across the entire yield curve. This is particularly the case in the shorter sections, with the yield on 2-year bonds in the US and Germany climbing to a 15-year high.

Thus, the umpteenth change in the economic narrative in recent months – this time going from soft landing to no landing – appears to work in favour of the central banks' intention to stay on the current course, to continue to raise rates and, once the peak is reached, to remain in restrictive territory for longer than previously expected. The negative effects of this new round of monetary tightening on growth can be expected to be felt next winter, as the steepening of the downward slopes of the yield curves on both sides of the Atlantic appear to be anticipating. In other words, we have saved match point in the energy sphere, but the game is still at stake, given the complexity of assessing the potential effects of the sharpest monetary tightening cycle in the last four decades on a world that has not ceased to accumulate debt.

According to data from the IIF, despite the slight decline in 2022 (4 trillion dollars), total global debt stands at 299 trillion dollars (338% of GDP), doubling the levels of 2006 in nominal terms (+50 pps as a percentage of GDP). In addition to the well-known high leverage of Chinese firms (160% of GDP), the group that is most vulnerable to this latest tightening of the monetary environment is emerging countries. They are vulnerable both because of the increase in their total debt since the beginning of the pandemic (+20 trillion, bringing the sum to 95 trillion dollars) and due to the high volume of maturities falling due in 2023 (7 trillion dollars), just at a time when the dollar is appreciating against the major currencies. Let us remember that, since 2020, three emerging countries (Zambia, Sri Lanka and Ghana) have defaulted on their debts.

The truth is that in a world as complex as today's, with different shocks interacting at the same time, it is difficult to gauge the effects of the interest rate hikes on economic activity and inflation, taking into account the variety of distortions that are affecting the monetary policy transmission channels. The exercises recently published by the ECB show significant dispersion in their conclusions, depending on the model selected to assess the impact. The average result of all the estimates is that for every 100-bp rise in interest rates, growth would be reduced by 0.7 pps and inflation by 3 pps. Taking into account that by the end of the journey the cumulative rise will amount to between 400 and 450 bps, the price to be paid in terms of growth in order to try and bring inflation back to the target rate will be significant.

Therefore, the central banks are navigating this most complex of times with little certainty about what effects their decisions will have, while also having to show a high degree of flexibility in the event of possible surprises along the way. Above all, it is unclear whether the issue we are really facing could be a structural insufficiency of supply, as a result of a decade and a half of low levels of public and private investment and the changes that are beginning to emerge in the labour market in OECD countries (retirement of baby boomers, smaller cohorts of young workers, and quiet quitting). This would limit their ability to correct the current «sticky» inflation (another buzzword referring to the inertia in prices) through demand-side policies. In any case, as background currents such as the energy transition (or deglobalisation) gradually settle, in the short term we will have to get used to a world with higher interest rates. For now, the implicit 10-year rates of the deposit facility in Europe are at an average of around 3%, well above the levels we have lived with in the last decade and which we considered neutral up until a couple of quarters ago. This is a major shift, and its effects are not to be underestimated.

José Ramón Díez