How high will interest rates go?

We are facing a radical change in the financial cycle. Inflation is forcing central banks to raise interest rates. How far will rates climb? And how will higher rates affect our economic recovery? Enric Fernandez, chief economist at CaixaBank, and Jordi Gual, professor at IESE, share their views.



June 21, 2022

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In the United States, in the euro area and, more specifically, in Spain, we are currently facing headline inflation rates of between 8% and 10% — rates that have been climbing ever since March-April 2021. If we look at core inflation — the change in prices of goods and services, except for those from energy or food — it is currently at 6% in the United States and between 4 and 6% in the euro area and Spain.

Against this background, what can we expect next? Enric Fernandez, chief economist at Caixabank, and Jordi Gual, economics professor at IESE, analyzed this question on June 21, 2022, during a special session for members of IESE's Alumni Association on inflation and the threat it may pose.

Causes of inflation

Before COVID, the price of oil was around $60 a barrel. In April 2020, it fell to about $25. In April 2021, the price per barrel had already returned to pre-COVID levels, and from there it continued to climb due to higher demand with supply-side issues and further geopolitical tensions. In May 2022, the price per barrel was over $110.

Meanwhile, there have also been higher prices for chips and ships — referring to microchips and shipping containers. This can be attributed to the inability of supply to meet demand in the revived economy, owing to a series of stimuli designed to keep demand alive. Moreover, there was a change in the composition of demand, as consumers were unable enjoy many services and wished instead to purchase goods, which put pressure on international transportation systems. As a result, the price of containers in 2021 was five times higher, on average, than in 2019. Fernandez adds that China's "zero COVID" strategy — which has been very expensive to maintain in the face of the more contagious Omicron variant — isn't helping. He doesn't expect the situation to improve in the short term.

In the euro area and in Spain, Fernandez adds, the situation also reflects the depreciation of the euro compared with the dollar. The price of food has been affected by rising energy prices and increased transportation and fertilizer costs. Additionally, the war in Ukraine has raised the price of some foods significantly. Futures markets point to consistently higher prices ahead. When companies transfer this increase in their input costs to final prices for consumers, indirect effects yield higher product prices.

In the United States, there has also been a phenomenon not seen in the euro area, Fernandez says: significant wage pressures on companies, mainly due to a decline in labor participation. During what has been called "the great resignation," many people in the United

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States, protected by government subsidies, left their jobs. At the same time, there was a brake on immigration. This has caused the country to observe more so-called "second-round effects" on inflation; that is, the pressure of wage demands from workers who want to maintain their purchasing power.

In Spain, the main drivers of headline inflation until December 2021 were energy and food, contributing 6.5 percentage points to the headline inflation rate, which was 8.7% as of May 2022. Now we observe that the costs of goods and services contribute to inflation more and more.

Data indicates that inflation expectations for both the United States and for the euro area are high looking ahead at the next 12 months. However, in the medium-to-long term, inflation expectations remain anchored to the central banks' target of around 2%. This should help prevent the strong second-round effects, especially in the euro area, where there is less demand pressure compared with the United States.

The central banks, therefore, play an important role in inflation expectations. Let's see what they're doing.

The role of the central banks

Although central banks play a predominant role in inflation expectations, are they also the cause? What's certain is that "we are facing a radical change in the financial cycle," asserts Jordi Gual.

As inflation climbed, so did interest rates. And not only are the latter expected to continue rising, but, in the long run, interest rates are going to exceed even the equilibrium or neutral level. This is a global phenomenon, Gual explains, with three exceptions.

The first exception is China, which is immersed in a cycle of monetary expansion, because of difficulties associated with its "zero COVID" policy and its possible need to burst a real estate bubble so as not to affect the economy as a whole. Japan and the euro area are the other two exceptions because they are also resisting raising interest rates: the former by way of chronic deflation and the latter convinced that inflation levels won't reach those of the United States.

In economics, there is a level of interest rates that is called neutral. In the United States, it is between 2 and 3%, and in Europe, between 1 and 2%. It is called neutral because it is the appropriate interest rate when there is no inflation and the economy can grow at its

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potential.

In the United States, the Federal Reserve intended to wait until the economy was growing at potential and then gradually raise rates to the neutral point. But "it took too long to decide to raise rates, and now it needs to be done very quickly," says Gual. The case of the European Central Bank (ECB) is similar, although it remains to be seen how far interest rates will have to be raised.

Fernandez believes central banks must be careful when reacting to what appear to be supply shocks, as little can be done to lower the price of food, only to curb demand. As such, what they must do is verify that there is a demand problem: and if there is, take action.

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Now we not only have "to raise rates quickly, because we failed to anticipate how much was needed, but we will also have to put them above the neutral level," says Gual. Markets are already expecting it, raising rates on their own by more than 200 basis points. However, the markets are not always right, and everyone has an opinion.

For Gual, interest rates will rise above what the market expects. In fact, he thinks, "the euro area should be raising rates more than it is." Historically, when the United States has applied a restrictive monetary policy, the euro area has followed suit. Otherwise, the euro depreciates, and that depreciation leads to imported inflation.

The euro area has an additional challenge: its economic and monetary union is not yet complete and member countries have very different debt levels. This entails an enormous risk, "which was already experienced with the euro crisis and which is likely to come up again this time," Gual warns. For example, how is raising rates compatible with Italy's high risk premium? If the ECB buys too much debt from Italy or Spain, it will be breaching its mandate to fight inflation.

For his part, Fernandez is more optimistic. Right now, reference rates in the euro zone are between -0.50 and 0%. The markets expect that -0.50% to move to something between 2 and 2.50%. Fernandez believes that the ECB is not going to go that high, so interest rates will be in the range of between 1.25 and 1.75%, with a 12-month Euribor in that scenario around 1.8%. These figures, according to Fernandez, will be enough to cool down the pressures on the demand side in the euro area.

What could happen now?

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In February 2022, former U.S. Federal Reserve Vice Chair Alan Blinder examined 11 occasions when the U.S. central bank raised rates from the 1960s to now. He drew attention to the perfect landing achieved in 1993, which avoided recession, and a further six occasions in which raising interest rates had only minimal effect on the economy — a soft landing.

Along the same lines, Gual sees the euro area faced with four possible scenarios: 1) credible disinflation, in which the ECB announces that it will raise interest rates and manages to achieve a soft landing, with low inflation and moderate growth; 2) a hard landing, with a sharp rise in rates and a recession; 3) fiscal dominance, in which inflation remains high because central banks are reluctant to raise rates to avoid harming countries with high public debt, but growth is moderate; and, finally, 4) stagflation, in which resistance to interest rate hikes causes not only inflation but also recession, given the negative effect of rising raw-material prices.

Gual's opinion is that, if demand cools down sufficiently, second-round effects will be avoided in the euro area. Meanwhile, in the United States, where interest rates were raised later than they should have been, Gual thinks a recession becomes likely looking out to 2023-4. That said, "it may be a mild recession of the kind flagged by Alan Blinder."

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