SINGALLIANCE

Letter n°64

Should we fear rising interest rates?

" By not wanting to know, we end up not being able to know."
Simon Weil.

Governments and central banks did not want to or did not know how to recognize inflation, but today they do not know how to control inflation without risking a lasting recession and this word from the philosopher ***Simone Weil*** sums up the situation well.

- Between 2010 and 2019, the average inflation rate was only 0.9%/year in Europe, lower in Japan and slightly higher in the United States. Even though liquidity injections were very large and central bank rates were close to zero in the United States and Great Britain, and negative in Switzerland, Europe and Japan, nothing seemed to threaten a return to inflation.

- Today, inflation rates in many major countries, with the exception of Japan (2.6% in July) and Switzerland (3.5% in August), are close to 10% because, since 2019, there has been the Covid crisis, the invasion of Ukraine, supply and demand shocks, substantial measures to support demand (10% of GDP, for example, with the combination of Trump and Biden measures), disruptions in supply chains caused by a sudden recovery in consumption, and a spillover of savings accumulated during the lockdown.

- Late, but determined, central banks are raising rates and the World Bank, in its latest report, warns of the risks of a global recession caused by rate hikes.

- The rise in interest rates is necessary because, as we shall recall in the first part, inflation may not simply have cyclical causes. Indeed, there is a trend towards a shrinking labor force and labor shortages in certain sectors. But, in a second part, we will show that the rise in rates will necessarily remain moderate and that lucidity requires us to follow the real rates. At -7% or even -8%, they have never been so negative in Europe or the United States, whereas before the Covid crisis they were at -1%.

The increase in rates is necessary:

- ***The mixed effects of low rates***:

The low interest rates observed in recent years have three fundamental causes: firstly, the surplus savings of oil-exporting countries, China and Germany; secondly, the lower capital intensity of our post-industrial societies; and thirdly, the ageing of the population and therefore the lower propensity to consume.

The impact of these low rates differs between public debt and private investment.

Undoubtedly, low rates are a boon for governments. In the United States, for example, the federal government's debt service, 2% of GDP in 2020, is virtually unchanged from 2000 when the debt-to-GDP ratio at the time was not even half the current percentage.

However, while rates have never been so low as in the last decade, the investment rate has never been as low. The decline in the investment rate is partly explained by the shift from industrial companies to less capital-intensive service companies. But the fall in the investment rate also has another cause, well analyzed by ***Jacques de la Rosière***, the idea that the low return on capital and risk-taking discourages investment and pushes savings into financial investments. Let us add the survival of uncompetitive companies, made possible by these low rates, therefore overcapacity, brakes on investment.

In short, between an incentive for fiscal laxity and a potential brake on investment, low rates do not have only advantages and they must be raised.

- ***Inflation is underestimated***:

We know ***Alfred Sauvy's*** words about the means of fighting against inflation: ***"The government has the choice between breaking the thermometer, distorting the graduation, putting ice around it, suppressing the publication of results, taking measures to lower prices, announcing reality... the last two being unpleasant, it is to the others that the government has more readily recourse."***

Today, inflation is underestimated because European states spend on average 2% of their GDP to protect purchasing power (Germany 2.5%, France 2%) by setting price ceilings on energy prices or equivalent measures, in addition to reducing incentives to save energy, minimize inflation.

- ***Inflation is feared***:

Will central banks and governments tolerate inflation? The answer is no because in ageing countries, with a disproportionate weight of elderly voters, there is a low tolerance for inflation that could erode pensions and affect the bond portfolios of pension funds.

- ***Central banks are playing their credibility***:

In the short term, action on rates is the essential weapon of central banks. By raising rates, they give themselves the flexibility to be able to lower them in the event of a recession. By raising rates, they intend to ward off the risk of a price-wage spiral. By raising rates, probably up to 4-4.5% in the United States for the Fed and to 2% by the end of the year in the Eurozone, before continuing in 2023, they intend to ward off the recent inflationary drift.

In the longer term, central banks need to anticipate the hypotheses of a drying up of the savings surplus, a structural rise in rates and higher inflation than before 2019. There are three reasons for this: the surplus of savings recorded by the Persian Gulf countries, $1.3 trillion according to the IMF, will fall as the energy transition should reduce the demand for fossil fuels. Secondly, China's savings rate, close to 40% of GDP, will be reduced if China (finally) succeeds in its transition to a consumer society. Finally, central banks must consider the consequences of a decline in the world's labour force. After thirty years of wage stagnation in many countries, increases are recorded and some fear the beginning of a new wage-price spiral detrimental to inflation. They must be vigilant because wage increases are growing, for example in the United Kingdom at 5.5% over one year for a price increase of 9.9%, in the United States at 5.2% for a price increase of 8.3% and core inflation, excluding energy and food prices, at 7.4%. For the time being, the problem is less acute in the Eurozone with wages rising by 2.1% year-on-year.

One caveat to this last point is developments in Japan. Curiously, for years, notwithstanding the low unemployment rate, notwithstanding the government's incentives for companies to raise wages and notwithstanding the abundance of liquidity in companies, the aging population, the decline in the labor force have had no effect on wages.

In the United States, the situation is different because there are almost two job offers for every unemployed person, the resignation rate has reached a quarter of the employed population in 2021, the unemployment rate is historically low. Certainly, the job market is shrinking, some large companies, such as Ford and Walmart, have announced job cuts, but, according to ***Larry Summers***, the price-wage spiral will not be broken before the unemployment rate rises to 5%. This is a long way off. In August, there were 315,000 new jobs after 526,000 the previous month, and while the unemployment rate rose from 3.5% to 3.7%, there was still an increase in job offers in July to 11.2 million from 11 million in June.

- ***The rise in rates will weaken certain sectors but if there is a recession, it will be moderate***:

The first consequence of the rise in rates is a weakening of the real estate sector. In the United States, the 30-year mortgage rate has risen to 6.02% and the sector is all the more fragile because in three years prices have risen by 46%, or 26% net of inflation. This explains the decline in real estate transactions over the past 6 months and that of mortgage volumes, $4.4 trillion in 2021, will probably reach half that amount this year.

Consumption is resilient, boosted by rising household confidence in August, income growth of 0.2% month-on-month in July, the abundance of savings of the richest 40% who make 60% of consumption, the prospect of government measures to reduce student debt.

The rise in rates will necessarily remain moderate: 4 reasons.

- ***Rising rates are only a partial response to inflation***:

Just as the massive injections of liquidity since 2008 have not enabled inflation to reach the 2% target, today the rise in rates will not be enough to bring inflation down from 9% to 2% because inflation is not a purely monetary phenomenon.

The good news is that one of the major causes of inflation is not excess demand that can be corrected by rising rates, but supply shortages, which are being resolved. Transport costs have started to fall by more than 50% since the peak of 2021 as trade has recovered, oil and several metal prices have also fallen back to pre-conflict levels. At the beginning of 2021, 10% of spending was on energy, now 20%, but no one expects this to continue as rising prices dampen demand and stimulate production.

- ***The public debt constraint***:

Global public debt will be 115% of global GDP in 2021, or more than $100 trillion compared to a global GDP of $88 trillion. In many countries, public debt has risen rapidly since the 2008 financial crisis. In the United States, the federal debt had already risen from 64% of GDP at the beginning of 2008 to 84% at the end of 2009 and, since then, it has substantially exceeded 100% of GDP.

The most emblematic example of this public debt constraint is of course Japan, with a debt at 260% of GDP and a central bank holding nearly 50% of the debt with a balance sheet at 1.3x GDP against 65% for the ECB and 35% for the Fed in mid-2022.

If inflation allows a reduction in a country's debt ratio, since the stock of debt is diluted by nominal GDP growth, if there is a mechanical increase in certain tax revenues such as VAT, there is nevertheless an increase in the cost of servicing the debt on new debts, a reduction in purchasing power, and therefore of consumption and growth.

- ***Public expenditure needs***:

As a result of rising inequality and skepticism about the trickle-down economy, governments, even in liberal countries, are more interventionist and are increasing their spending in health, education, infrastructure and climate change.

In Anglo-Saxon countries, if public services have long been sacrificed, part of public infrastructure has deteriorated due to a lack of investment. Joe Biden has launched a vast spending and investment plan and, shortly before that, Boris Johnson had promised a £600 billion infrastructure plan partially funded by the state.

While issuing debt to finance such projects is a solution because profitability is deferred, issuing debt to fund social programs, even if it is due to lower revenues in difficult times, is a burden for the future. However, for the last two to three years, measures have been multiplied.

- ***The imperative of the energy transition***:

If the cost of the energy transition to be borne by the state is estimated at 2% of GDP each year, it remains to be financed. More debt or channeling savings, it will probably be both but this additional investment should push rates up.

Conclusion :

- ***From the point of view of indebtedness***, since debt cancellation is impossible because it would provoke a flight from money and a loss of confidence on the part of savers, the states will continue to live with a high level of debt, or even worsen it, and the stated objectives of lowering it to 60% seem illusory.

- ***From the point of view of interest rates***, the rise is worrying the markets but we are far from the orthodoxy of a ***Paul Volcker*** who, at the beginning of the 1980s, did not hesitate to push interest rates up to 20% in order to reduce inflation to 14%. Today, key rates are at 2.5% in the United States, 1.75% in Great Britain, 0.75% in Europe. Let us bet that many central banks will forget their 2% inflation target and tolerate a temporary inflation of 3 or 4%.

- ***From the perspective of controlling inflation***, apart from rate hikes, there are other ways to reduce inflationary pressures. Contrary to ***Milton Friedman's*** claims, inflation is not simply a monetary phenomenon. The rise in energy prices, freight costs in 2021, and the rise in semiconductor prices, also in 2021, were primarily the result of a temporary imbalance between supply and demand. The response to these increases has been partly an increase in investment, and the massive investments in semiconductors augur well for a market turnaround. We will therefore be cautious with these stocks on the stock market. Investments to improve infrastructure, and therefore productivity, and the fight against oligopolies are also ways to bring prices down, such as the "Inflation Reduction Act", recently adopted in the United States, with the aim of tackling high drug prices and restoring purchasing power to households. Technological progress could also be mentioned as it often helps to bring down prices.

  Three more structural inflationary pressures will remain: on the one hand, the ageing of the population, which will lead to a decline in the producer/consumer ratio, and the increasing scarcity of labor, which will not always be compensated for by robotization, and which could therefore lead to higher wage costs; on the other hand, the cost of the energy transition, which will lead to the depreciation of fossil fuel assets and costly investments in renewable energies; and lastly, pressure on the supply of metals such as copper and lithium, which will be in great demand for new energies.

- ***From a fiscal perspective***, in the United States, the rapid contraction of the budget deficit, from 13.5% of GDP in 2021 to 5% in 2022, supports the Fed in its fight against demand-driven inflation. In Europe, the budgetary effort, about 2 to 2.5% of GDP, helps households and businesses to cushion the shock of rising energy prices.

- ***From the point of view of the financial markets***, liquidity injections by central banks had caused the appearance of various bubbles in real estate, private equity, SPACs, cryptocurrencies, very low premiums on risky bonds. Today the default rate of "junk bonds" on a market valued at $1.5 trillion is 1%. It could reach 3.2% according to Barclays. Thus, the cessation of injections, or even the reduction, as in the United States, of the balance sheet of the central bank will cause a bursting of these bubbles and it is important to anticipate it.

  Gold, a traditional safe haven, has not played its part in the recent crisis. From $2070/ounce in early March, shortly after the invasion, the ounce has fallen back and is now down 20% from the August 2020 high and 8% year-on-year, marking its worst performance since 2015. Rising interest rates and the appreciation of the $ are making it more expensive to buy gold.

- ***From a stock market perspective***, many companies are currently benefiting from inflation, preserving their margins because they have managed to increase their prices and grant non-wage benefits (modulation of the work week) without granting wage increases equivalent to the inflation rate. However, this is fragile as demand could dry up and social demands could increase.

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