Ibec Global

INTEREST RATE FLUCTUATIONS

DRIVEN BY PERSISTENT UNCERTAINTY

A straightforward way to explain the enormous relevance of interest rates in the global economy is to think that these rates, fundamentally, put a price on money. This commodity, managed by governments, businesses, and individuals, has a price - which includes the risk assumed when lending it - and interest rates condition its ease or difficulty to access it. For central banks, interest rates are the key tool of their monetary policy to control inflation, with some central banks having mandates to stimulate economic growth or stabilize currencies too.

Interest rates influence the decisions of individuals and businesses when considering spending, saving, or investing their resources, and they can incentivise investors towards buying bonds or stocks if rates are high or low; in other words, they move everything.

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Current context of interest rates in Europe and the United States

The decisions of major central banks have a direct reflection on all economic spheres. Currently, the European and US economies are not in the same situation regarding inflation, but no one doubts that the actions of their respective central banks will always have a dollar/euro correlation due to the close relationship between exchange rate expectations. In fact, economists argue that since European inflation is falling more rapidly than that of the United States, it is possible that the ECB could start lowering rates before the Fed.

The ECB has increased interest rates up to 4.5%, the highest level since 2001, in just 14 months. The Fed has also raised interest rates, putting them in a range of 5.25% to 5.5%, the highest in 22 years, after a pause in June.

The inflation rate in the eurozone stood at 2.6% year-on-year in February, twenty basis points below the 2.8% registered in the first month of 2024, according to preliminary data from the Eurostat statistics office[1]. Excluding energy, the inflation rate is 3.3%. The profile shows a clear decrease since in September 2023 it soared to 10%, initiating a pronounced decline.

Despite this downward trend, inflation still exceeds the ECB's target rate of 2% considered optimal for the economy. The Frankfurt-based bank is aware that these higher interest rates restrain the economy, increase industrial investment costs and mortgage payments. However, it also considers that inflation can have a crippling effect over the more disadvantaged households' purchasing power.

On the other side of the Atlantic, the situation is different. Since June 2023, inflation has fluctuated between 3.1% and 3.7%, according to the US Department of Labor[2], an unstable situation that worries Jerome Powell, president of the Fed. The rate for this past February was 3.2%, one tenth higher than the previous month.

[1] Eurostat (March 2024) HICP monthly data, available online here.
[2] Bureau of Labor Statistics, US Department of Labor (March 2024) Consumer Price Index – February 2024, available online here.

Both institutions face the challenge of curbing price increases without suffocating credit demand and economic growth, a complicated challenge due to volatile factors such as the cost of oil, gas, and others caused by the war in Ukraine and the conflict in Gaza. However, the ECB has hinted, for the first time, that in June it could start lowering rates, given price controls and weak economic growth in many eurozone countries. The largest European economy, Germany, remains in recession. Its GDP fell by 0.3% year-on-year in 2023, and its prospects for this year are no better. Ireland experienced the largest contraction within the eurozone, with a decline of 3.2%; Lithuania also suffered a slowdown in its economy.

However, no one doubts that if there was a glimpse of inflation recovery, especially due to a possible increase in oil prices, the ECB would refrain from lowering rates. The European Central Bank has come a long way by increasing rates, but it does not want to take any misstep that would force it to resume the upward path.

The Fed maintains a firm stance and advocates keeping interest rates high to combat inflation because its economy is stronger than the European one, unemployment is lower (3.9%), and there is pressure for wage increases, with increases of 4.3% up to February while inflation stands at 3.8%; with these factors, no short-term reductions are expected. In 2023, GDP grew by 2.5%, six times more than what Bloomberg analyst consensus expected at the beginning of the year[3], which represented an acceleration from the 1.9% recorded in 2022. The push is due to the good performance of private consumption, favored in turn by the strength of the labor market and the savings surpluses accumulated during the pandemic, as well as the push of public consumption.

DID YOU KNOW...

Despite the current focus on the problems of rate hikes, if we look at interest rates over the last 50 to 100 years, we find higher levels and very significant fluctuations, as responses from central banks to different economic conditions, such as inflation, economic growth, and financial crises.

For example, in the 1980s, interest rates in many Western countries reached record levels as a measure to combat the high inflation of the time. In the United States, under the presidency of Paul Volcker, the Federal Reserve raised rates to a maximum of 20% in 1981. This drastic measure had the desired effect of reducing inflation, but it also led to an economic recession and increased unemployment due to the higher cost of credit for consumers and businesses.

[3] CaixaBank Research (January 2024) US GDP grows 2,5% in 2023, six times faster than expected last year, available online here.

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Relevance and implications
for the private sector

For businesses, an increase in interest rates makes financing more expensive. This is particularly significant for those that depend on variable-rate loans, as interest payments increase, reducing the available cash flow for other operations or investments. Debt issuance also becomes more expensive. As a result, companies may postpone or cancel investment projects, especially those with marginal returns that do not justify the higher financial costs. On the other hand, businesses with high liquidity or low levels of debt are in a more favorable position. They can take advantage of investment opportunities that arise when more indebted competitors are forced to retreat.

Among the sectors most affected by interest rate fluctuations are real estate and construction because they require large investments often financed through loans. Additionally, they are affected on the demand side because high rates increase the cost of mortgages and reduce appetite for housing **-US 30 year fixed rate mortgages climbed in 2023 to their highest rate in over 22 years[4]-.**

The manufacturing and sale of automobiles often involve financing for both manufacturers and consumers. The former need loans to finance production and the development of new models, while consumers rely on loans to purchase vehicles, which can decrease both supply and demand. **For instance, according sector records, average monthly finance payments in the automotive sector have increased by 21% since January 2021 -from $599 to $722 in February 2024[5].**

Technology companies and startups grew in the era of zero rates as an investment alternative when liquidity was abundant and cheap. Now they have seen their access to capital necessary for research or business expansion limited, while being required to offer higher returns on investment, something that some cannot provide, leading them to lose investors.

The energy sector also makes large investments, usually in corporate bonds, which, when renewed, raise their prices and reduce economic profitability.

The retail sector often operates with tight margins and may depend on loans to finance inventory or store expansion. Therefore, high rates reduce margins while raising costs. Manufacturing is a capital-intensive sector that requires continuous investment in machinery, equipment, and technology, which becomes more expensive in these situations. High rates can delay or discourage new investments. In fact, **another piece of data that will be on the table of the bankers in Frankfurt is the 10.3% year-on-year[6] decline in capital goods production, an indicator of industrial production, which has led experts to anticipate a slowdown in business expectations**, with the consequent decline in investment.

In conclusion, high rates imply a reduction in the demand for goods and services, negatively affecting companies' production and therefore medium and long-term employment.

[4] Bloomberg (27 September 2023) US Mortgage Rate Climbs to 22-Year High of 7.41%, Curbing Demand, available online here.
[5] J.D. Power (January 2021 and February 2024) GlobalData US Automotive Forecast, available online here.
[6] Eurostat (January 2024) Industrial production down by 0.3% in the euro area and by 0.2% in the EU, available online here.

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Future evolution
of interest rates

The media and analysts frequently make projections about the behaviour of the ECB and the Fed. However, the most reliable approach is to listen to the latest statements from the central banks' top officials. Luis de Guindos, Vice President of the European Central Bank, commented on March 15 in an event in Barcelona[7], that the evolution of inflation in the eurozone is positive, going from being above 10% to now being below 3%. He added that these "good news regarding the evolution of inflation would end up being reflected in monetary policy[8].

"We want to gather information about the evolution of factors that influence inflation, and we are convinced that in June we will have a higher level of knowledge," Guindos commented. In these months, many collective agreements must be signed, in which possible wage increases will be determined, impacting decisions on the monetary policy of the organization. In any case, he clarified, we should not expect a reduction in rates to levels of five or six years ago.

Two other relevant statements are the ones from Yannis Stournaras, Governor of the Bank of Greece, and Klaas Knot, President of the Bank of the Netherlands, since they both represent opposite ends of the hawk-dove spectrum in the ECB's Governing Council, thus helping to narrow the discussion.

According to their most recent statements, they both agree that June could be the scene of the first cut, barring major surprises. However, the conversation is quickly shifting towards the number of cuts. The Greek advocates for consecutive cuts in June and July, of 0.25 points each, up to four. Knot, considered a hawk who would be cautious in advocating cuts, speaks of three cuts this year.

[7] Luis de Guindos statements during La Vanguardia Forum as stated in La Vanguardia (14 March 2024) Luis de Guindos alerts that Europe is falling behind and advocates for higher defence spending, available online here.
[8] Bloomberg (29 January 2024) ECB's Guindos Says Policy Will Reflect Good Inflation News, available online here.

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Conclusion

In conclusion, we find ourselves in an unprecedented situation compared to the past - the long period of near zero and occasional negative interest rates, as well as the subsequent rapid rise inside the last year-. There are no maps to establish a route, especially with two ongoing armed conflicts that increase uncertainty -perhaps the word that best summarizes the whole situation-. The severe blow that rates are causing to the economy, to businesses, and to individuals, as well as the fall in inflation, lead to the belief that central banks -the ECB especially- may begin to reduce rates sooner rather than later. However, oil, wages, and the limited increase in competitiveness may overshadow these forecasts. With so many variables out of control, as the members of the ECB say, more information is needed. Certainly, no one doubts that Frankfurt nor Washington will not lower the price of money if they do not see a clearer panorama than the current one.

The great reset in interest rates will change business models that were heavily debt financed in the last decade along with changing the relative strength of employees versus employers in the labour market. On many dimensions this reset is returning our business world to a normality seen before the Great Financial Recession of over a decade ago. New normals advanced during and after the Covid pandemic are dissipating as the power of compound interest rates recert their primacy on human time preferences.