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Are higher interest rates and inflation ahead? A long-term view beyond the pandemic

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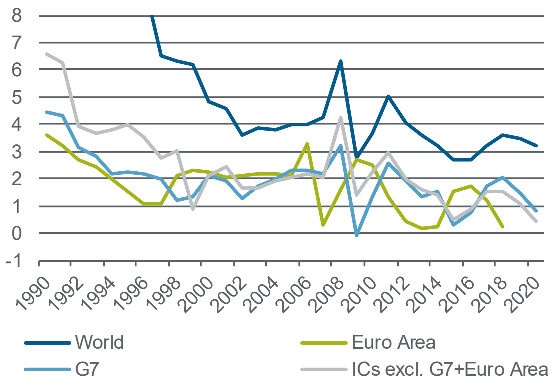
Inflation and interest rates in industrialised countries (ICs) have trended downward for a good 30 years now. Today they are well below their long-term average. Central banks and their low to negative interest rate policies are an important but by no means the sole driver of this development. Rather, demographic processes, the rise of China and advancing globalisation since the 1990s are likely to have been the main factors that have exerted downward pressure on price and interest levels. So even without the monetary policy responses to the crises of the past decade interest and inflation rates today are likely lower than as recently as in the 1990s, for example. This article discusses the impact chains of these processes in greater detail and explains that longer-term upside risks to inflation and interest rates in ICs are likely to result primarily from the reversal of the former.

Introduction

Inflation and interest rates in Germany and other member states of the euro area have trended downward for a good 30 years now (Figures 1 and 2). Today they are below the historic average. This development is the result of chronically weak demand following the financial crisis of 2008 and structural upheavals such as demographic change, technological progress, advancing globalisation and the rise of China. We will describe these in greater detail and embed them into the macroeconomic context and we will take a closer look at medium to long-term upside risks.

Figure 1: Inflation rates

In per cent



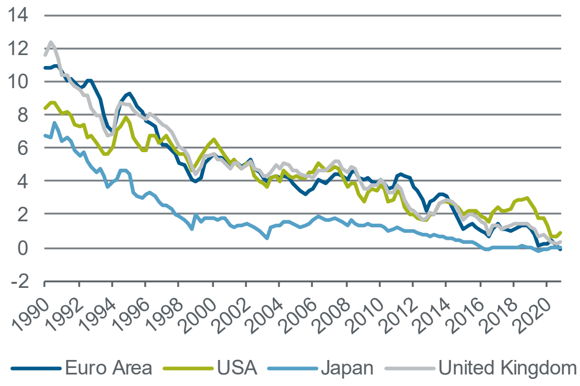
Source: IWF WEO Database

On the demand side, monetary policy since 2008 in particular …

After 2008 and again in the course of the COVID-19 pandemic, many central banks such as the US Federal Reserve and the ECB were forced to lower their key interest rates to zero or even into negative territory. They also launched asset purchase programmes which also lowered medium and long-term interest rates through various channels of the monetary policy transmission mechanism (Wieland, 2018).

Figure 2: Yields of 10-year government bonds

In per cent



Source: Fred Database, Federal Reserve Bank of St. Louis

… and structural factors have reduced interest and inflation levels

But even without the ultra-expansionary measures of central banks, inflation and interest rates today would likely be lower than the 1990s level. Massive technological progress in the area of information and communication technology (ICT), the demographic situation in the ICs and China and the strongly growing globalisation of value chains from the 1990s were accompanied by lower prices, especially in the manufacturing sector but also by lower demand for investment capital in the ICs.

The entry of the baby boomer generation into the labour market also had a massive impact on the interest level (Goodhart and Pradhan, 2020). The sharp rise in private savings contrasted with a high supply of capital and lower demand on the part of the corporate sector. In a balanced market one would expect the interest rate, which brings aggregate economic savings into balance with aggregate economic investment, to fall. The macroeconomic literature also refers to this interest rate as the equilibrium interest rate.

The equilibrium interest rate is an important anchor for the interest level. Central banks follow this rate, for example, to decide on an interest policy whose real impacts are in harmony with the (medium-term) inflation rate. For the euro area, for example, some studies estimated that the equilibrium interest rate has declined by as much as 2.8 percentage points since the 1990s (Holston et al. 2017; Brand et al. 2018). This rate could now even be negative. The decline in the equilibrium interest rate is thus likely to have contributed considerably to the drop in the overall interest level (Brand et al. 2018).

But just like the growth potential of an economy, the equilibrium interest rate is not an observable parameter. Estimating its level, in particular, proves to be statistically highly unreliable and fraught with great uncertainty (Hamilton et al. 2015; Beyer and Wieland, 2017). And this does nothing to change the concept of a trend decline in the past three decades (Laubach und Williams, 2003; Holston et al., 2017).

That is a problem in a macroeconomic environment such as that of the past decade, in which key interest rates were already near or even below zero and the inflation rate was well below its target (around 2% in the economic areas observed). In order for monetary policy to be able to actually have a stabilising effect on the production gap and employment level in this situation, it must lower the key interest rate to below the equilibrium interest rate, meaning if necessary even below the zero interest level (Galí, 2015). If it does not wish to do this (like the US Federal Reserve) – or if it assumes that the negative effects of a negative interest rate could exceed its stabilising effect – asset purchase programmes could additionally increase the degree of the central bank's expansionary policy (Orphanides and Wieland, 1998).

Central banks must keep an eye on upside risks to interest rates and inflation …

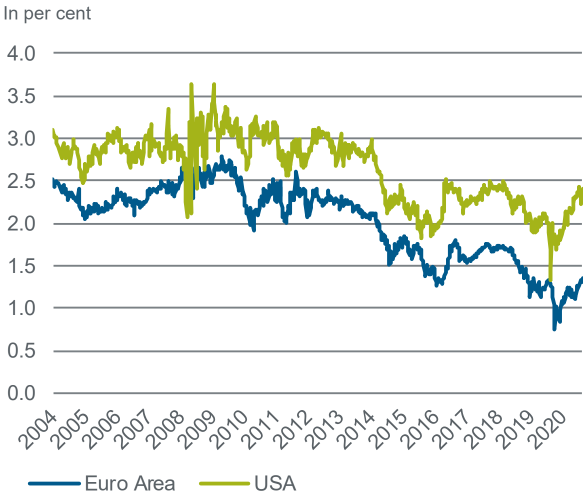
Fiscal policy also influences the interest rate level. Higher government debt theoretically goes hand-in-hand with a higher equilibrium interest rate. So long as central banks do not (immediately) lift their key interest rates in this situation, the fiscal impetus further intensifies the effect of the monetary policy measures and, hence, their effect on the overall economy.

The economic policy measures adopted to contain the coronavirus pandemic demonstrate that fiscal policy in industrialised countries, particularly in the US but also in Europe, is once again holding the reins. If they succeed in sustainably overcoming structural growth weaknesses, for example through targeted investment – including by the public sector – and strengthening the growth potential, then interest and inflation rates will likely return to historically 'normal' ranges in the medium term. In order to achieve this, it is important to understand the current crisis as an opportunity and not to let it go to waste. Prudent and efficient use of fiscal stimuli for projects that lift these economies' growth potential would be an important step in this direction.

… and ensure that inflationary expectations remain anchored

Central banks' communication is also crucial in this type of situation. It would be a problem if market players lost their faith in central banks and their ability to exit from their very expansionary monetary policy in a controlled manner. This could lead to a scenario in which inflation expectations are no longer well anchored, which would likely result in higher inflation rates in the medium to long term. Currently, however, there are no well-founded indications of such a trend. To be sure, based on the 5Y5Y inflation swaps, market-based inflation expectations have grown moderately of late. But in the euro area they are still well below the ECB's target inflation of 'close to but below 2%' in the medium term.

Figure 3: Market-based inflation expectations (5Y5Y from inflation swaps)



Source: Bloomberg

On the supply side, globalisation and demographics have been the main drivers of lower interest and inflation rates

Structural factors such as demographics, technological progress as well as societal processes such as increased globalisation of value chains since the 1990s have had long-term impacts on prices and interest rates in the ICs.

Particularly the rise of China, the reintegration of former CIS states into the global trading system and baby boomer cohorts in industrialised countries have led to a massive growth of the global labour force. This global oversupply of labour has led to relatively lower wage agreements and lower price growth. At the same time, the offshoring of production processes, for example in the manufacturing sector, has likely been accompanied by downward pressure on interest rates. Furthermore, trade liberalisation and, most of all, the reduction of trade barriers, has led to lower prices and greater prosperity in the aggregate economy.

But there are growing signs that this positive situation could change in the coming decades. That generates upside risks to interest and inflation rates. Demography presents the most obvious risk. The favourable initial demographic situation in China and the industrialised states is already beginning to see a reversal. Within the next three to four decades, the growth rate of the working-age population in these countries is set to drop significantly. The working-age population is likely to even shrink in some of the larger economies, such as Japan and China, but also in Germany, Italy and Spain.

Whether we will see a reversal of interest rates and inflation …

Whereas in the past the strong growth in available labour was associated with a drop in real wage growth, particularly for low-skilled workers, and falling prices in manufacturing, the expected future labour shortage will lead to higher wages and ultimately rising prices. An older population that consumes more than it produces also tends to have an inflationary effect on the aggregate economy. This can already be seen in rising health and long-term care expenditure, for example.

Furthermore, with the baby boomer generation spending their savings in retirement, the cost of capital is likely to be above current lows in the medium to long term. As the effective retirement age and labour participation rate of women and older workers cannot be raised at will, productivity growth will need to be much higher than today in order to weather the imminent demographic change. That demographic change could be a primary factor of future increases in inflation and interest rates is a hypothesis that has recently been floated primarily by Goodhart and Pradhan (2020) under the heading ‘The Great Reversal’ and is currently being hotly debated.

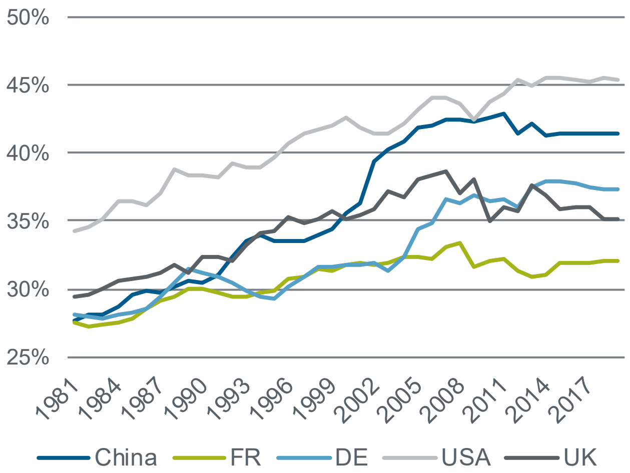
… will at least partly depend on globalisation policies……

Globalisation as a ‘success model’ is also at a crossroads. To be sure, the strong growth of the global economy has helped many people escape poverty, particularly in Asia. In addition, the dismantling of trade and non-tariff trade barriers and integration into global value chains has led to enormous prosperity growth, a decline in global inequality and lower prices.

But there have been losers as well and the view that globalisation has not been a success model but a zero sum game is gaining influence in the political arena. Thus, since the 1980s inequality has grown within most ICs but also in China and sharply in some countries (Figure 4). The failure of free trade agreements such as TTIP, trade wars, hostile attitudes towards migration and the emergence of populist currents in the West could become catalysts of an altogether less integrated global economy.

Figure 4: Inequality (top 10% income) from 1981

Percentage of income from work (before taxes)



Source: World Inequality Database

Supply shortages and considerations on re-shoring production processes in the course of the coronavirus pandemic may already have provided a foretaste of this trend. Should these factors continue they may generate higher costs for enterprises and, ultimately, higher prices for end consumers in the medium to long term.

However, it is not set in stone that this would have to lead to less trade integration and a decrease in globalisation. This can be prevented by political efforts such as a reintroduction or expansion of the rule-based trading system but also by systematically endorsing globalisation and the freest possible trade. Particularly a heavily export-oriented economy like Germany, which would be very negatively affected, should have a vested interest in this.

… and efficiency gains from technological change

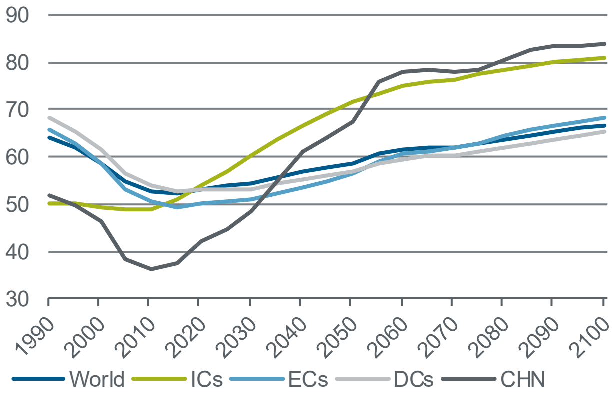
Besides globalisation, it will primarily be the advancing technological transformation that will lead to long-term efficiency gains and lower prices. Furthermore, growth-friendly reforms combined with investment in forward-looking projects that support the structural transformation will likely counteract a rise in interest rates and prices in the long term.

In the short term, policymakers can only do little to reverse the demographic trend in ICs

Demographic processes are hard to slow down in the short to medium term, particularly since regions with a young, fast-growing population (India, Sub-Saharan Africa) are likely either too small or economically/institutionally not sufficiently equipped to offset the drop in population and shortfall in demand from China and the ICs. Demographic pressure on prices and interest rates in the medium to long term is therefore quite likely.

Figure 5: Development of the dependency coefficient

0 to 14-year-olds and 65+-year-olds for every 100 persons between 15 and 64



Source: World Bank

Conclusions and outlook

The economic recovery from the coronavirus pandemic has so far been accompanied by moderate increases in interest and inflation rates. This trend is likely to intensify somewhat in the course of the year. Over the coming years, however, there is no reason to expect interest and inflation rates to increase noticeably or even sharply above their current level. On the contrary: as base effects disappear and capacity bottlenecks are overcome, price pressure is set to be even slightly lower in the coming years. The ECB and other central banks never tire of stressing that they will keep a close eye on these developments and keep interest rates low for some time to come.

From a long-term perspective, however, it is clear that the current low level of interest and inflation rates is not a matter of course and is unlikely to remain this low forever. The possible growth rate results from the interplay of the demand and supply side factors described, the further development of which must be closely monitored.

This will pose a dilemma for central banks in the medium to long term. On the one hand, in the mid-1980s central banks gave impressive proof that they know how to handle higher inflation rates. On the other hand, current debt levels of industrialised countries, governments, households and businesses cannot be compared to the levels back then. If central banks were to respond to higher inflation rates with swift and sharp interest rate increases in the current situation, that would not just trigger an adverse effect on growth and employment. A significantly higher interest level, in combination with the current debt burden of ICs, would also substantially narrow the scope for investment in the necessary green and digital transformation and cause social-policy objectives to be missed.

On the other hand, should central banks no longer (wish to) fulfil their responsibility for price stability as systematically as they have in the past 30 years, that too would not be a solution that comes at zero cost.

Given the enormous challenges facing society, policymakers in particular are likely to increase pressure on central banks to keep key interest rates at their current low levels for longer than necessary. Against this background, the constitutionally guaranteed independence of many central banks is a particularly valuable good that deserves to be protected.

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