Why are interest rates still rising?

Vicky Pryce

You may be forgiven for still wondering when the current interest rate hiking cycle might end given that the world economy is not picking up pace fast enough, despite the fact that the energy crisis seems to have abated. Monetary tightening continues even though the latest IMF forecast remains pretty pessimistic about overall growth returning to pre-pandemic rates any time soon. The IMF's latest projection for overall global growth is for it to fall from 3.5% in 2022 to just 3% for this year as a whole and stay at that rate also in 2024. It blames this on the fact that "the rise in central bank policy rates to fight inflation continues to weigh on economic activity".

Yes, inflation remains the number one priority , still above most central banks' 2% target. The IMF has just revised its forecast for inflation upwards for 2024 and now thinks that core inflation will drop more gradually than had been anticipated. But are we perhaps reaching the point where more emphasis needs to be paid to what is happening in the real economy? Interest rate increases take time to have an effect in slowing down activity and therefore reducing inflation- typically 18 months. And we may be approaching that point now ,given when rates started being moved up from near zero where they had been moved to deal with the pandemic.

It is worth remembering indeed that that the Bank of England raised rates first in December 2021, followed by the Fed in March 2022 and by the ECB in July 2022. We are only now beginning to see the impact of the early rises and the cumulative impact of the ones that followed and what the overall effect on the real economy and therefore on inflation is still not clear. Although the IMF rends to advocate sticking with tighter monetary policy in all its recent quite hawkish pronouncements, there is concern about the wider economic impact for global growth of what looks like concerted interest rate increases which seem to be continuing .

So in late June the Bank of England raised rates by 50 basis points to 5% , the highest in 15 years to combat what it perceives to be sticky inflation– only then to be faced with an inflation drop to 7.9% which seemed to be better than anticipated. Then this week the US Federal Reserve raised rates again after a pause , by 0.25% to a range of 5.25 to 5.50% , the highest for 22 years. We saw a similar 25 basis points increase a day later by the European Central Bank(ECB) , to 3.75-4.25%.

And yet inflation is falling in all these places, and globally as well, mainly due to lower oil and gas prices. In the US, the annual rate of inflation is now at just 3%, a third of what it was at its peak in the current cycle, and just 1% above the Fed 2% target. The inflation rate is also falling in the Eurozone easing to 5.5% in the 12 months to June , down from 6.1% in May. In Spain, the EU's fourth largest economy, but also in Belgium and Luxembourg, inflation is already below the ECB 2% target. Even Greece, currently ravaged by wild fires and a ferocious heatwave, had an inflation rate of just 2.7% in June.

Inevitably, concerns that the tightening phase may have been overdone are beginning to emerge . Perhaps, ' data dependency', which has replaced 'forward guidance' in central bank interest rate vocabulary , maybe relying too much on short term indicators, obscuring what is to come next. Surely rates must now be at their peak. Yes, good Q2 quarterly US data suggest that the expected slowdown in the economy is milder than had been anticipated. Still not much to shout home about though if growth for the year ends up at between 1% and 2% as the IMF forecast . And the housing market there has taken a hit with a 16.4% year on year drop in the numbers of homes sold in June.

And witness the UK where the cumulative increase in mortgage rates has now finally scared house buyers off and seriously dented real disposable incomes, already suffering from below inflation wage rises and higher stealth taxes. Consumer confidence has taken a renewed knock and insolvencies are rising sharply. Witness also the EU where the IMF forecasts growth of just 0.9% for the region as a whole this year but recession in Germany . Lending conditions are tightening, business climate indicators are beginning to go backwards again and the heatwave-hit countries will find it difficult to hang on to the hoped- for tourist receipts this summer.

Vicky Pryce is Chief Economic Adviser at CEBR and a Visiting Professor at BCU and King's College, London

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