CENTRAL BANKS: HOW MUCH IS TOO MUCH?

The significant and fast paced monetary tightening by major central banks and the prospect that more is to come raise the concern of a monetary 'overkill'. This could happen due to a non-linear reaction of economic agents to an umpteenth rate increase. Several factors can play a role in this respect: negative animal spirits, debt levels and their characteristics, asset valuations, bank lending, capital markets. This calls for increased gradualism and, at some point, taking a pause whilst insisting that this doesn't represent an end to the tightening cycle.

During the press conference following the latest ECB governing council meeting, Christine Lagarde made it very clear that more rate hikes were to follow. Last week, Jerome Powell, speaking to US Congress, explained that it was a *"pretty good guess"* that the Federal Reserve would hike rates twice more this year[1] and the Bank of England surprised markets by a 50 basis points increase in its policy rate. The significant and fast paced monetary tightening and what may still come further raise the question of how much is too much.

What will be the straw that breaks the camel's back? As is often the case, asking the question is easier than answering it. J. Powell used the metaphor of driving a car. When you get closer to your destination, you leave the highway and start using local roads. In doing so, you slow down. However, road conditions and the appropriate speed are easier to assess than the pace of disinflation, which depends on how fast and how much past rate hikes influence demand, employment, pricing decisions etc.

Assessing the warranted tightness of monetary policy -the equivalent of deciding on the speed of the car in Powell's metaphor- is also a challenge. In the past, the Fed Chair has insisted on the need to have positive real interest across the yield curve, but this raises the question of the reference point. In this respect, the neutral rate of interest[2] works in theory but in practice it does not provide a conclusive answer due to the wide range of its estimates. One is left with the obvious conclusion that the bigger the cumulative tightening in a cycle and the higher the level of real interest rates, the bigger the risk that economic agents end up reacting in a disproportionate way to another rate increase.

Why might this ultimately happen? Several factors could trigger such a non-linear reaction (*exhibit 1*). The first one is a sudden drop in confidence, a manifestation of negative animal spirits[3]. This could reflect increased uncertainty of economic agents about the future, given the ever-higher interest rates. Although they may personally not (yet) be financially constrained, this increased uncertainty may lead to a more cautious stance in terms of spending.

A second driver is the debt level and structure of companies and households. A high level of debt that needs to be refinanced can make companies very sensitive to increases in interest rates. Likewise, for households, mortgages with variable rates or with fixed but adjustable rates also create a high sensitivity.

ACCELERATORS OF MONETARY TRANSMISSION

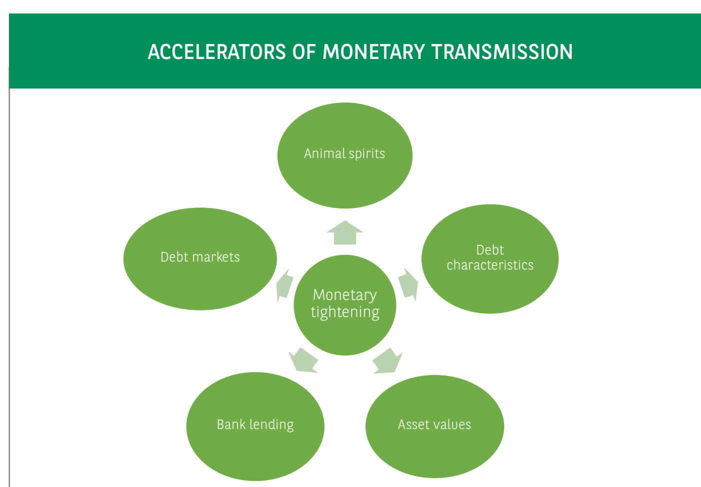

EXHIBIT 1 SOURCE: BNP PARIBAS

In the UK, the Bank of England has calculated that *"around a quarter of the outstanding stock of mortgages are scheduled to reach the end of their fixed-rate term between 2022 Q4 and the end of 2023."*[4] This implies that a considerable part of the impact of past rate hikes still needs to make itself felt. Rate hikes not only weigh on the demand for new mortgages but as time goes by, they also increase the cost of existing mortgages, which reinforces the impact of monetary tightening on the economy[5].

A third channel runs through asset prices. High interest rates reduce *ceteris paribus* the net present value of future cash flows and eventually they should also cause downward revisions of the cash flow projections. These should be gradual phenomena. A jump in the required risk premium due to a drop in confidence about the outlook and a feeling of greater uncertainty amongst investors, is a more likely candidate for a sudden, non-linear reaction[6].

Such a development may weigh on spending through a wealth effect. In addition, the value of an asset as loan collateral declines, which may reduce the access to credit. Such a phenomenon is part of the fourth channel, that of bank lending. Loan conditions may be tightened because of the decline in the collateral value -a process also known as

1 Source: Key takeaways from Fed Chair Powell's testimony, CNN, 21 June 2023.
2 The neutral rate is the official interest rate at which the stance of monetary policy is neither accommodative nor restrictive. "It is the short-term real interest rate consistent with the economy maintaining full employment with associated price stability." Source: Robert Kaplan, The neutral rate of interest, Federal Reserve Bank of Dallas, 24 October 2018.
3 J.M. Keynes referred to animal spirits as "a spontaneous urge to action" whereby decisions are not "the outcome of a weighted average of quantitative benefits multiplied by quantitative probabilities". Source: George A. Akerlof and Robert J. Shiller, Animal Spirits, Princeton University Press, 2009.
4 Bank of England, Monetary policy report, November 2022.
5 The Institute for Fiscal Studies, a British independent economics research institute, has calculated that if mortgage rates stay at their current level, 1.4 million UK households could, due to the reset of the rate on their mortgage, see a reduction of 20% of their disposable income -after paying the interest charges on their mortgage- compared to their situation in March 2022. Source: Tom Waters and Thomas Wernham, Interest rate hikes could see 1.4 million people lose 20% of their disposable income, Institute for Fiscal Studies, 21 June 2023.
6 For a detailed description see William De Vijlder, How the willingness to take risk can evaporate, Ecoweek, BNP Paribas, 28 July 2017.

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the financial accelerator- or simply because banks worry more about the economic outlook and the associated risk to their loan book. Finally, higher policy rates may raise the risk aversion of investors and trigger an increase in corporate debt yields and/or reduce the access to debt capital markets by companies.

These multiple factors remind us of the delicate task faced by central banks in the late stage of a tightening cycle. They do not mean that central banks should start taking risk with inflation and stop raising rates, but they do call for increased gradualism in the form of smaller and less frequent increases. This will allow to monitor how the economy reacts, whilst reducing the risk of raising rates too much. Insisting that a pause does not mean that the tightening cycle has ended should help in avoiding that inflation expectations start to drift higher in reaction to increased central bank caution.

William De Vijlder

In the late stage of a tightening cycle, the risk of a non-linear reaction of economic agents increases. This calls for increased gradualism in the form of smaller and less frequent rate hikes.