EDITORIAL

SYNCHRONOUS RATE HIKES: A SUM-OF-THE-PARTS ANALYSIS

A sum-of-the-parts analysis, which is popular in corporate finance, has made its way in the world of central banking, reflecting concern that the multitude of synchronous rate hikes could have a combined tightening effect that is larger than the sum of its parts. To the extent that inflation in a given country is largely a function of global slack, these hikes could cause an unexpectedly large decline in inflation. Rising import prices due to currency depreciation are another factor because they could force countries to tighten monetary policy. Confidence effects may also play a role, especially at the level of export-oriented companies. To address these risks, central banks could insist that synchronous rate hikes should moderate inflation expectations globally. They should also take into account the spillover effects of the actions of foreign central banks when designing their own course of action.

In corporate finance, a sum-of-the-parts analysis tries to answer the question whether breaking up a conglomerate by spinning off certain entities would create shareholder value. The underlying idea is that the sum of the value of the individual units might be worth more than the current valuation of the conglomerate.

The concept has now made its way in the world of central banking. In a recent speech[1], Lael Brainard, vice-chair of the Federal Reserve noted that *"the combined effect of concurrent global tightening is larger than the sum of its parts."* The number of synchronous[2] rate hikes is indeed exceptionally high (*see chart*). This is not a surprise considering that many countries are suffering from elevated inflation. According to Brainard, it forces the Federal Reserve to take *"into account the spillovers of higher interest rates, a stronger dollar, and weaker demand from foreign economies into the United States, as well as in the reverse direction."*

A similar point was recently made by ECB chief economist Philip Lane: *"The deeply integrated nature of the global economy implies that our analysis needs to incorporate international monetary policy spillovers."*[3]

Another warning came from World Bank staff: *"the highly synchronous tightening of monetary and fiscal policies could cause more damage to growth than would be expected from a simple summing of the effects of the policy actions of individual countries in a highly integrated global economy."*[4]

1. *Restoring Price Stability in an Uncertain Economic Environment*, Remarks by Lael Brainard, Vice Chair Board of Governors of the Federal Reserve System at "Shocks and Aftershocks: Finding Balance in an Unstable World", 64th National Association for Business Economics Annual Meeting, Chicago, Illinois, 10 October 2022.
2. 'Synchronous' refers to the idea that the rate hikes happen during the same timespan, although not in a coordinated way, in which case 'synchronised' would be used.
3. The transmission of monetary policy, Speech by Philip R. Lane, Member of the Executive Board of the ECB, at the SUERF, CGEG|Columbia|SIPA, EIB, Société Générale conference on *"EU and US Perspectives: New Directions for Economic Policy"*, New York, 11 October 2022.
4. *Is a global recession imminent?*, Justin Damien Guénette, M. Ayhan Kose and Naotaka Sugawara, CEPR Discussion Paper DP17566, 03 October 2022.

Why is there a risk that the combined effect of higher interest rates could be greater than the sum of the parts?[5] Maurice Obstfeld of the Peterson Institute for International Economics sees two reasons[6].

To the extent that inflation in a given country is largely a function of global slack -i.e. the global output gap determines to a large degree the price developments at the level of individual countries-, synchronous rate hikes by many countries, through their impact on the global output gap, could cause a sudden, unexpectedly large decline in inflation. Rising import prices are another factor. Tighter monetary policy in a given country should, all else remaining the same, cause an

5. A rate hike in a given country should be negative for growth and inflation in that country. Via a reduction in its imports, this country also creates a spillover effect to other countries. In a sum-of-the-parts approach, synchronous rate hikes in various countries have an impact that corresponds to the sum of the individual country effects.
6. Uncoordinated monetary policies risk a historic global slowdown, Maurice Obstfeld, Peterson Institute for International Economics, 12 September 2022.

CENTRAL BANKS' POLICY RATES

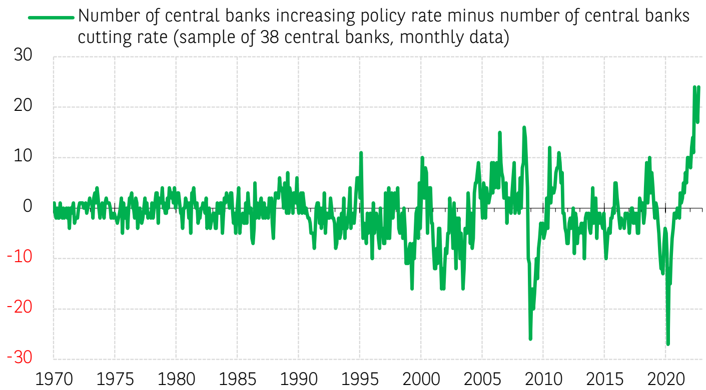

CHART 1 SOURCE: BIS (OCTOBER 2022), BNP PARIBAS

> Synchronous rate hikes by a large number of central banks could have a disproportionate effect on global growth, causing inflation to ease more quickly than anticipated.

appreciation of its currency. The depreciation of the trading partners' currencies could cause an increase of import price inflation that forces the respective central banks to tighten policy as well, thereby contributing to the global growth slowdown. In addition to the points mentioned by Obstfeld, confidence effects may also play a role. This is especially important for export-oriented companies. Demand for their products in a given export market may suffer when the local central bank raises interest rates. When this happens in a synchronous way in several of their export markets, the negative effect in terms of loss of confidence may be disproportionate.

What could be done given the risk that the combined effect of higher interest rates could be greater than the sum of the parts? Central banks could insist in their communication on the synchronous nature of rate hikes. This could moderate inflation expectations globally[7], which should help, to some degree, in bringing inflation back to target.

Consequently, the cumulative tightening could be smaller, thereby reducing the risk of a monetary 'overkill'. As mentioned by Brainard and Lane, central banks could also pay particular attention to the spillover effects of the actions of foreign central banks. This could again imply a smaller cumulative tightening. There is a risk however that investors would interpret this as a premature dovish twist, so clear communication will be crucial to avoid a loss of credibility.

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7. This point is made by Maurice Obstfeld.