ECONOMIC VIEWPOINT

Beware of Anticipating Too Many Interest Rate Hikes

They Are Not a Miracle Cure

By Hendrix Vachon, Senior Economist

Over the last few months, the wind has shifted in the financial markets, and they're now quicker to anticipate more key rate increases to combat rising inflation. However, it is important to remember that raising interest rates is not a miracle cure, especially in the current context. There are several arguments for moderate monetary firming in 2022. For now, our main scenario calls for three 25-basis-point key interest rate increases in the United States and Canada.

Interest Rate Increases Will Not Solve the Supply Problems

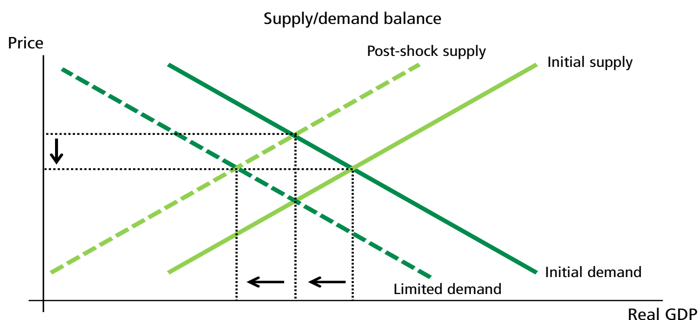
As we discussed in a previous *Economic Viewpoint*, it is hard for central banks to combat the inflation triggered by supply issues. Currently, in many countries, the production of goods and services is still being constrained by the impacts of the pandemic and public health measures. Raising interest rates in this context would not help resolve the supply problems. The best remedy would be favourable pandemic developments, with public health measures being lifted.

Interest rates primarily work at the demand level. Raising them would essentially result in curbing consumption and investment. This could still help lower inflation, but at the cost of an economic slowdown (graph 1). In the worst case scenarios, the combined impact of still weak supply and demand that is being curbed by several interest rate increases could precipitate another recession in early 2023.

The Heavy Debt Load Suggests Greater Sensitivity to Interest Rates

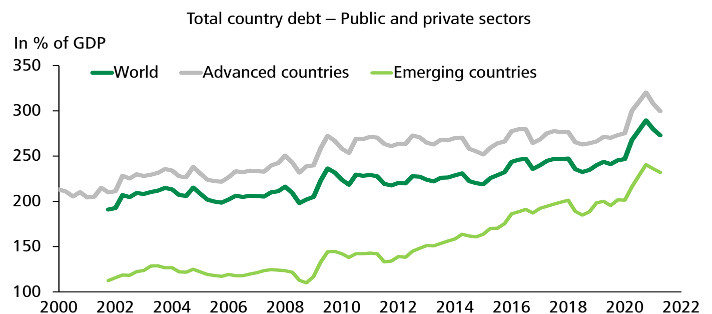
The risk of an economic slowdown or even a recession also increases with sensitivity to interest rates. Although it is hard to accurately estimate sensitivity, we know that it increases with the level of indebtedness. In this regard, the debt load has grown in recent years (graph 2). The pandemic didn't help, obviously, particularly with respect to government indebtedness (graph 3 on page 2). Governments could face a fast increase in their financing costs. To compensate, some governments could be tempted to cut back on other spending or increase their revenue. Both would end up curbing demand and economic growth.

GRAPH 1
Interest rate increases reduce demand without increasing the supply



Source: Desjardins, Economic Studies

GRAPH 2
The debt load is higher than it was before the pandemic



Sources: Bank for International Settlements and Desjardins, Economic Studies

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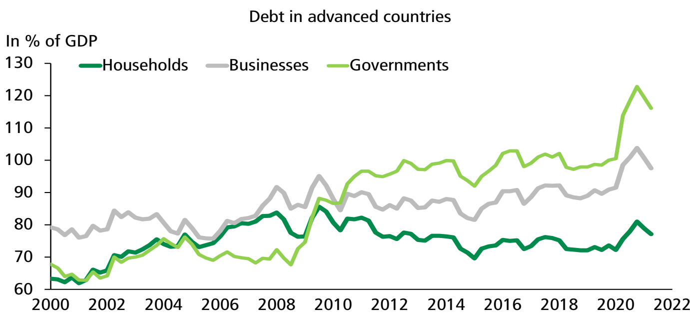
GRAPH 3
Government debt has increased more sharply



Sources: Bank for International Settlements and Desjardins, Economic Studies

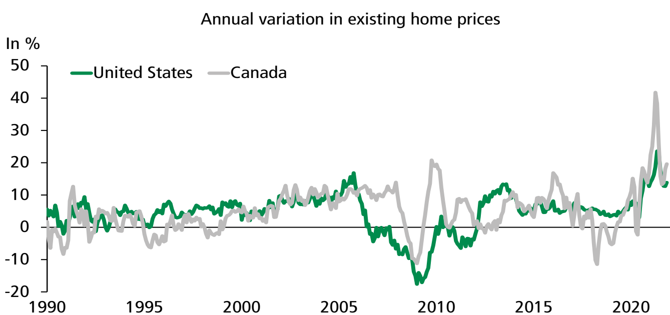
Household and business debt is also an issue in many countries. Low interest rates are currently making the situation sustainable, but that could change fast following several interest rate increases. Businesses and consumers could then cut back on their investments and spending.

We Must Not Rein In the Housing Market Too Quickly

Some activity sectors could respond more sharply to overly abrupt interest rate increases. In particular, the housing market must be monitored. During the pandemic, activity in this sector shot up, compensating for sectors that were having more difficulty. The low interest rates probably had a hand in the boom. Rapidly rising interest rates could seriously hurt the housing sector and drag other sectors of activity with it.

Valuations in the housing market are another issue. Home prices have risen sharply for the last two years and could now correct (graph 4). Higher interest rates should reduce the number of potential buyers, which could translate into downside pressure on prices. It would not be catastrophic for prices to moderate or edge down. However, a major correction would have a bigger downward impact on the economy. Among other things, many people could be prompted to cut back on their spending if they saw their home values drop substantially. This would be a negative wealth effect.

GRAPH 4
Home prices could correct after rising sharply in recent years



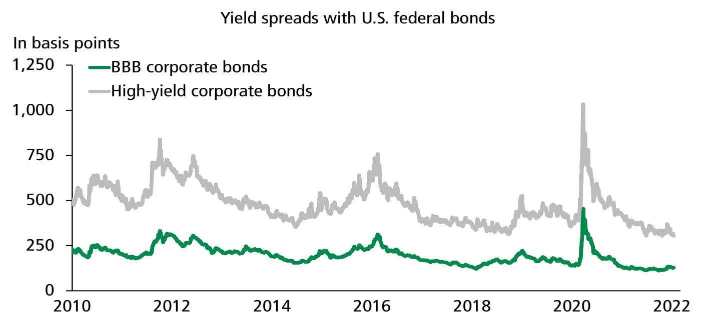
Sources: National Association of Realtors, Canadian Real Estate Association and Desjardins, Economic Studies

Risk of Widespread Financial Instability

In addition to a correction in property prices, securities could also drop steeply and magnify the impact of the negative wealth effect on consumer spending. The ultra-accommodating monetary policies of recent years have been one factor supporting the valuations of different asset classes. Reversing these monetary policies too quickly could heavily penalize the value of financial assets, such as stocks and bonds.

There is also a risk of generalized financial instability. The financial markets do not work as well during times of high volatility. Businesses and financial institutions could have more trouble refinancing, and bankruptcies could increase. The effect could be magnified by higher risk premiums. For now, risk premiums remain very low, but the situation could change quickly over the coming quarters (graph 5). Higher volatility in exchange rates and international capital flows that would play against some countries are other factors that could aggravate financial instability.

GRAPH 5
Credit spreads could widen with the economic and financial uncertainty

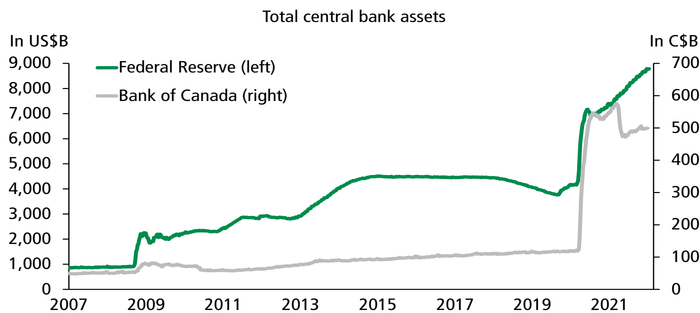


Sources: Datastream and Desjardins, Economic Studies

Smaller Central Bank Balance Sheets Would Mean Fewer Rate Hikes Are Needed

In addition to interest rate increases, the central banks could start shrinking their balance sheets (graph 6 on page 3). The Federal Reserve (Fed) and the Bank of Canada have already mentioned this option. Recently, the Fed's Chair even said that could start toward the end of the year. Expanding the balance sheet had a downside impact on bond yields; shrinking it should help bring those yields up. Such monetary tightening could lead to additional steepening of the bond yield curve. That could also help raise risk premiums.

GRAPH 6
Some central banks could reduce their asset holdings



Sources: Datastream, Bank of Canada and Desjardins, Economic Studies

We think that forecasts for key rate increases must consider the onset, in 2022, of balance sheet reductions. All else being equal, it would then take fewer key rate increases to bring inflation down. Note that balance sheets should be reduced by allowing the securities central banks hold to mature. It would be a very gradual process. That said, central banks could opt to pick up the pace by selling assets if they judge that a more pronounced tightening proves to be necessary. Government policies must also be taken into account. Less government intervention would help to slow the economy and inflation.

Conclusion: Moderation Seems Best

There are several arguments for moderate key rate increases. Central banks will probably be cautious in order to avoid seeing the economy relapse into recession. At the same time, central banks would count on supply problems being resolved gradually; this would allow inflation to drop substantially in the coming quarters.

However, history shows that, to reduce inflation, central banks have already had to rein in the economy to the point of lowering real GDP and increasing unemployment. We cannot rule out this possibility completely. On one hand, the supply problems could be more persistent, especially if the pandemic and public health measures stay with us longer than forecast. After that, the main danger will be high inflation settling in. If inflation expectations increase, with successive price adjustments, particularly in wages, central banks could worry that inflation will remain high over the medium term. In that case, sharper monetary tightening than we currently expect could be required.