The real question about real interest rates

Real interest rates in the Euro area remain negative on 10 years government bonds in both Germany and Italy even after the fast increase in interest rates in the history of the ECB.

At the same time, most governments in the EU and OECD are running significant deficits on the general government's account thereby adding additional demand to the economy.

The real question is therefore: Why should the economies have a hard landing when real interest rates remain negative?

Real interest and monetary policy

In a number of our most recent Newsletters, we have looked into inflation and its implications for monetary policy, a theme that, given its importance, we feel obliged to continue this month.

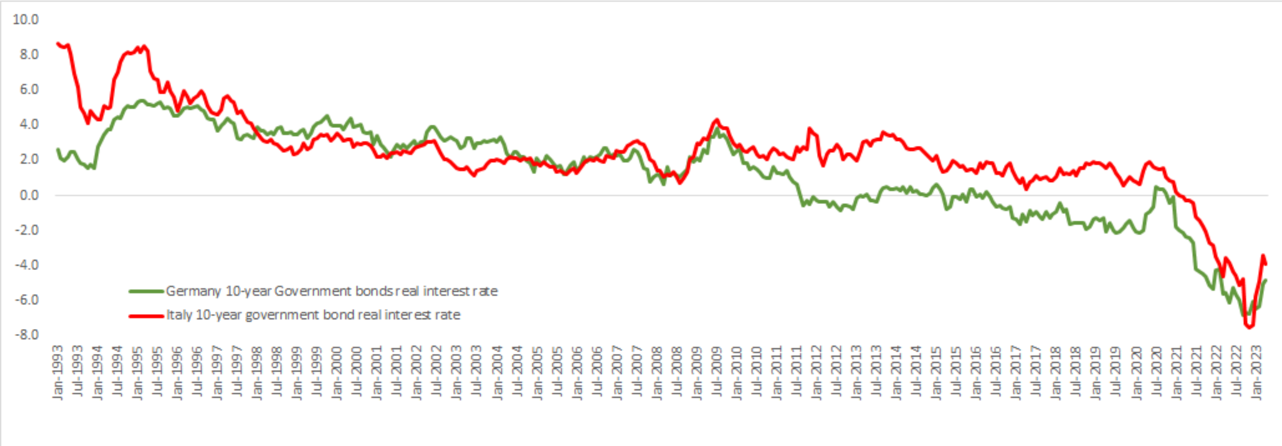
Since our last Newsletter, the ECB, the Bank of England and the Federal Reserve have all hiked interest rates by 0.25%.

Despite this, the financial markets still expect that the central banks will be forced to pivot and begin lowering interest rates again during the second half of this year.

In our view this seems rather unlikely given the current level of real interest rates.

Quantrom Limited, 59-60 O'Connell Street,
Limerick, Ireland, V94 E95T
+353 1 513 6215, client@quantrom.com
quantrom.com

Figure 1 Germany and Italy 10-year real interest rates *source: ECB and OECD*



10-year real interest rates in April 2023 in both Germany and Italy remained negative, at -4.8% and -3.9%, respectively. From an economic perspective, it is difficult to argue that this should have a dampening effect on the economy.

For the many private individuals and companies now struggling with higher interest rates, these are trying times.

However, on a macroeconomic level, negative real interest rates should, all other things being equal, encourage increased spending and investment in real assets. In simpler terms: why not spend the cash you have today when the real value of your money will be 3-4% less next year?

As long as long-term real interest rates remain negative, there is no reason to expect a serious slowdown in ecnomic activity.

If the central banks want to slow down the economy, they will either need to hope that inflation drops quickly to the 2% level, or continue to hike interest rates if inflation does not fall.

Fiscal effect of general government deficits

As established above, negative real interest rates are currently pushing the economy forward, and the same can be said of the fiscal policies of general governments.

According to the latest available data from the OECD, the European Union is expected to show a deficit of 3.4% of GDP for 2022, the US had a deficit of more than 12% of GDP in 2021, while the UK lowered its deficit to 5.2% of GDP in 2022.

Only a few countries in the OECD are running general government surpluses (e.g. Denmark and Norway, with a whopping surplus of almost 26% of GDP), meaning that all the remaining governments are stimulating their economies with additional spending from their fiscal policy.

Implications going forward

As long as both monetary and fiscal policies remain expansive in the EU, the UK and the US, it is difficult to foresee these economies heading for a hard landing.

Bringing inflation down further will remain a very difficult task for the central banks and, in our view, the financial markets should be expecting “higher for longer”.

This is indeed a total reversal of the “lower for longer” Federal Reserve policy of just a few years ago.