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MACROECONOMIC OUTLOOK

Professor Ricardo Reis

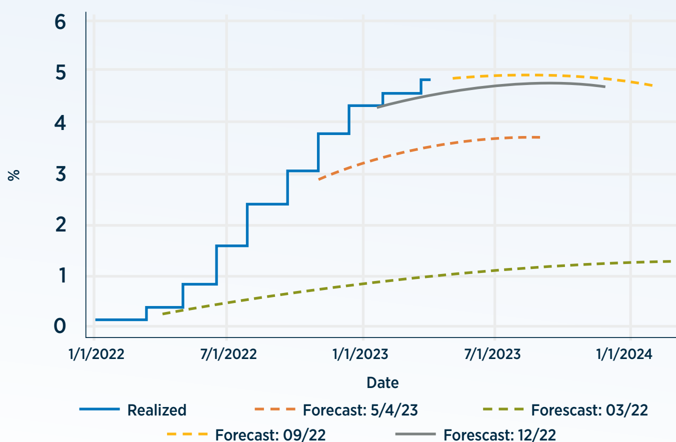
MONETARY POLICY AND SHORT-TERM INTEREST RATES

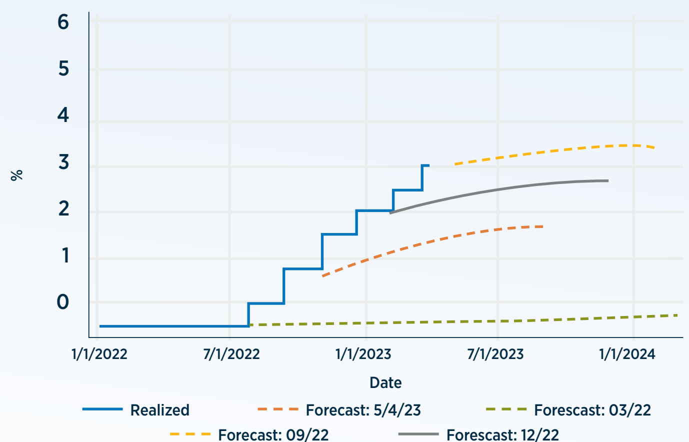
The outlook for interest rates across the UK, European area and US, and why the construction industry could be the canary in the coal mine for any impending recession.

The past 12 months have seen a rapid ratcheting up of interest rates from the European Central Bank, the United States' Federal Bank and the UK's Bank of England, largely driven by the need to cool the inflation hitting each of their economies.

As we approach the peak of the hiking cycle, the capital markets are expecting the central banks to start cutting rates sooner than what they have announced. However, markets have been successively wrong about interest rates over the past year, always expecting the Fed and the ECB to be more doveish than they were.

So how should we approach the challenge of understanding how quickly the monetary tightening in each region might be unwound?





Financial markets expect that both the Fed and the ECB will raise interest only by an extra 25 basis points. Yet, as of March, Fed officials have consistently stated for months that, while they are monitoring data and updating decisions every meeting, its baseline forecast is of raising rates by a further 75 basis points. The expectation is that peak policy rates will be hit by the end of Q2 2023, if not earlier.

The same applies to the ECB, where policymakers have, if anything, indicated in Q1 of this year that relative to previous announcements, an extra 25-50 basis points of hikes may be needed. Likewise, all indications are that interest rates will stay at those levels for a while and only start being cut in 2024—and even then, only slowly in 25 basis point steps.

The resolve of central banks to keep hiking interest rates is ultimately constrained by whether the economy appears to be entering a recession. Forecasting whether interest rates will rise more or less than indicated above is therefore based on this associated risk and whether rates will be cut faster or slower depends mainly on the probability and on the intensity of a recession.

Recession signals

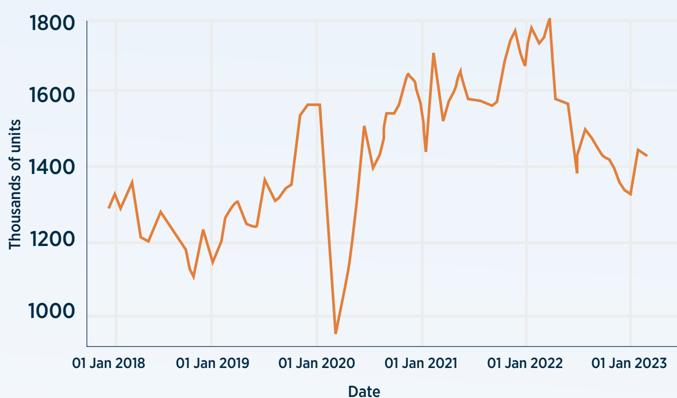
The path of interest rates and the speed at which central banks try to bring inflation down depends strongly on the evolution of the real economy. And the key tradeoff that will shape the path of policy interest rates is the behavior of unemployment.

The construction sector is usually the one to look at for signs of a coming recession. The sector is one of the most sensitive industries to interest rates and therefore the one that often leads the economy in entering a recession caused by a tightening of monetary policy.

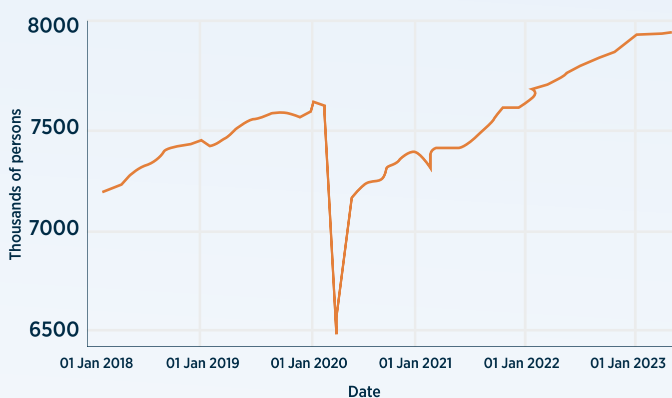
The below graphs show some intriguing patterns in that industry for the US. Since the first quarter of 2022, construction of new units has ground to a halt. With the usual slight delay, this has led to a fall in sales and in value added. Yet, employment has barely had a blip. In fact, the data suggests construction companies have been hoarding workers.

The US construction sector today and the usual pattern of recessions

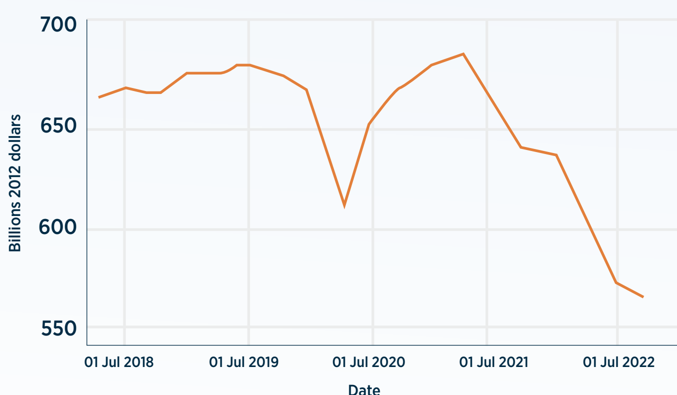
New Privately-Owned Housing Units Started

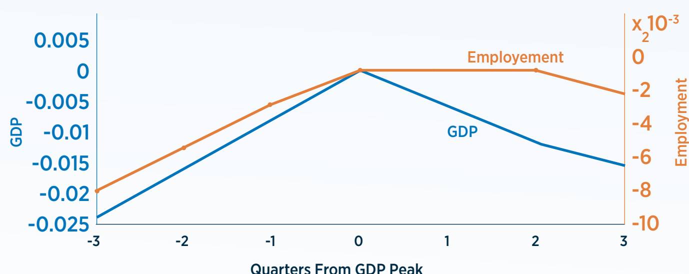


Employees, construction



Real Value Added in Construction





On average, in the post-war period, employment falls six to nine months after value added started falling. If this (weak and imprecise) regularity is repeated, then employment in the US construction sector may well start falling between now and September.

The impact of fiscal tightening on the availability of credit is also worth considering. To date, bank credit has held up well, but the increase in funding costs makes it inevitable that over the next six months there is an adjustment in either loan volumes or the interest rate on loans.

If credit from their local bank ends, it is plausible that shedding some of these construction workers will be a first response. Therefore, the main source of concern is for unemployment, which could suddenly jump upwards over the next six months.

Should that come to pass, it will test the resolve of the central bank in continuing to use high interest rates to bring down inflation.

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Another notable development during this US hiking cycle has been that bank deposits have fallen faster than in fiscal tightening periods. Similar dynamics to a smaller degree will hit other regions, as well as other sectors, with commentators already keeping a keen eye on policy lapses in life insurance.

In the final article in our mini series, Professor Ricardo Reis uncovers what happened in the US banking sector in March 2023, and where all the deposits ended up.

It's the *way* we do it.

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Source

This article is based on findings from research by Professor Ricardo Reis at the Centre for Macroeconomics at the London School of Economics. This research looked at the measurement of relative prices, the interpretation of differing expectations data, the measurement of inflation tail risks, the identification of changes in risk premia in bonds, the path for monetary policy given the trade-offs it faces, the trends in employment and output in the construction industry relative to their usual behaviour, and the financial flow of funds. This was done to understand the likely behavior of inflation and short-term interest rates, and to lay out some of their risks and consequences for non-bank financial intermediaries.

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