How high will central banks go? Interest rates may have to rise sharply to fight inflation

But the low-rate era is unlikely to come to a permanent end

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Jerome powell, the chairman of the Federal Reserve, once compared setting interest rates to celestial navigation. Today, as inflation spikes, there is a growing sense that the Fed has lost its way. It looks as if it is about to make an abrupt change of course by tightening monetary policy hard and fast. That prospect has battered stockmarkets and led many firms and homeowners to wonder if the era of low rates might be over for good.

The reality is more complex. In the short term the Fed does indeed need to get a grip. But, as we explain, in the long run the world's ageing population will keep a cap on interest rates. That points to an unpleasant financial squeeze, rather than a return to the 1970s.

Interest-rate rises are daunting because much of the world has got used to an era of almost-free money. No g7 central bank has set interest rates above 2.5% in over a decade. Back in 1990 all of them were above 5%. Cheap financing has come to seem like an indelible feature of rich economies. It has let governments run extraordinary deficits, propelled asset prices to astronomical highs and forced policymakers to reach for other tools, such as bond-buying and stimulus cheques, to prop up the economy during slowdowns.

That is why surging prices over the past 18 months have been such a rude surprise to the Fed and other central banks. In America consumer-price inflation has reached 7% and, far from being transitory, is feeding through into wages as the idea that bills will go up is being baked into households' and firms' expectations. Private-sector wages and salaries in America are up 5% in a year. In December the median American consumer expected prices to rise by 6% over 12 months. Many of these trends are being felt around the world: global inflation has now reached 6%.

As a result, central banks are stirring. Twelve emerging-market rate-setters raised interest rates in 2021. The Bank of England did too. It did so again on February 3rd, and more rises are likely. Investors expect even the glacial European Central Bank, which has not raised rates for more than a decade, to do so twice this year. Yet all eyes are on America and Mr Powell. That is partly because they have a dominant role in the world's financial system, but also because American inflation is high and the Fed is behind the curve. For months it has been stimulating an economy that is already red hot by buying bonds and keeping interest rates at 0-0.25%.

The Fed says it plans to get interest rates back to about 2% by 2024, not far off most estimates of their neutral level, which in theory neither stimulates the economy nor holds it back. But as the Fed has dragged its feet, the risk has grown that it will have to go further. Higher inflation expectations make the impulse to raise prices harder to eradicate. For any nominal rate, they also reduce the real interest rate that borrowers pay, offsetting the effect of Fed tightening. The real cost of borrowing over five years is still lower now than it was in mid-2020.

The most likely prospect is therefore of a year or more of interest rates in America rising more sharply than the Fed has so far indicated. Some forecasters predict that it will raise rates by 1.75 percentage points in 2022, more than in any year since 2005.

What about the longer run? After all most homeowners and firms seek to borrow over years or decades. For an answer, you have to look beyond Mr Powell to the forces driving the economy. Monetary policy is anchored around the neutral rate of interest, the price of money needed to balance the global appetite to save with the desire to invest. This is a fundamental variable over which central bankers have little control.

Over the past 20 years this underlying neutral rate has steadily fallen as savings and investment have got out of whack. Rising global savings, caused at first by the hoarding of reserves in Asian economies, meant that vast amounts of money chased any return, however meagre or risky. Meanwhile companies battered and bruised after the global financial crisis of 2007-09 were reluctant to invest.

The question is whether these forces have shifted. On one side of the ledger, perhaps they have a little. Business investment may be entering a new phase. Since the pandemic, it has recovered faster than it did after the financial crisis. That is partly thanks to the pandemic stimulus, which is now being withdrawn. But it also reflects optimism about technological progress that is fuelling spending on intellectual property. This now accounts for more than two-fifths of American business investment. Meanwhile the clean-energy transition is creating an investment need of perhaps 60% of gdp in the rich world. If techno-optimism lasts and the world is serious about fighting climate change, investment is likely to be stronger in the 2020s than it was in the 2010s.

However the other side of the ledger, the world's wish to save, is unlikely to weaken. Since Ben Bernanke, one of Mr Powell's predecessors, first noticed the "global saving glut", the growth in the reserves of Asian economies has slowed, and some governments have chalked up more debt. But the share of the world's inhabitants older than 50 is projected to rise from 25% to 40% by 2100, and may climb higher still, given recent falls in fertility in India and China. Experience shows that ageing leads to more saving, because rising life expectancy causes households to put more aside for their retirement and retirees tend to run down their assets slowly.

Bumps and slumps

These factors lay down a map for interest rates. In the long run any upward shift is likely to be small, and, to the extent that this reflects a pick-up in investment, welcome. However, between now and then there is likely to be a sharp and potentially painful rise in rates. The world's debts have reached 355% of gdp, making firms and households more sensitive to even small rate rises. There are few examples of central banks taming inflation without the economy suffering a recession. The last time America's inflation fell from over 5% without a downturn was over 70 years ago. Fighting inflation could put the world in a slump. If so, the prospect that rates will one day fall back again would be only some consolation.