CAPITAL ECONOMICS

GLOBAL ECONOMICS UPDATE

Hikes nearly over, but most of their effect still to come

- **While the hiking cycles of all major central banks will soon be in the rear-view mirror, most of their impact on activity lies on the road ahead. Based on the latest national accounts data, we estimate that there is still plenty of scope for higher interest costs on existing debt to eat into incomes. And our financial conditions indices (FCIs) are flagging significant downside risks to growth from the high cost of new credit.**
- **Major central banks' tightening cycles are drawing to a close.** The Bank of Canada stopped hiking in March, and last week's RBA and FOMC meetings reinforced our view that policymakers are now done with hiking in Australia and the US. Last Thursday's decision by the ECB to reduce the pace of tightening suggests that it will soon conclude its hikes, and we expect the Bank of England to deliver its final 25bp hike later this week.
- **However, while the rate hikes themselves will soon be over, their effects on economic activity will play out in the year ahead.** In a *Focus* earlier this year, we set out the ways in which monetary policy transmits to the real economy. In our view, the most potent of these channels is the effect on the cost of borrowing.
- The latest national accounts data reveal that **higher interest rates had already caused interest costs of firms and households to rise significantly by the end of 2022**. The effective interest rate – interest costs as a share of debt – in advanced economies rose to 2.5% in Q4, on average, up from 1.7% in early 2022. **And given the time lags, this rise will have only partly reflected the increases in private sector interest rates that had occurred by the end of last year, never mind the further increases we have seen in 2023.** (See Chart 1.)
- There have been significant differences between DMs, depending on the share of debt with fixed interest rates. For instance, firms and households in New Zealand are highly sensitive to interest rate changes so their effective rate has soared, in contrast to the US where fixed-rate bonds and long-term mortgage fixes are prevalent. Within the euro-zone, Germany's interest costs remain very low, whereas they have risen a lot in Spain, where there is a greater dependence on variable-rate or short-term-fix loans. (See Chart 2.)
- **We estimate that the share of income firms and households spend on interest increased by more than 1.5%-pts in late 2022, on average, and this share is likely to rise at least as much in 2023.** (See Chart 3.)

Chart 1: Average Interest Rates in DM Economies (%)

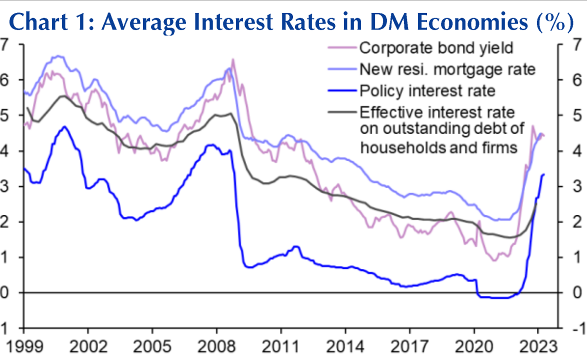


Chart 2: Priv. Non-Fin. Sector Effective Interest Rates (%)

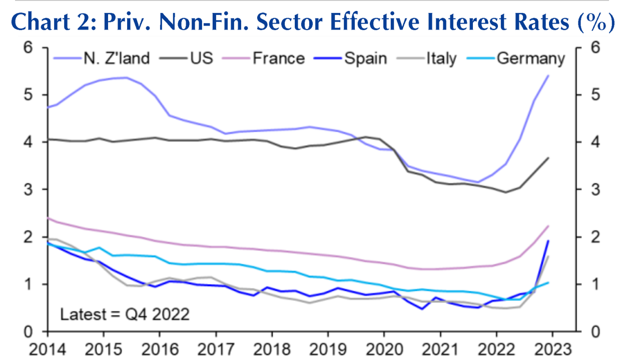


Chart 3: Average Share of Income Accounted for by Interest Expense in Advanced Economies (%)

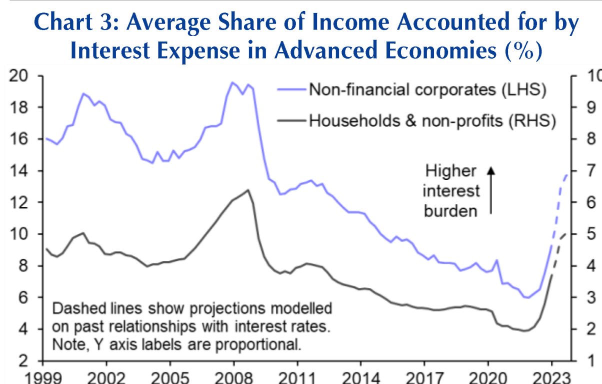
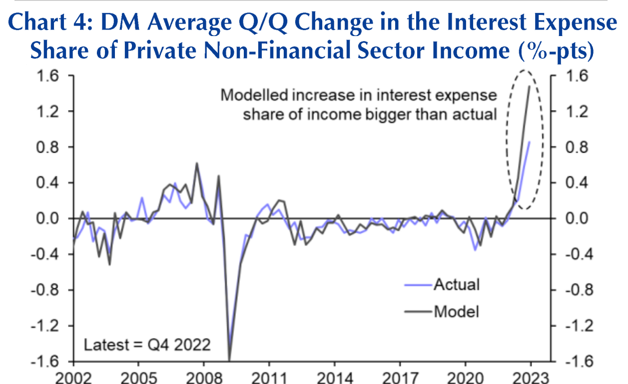


Chart 4: DM Average Q/Q Change in the Interest Expense Share of Private Non-Financial Sector Income (%-pts)



Sources: Refinitiv, Capital Economics

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- Admittedly, as we pointed out in our *Focus*, a shift towards fixed-rate debt in many advanced economies has meant that past relationships are not as reliable a guide to changes in interest costs as they used to be. (See Chart 4.) But the flip-side of a slower passthrough of market interest rates to interest costs is that the latter will probably continue to rise even as market rates peak. So, regardless of the precise timing, **we are likely to see the biggest cumulative increase in the private sector interest burden in advanced economies in 40 years**. This will eat further into incomes and, with saving rates now so low, weigh on real spending.
- **In addition to the headwind posed by higher costs of servicing *existing* debt, conditions for raising *new* finance are very tight by past standards.** Our broad financial conditions indices (FCIs) were close to their highest levels since the global financial crisis in all major DMs in April. (See Chart 5.) The tightening in financial conditions during the past 18 months has been driven partly by a normalisation of measures of stress, such as spreads and banks' appetite to lend, but mainly by a surge in borrowing costs. (See Chart 6.)
- **And with First Republic Bank unlikely to be the last banking domino to fall this cycle, credit availability is likely to become more restricted in the US, even as borrowing costs peak or fall.** Admittedly, today's NFIB survey suggested that firms found it slightly less difficult to access credit in April compared to March. But yesterday's Senior Loan Officer Opinion Survey for Q1 revealed that the net share of banks tightening lending standards rose across major loan categories, particularly for consumer loans. And with the drain on US bank deposits likely to endure, we doubt there will be much let-up in bank lending standards anytime soon.
- **While the latest ECB and Bank of England lending surveys suggest that the US and Swiss banking troubles have had little impact on credit conditions, tight monetary policy is still ensuring that banks are cautious to lend.** In theory, even if European banks decide not to restrict credit availability in response to banking jitters elsewhere, those jitters could still spill over to global financial markets, in turn causing financial conditions in Europe to tighten. But, as SVB's collapse showed, any rise in measures of market stress can be largely offset by falls in risk-free rates, meaning that overall financial conditions need not tighten. We've seen the same dynamic play out in the wake of First Republic's demise, albeit on a much smaller scale. (See Chart 7.)
- **Whether or not banks further restrict the availability of credit in the quarters ahead, the big picture is that financial conditions are already flashing red. This suggests that, in the absence of strong countervailing forces, there is a significant likelihood of recession in advanced economies in the coming year.** Our DM FCI foreshadowed the post-dotcom bubble downturn, the GFC recession, and the euro-zone crisis downturn. (See Chart 8.) Currently, it suggests that while excessively loose financial conditions in 2021 propped up growth in the past year or so, this financial tailwind has turned into a headwind for growth in the year ahead. **Keep track of our FCIs on our Financial Conditions dashboard, which we update at least twice a month.**

Chart 5: CE Broad Financial Conditions Indices (Z-Scores)

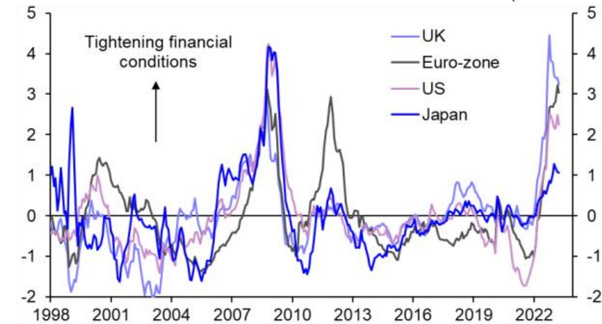


Chart 6: Decomposition of CE Broad DM FCI (Z-Scores)

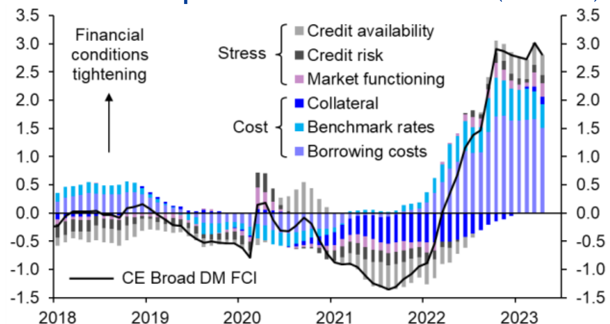
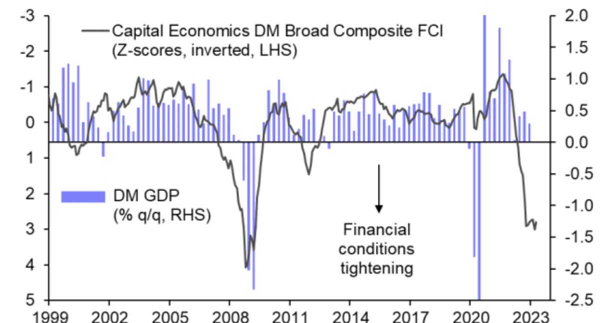


Chart 7: Breakdown of CE Narrow DM FCI (Z-Scores)

Chart 8: CE Broad DM FCI & GDP



Sources: Refinitiv, Bloomberg, RBA, Statcan, Capital Economics

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