Bank for International Settlements calls for accelerated interest rate hikes

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The Bank for International Settlements (BIS), the umbrella organisation for the world’s central banks, has called for an escalation of interest rate rises to stop inflation becoming “entrenched,” that is, to hit harder against wage demands by slowing down economic growth, even to the point of inducing a recession.

The call was made in the BIS annual economic report issued over the weekend as leaders of the G7 group of major economic powers were meeting in Germany to determine future action against Russia, and to discuss policies in response to the deepening crisis in the global economy.

“Gradually raising policy rates at a pace that falls short of inflation increases means falling real interest rates. This is hard to reconcile with the need to keep inflation risks in check,” the report said. “Given the extent of the inflationary pressure unleashed over the past year, real policy rates will need to increase significantly in order to moderate demand.”

The BIS pointed to the effects of the previous monetary policies of the world’s central banks in pumping trillions of dollars into the financial system after the global financial crisis of 2008 and the market meltdown of March 2020. These measures had boosted stock markets and lifted asset prices to record highs, especially property.

“The coexistence of elevated financial vulnerabilities and high inflation globally makes the current conjuncture unique for the post-World War II era,” it said.

Tighter monetary conditions needed to bring down inflation could cast doubt on asset valuations, including housing, priced on the basis of persistently low interest rates and the provision of central bank liquidity and “even traditionally more secure assets could be exposed.”

“Bonds, for example, have provided a safe haven for investors in the low-inflation environment of recent decades. During this phase, bad economic times, when the prices of riskier assets like equities typically fall, were generally met with monetary easing, which boosted bond prices. But when inflation is high, economic downturns are more likely to be triggered by tighter monetary conditions, causing both bond and stock prices to fall.”

The BIS said that a “modest slowdown” in the economy “may not be enough,” and lowering inflation “could involve significant output costs, as after the ‘Great Inflation’ of the 1970s.” It said that “some pain will be inevitable,” but the “overriding priority is to avoid falling behind the curve.”

The economic response to the 1970s inflation, which resulted in an upsurge of struggles by the working class around the world, was the “Volcker shock” of the early 1980s.

Under the chairmanship of Paul Volcker, the Fed lifted interest rates to record highs—20 percent at one point—resulting in the deepest recession to that point since the Great Depression to crush wage demands.

But as the Wall Street Journal noted, the risks to the global economy are much greater today because “overvalued assets and high debt … were much less of a concern” at that time.

As with central banks around the world, the BIS insisted that the key issue is wages and “whether inflation becomes entrenched or not ultimately depends on whether wage-price spirals will develop. The risk should not be underestimated, owing to the inherent dynamics of transitions from low- to high-inflation regimes.”

It warned that “price-induced cuts in real wages are
likely to prompt workers to seek to recoup the lost of purchasing power” and noted that “in many countries, a substantial part, if not the bulk of wage negotiations were still to come.

In other words, the present upsurge in the struggles of workers seeking higher wages is only the beginning of a much bigger movement building up.

The BIS left no doubt about what the response had to be. It drew attention to the fact that existence of private debt at “historical peaks” and “elevated valuations” could make financial markets overreact. This raised a “policy dilemma” because financial markets reactions “may counsel caution.”

But, it insisted, notwithstanding this “dilemma,” central banks had to press ahead because “the risk of inflation becoming entrenched calls for a more pre-emptive and vigorous response.”

Underscoring this prescription, the BIS general manager Agustín Carstens said, “The key for central banks is to act quickly and decisively before inflation becomes entrenched.”

On top of a pre-emptive strike against wages, the BIS called for cuts in vital government spending, in other words, an austerity drive.

“For far too long,” it said, “there has been a temptation to turn to fiscal and monetary policy to boost growth, regardless of the underlying causes of weakness” and that loosening during contractions had not given way to “consolidation” [that is, major spending cuts] when the economy was growing.

“The temptation to postpone adjustments has been too strong. Such a strategy has arguably generated unrealistic expectations and demands for further support,” the report stated.

The rapidly worsening economic outlook hangs over the G7 leaders meeting now underway in Germany. While the first day of discussions were dominated by moves to increase measures against Russia with regard to oil exports, the economic crisis is a key issue.

A survey of economists conducted by the Financial Times on the eve of the meeting concluded that the risk of recession in Europe and the US had increased markedly following the decision by the US Federal Reserve to “go big” on rate increases with its decision to lift its base rate by 0.75 percentage point earlier this month.

The mood was summed up by Berenberg chief economist Holger Schmieding who said the balance had “tipped” in favour of an economic contraction. “What used to be a rising risk has now turned into a base case,” he told the FT.

“It would have been impossible to imagine at the last G7 summit that we’d be facing a situation like this,” he said. “Things are pretty bad and could get even worse.”

An unnamed “senior German official” cited by the newspaper said at the start of the pandemic there was a “simple consensus” on how to respond through “expansive monetary and fiscal policy.”

“The situation we’re now in is a lot more complex, a lot more difficult. This completely clear, almost instinctive idea that you just pursue expansionary polices is no longer so obvious,” he said.

The way in which the leaders of the major powers will seek to use the economic crisis that their own policies have created in order to intensify the war against Russia and draw China into the line of fire was revealed in Schmieding’s comments.

“It’s not the G7 leaders who have caused these problems—it’s [Chinese president] Xi Jinping and Vladimir Putin,” he said.

That is, the inflation crisis is not the result of the inflationary monetary policies pursued over the last two decades and the refusal of capitalist governments to eliminate the pandemic but the product of Putin’s Ukraine war while the Chinese government is responsible for the supply chain crisis because of its zero COVID policies based on necessary and effective public health safety measures.