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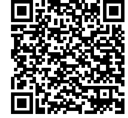

By: Daniel Lacalle

Interest Rates and the Global Fiscal Irresponsibility

Global central banks are unable to reduce inflation because fiscal policy is sabotaging the battle against rising prices.

For the first time in decades, governments in developed economies, particularly in the United States and the European Union, are increasing spending and implementing wrongly called stimulus packages in an overheated economy with persistent inflation.

In such an environment, central banks can only keep rates, and the biggest risk today is that they cut interest rates too fast and must increase them afterwards if inflation continues above target.

Debt crises do not occur because of elections or market evil. Allowing fiscal excess for years generates a debt crisis.

Negative effect for families and small businesses

When governments ignore inflation and continue to increase expenditure despite rising bond yields, two negatives happen: all the monetary policy tightening falls on the shoulders of small businesses and families and rising taxes due to elevated deficits also make the middle class and small enterprises poorer.

Market participants are already expecting higher rates and elevated inflation for a longer period of time.

> The negative effect for families and small businesses is not just more taxes and persistent inflation

Global disinflation trends are slower and more painful when the states, which represent between 35% and 58% of developed economies' GDP, ignore elevated prices and continue to spend significantly more than what they collect in tax receipts.

The negative effect for families and small businesses is not just more taxes and persistent inflation, but declining access to credit as the states crowd out private investment and bloat public debt.

Government stimulus plans

Government stimulus plans are backfiring in all developed economies. From the Inflation Reduction Act to Europe's Next Generation Fund, these programmes are perpetuating the negative effects of inflation on citizens. This implies that rates will remain elevated for an extended period.

It is also worth noting that the increased weight of governments in the economy gives a false impression of economic strength, as GDP can be easily inflated with a higher public deficit and debt.

Public debt bond yields have risen even with dovish messages from central banks. Those who say nothing is happening reiterate that sovereign spreads and risk premiums are very low.

> The central bank has stopped ensuring budgetary stability and controlling monetary imbalances to become an agency justifying fiscal irresponsibility

This is true, but we cannot forget that all this is happening in the midst of Keynesian machinery in which the United States deficit is expected to be $2 trillion per annum to 2036, and in the euro area, the ECB maintains its aberrant "anti-fragmentation" mechanism, which is actually an anti-market mechanism that rewards those who fail to comply with their debt reduction path and who benefit from the support of the ECB with the funds from which they reduce their debt. Mind-boggling.

The central bank has stopped ensuring budgetary stability and controlling monetary imbalances to become an agency justifying

fiscal irresponsibility.

Inflation is not a coincidence or a fatality

When central banks monetize debt to disguise fiscal imbalances, inflation remains above target and citizens become poorer. No matter who wins in the numerous 2024 election processes, a debt crisis will occur if this does not stop.

In an environment of persistent inflation, the outlook for interest rates is that we may see one or two tactical cuts, but it is very difficult to believe that we will see negative real rates soon - Daniel Lacalle

The world economies cannot try to emulate the US deficit and debt. First, because it is unsustainable in the United States and will end up damaging the credibility of the US dollar, and second, because it creates numerous negative side effects, including a debt crisis in Europe or a sudden stop in emerging economies when the inflow of foreign currency reverses.

Inflation is not a coincidence or a fatality; it is a policy. Unfortunately, many governments are comfortable with this process of impoverishment because they disguise their fiscal imbalances, but the impact is always negative on the productive fabric of society.

When fiscal policy ignores inflation and continues to promote unsustainable deficits, the entire monetary policy restriction falls on the productive sector. In an environment of persistent inflation, the outlook for interest rates is that we may see one or two tactical cuts, but it is very difficult to believe that we will see negative real rates soon.