SGFER x Reatch: Inflation, Real Estate and Macroeconomic Outlook 2023 Panel Discussion

SGFER

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Sebastian Maser: Welcome, everyone, to our panel discussion today about Macroeconomics. And we're going to talk about inflation, real estate, financial stability, and banking. Today we have three great panellists, and I would like to do a quick intro to each of them. So, Alexander Gruber is the head of economic research and advisory at Finreon, but most of you probably know him as a lecturer at the University of St Gallen. He also did his PhD at the University of St. Gallen in Economics and Finance, and during his doctorate, he spent a year at Stanford University and did his thesis on international macro, banking and financial stability. He also gathered some work experience, among others, at Rothschild in the Investment Banking division and at General Electric in the Corporate Finance department. Next, we have Thomas Veraguth, also an alumnus of HSG. He is a global real estate economist/strategist and is the CIO of Swiss and global real estate policy at UBS. He also previously gathered experiences as a lecturer at Bern University of Applied Sciences and working at Credit Suisse conducting industry research. Last but not least, we have Prof. Dr. Winfried Koeniger, a professor of Economics at the University of St.Gallen and co-head of the Swiss Institute of Empirical Research at this university. He's also a research fellow at CESifo, worked at the Institute for the Study of Labor (IZA) as a senior research associate, and is a Swiss Finance Institute faculty member. His main research interests include macroeconomics, financial economics, consumption, and saving decisions and labour markets.
Now, let's dive into the first topic of inflation and inflation pressure on us. Alexander, what do you think? How is inflation going to evolve over the next few years and will inflationary pressures remain higher in the coming years compared to the recent ones?

Alexander Gruber: Well, thanks first of all for having me here. Regarding the inflation environment, I think first it's important to see where we are to realise where we are coming from. Most of the problems we're seeing now come from monetary policy and the fiscal dimension. Now, we haven't seen inflation for a very long time after the great financial crisis. Then, after COVID-19 hit, central banks and governments intervened heavily and overshot dramatically, especially when President Biden came to power. And therefore, we have too much demand for the little supply because supply was killed at the same time by supply chain problems, etc. So now we have a short-term dimension which people hope will subside after some time. But going forward, I think that we will keep some of that high inflation. I think that we will soon be at the top of 8-10% in the Eurozone, and then I think it will drop to 5% or 5.5% rather quickly. But I think it will remain around this range because the fiscal policy will still have to be heavily expansionary. Monetary policy may not be able to be tightened as soon as they would wish to due to other problems, such as the banking sector, etc. And most importantly, I think there are broader trends that are currently hitting at the same time that will not go away. So, for example, the disintegration of the world economy, and the fragmentation with China, which was basically providing cheap labour for four decades now and therefore kept inflation low. Also, demographics in China and in Western Europe are changing now, all in ways that definitely speak for higher inflation than we have seen in the last 10 years, but lower than it is now. So finally, I would say 3% to 5% in Europe and the US for a long time.

Thomas Veraguth: I would like to add that we had almost 35-40 years of declining inflation and interest rates, which led to inflation expectations coming down as well in the system. And to the surprise of everybody, in 2020, we closed and reopened the economy in 2021 and 2022, while the Zero-Covid policy remained for the most part in China. Politicians across the world then started to experiment with the economy with strong fiscal expansion to keep the economy running while everyone was locked away at their homes. And of course, once you learn the economy is made from a lot of frictions and also the real effect of monetary and fiscal policy, meaning we have relative prices that are affected, we become aware that we cannot just close and reopen and expect that the relative price of different goods (e.g. services vs goods) stay stable. On the contrary, it was a huge shock in relative prices. And this shock, because it was relatively asymmetrical, created winners and losers. And this is one explanation, besides the fact that we have this fiscal and monetary push, as to why we get such high inflation – it's because the system is not functioning that well. Now there are many arguments and many discussions. One element is that, when looking at the long-term curve and inflation data, given the fast pace of increase in inflation, typically, we have seen inflation go down almost as quickly as inflation went up. And at this point, we think that inflation in most industrialised countries will go below 2% in 2024. However, we also believe that these base effects will fade out, and then inflation will come back up quickly. So, we are quite confident that over the summer of 2023, we will get peak policy rates, obviously first the Fed, then other central banks. Hence, already this year, we should see a pivot in the policy rates, and that should reflect a deterioration in economic growth which we expect for the next quarter.

Winfried Koeniger: One thing regarding policies is that it is not only difficult to say how inflation is going to develop in the next couple of years, but it is that policies manifest themselves in terms of the effects they have on banks. The effects of policies by central banks or fiscal policymakers in the last couple of years can be seen now, and the effects of what the policymakers do now will be seen at some point in the future. This obviously also makes it hard for policymakers because they need to try to engineer the policy with the view that it will affect the economy at one point. Hence, if you look at the Eurozone and take into account break-even inflation at ten-year inflation expectations, they are above 2%, coming up about two percentage points in the last couple of years above the target of the European Central Bank, and I think there is a bit of a danger. And this is important, how inflation expectations develop in the future, whether they really become anchored, possibly at some point. And that's going to be very costly, possibly in the future, on the part of the monetary policy to bring them down again. Of course, we can remember the eighties, in which bringing down inflation was very costly in terms of recessions. So we're going to see risks by the central banks, particularly the ECB, and maybe also the Fed, of not reacting aggressively enough to contain inflation. But one effect that has become very clear recently is financial stability because if you aggressively hike up interest rates, then asset prices adjust, so institutions which have a lot of assets are damaged, and one can see who is hedged, who is not hedged and hence you see the consequences. This could lead central banks to become a bit more worried now. So central banks may allow a little bit more inflation than they otherwise would and maybe not hike as aggressively as they would because they're worried about financial stability. And I think another issue, especially in the Eurozone, is whether we're going to see a wage-price spiral, and it's starting to show a little bit. So, now unions have begun to demand wage increases because of the price increases and high inflation rates. Before, the argument of policymakers has always been the increase in energy prices is a one-off, but now inflation is going to stay for the next year and then the year after. But the unions want to protect the salaries of the employees, and they become more aggressive in terms of wage demand, which ultimately creates a spiral. It creates price pressure, and it becomes much more difficult to contain inflation in the future and much more costly.

Thomas Veraguth: One point on this is that sometimes you could ask the question of whether central banks understand what they do or whether they just do trial-and-error policies. And it's very important to understand what central banks want since central bankers themselves don't know what they're going to do at the next meeting. But I think central banks did not see this inflation issue coming before it happened, so they began increasing interest rates in the hope that it might control the price, which is typically the result of the interaction between supply and demand. Hence, they tried to manipulate the market to give some incentive for supply and demand. And what is now happening is that this supply and demand is reacting to the price manipulation of interest rates. And the reaction that we see in some part of the money market, and the relative price has changed through this policy, which is not neutral in the system. And now, one result is that the liquidity in the capital market, treasury market and money market is drawn out, which leads to difficulties in refinancing. And then, we understand how bank regulation is working in the US compared to Europe. And we understand that regional banks are not regulated the same way as the major and big banks in the US, which is why we have this liquidity question for the regional banks. And so now we have a reaction to these interest rate manipulations that the central banks are now learning to cope with, which will bring them to rethink their decisions based on new realities, based on the cracks that are opening up in the system. And our economists say the recession risks are higher than the markets are now pricing in, meaning that central banks will base their reaction function less on inflation and change it to focus on avoiding a recession.

Sebastian Maser: We have talked about lags in transmission now and Prof. Koeniger, you are also following how consumption patterns shift. Have you already seen a change in consumption patterns due to inflation?

Winfried Koeniger: It's very heterogeneous, i.e. some people gain, some people lose. If you borrow and have taken on a mortgage, fixed rate, close to 0%, there you don't mind inflation. Now you also have your salary and how much this salary is worth in terms of buying your consumption basket, there inflation hits you. So if you think about it, this is where it's useful to do economics: you think about the budget constraint, the components, the assets, the labour income, the consumption basket etc., and then you see how different parts of the population are affected differently. What is interesting from a distributional point of view is obviously that the consumption basket is not exactly the same for the income poor as it is for the income rich. The income poor are relying more heavily on buying food, but food inflation is particularly high in the country. So in that sense, it is a distributional issue as well.

Sebastian Maser: Regarding interest rates, do you think we will continue to see the inverted yield curve, and where do you see interest rates and mortgage rates ahead?

Alexander Gruber: I think it is important for everyone to just clarify quickly where we currently are, interest rate-wise because it's quite heterogeneous as well. So in Switzerland, we have a policy rate of 1.5%, in the Eurozone of 3.5%, and in the US of 4.75 to 5%. As you can see, there is now a huge gap again between, for example, Switzerland and the rest of the world compared to where we started. It's always important to start with the US since, basically, they set the tone. Whatever they do, it's important for us since the USD remains the most important currency and it's a major financial centre. Now for the US, it becomes very interesting because, in the beginning, the Fed told markets that they were going to 5 – 5.5%, but the market did not believe this. Now, the Fed worked very hard to convince the market so that the market finally believed the fact that it would go to 5.25%. I think that was a big accomplishment for the Fed because the Fed had lost a lot of credibility in this direction. The Fed's credibility in raising interest rates got lost to some degree in the last few decades. All the central banks acquired a certain reputation for being very lenient when things go down to support the economy, but not the other way around. There's a very good paper about that by Michael Bauer[1], who realised that the Fed is very lenient on the way down and very data-dependent on the way up. However, now it becomes really tricky because the Fed has to fight inflation, which is the mandate, also considering the lags of course, because maybe some of the effects that they may have already caused will only show at the end of the year while paying attention to the cracks in the banking sector. So they are a little bit cautious already regarding the speed. Now you have all of these fears about financial stability, where I must express my criticism towards central banks. Last fall, I looked at some of the stress tests they did for US banks, and it is really bad. They still tested the big banks but only with interest rates going to 3-4%, even though they are actually already at 5%. They did not even test Silicon Valley Bank since it was below the size threshold, but if they had tested it, they would also have passed. So this mistake damages the Fed's credibility. Furthermore, they really pushed banks into holding government bonds in the first place for liquidity reasons and HQLA requirements and then proceeded with punishing them for doing that by raising rates, which of course, the banks didn't know before. Therefore, the bailouts they've done are not only the individual banks, it's a systematic bailout, I think. And you have all of these arguments: interest rates are up, credibility is damaged, people really didn't trust that they would follow through with so many hikes, and now they seem to be in a gamble: inflation is still high, but we have these new problems in the banking sector. And I think what the Fed is actually hoping for, given the weakness in the banking sector, is that a lot of money that is created in the system will stop being created anyway. Private money will stop being created because banks create private money. And when there is a credit crunch, that will bring money creation down. You've seen central bank balance sheets grow the last few weeks very, very fast. But, I think, it's the hope that this credit crunch kills inflation. It helps them keep the inflation part so that they will not have to raise interest rates higher anymore. And since you asked for a range, I think the next 0.25%

[1] Bauer, M. D., & Swanson, E. T. (2023). An alternative explanation for the "fed information effect". American Economic Review, 113(3), 664-700. DOI: 10.1257/aer.20201220

in the US will be the last or second last hike that they will do. There might be another one in summer. But the underpinning factors speak clearly for interest rate increases. And since you asked if things are worse, yes, of course, because they have to go up on the short end a little more and on the long end, if people start pricing in a recession, especially if the banking sector is involved, it becomes more likely the interest rate curve will stay inverted which can bring future problems. But then it's also just as the last point, very different this time for Europe, in the US. In the US, the exposure to government bonds is on average 30% on the balance sheet of US banks. Now some of them are paying the price, and some were even excluded from stress tests as their balance sheet does not exceed 250 billion. That's really, really, really bad regulation in the US. So the US is wrong this time. And I think Europe is lost in that sense. Because Europe has another problem, mainly the heterogeneity between countries which did not hit yet but might at some point which makes it even trickier.

Thomas Veraguth: You have to ask yourself, why are they increasing interest rates so fast? They haven't increased rates this fast since the creation of the Federal Reserve in 1913. When asking colleagues, oftentimes the answer is: It's because they want to be able to decrease them again. Central bank money is small compared to the money created privately by banks through credit – the central bank does not have much control. They, therefore, feel like they want to have more control. One argument is that they want to control inflation expectations fast, but they also wanted to crush Bitcoin because they want to introduce their own CBDC and, therefore, more powers. They think they can do the job better than private banks. However, we should not forget that we have cost-push inflation. Inflation is coming from closing and re-opening the economy. Now this is in part slowly disappearing. But it is very important to look at where the inflation is exactly coming from. The answer is not that clear. But we have both cost-push and demand-pull inflation in the US, while we have more cost-push inflation in Europe and less demand-pull inflation. Regardless, the result is a high inflation rate. When you are a central banker, you want to control inflation, but it's very hard to control cost-push inflation. You can't go to companies and tell them not to increase prices, as they still want to maximise their margins. Central banks cannot do anything against cost-push inflation. But they can prevent demand-pull inflation through the creation of these inverted interest curves, meaning higher short-term interest rates and refinancing costs or a credit crunch. In any case, when you try to understand what central banks do with interest rates, you should never forget that interest rates are the endogenous variable in the system, not the exogenous one. But they want to interfere with it, so it's very risky. Now we have this confidence crisis as a result of these policies.

Sebastian Maser: Prof. Koeniger, can you elaborate on how real estate prices are affected by these developments, mostly a result of these higher interest rates?

Winfried Koeniger: If you want to structure this, I think about the demand and supply side again. So we have inflation, and therefore central banks are raising interest rates. Then you have issues from the demand side in terms of affordability since interest rates for mortgages are up. And the supply side is determined by how the balance sheets of banks are affected right now by financial stability issues and how willing they are to give out mortgages. These two things come into play, it's a cocktail of factors where you have financial stability issues. Banks have to adjust their balance sheets, and it depends on how they have been hedged against certain kinds of duration risks which determine the supply. And let me just add one small point. Central banks may do what they want. But nothing prevents the banks from hedging against duration. So it's not exactly or entirely the fault of the central bank. Nothing prevents the banks from surviving, given the ability to hedge against rising interest rates. You can argue that regulators can be blamed in so far as that they were not paying attention. And, of course, government bonds are not necessarily safe bonds. There is duration risk! To some extent, to defend central banks a little bit – I am also very critical of them – but we should not overburden them. The central bank has a role to play, but the private sector is also responsible for its own risk management. In general, what's the effect on the real estate sector? There are direct effects of changes in interest rates on asset prices. Then there are demand and supply effects which depend on the economy, which I talked about before. But the effect of this part is still very vague. What does it look like in Switzerland? One important thing to know is that if interest rates go up, the constraints on households are less severe. The imputed interest rates are calculated to be around 5% anyways. If interest rates go from 0 to a slightly higher rate, this should not be a concern for Swiss households.

Germany is quite different. We see that to some extent, with housing prices coming down more in Germany than in Switzerland. But it's going to take time until we see housing prices fall further, as there is always a delay. When you cannot sell your house at the desired price, you tend to wait a bit until you realise transactions are down a lot, and you have to possibly sell at a capital loss.

Thomas Veraguth: Transaction volumes are down by 25% compared to last year. And the first quarter of 2023 is not looking good at all. US regional banks which have increased their financing to real estate are under more pressure in this cycle of interest hikes. But think of real estate as cash flows divided by the capitalisation rate. Both determine the value. Of course, the cap rate is increasing now in the world, but not so much in Switzerland. Around the world, the capitalisation rates are increasing, between 50-75 basis points, or even 1% on average. The income yield in Switzerland is around 3.2%. If you add 1%, this leads to 4.2%, which is something different. In the US, typically, the capitalisation rate is around 6.5 - 7%. This is a completely different world for real estate. The Federal Funds Rate is below the capitalisation rate. This means that the US real estate markets seems to be functioning quite okay. If you take into account the inverted yields: your margin is still okay compared to the 10-year yield. Overall, from the yield difference point of view, the real estate market in the US is quite okay. On the other hand, we have a lot of discussions as to whether there will soon be a credit crunch. We say no – but are not sure either. In 2004 - 2008 we had something called subprime mortgages, where mortgages were given to households who could not afford to pay them back. Banks were forced in a way to increase exposure to subprime mortgages. This is in no way in the system today. The regulation is much stricter and more efficient. Thanks to the bottlenecks we created through closing the economy, the construction costs for real estate have risen by 10 - 20% or even more depending on the region. Building a new building will be 10 - 20% more expensive compared to the ones already built. The construction constraint due to supply bottlenecks can protect the value of the real estate by creating some scarcity. In addition, due to inflation-indexation, the cash flows are increasing. Today the inflation indexation is below the headline inflation. As an investor, you are unable today to fully pass on all inflation to your tenants. So you still have an indexation that is below the inflation, so there is still some kind of erosion. Your cost as an investor grows as inflation increases. But all in all, cash flows are still relatively protected as they are not at risk from increasing vacancy because there won't be new suppliers to the system. In the end, you will get compensation for the increasing capitalisation rate with increasing rental income in the nominator that will protect the value but will likely not prevent the value on average in the world from going into a correction.

Sebastian Maser: Thank you, Thomas. Let's go on to the next topic: Financial stability. I think it's the hot one tonight. Alex, what are your views on the environment with a lot of banks in crisis? Do you think we will see any regulatory changes? How is financial stability in general now?

Alexander Gruber: A very clear view, yes. A very strong one with regard to financial stability. What I fully agree with is that banks could hedge themselves. Credit Suisse could have avoided Archegos and Greensill, with proper risk management. But the banks themselves will never do that. They will always make mistakes or game the system, consciously or unconsciously. And it's driven by someone sitting on the board, thinking they have protection from the government, and therefore they do these crazy things. The biggest issue, the headline, is that they are dramatically short-term oriented. And that will stay forever unless you punish this behaviour. In Switzerland, for example, you have companies like Lombard Odier, Pictet or LGT in Lichtenstein. These banks are more long-term oriented, they are owned by a few active owners and partners. They have a clear incentive to behave in a long-term way. But big banks do not have these incentives. They will measure their performance in the short term. Hence, they do not hedge, as hedging costs something in the short term. This allows for more profit until next year, and after that, I may not be the manager anymore anyways. That will never change. The original mistakes were clearly made by the private sector, the banks themselves. But as a regulator, you know that eventually, a banking crisis will happen from this behaviour. You know they will come, banking crises will always happen. The last crisis was not long ago. What happened back then, UBS had 2% of their balance sheet backed by equity, now it's 5-6% on average and unweighted. That's higher compared to back then (GFC), but it's still very low. After the GFC, the solution was to make the equity ratio higher. Liquidity ratios were also a bit higher. For too big to fail, they also thought they had the perfect solution. If Credit Suisse fails, we can shut them down and split them into three parts. For equity, there was also a great solution, according to them. They do not need more equity, they can use CoCo bonds or AT1 bonds instead. But when Credit Suisse happened, they did not follow these rules at all. It happens the first time, and it gets thrown out of the window. For this to happen, this implies that financial stability was at clear risk. You can always say that it's the bank's fault, but you need to be strict on regulation before this happens. Short-termism drives big banks. But also, I miss someone on the policy side or regulator side that has a certain integrity and character to push these policies through. The equity ratio should be much higher than 5%, let's say 15%. Then the banks would be more incentivised to hedge their risk. This would also promote a better long-term view. You need to have someone who can resist the pressure from powerful bank lobbies everywhere. In Switzerland, it's even more important, as Switzerland cannot have a bank that is this big. That cannot be the solution. Therefore we need more equity requirements. Bans would abolish some short-term oriented risky projects and move more towards the old-school and long-term oriented businesses. As of now, we are in this situation again. As I like to say, banks are holding the government hostage frequently. Every 15 years, there is another hostage situation. And 5 years later, you let them out with a gun and 10 years later, there is another hostage situation. You already know this is bound to happen if you do not regulate more strictly and in smarter ways. I am very clear there must be higher equity requirements which would allow things to regulate themselves better for starters. The banks in the system make the mistake, but the system knew before that these mistakes would happen sooner or later. So you need to avoid it by making credible regulations.

Sebastian: Thank you, Alex, for sharing your views. I would also love to hear your thoughts in response to Alex, Professor Koeniger.

Winfried Koeniger: I do agree. Where I am sceptical, however, is when you think that with detailed regulations, you can fix this problem. There is going to be financial innovation, and regulators always have to play catch up. So you write your regulation at time T, and there is going to be financial innovation and certain things which are not captured by the regulations later. Where I completely agree is making banks have higher equity requirements. Then a lot of these other things would fall into place. What I think is futile is the view that more detailed regulation can actually fix the problem. I also think there is a bit of risk out there, maybe more in the US than in continental Europe, in terms of real estate, mostly commercial real estate. Because what has been documented following the pandemic is that there have been quite substantial shifts in terms of demand for office space. It's much more prevalent in the US. For example, in Manhattan, there is a huge amount of empty offices. And for these offices, there are two possibilities. One possibility essentially is to convert them into apartments, but that's very costly. And you already have seen a few investors who said it's too expensive. Therefore, you hand the keys to the banks. And some of these offices are still on the balance sheet of these banks with prices which are fantasy. They are not mark-to-market, and they trade in an illiquid market. So there is going to be some adjustment going forward for those who hold this commercial real estate on their balance sheet. So it will be interesting to see if they have a robust enough balance sheet to bear some capital losses there.