CENTRAL BANKS: NO HURRY, NO WORRY

In recent speeches and interviews, officials of the Federal Reserve and the ECB have cooled down market enthusiasm about the timing and number of rate cuts this year. In the US, the message is that there is no reason to move as quickly or cut as rapidly as in the past, considering the healthy state of the economy. In the Eurozone, despite the drop in inflation in 2023, there is still uncertainty about the inflation outlook, particularly due to the pace of wage growth. Moreover, there is also a concern that the easing of financial conditions -due to overly optimistic market assumptions about the policy rate path- would be counterproductive from a monetary policy perspective. Both the Federal Reserve and the ECB want to tread carefully in deciding when to start cutting rates. They are in no hurry but that should not be a source of worry. After all, policy rates should be reduced this year.

When something is overheated, pouring cold water should help. That has been the approach of officials of the Federal Reserve and the ECB who have cooled down in recent speeches and interviews market enthusiasm about the timing and number of rate cuts this year. In the US, market pricing has adjusted and is now less bullish but in the Eurozone the impact has been very limited (chart 1 and 2). In the US, Federal Reserve Board member Christopher Waller called the current situation 'as good as it gets' [1] adding that the data in recent months should allow the FOMC to consider cutting rates in 2024. "*However, concerns about the sustainability of these data trends requires changes in the path of policy to be carefully calibrated and not rushed*." Moreover, there is no reason to move as quickly or cut as rapidly as in the past, considering the healthy state of the economy. It was a thinly veiled message that market pricing was too aggressive in terms of the start of the easing cycle and the number of rate cuts this year. ECB president Christine Lagarde, speaking to Bloomberg at the World Economic Forum in Davos, also brought a two-layered message: interest rates are likely to be cut this year but only in the summer, considering that *"there is still a level of uncertainty and some indicators that are not anchored at the level where we would like to see them."*[2] In a recent interview[3], ECB chief economist Philip Lane provided more detail on the ECB's thinking. There are still headwinds to services inflation and he doesn't expect energy prices to fall as much as in 2023. *"For the time being, wages are still growing well above any kind of long-run equilibrium rate"* and *"it will take time to have a good understanding of whether the wage settlements are decelerating." [4]*

By insisting that rates will be cut but that the process will be cautious and gradual, central banks seek to reassure households, firms and financial markets -eventually policy will be eased- whilst acknowledging the many uncertainties about the disinflation process.

UNITED STATES

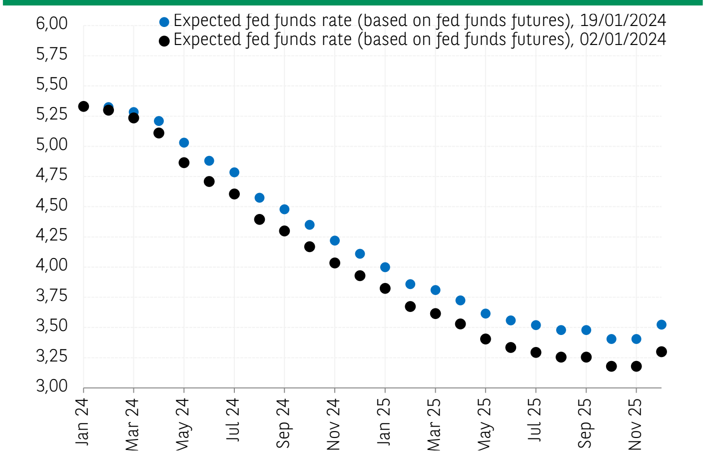

CHART 1

SOURCE: REFINITIV, BNP PARIBAS

Normalizing policy too quickly would run the risk of triggering another inflation wave, necessitating to hike rates again[5]. Moreover, there is also a concern that the easing of financial conditions -due to overly optimistic market assumptions about the policy rate path- would be counterproductive from a monetary policy perspective. Isabel Schnabel, member of the executive board of the ECB, recently made this point.

1 C. Waller was referring to real gross domestic product growth expected to be between 1 and 2 percent in the fourth quarter (seasonally adjusted annualized growth versus the previous quarter), an unemployment rate still below 4 percent and core personal consumption expenditure (PCE) inflation close to 2 percent for the last 6 months (in annualized terms). Source: Almost as Good as It Gets...But Will It Last?, Remarks by Christopher J. Waller, Member Board of Governors of the Federal Reserve System at The Brookings Institution, Washington, D.C., 16 January 2024.
2 Source: *Lagarde Says It's Likely ECB Will Cut Rates in Summer,* Bloomberg, 17 January 2024.
3 Source: ECB, Interview with Corriere della Sera. Interview with Philip R. Lane, Member of the Executive Board of the ECB, conducted by Federico Fubini, 13 January 2024.
4 "The most complete dataset is in the Eurostat national accounts data. The data for the first quarter will not be available until the end of April."
5 For a description of the historical experience, see : Ari, A., Mulas-Granados, C., Mylonas, V., Ratnovski, L., & Zhao, W., *One Hundred Inflation Shocks: Seven Stylized Facts*. IMF Working Paper WP/23/190, 2023.

> The Federal Reserve and the ECB have made it clear recently that they are not in a hurry to cut rates, given the uncertainty about the near-term inflation outlook. Absence of hurry should not be a source of worry: after all, policy rates are at their peak and should be reduced this year.

To conclude, both the Federal Reserve and the ECB want to tread carefully in deciding when to start cutting rates. They are in no hurry but that should not be a source of worry. After all, policy rates should be reduced this year. That was already the message from the dot plot in the FOMC's Summary of Economic Projections last December and Christine Lagarde's interview in Davos was very clear as well. Fixed income investors will continue to price the possibility of an earlier than expected cut, but this pricing will fluctuate depending on the data and the comments of central banks. Likewise, it will be tempting to speculate that central banks would cut rates quickly after all. Concerning the Eurozone, Philip Lane has acknowledged that there was an insurance element in the rate hike in September last year, adding that *"I will fully take that into account in terms of the scale and timing of the rate adjustment towards a more neutral monetary policy stance when it comes to it."* Perhaps we will be positively surprised after all.

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EUROZONE

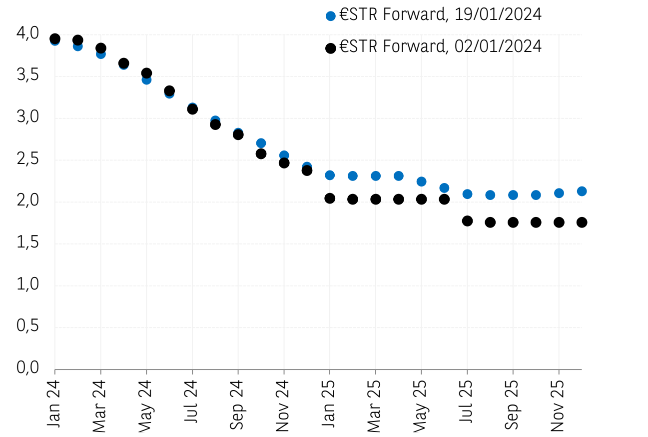

CHART 2

SOURCE: BLOOMBERG, BNP PARIBAS