2024: LOWER CENTRAL BANK RATES AND THEN WHAT?

Further progress in terms of disinflation and the room this creates for central bank easing seem to be the only economic 'certainties' for 2024. What is left is a list of important questions that should be answered as the year progresses. What will be the pace and extent of rate cuts? Is there a risk of underestimating the impact of past rate hikes that still must manifest itself? What about the timing and strength of the pickup in growth in reaction to lower inflation and the start of policy easing? Is there a downside to the scenario of a soft landing in the US? The answers to these questions matter for the real economy but are especially important for financial markets and the policy rate expectations.

From a macroeconomic perspective, one of the defining characteristics of 2023 was the ongoing tightening of monetary policy, with the Federal Reserve and the ECB raising rates more than expected. These decisions, in combination with accumulating evidence in the latter part of the year of a clear downward trend in core inflation, changed the outlook for interest rates for 2024. 2022 was the year of the start of a tightening cycle, 2023 saw the terminal rate being reached and 2024 should be the year of cuts in official interest rates. In the US, the FOMC members' December projections pencil in three 25 basis points cuts in 2024. The message from the ECB is more opaque although recent comments of several governing council members suggest that the debate has clearly shifted from whether further hikes are warranted to how long rates should be kept at present levels. The consensus expects the ECB to start reducing rates in July, bringing the deposit rate back to 3.25% by the end of the year, compared with the current level of 4.00% (chart 1[1]). A similar survey in the US expects the first rate cut by the Fed in June and a cumulative reduction of the federal funds rate this year of 125 basis points[2]. It is safe to conclude that there is hardly any or even no debate on the question whether policy rates will go down this year. Further progress in terms of disinflation should warrant a reduction in official interest rates, if only to avoid that otherwise, real interest rates would increase thereby causing an unwanted further tightening in the monetary environment.

Further progress in terms of disinflation and the room this creates for central bank easing seem to be the only economic 'certainties' for this year. What is left is a list of important questions that should be answered as the year progresses. The first concerns the pace and extent of rate cuts. Central bankers have repeatedly insisted that their policy is data dependent, so key variables to monitor are the labour market -as an indicator of economic resilience or softness-, wage growth, inflation and inflation expectations.

ECB DEPOSIT RATE CONSENSUS FORECAST

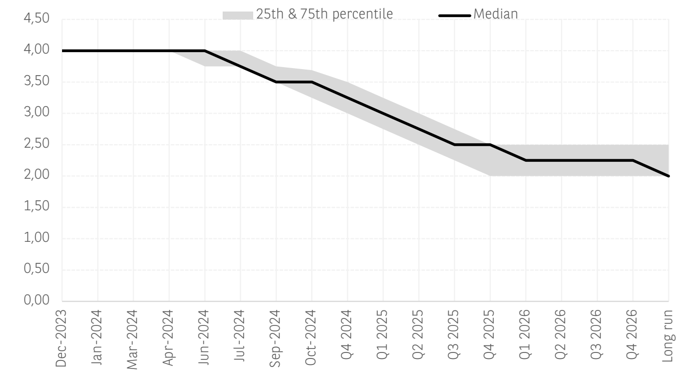

CHART 1 SOURCE: ECB SURVEY OF MONETARY ANALYSTS, DECEMBER 2023, BNP PARIBAS

A second question centers around the lingering concerns that part of the impact of past rate hikes still must manifest itself. This matters for companies that need to refinance debt or for households with adjustable-rate mortgages facing a rate reset. Concerning the former, key factors are the extent of debt refinancing[3], the increase in interest charges and how firms will cope with this increase by cutting costs, scaling back investments or simply by accepting a decline in profits. In addition, bankruptcies, which are already on the rise, may increase further. The role of adjustable-rate mortgages very much depends on the country being analysed. In the US, mortgages are typically at a fixed rate, whereas in the Eurozone, there are significant differences across countries[4].

1 'Consensus' refers to the median forecast in the latest ECB Survey of Monetary Analysts, published on 18 December 2023. The survey period was from 27 to 30 November 2023 and 39 respondents participated.
2 'Consensus' refers to the median forecast in the latest Survey of Market Participants conducted by the Federal Reserve Bank of New York. Responses from 27 market participants were received by 4 December 2023.
3 According to S&P Global, in the US, USD 247.7 billion of speculative-grade nonfinancial debt will mature in 2024 -more than double the amount of 2023- and for 2025 this should increase to USD 389.3 billion. For investment-grade issuers, the increase is a lot smaller. Source: Ballooning maturity wall a growing risk for speculative-grade companies, S&P Global, 14 June 2023.
4 According to calculations by the ECB (data for July 2023) the percentage of floating rate mortgage loans is high in Ireland (70.2%), Spain (73.1%) and very high in Portugal (85.7%), Greece (89.8%) and Finland (96.4%). In Belgium, 67% of mortgage loans had an interest rate fixation period at origination of more than 10 years. In France the equivalent number is 78.4%. Source: Real estate markets in an environment of high financing costs, ECB, Financial Stability Review, November 2023.

> In 2024, ongoing disinflation should enable the Federal Reserve and the ECB to start cutting their policy rates. Both factors should be followed by a gradual pickup in economic growth.

Although the macroeconomic impact of the remaining effect of higher interest rates is very difficult to assess, there is a clear downside risk to growth and hence inflation. This also matters for financial markets and policy rate expectations.

Question number three is about the timing and strength of the pickup in growth. Concerning the Eurozone, the ECB Survey of Professional Forecasters for the fourth quarter of 2023 saw respondents anticipating an improvement in the first half of 2024[5]. The December 2023 Eurosystem staff projections expect growth "*to recover gradually from the first quarter of 2024, supported by increases in real income and foreign demand*[6]." We expect a gradual pickup of quarterly growth from a non-annualised 0.1% in the first quarter to 0.3% in the second and 0.4% in the third and fourth quarter. In the US, the latest Federal Reserve Bank of Philadelphia's Survey of Professional Forecasters sees real GDP growing slowing in the first quarter of 2024 and reaccelerating as of the second quarter[7].

We expect zero growth in the first quarter and a contraction of -0.3% in the second followed by a slow recovery in the second half of 2024 with 0.2% non-annualised quarterly growth in the third and 0.3% in the fourth quarter. The question about the timing and strength of the growth pickup is especially important for financial markets and the pricing of the expected path for policy rates. This pricing will also depend on the answer to the fourth and final question: is there a downside to the scenario of a soft landing in the US? Such a landing implies that following sufficient monetary tightening, inflation converges back to target without a recession and a significant increase in the unemployment rate. This entails a risk that once activity is again in an upswing, bottlenecks and the ensuing risk to the inflation outlook would resurface quickly, triggering a reassessment of the outlook for monetary policy -an early end to the easing cycle- and an increase in bond yields.

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5 The survey was released on 27 October 2023.
6 The forecast for non-annualised quarter-over-quarter growth is 0.2% in the first quarter of 2024, 0.3% in the second quarter and 0.4% in the third and fourth quarter. Source: Eurosystem staff macroeconomic projections for the euro area, ECB, December 2023.
7 Annualised quarter-over-quarter growth was estimated at 1.3% for the fourth quarter of 2023 and projected to slow down to 0.8% in the first quarter of 2024 and reaccelerate thereafter to respectively 1.3%, 1.5% and 1.7% in the second, third and fourth quarter. Source: *Federal Reserve Bank of Philadelphia, Fourth Quarter 2023 Survey of Professional Forecasters,* 13 November 2023.

2023 AND THE OUTLOOK FOR 2024