AFTER JACKSON HOLE: A LITTLE CLARITY, BUT A LOT OF UNCERTAINTY REMAINS

While the date of the Fed's first rate cut is now foreseeable (it will be at the FOMC on 17-18 September), everything else remains uncertain: the size of the cut, as well as the overall extent of the easing cycle and the timing of the cuts. Developments on the US labour market are key in this calibration. In terms of inflation, significant progress has been made regarding the return to price stability on both sides of the Atlantic, but the battle is far from won. This calls for caution in the monetary easing that is beginning. We expect the Fed to open this cycle with a cut of 25 bps rather than a cut of 50 bps – the orderly slowdown in the labour market working in favour of this – and to make a total of eight rate cuts by the end of 2025 (five consecutive cuts, then one per quarter), bringing the Fed Funds range to 3.25-3.50%. We anticipate that the Fed will succeed in piloting the US economy's soft landing. The ECB and the BoE started their monetary easing a little earlier than the Fed (June for the ECB, August for the BoE), and they would continue at a very gradual pace of -25 bps every quarter (until Q3 2025 for the ECB, bringing the deposit rate to 2.50%; until the end of 2025 for the BoE, the bank rate ending at 3.75%), each totalling six rate cuts.

At least one thing is clear after Jackson Hole and Jerome Powell's opening remarks on 23 August: the US Federal Reserve considers "*the time has come for policy to adjust*", i.e., for policy rates to be lowered[1]. Furthermore, he was very explicit about the reasons behind this announcement and the reversal of the balance of the risks between the two components of the Fed's mandate (price stability and full employment): inflation is no longer the primary concern, it is the situation on the labour market that now matters. Powell was also clear in his presentation of the reasons behind the surge in inflation ("*an extraordinary collision between overheated and temporarily distorted demand and constrained supply*" and then its decline (the unwinding of these distortions and the monetary policy response), congratulating himself on the important role of monetary policy in this reversal. Philip Lane for the ECB[2] and Andrew Bailey for the BoE[3], on the other hand, gave monetary policy only one role among others, while highlighting, as a minimum and rightly so, the importance of monetary tightening on anchoring inflation expectations.

While the date of the Fed's first rate cut is now foreseeable (it will be at the FOMC on 17-18 September), the question of the size of the cut remains open, as well as, quite naturally, the overall extent of the easing cycle and the timing of the cuts. Just after stating that it was time for the Fed to adjust its policy, that "*the direction of travel is clear*", Powell did not tie his hands any further and stated that "*the timing and pace of rate cuts will depend on incoming data, the evolving outlook, and the balance of risks*".

Developments on the US labour market are key for the monetary policy that will be adopted. Today, the exact nature of the current slowdown is still difficult to determine. Is this merely and essentially a normalisation of post-Covid-19 pressures? If so, a natural halt to the slowdown can be expected in a not-too-distant future. Or is this slowdown mainly due to monetary tightening? If so, a further deterioration is to be expected until a possible recession occurs, unless the Fed succeeds in a soft landing thanks to monetary policy easing. The difficulty, of course, is that the slowdown in the labour market is probably due to both effects, but to an indeterminate extent. Nevertheless, this can work in the Fed's favour and help it in its fine-tuning of the landing. The Richmond Fed President Tom Barkin talks about a '*low-hiring, low-firing mode*'[4], from which it is not yet clear how the US economy will emerge, either upwardly (higher hirings) or downwards (stronger firings). Our baseline scenario continues to anticipate an upward exit, a soft landing of the US economy rather than a recession, supported in particular by lower interest rates. But, while the risk of recession remains low from our point of view, it is increasing.

In terms of inflation, significant progress has been made regarding the return to price stability on both sides of the Atlantic, but the battle is far from won. The fall in headline inflation is significant, but the decline in core inflation is much more modest and slower, due in particular to persistently high inflation in services: the 2% inflation target still looks relatively remote from this point of view. Philip Lane made this clear at Jackson Hole, stating in his conclusion that "*the return to target is not yet secure*". This calls for caution in the monetary easing that is beginning. Isabelle Schnabel is also an important advocate of this approach, as her latest speech proves[5]. There are also two arguments in favour of moving rather relatively quickly into monetary easing and, at least, a return to neutral interest rates: 1. balancing the policy mix in order to try and offset the expected tightening of fiscal policy (this argument is more true for Europe than for the United States, where fiscal policy risks remaining accommodative rather than becoming restrictive[6]); 2. starting from a relatively high degree of monetary restriction (which alone could justify a rapid easing from certain points of view), the apparently smaller impact of monetary policy on activity and the long transmission lags.

According to our very recently updated forecasts, the Fed, the ECB and the BoE's easing cycles, although not completely identical, would remain generally synchronous, in line with a gradual approach. This would be a little more significant on the US side, considering the higher starting point, all of which is part of a generalised movement of rate cuts (see table). We expect the Fed to kick off its monetary easing cycle with a cut of 25 bps in the Fed Funds rate at the FOMC on 17-18 September. The labour market data released on 6 September and other recent US labour market indicators continue to describe an orderly slowdown and justify a cut of 25 bps instead of 50 bps.

1 Speech by Chair Powell on the economic outlook – Federal Reserve Board, 23 August 2024.
2 The effectiveness and transmission of monetary policy in the euro area (europa.eu), 24 August 2024.
3 Reflecting on recent times – speech by Andrew Bailey | Bank of England, 23 August 2024.
4 How Richmond Fed President Tom Barkin Sees the Economy Right Now – Bloomberg, 27 August 2024.
5 The euro area inflation outlook: a scenario analysis (europa.eu), 30 August 2024.
6 A risk that the Fed should communicate more about, according to Adam Posen (President of the Peterson Institute for International Economics), to prepare itself, and the public, for at least the high probability of a shift to tightening by mid-2025 should inflation accelerate (What Jay Powell should say at Jackson Hole (ft.com), 22 August 2024).

The latest comments from President of the New York Fed John C. Williams[7] and Fed Governor Christopher J. Waller[8] are also consistent with such a gradual first move. This first cut would be followed by four others (-25 bps at each meeting, in November and December 2024 and January and March 2025), followed by a cut of 25 bps per quarter, bringing the Fed Funds range to 3.25-3.50% at the end of 2025 and then to 2.75-3.00% in mid-2026, which would mark the end point. The next ECB meeting (12 September) is expected to deliver a second cut of 25 bps in the deposit rate. Easing would continue at a gradual rate of -25 bps every quarter (with a third cut in Q4 2024 more likely in December than in October) until Q3 2025, bringing the deposit rate to 2.50%, which is the upper range of our neutral rate estimate. The BoE would follow the same pace as the ECB, with a drop of -25 bps every quarter but, having cut its policy rate (bank rate) for the first time in August, the next cut would take place on 7 November. The bank rate would stand at 3.75% at the end of 2025 but the easing cycle would extend until around mid-2026, bringing this rate to 3%.

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7 'E' Is for Equipoise – FEDERAL RESERVE BANK of NEW YORK (newyorkfed.org), 6 September 2024.
8 Speech by Governor Waller on the economic outlook – Federal Reserve Board, 6 September 2024.

POLICY RATE CHANGES

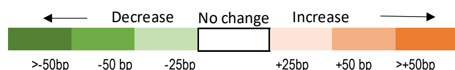

TABLE 1

SOURCE: CENTRAL BANKS, BIS, * BNP PARIBAS, GLOBAL MARKETS FORECASTS