THE LIKELY END OF INTEREST RATE HIKES BUT NOT OF MONETARY RESTRAINT

The rate hikes cycle is coming to an end. The further weakening of economic activity and lower inflation that we expect to see by the end of this year should prompt the Fed, like the ECB and the BoE, to stop raising their policy rates. However, a further tightening cannot be ruled out. Interest rate hikes would not be followed immediately by cuts: to continue the fight against inflation, monetary response is expected to hold policy rates at their current high level for an extended period, until mid-2024 according to our forecasts. The first rate cuts would then occur to accompany the sharper fall in inflation and offset its positive impact on real policy rates. From this point of view, monetary policy would remain restrictive until the end of 2024.

In September 2023, out of a sample of some 40 central banks, only around ten raised their policy rates, including the ECB. After the global tightening movement that began at the end of 2021, such a move is now more of an exception than a rule (see Chart 1). The ECB raised its policy rates instead of leaving them unchanged as we expected, standing out above all from the US Federal Reserve (Fed) and the Bank of England (BoE) which opted for the status quo in September (Fed funds range maintained at 5.25-5.50% and BoE bank rate unchanged at 5.25%). This decision was expected for the Fed, but not for the BoE. It was certainly not in line with our scenario, and the vote was very tight with four out of ten committee members in favour of a 25 bp increase to 5.5%.

RATE HIKES ARE NOW MORE OF AN EXCEPTION THAN A RULE

As regards the ECB, its decision was surrounded by considerable uncertainty, between the arguments in favour of a further rise (still very high inflation and unsatisfactory disinflation) and those calling for a status quo (deterioration in credit supply and demand, delayed effects of the monetary tightening, loss of momentum of GDP growth). We thought that concerns about GDP growth would outweigh those about the sluggish disinflation and that the ECB would opt for the status quo; on the contrary, by hiking once again for the tenth consecutive time in a row, the ECB showed that the inflation situation remained a major concern. This is not surprising given its inherent reaction function, which depends on its assessment of the inflation outlook in the light of the incoming economic and financial data, the dynamics of core inflation and the strength of monetary policy transmission[1].

While the ECB acknowledges the good transmission of monetary tightening to the economy through the credit channel, progress on disinflation still appears to be insufficient and there is still a long way to go before returning to the 2% target. While the ECB expects headline inflation to be close to 3% y/y by the end of this year, a figure that is significantly lower than the peak reached a year earlier (10% y/y in Q4 2022), core inflation is expected to fall much less, at 4.1% y/y in Q4 2023, only 1 percentage point lower than in Q4 2022. By 2024, further progress is expected to be limited. Headline inflation would lose only 0.4 points between Q4 2023 and Q4 2024 (at 2.9% y/y). The expected decline in core inflation is larger (-1.6 points), but it would remain significantly above 2% (2.5% in Q4 2024). Inflation would not return to the target before the end of 2025: slightly below for headline inflation (1.9%), and slightly above for core inflation (2.1%). Our 2024 inflation forecasts are close to those of the ECB[2] as well as our growth forecasts, as the ECB significantly revised its eurozone scenario downwards between June and September[3], a revision that we thought would lead it to favour the status quo.

CENTRAL BANKS POLICY RATES:
NUMBER OF HIKES VERSUS NUMBER OF CUTS

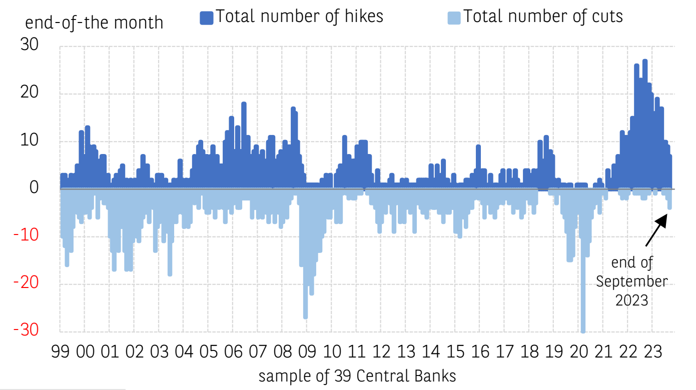

CHART 1 SOURCE: CENTRAL BANKS, BIS, DATASTREAM, BNP PARIBAS

The Fed and the BoE must deal, broadly speaking, with the same trade-off and balancing act as the ECB – fighting inflation without an unduly negative impact on the economy – but their decision in favour of the status quo in September may have been facilitated by somewhat more advanced disinflation in the US and bigger downside risks to growth in the UK. Moreover, since the ECB has, so far, increased its policy rates less (450 basis points between July 2022 and September 2023, compared with 525 basis points for the Fed between March 2022 and July 2023 and 515 basis points for the BoE between December 2021 and August 2023), this gives it additional latitude to complete its hiking cycle, if need be, all things being equal. If one also compares the degree of monetary restraint measured by real policy rates (nominal rate minus spotted inflation in year-on-year terms), the Fed has been in restrictive territory since Spring 2023. This is not the case for either the ECB or the BoE. From this perspective, these two central banks may not have completed the rate hikes, unlike the Fed.

END OF RATE INCREASES BUT NO EXPECTED CUTS UNTIL MID-2024

According to our forecasts, the Fed, the ECB and the BoE should no longer raise their policy rates or change them before mid-2024, which should mark the first rate cuts. The Bank of Japan (BoJ) stands out because it would begin its monetary tightening in April 2024 when the issue of monetary loosening would likely begin to emerge more clearly for the Fed, the ECB, and the BoE.

1 William de Vijlder, Ecoweek editorial, 18 September 2023 : ECB: at the peak (bnpparibas.com).
2 Except for headline inflation by the end of 2024, which we expect to be lower (2.3%).
3 In June 2023, the ECB expected a growth rate of 0.9% in 2023 in annual average terms and of 1.5% in 2024; in September, these figures had been revised down to 0.7% et 1%, respectively.

The end of the rate hikes cycle is not yet certain, however, given the still high inflation and the contained economic slowdown at the time of writing. The Fed's status quo in September was characterized as a "hawkish pause"[4], which also applies to the BoE. But rather than deciding on further rate hikes, monetary policy could now be achieved by maintaining policy rates at their current high levels for a prolonged period. This is an important line of communication s for central banks recently, as illustrated, for example, by the emphasis on perseverance by Bank of France Governor, François Villeroy de Galhau, in a recent speech[5].

We have been defending this "high for long" position for some time now. "Long" translates, concretely, in our forecasts, by rates kept at their current high level for 8 months for the Fed, the ECB and the BoE (policy rates unchanged from October 2023 to May 2024). However, this long duration is not as long as the previous "high-for-long" period which lasted 15 months, from June 2006 to August 2007 in the US (with Fed funds at 5.25%, i.e. the current low range). Unlike that time (which was followed by a severe financial crisis and a major recession), our current baseline scenario does not anticipate such a deterioration in the economic situation, far from it.

The rate cuts envisaged from mid-2024 do not respond to the economic downturn: they mainly accompany the fall in inflation, to offset its positive impact on real policy rates. We expect regular rate cuts from the Fed and the BoE (five, 25 bp at each meeting) and more gradual ones from the ECB (three, 25 bp each). This normalisation simply avoids further monetary policy tightening; there is no real easing by the Fed and the ECB, which is somewhat less the case for the BoE given our inflation forecasts (see Chart 2). From this point of view, monetary policy would remain restrictive until the end of 2024.

We would like to draw attention to the large gap existing between our rate scenario for the Fed and the Fed's own projections. According to its September dot plot, the median Fed funds estimate includes a further 25bp increase by the end of this year and only 50bp of cuts next year. Part of the explanation for this gap is the Fed's more optimistic growth forecasts, whose revised scenario approaches much of the expected soft landing. Compared to the June economic forecast, the growth forecast was significantly raised for 2023 (+1.1 percentage point, to 2.1% year-on-year in Q4 2023) and 2024 (+0.4% ppts, to 1.5%), the unemployment rate was lowered for both years (-0.3 ppts to 3.8% in Q4 2023, -0.4 ppts to 4.1% in Q4 2023) as well as core inflation in 2023 (-0.2 ppts, to 3.7% year-on-year in Q4 2023). Even the IMF, in its October 2023 World Economic Outlook, which has been just published, considers that the probability of a soft landing has increased (bringing inflation down without a major downturn in activity)

This more optimistic assessment of the economic situation, particularly in the United States, is also reflected in Google's search for the term 'soft landing', which has recently soared and replaced the term 'recession' (see Chart 3). We do not entirely share this optimism and continue to believe that the US will not escape a recession as a result of tighter monetary policy. The recent tightening of monetary and financial conditions, through higher long-term rates combined with the rise in oil prices and the USD appreciation, tends to strengthen this scenario and weaken that of a soft landing. But, given all the shocks, the shallow nature of the recession we anticipate could give the impression of a soft landing.

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REAL POLICY RATES*

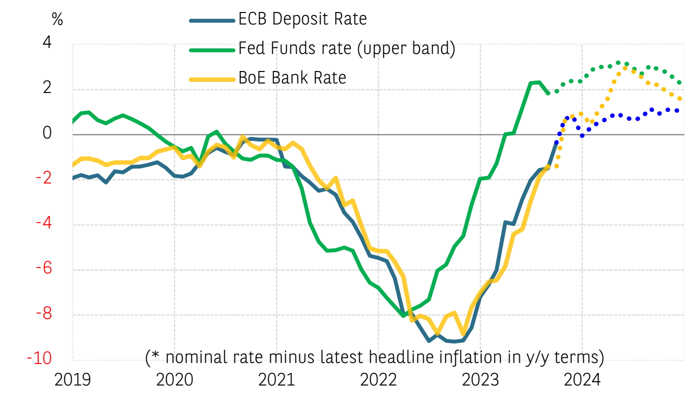
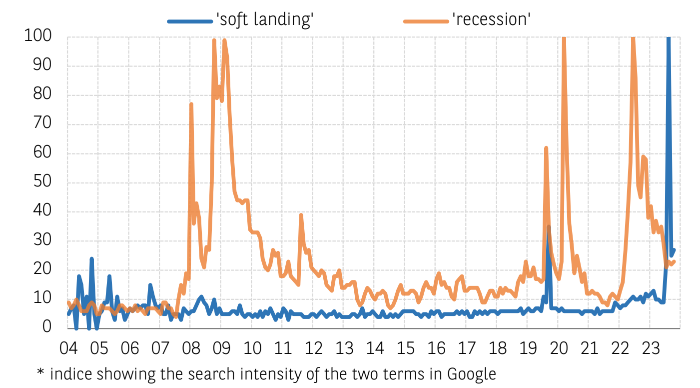


CHART 2 SOURCE: EUROSTAT, BLS, ONS, CENTRAL BANKS, MACROBOND, BNP PARIBAS

NUMBER OF OCCURRENCES OF 'SOFT LANDING' AND 'RECESSION'*



* indice showing the search intensity of the two terms in Google

CHART 3 SOURCE: GOOGLE, BNP PARIBAS

4 *William de Vijlder, Ecoweek editorial, 25 September 2023 (*Federal Reserve: high(er) for longer (bnpparibas.com)*)*
5 *onetary policy in the euro area: was it too late? Or could it now be too much? | Banque de France (banque-france.fr), ECB – CEPR – Banque de France Conference – Paris, 25 September 2023*