THE OTHER TERMINAL RATE: HOW FAR WILL POLICY RATES BE CUT?

Recent communication by the Federal Reserve and the ECB has made it clear that the first cut in official interest rates is coming. Both central banks are saying the same -it depends on the data- but the ECB communication is more opaque than that of the Federal Reserve, which provides interest rate projections of the FOMC members (dot plot). In assessing how fast and how much the ECB might cut policy rates in this cycle, several approaches can be adopted. Based on the credibility of the ECB and plausible estimates of the neutral rate, it makes sense to use an assumption of a range between 2.00% and 2.50% for the ECB deposit rate as the end point of the easing cycle.

Recent communication by the Federal Reserve and the ECB has made it clear that the first cut in official interest rates is coming. On the presentation of the semiannual monetary policy report to the Congress, Jerome Powell stated that the FOMC is waiting to become more confident that inflation is sustainably moving to 2%, adding "*When we do get that confidence — and we're not far from it — it'll be appropriate to begin to dial back the level of restriction.*[1]" In his press conference on 20 March following the FOMC meeting, he confirmed the message that policy easing will start this year[2]. Earlier this month, Christine Lagarde had mentioned during her press conference that the ECB is making good progress towards its inflation target but that more data are needed to be sufficiently confident that the inflation target will be reached. "*We will know a little more in April, but we will know a lot more in June.*[3]" So far for the easy question -will there be a rate cut?- so let's move on to the difficult questions of how many cuts and how fast. What will be the 'other' terminal rate, i.e. the rate at which central banks will stop reducing their policy rate[4]. At first glance, both central banks are saying the same -it depends on the data- but upon closer inspection, the ECB communication is more opaque than that of the Federal Reserve. During his press conference, Jerome Powell referred to the FOMC members' projections for the federal funds rate (the 'dot plot'). "*If the economy evolves as projected, the median participant projects that the appropriate level of the federal funds rate will be 4.6 percent at the end of this year, 3.9 percent at the end of 2025, and 3.1 percent at the end of 2026—still above the median longer-term funds rate.*[5]" Clearly, given the data-dependency of policy, the policy rate path decided by the Fed would be different should the economy evolve differently than expected. Nevertheless, the dot plot provides a clear picture of the base scenario that the FOMC members have in mind and serves as a good reference point for economic agents. Speaking at the recent ECB Watchers conference, Christine Lagarde stated "*We cannot precommit to a particular rate path however tempting that is, however much some of you would like to see it. If we are honest to our methodology and if we have discipline in adhering to this principle, we cannot.*[6]" The absence of guidance on Eurozone policy rates -there is no ECB dot plot- raises two questions: does it matter, and, how should one go about in assessing how far rates could be cut? Concerning the former, in theory, one would expect a positive impact on macroeconomic performance from publishing interest rate projections. They should lower the uncertainty about the future interest rate path.

€STR FORWARD RATE

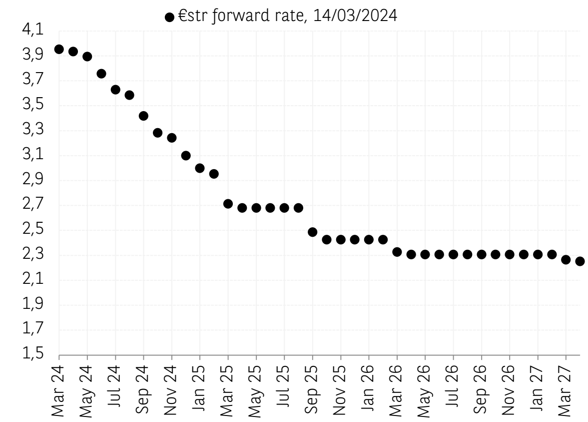

CHART 1 SOURCE: CME GROUP VIA BLOOMBERG & MACROBOND, BNP PARIBAS

€STR FORWARD RATE

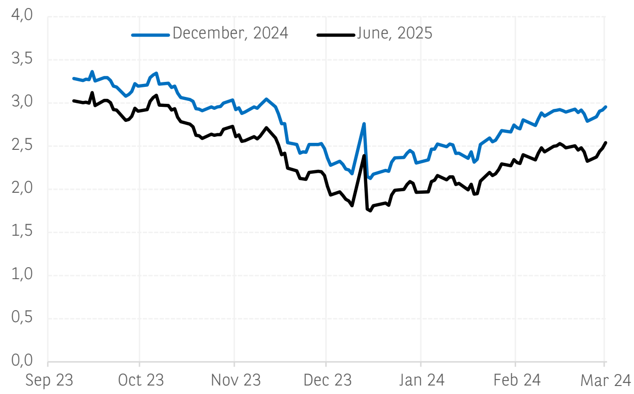

CHART 2 SOURCE: CME GROUP VIA BLOOMBERG & MACROBOND, BNP PARIBAS

1 Source: Fed Is 'Not Far' From Confidence Needed to Cut Rates, Powell Says, Bloomberg, 7 March 2024.
2 *"It will likely be appropriate to begin dialing back policy restraint at some point this year."* Source: Federal Reserve, Transcript of Chair Powell's Press Conference, 20 March 2024.
3 Source: *ECB, Monetary policy statement and press conference,* Christine Lagarde, President of the ECB, Luis de Guindos, Vice-President of the ECB, Frankfurt am Main, 7 March 2024.
4 The concept of the terminal rate was often used when central banks were tightening policy. It corresponds to the peak level of the policy rate in this phase of the business cycle.
5 Source: *Federal Reserve, Transcript of Chair Powell's Press Conference,* 20 March 2024.
6 Transcript from the video on Bloomberg: *Lagarde says ECB can't commit to cuts after likely June move,* Bloomberg, 20 March 2024.

Consequently, households and companies may be more eager to react to the prospect of rate cuts as reflected in these projections than to those that can be inferred from financial markets and which are inherently more volatile. Interest rate uncertainty matters because of its negative impact on firm decisions[7]. However, one should be mindful that major changes in the interest rate projections could increase uncertainty by wrongfooting markets, households and firms.

At the current juncture, the more relevant question in the Eurozone is how fast and how much policy rates might be cut in this cycle under the hypothesis that key economic variables -inflation, growth, wages, etc.- would evolve in line with the latest ECB staff projections. Several approaches could be adopted (table). The first consists of looking at the consensus forecast. The latest ECB Survey of Monetary Analysts (March 2024) sees the deposit rate, which is currently at 4.00%, dropping to 3.00% at the end of this year, 2.25% at the end of 2025 before reaching its long-term projection of 2.00% in 2027. Secondly, one could look at market pricing. Based on the euro short-term rate (€STR) forward curve, markets expect a decline in the deposit rate of 85 basis points (bp) by the end of this year and 150 bp by the end of 2025 (chart 1). However, market pricing can fluctuate significantly, in reaction to data surprises and comments of ECB governing council members. A shown in chart 2, based on €STR futures, the implied interest rate for December 2024 had dropped about 120 basis points in the fourth quarter of 2023, before rising again approximately 80 basis points. Clearly, the stability of the deposit rate -the last hike occurred at the September 2023 governing council meeting-, did not stop market pricing for the future path to be very volatile.

Thirdly, a simple approach consists of applying the expected decline in inflation to the nominal deposit rate. In doing so, one (implicitly) assumes that the current real policy rate should remain appropriate going forward.

This makes little sense. High real interest rates are necessary when inflation needs to be brought back under control but subsequently, real rates should be lowered through nominal policy rate cuts that are bigger than the decline in inflation. For this reason, a fourth approach consists of trying to understand the ECB's reaction function. Governing council members have repeatedly explained that it is built around three criteria: the inflation outlook, the dynamics of underlying inflation and the strength of monetary transmission[8]. However, this does not answer the question of calibration: at which point will the nominal policy rate have dropped sufficiently considering the inflation outlook and the monetary environment? The historical experience offers little help due to the limited number of easing cycles and the specificity of the then prevailing economic environment. A more obvious approach, in theory at least, is to look at the neutral rate, i.e. the real short-term interest rate that is consistent with output corresponding to its potential level whereby inflation is stable and consistent with the central bank's objective. This rate cannot be observed, and empirical estimates depend on the models and assumptions that have been used. Recent research by the ECB, shows that since the second half of 2023 model-based estimates "*have ranged between about minus three-quarters of a percentage point to around half a percentage point*" with the median estimate slightly above zero[9]. Interestingly, this is rather close to the implied real rate that can be inferred from the ECB Survey of Monetary Analysts, which has headline inflation in line with the ECB target of 2.00% as of the third quarter of 2025 -for core inflation this is expected to occur a quarter later-, and the ECB deposit rate dropping to 2.25% in 2025 Q4 and to 2.00% as of 2026 Q1.

In conclusion, although the ECB still needs to decide on its first rate cut, it is important to gauge the speed and extent of the policy easing. Concerning the end point of the easing cycle -the other terminal rate-, it makes sense to use an assumption of a range between 2.00% and 2.50%.

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7 Research by the Banque de France shows that *"in the presence of heightened short-term interest rate uncertainty, firms tend to decrease their future investments and hiring activities. They also adopt a more cautious approach by hoarding cash and cutting dividend payments."* Source: Anne Duquerroy, Klodiana Istrefi and Sarah Mouabbi, Interest Rate Uncertainty and Firm Decisions, CEPR Discussion paper 18722, December 2023.

8 Source: *Building confidence in the path ahead, Speech by Christine Lagarde, President of the ECB, at The ECB and its Watchers XXIV Conference,* organised by the Institute for Monetary and Financial Stability, Goethe University, Frankfurt am Main, 20 March 2024.

9 Source: Estimates of the natural interest rate for the euro area: an update, ECB Economic Bulletin, Issue 1/2024. From 2014 until 2018, the median estimate across a wide range of models had been equal to zero. It moved into negative territory in 2019 and dropped even more during the Covid-19 pandemic and its aftermath. More recently it has increased again, moving slightly above zero.

ANTICIPATING ECB MONETARY POLICY: REFERENCE POINTS

ITEM	COMMENT
Consensus forecast (ECB Survey of Monetary Analysts)	
Expectations based on market pricing	Can fluctuate a lot
Assume that expected decline in policy rate corresponds to expected decline in (core) inflation	Implies assumption of stable real policy rate, which is questionable
Looking for historical reference points for real policy rates	Limited number of easing cycles and each cycle was specific
Looking at the three criteria of the ECB's reaction function: inflation outlook, dynamics of underlying inflation, strength of monetary transmission	Not clear how they will influence decisions
Use the neutral rate as a reference point	Wide range of neutral rate estimates