



GLOBAL ECONOMICS UPDATE

When will interest rates start to fall?

- **Inflation is now on a downward trend and interest rates are at, or very close to, a peak. But central banks will only cut interest rates once there are clearer signs that underlying price pressures are under control. That could be as early as later this year in some countries including the US, but stickier wage pressures are likely to mean that rates in the UK and euro-zone only start to fall next year.**
- Earlier this year, it looked as though central banks might be forced to undertake an abrupt U-turn on interest rates in the face of an escalating banking crisis. But with fears about the banking sector having subsided, we are now back to a situation where inflationary developments are key to when interest rates start to fall – albeit with the tightening in credit conditions resulting from recent banking sector turmoil feeding into that inflation outlook.
- **One necessary condition will have to be a big drop in headline inflation, not least to ease central banks’ concerns about the potential second-round effects of higher inflation on inflation expectations.** Headline inflation has come down most quickly in North America, where the rise in energy prices was much smaller than in Europe. But falling energy prices are now pushing down headline inflation everywhere and, within a few months, it should have fallen to more comfortable rates for all central banks. (See Chart 1 and our latest [Global Inflation Watch](#).)
- **The more important issue now is when underlying inflation, which is proving more stubborn, drops back.** (See Chart 2.) Central banks have now raised interest rates sufficiently to cool demand; we expect recessions in all major economies. (See Chart 3.) But there are still uncertainties about the links between activity and inflation and whether this weaker demand will succeed in bringing inflation down. (See [here](#).)
- **Crucially, a sustainable reduction in core inflation is only possible if wage pressures have subsided.** Falling headline inflation and inflation expectations will help to bring wage growth down. And measures of labour market tightness have peaked in many countries. (See Chart 4.)

Chart 1: Headline CPI Inflation (%)

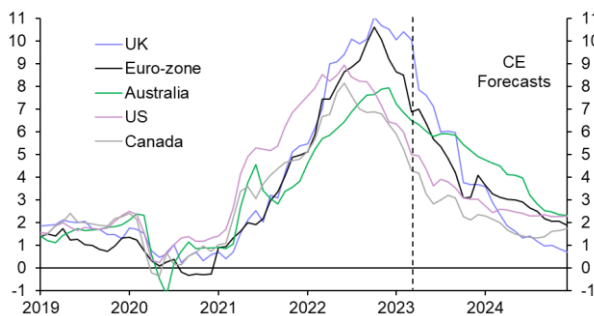


Chart 2: Core CPI Inflation (%)

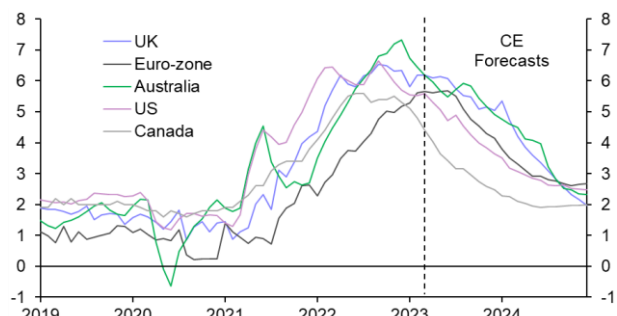


Chart 3: Peak to Trough Change in Real GDP (%)

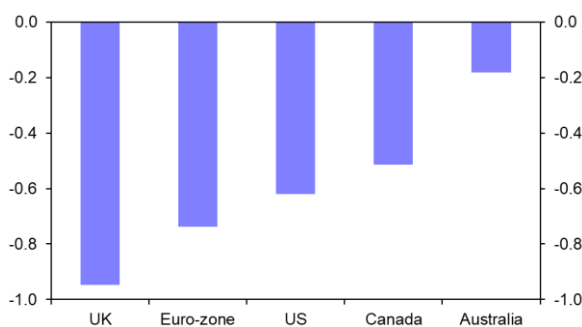
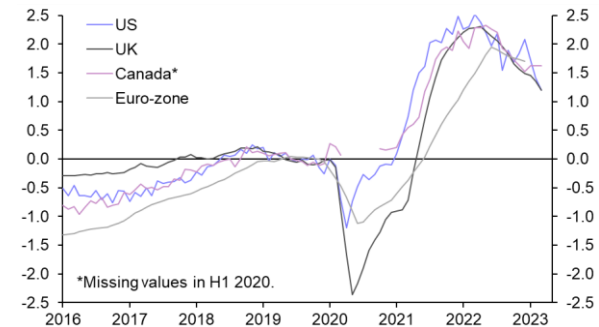


Chart 4: Job Vacancy Rate (Standard Deviations From 2019 Average)



Sources: Refinitiv, Capital Economics



- **We expect wage growth to slow, although this will take longer in some countries than others.** (See Chart 5.) Wage growth may be more persistent in the UK, where the labour supply is struggling to recover. (See [here](#).) Indexation and still-tight labour markets could mean that wage growth will be relatively slow to fall in the euro-zone too. (See [here](#).) In Australia, the previous rise in inflation will have a lagged impact on wage growth given that many workers are covered by collective bargaining with an average duration of three years.
- **The upshot is that we expect interest rates to be falling by the end of the year in the US and those in Canada should follow soon after. Rates should start to fall in early 2024 in the UK, and later in 2024 in the euro-zone and Australia.** (See Chart 6 and our [Central Bank Hub](#).)
- **Once inflation looks to be under control, interest rates could potentially fall fairly sharply.** After all, to quash inflation, they have had to rise significantly above their neutral or equilibrium levels. (See Chart 7.) **Rapid rate cuts could be more likely in any countries where tightening monetary policy to beat inflation has increased the risks to financial stability.** This includes the US, where the regional banking system has come under threat, and countries where there is a risk of falling house prices turning into a destabilising housing market rout. (See Chart 8.) In most places, housing markets have shown signs of stabilising in the past few weeks; however, with affordability still stretched, we doubt this will last. (See [here](#).)

Chart 5: Average Earnings (% y/y)

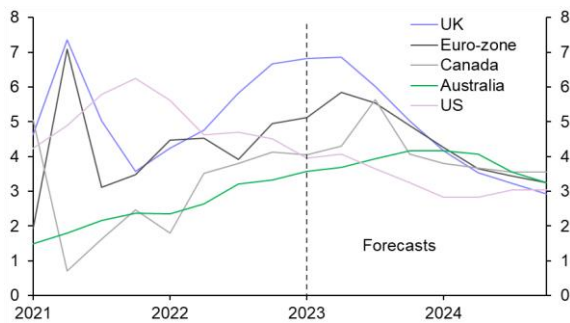


Chart 6: Policy Rates (%)

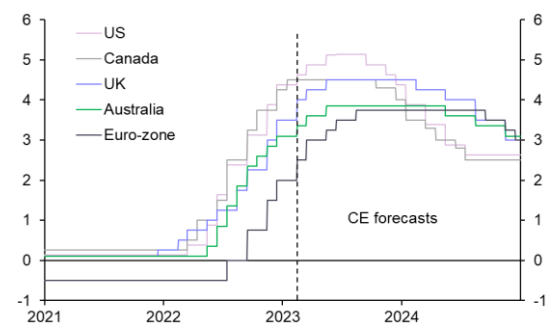


Chart 7: Interest Rates (%)

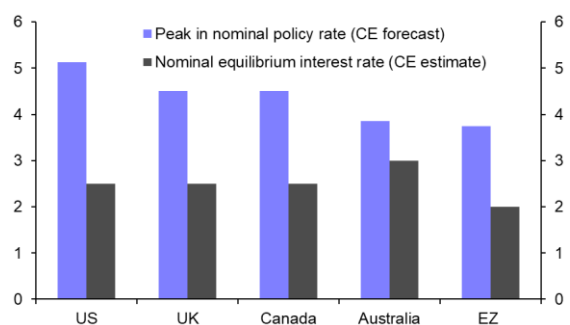
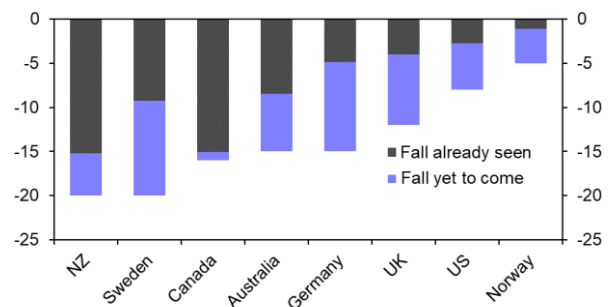


Chart 8: Peak to Trough Change in House Prices (%)



Sources: Refinitiv, Capital Economics, Statistics Canada



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