CAPITAL ECONOMICS

GLOBAL ECONOMICS UPDATE

Central banks at a plateau, but what next and when?

- **We held a *Drop-In* last week to explain our thoughts on the latest policy communications from the Fed, ECB, and Bank of England following their decisions to leave rates on hold. (See the recording here.) This *Update* answers several of the questions that we received about the economic and market implications.**

- **What do you make of the Fed's latest communications? Were markets right to have taken the statement as dovish?** The decision to keep interest rates on hold at 5.25%-5.50% and the accompanying statement were largely as expected. (See here.) But there were several dovish hints. The Fed repeated that it would "proceed carefully" and Powell downplayed the September projection of one more rate hike. He also suggested that resilient economic activity in itself need not prompt further tightening and that labour market conditions would be far more important. Meanwhile, he acknowledged that tighter financial conditions relating to higher bonds yields had begun to weigh on activity and that they would continue to do so.

- **Is your forecast of rate cuts in the US next year dependent on a major deterioration in the economic data?** We are still anticipating 200bps of rate cuts by the Fed in 2024, so if GDP continued to expand at Q3's strong pace this would be a major upside risk. But it needn't take a recession to justify the rate cuts that we are projecting so long as inflation keeps falling and the labour market continues to loosen. Last week's employment report offered strong support to our view that wage growth will weaken further.

- **What do you think is the outlook for Quantitative Tightening in the US and was it a key driver of the recent rise in yields?** The Fed has not announced any plans to alter the pace of its balance sheet rundown and we think that there is room for it to continue without prompting a liquidity crunch. However, QT has played a role in boosting yields over recent months. If we are right that growth will weaken markedly next year and inflation will drop, then it seems unlikely that the Fed would continue with QT at the same pace if this threatened to cause a renewed rise in long-term bond yields. (See here.)

- **Will the Bank of England cut interest rates as soon as financial markets expect?** We think that the market projection for rate cuts to begin in August/September may be a little soon and we anticipate the first cut around the end of the year. While the vote this month was slightly less hawkish, that reflected a change in MPC membership and the Bank stressed that rates cuts would not be warranted for some time. (See here.) A key difference with the US is that while it seems that labour market conditions are loosening there, UK wage growth has shown few signs of falling. The Bank of England has now revised up its estimate of the equilibrium rate of unemployment, acknowledging that some of the reduction in labour supply caused by the pandemic will persist. This suggests that wage growth will stay higher for longer.

- **How much does the upcoming election in the UK influence your view?** The Government will be keen to cut taxes before the next election, perhaps in the Budget next March. The extra support for demand will make the fight against inflation more difficult and adds to reasons for the Bank to hold off from rates cuts. That said, experience suggests that UK fiscal policy is typically tightened in the aftermath of elections. If that pattern repeats, it will add to the case for rate cuts in 2025. So this supports our view that when cuts do come, they will be sharper than markets anticipate – we see Bank Rate at 3% by end-2025.

- **Was the ECB more or less dovish than the Fed at its October meeting and how does this play into our interest rate forecasts?** There is now a particularly strong consensus that the ECB's tightening cycle is over and we agree. The run-up in inflation in the euro-zone was not about excess demand since the economy did not experience a strong post-pandemic recovery like that which we saw in the US and GDP has broadly flatlined in the past year. Instead, energy prices were the key cause of higher inflation and they are now much lower than they were in the thick of the tightening cycle. However, we think that the ECB will lag

Jennifer McKeown, Chief Global Economist, jennifer.mckeown@capitaleconomics.com

behind the Fed when it comes to policy loosening due to sticky wage growth. The euro-zone has not seen the pronounced drop in the labour supply which has affected the UK, but labour market conditions are still very tight. We suspect that structural factors and the nature of wage bargaining will mean that high wage growth persists for longer in the euro-zone than in the US, meaning that interest rates will be a bit slower to fall (just as they were slower to rise). We are still forecasting the first cut in September, although the recent weakness of the euro-zone economy and encouraging news on the inflation side have led us to conclude that the risks are skewed towards a slightly earlier cut. (See here.)

- **Could another energy shock caused by an escalation of the conflict in the Middle East mean further ECB rate hikes?** The recent softening of energy prices seems to reflect a view that the threat that the Israel-Hamas conflict will expand to other countries in the region and harm Middle East oil supply has dissipated. (See here.) But a renewed rise in energy prices is still a risk. In that event, we doubt that the ECB would respond as aggressively as it ultimately did to the surge in energy prices in 2021/22 because the weakness of the economy means that the risk of "second round effects" on inflation expectations and wages is lower now than it was then. (See here.)

- **What do our interest rate forecasts imply for the sterling exchange rate versus the US dollar?** Sterling's recent depreciation has owed much to projected interest rate differentials as markets' expectations for UK interest rates have fallen by more than those for the US. But we doubt that this will be the key driver of the exchange rate in the next twelve months. Instead, a rise in risk aversion as advanced economies fall into recession will be the key headwind for sterling. We forecast that the GBP/USD exchange rate will fall from 1.24 now to 1.20 by year-end and stay there in 2024.

- **Are you expecting UK mortgage rates to drop now that Bank Rate has peaked?** The biggest driver of mortgage rates will continue to be financial markets' expectations for policy rates. Ten-year gilt yields have already fallen as those expectations have adjusted, but our view that Bank Rate will stay on hold for longer than markets anticipate will limit any fall in UK yields in the near term. We suspect that mortgage rates will be around 5% for a while yet, which will bear down on house prices and broader economic activity.

- **How will concerns about government debt weigh on the US growth outlook?** With the US government deficit at around 6% of GDP in the past fiscal year, concerns about debt sustainability are understandable. One risk is that rising interest costs force the government to tighten policy aggressively, but there has been no real discussion of attempts to rein in borrowing so far. Instead, we think that persistently high borrowing will be one factor causing the 10-year term premium to edge up a bit further over the next year or so, which will limit the decline in yields even as markets come around to our view that policy rates will be cut aggressively. We forecast the 10-year Treasury yield to fall to 3.75% by end-2024, but it is possible that concerns over government debt will mean that the ultimate decline is smaller.

- **How worried should we be about debt in Italy?** We should certainly be concerned. While the Italian government consistently runs primary budget surpluses (excluding interest expenses), the weak growth outlook suggests that debt will continue to rise as a share of GDP. We have recently written a *European Economics Focus* on this topic and we will host a Drop-In this Thursday to address clients' questions.

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